ALLEN & OVERY

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EU proposals to regulate third country providers of financial services under CRDVI

As part of the proposed Banking Package 2021[1] (CRDVI), the European Commission has proposed a harmonised EU regulatory framework for third country bank branches. The proposals, if implemented in their current form, would have wide-ranging implications for non-EU providers of financial services to EU customers and counterparties. This would affect not just banks, but also lenders and other providers of financial services, whether they operate through EU branches or provide services cross-border. In this note we summarise the scope of and main requirements under the proposals, and discuss some of the key issues they raise for non-EU providers.

Background

How the EU regulates third country banks today

The proposals provide for amendments to the existing recast Capital Requirements Directive (CRDIV[2]). CRDIV is the core legislation providing for the regulation of banking in the EU. The existing CRDIV framework establishes the basic requirement that “credit institutions” (banks) – i.e. persons accepting repayable funds (deposits) from the public – be licensed, and provides detailed requirements around their fitness and propriety, governance, risk management and capital and liquidity. The framework also facilitates the EU single market for financial services by conferring so-called ‘passporting’ rights on EU credit institutions to enable them to provide services on a cross-border basis or establish branches across the EU.

CRDIV largely does not affect non-EU banks, beyond a high-level requirement that Member States should not apply more favourable treatment to them than is accorded EU banks and limited reporting requirements. Regulation of branches of third-country providers (third country branches, or TCBs) of banking services thus remains

1 https://ec.europa.eu/commission/presscorner/detail/en/IP_21_5401
2 CRDV, which amended CRDIV, was passed in 2019 and largely implemented in 2020.

overwhelmingly a matter of national competence. Today, the question of when and for what activities non-EU banks require authorisation (referred to as the regulatory perimeter) is largely a question of national law in each Member State, with divergent approaches taken to the perimeter and to the requirements applicable to, and supervision of, branches. A number of Member States offer relatively liberal regimes which permit the cross-border provision of services to non-retail clients. This may be contrasted with the position for non-EU investment services providers (including non-EU banks providing investment services), for which the recast Markets in Financial Instruments Directive (MiFID II) to some extent harmonised the regulation of the provision of cross-border investment services into the EU.

Why change is afoot

This situation has been a source of angst for the European authorities for some time. The introduction of the Single Supervisory Mechanism (SSM) in 2014, which created a single EU supervisory framework under the supervision of the European Central Bank (ECB), did not affect third country banks as these were not included. The Commission unsuccessfully advocated for their inclusion in the SSM at the time the SSM was introduced, and subsequently on the introduction of the most recent iteration of changes to the capital requirements framework in 2017 (CRDV), which included the introduction of the forthcoming requirement for certain third country groups to establish intermediate EU parent undertakings (IPUs).

The rationale for the need to include branches within the ECB's remit was that, without competence for branch supervision, the ECB lacks a 'single view' of non-EU banking groups' activities in the EU, and inconsistent local frameworks could potentially drive arbitrage and opacity. Lately, there is also a Brexit angle too, in that non-EU financial institutions have to some extent sought access to EU member states via branches following the UK's exit from the single market: between the end of 2019 and the end of 2020 the volume of TCB branch assets in the EU increased by 31%, from EUR390bn to EUR510bn. (To put it in context, total assets of EU-headquartered banks at the end of 2020 were EUR29.43 trillion, so third country branch assets remain a very small proportion of overall EU banking assets.)

The EBA published a report on third country branches in June 2021, which was mandated under CRDV. The EBA noted the disparity in local regulatory requirements in the report and recommended action to harmonise the frameworks. The Commission proposals largely follow those recommendations.

How CRDVI would apply

CRDVI would be an amendment to CRDIV. EU Directives are binding on EU Member States and must be transposed into national law and implemented. As such, the proposed legislation imposes requirements on EU Member States to make legislative changes, rather than being directly applicable.

Who would need to be authorised? The perimeter

A key entry point to the question is what is the perimeter of regulation – i.e. what activities are licensable under the proposed regime, and on what basis. The latter question is particularly sensitive for providers which have no place of business in an EU Member State.

Not just banks…. Activities within the licensing requirement

Although the requirement for authorisation as a credit institution arises only in respect of deposit taking activities, the CRDIV passport covers an array of activities – not just deposit-taking – reflecting the universal bank model common in Europe. Annex I to the CRD lists various activities, including lending, factoring, various investment services and payment services to which passporting rights attach. These are listed in the Appendix to this note. Some of those activities are primarily regulated under other EU legislation: specifically, investment services fall to be regulated under MiFID II, and payment services and electronic money issuance are regulated under the recast Payment Services Directive and Electronic Money Directive respectively. Others are unregulated in some or all Member States.

Article 47 of the draft provides the scope of the new licensing regime. This states that the requirements apply to "any of the activities listed in Annex I… by an undertaking established in a third country", and "the activities referred to in Article 4(1), point (b), of Regulation (EU) 575/2013, by an undertaking established in a third country that fulfils any of the criteria laid down in points (i) to (iii) of that point". The former picks up all of the Annex I activities; the latter captures the investment services of dealing on own account, and underwriting, by certain large investment firms (which are deemed credit institutions under the existing CRDIV framework). By way of exception, third country providers which are neither banks nor large investment firms providing the activities listed in paragraphs (4), (5), and (7)-(15) of Annex I are specified as being subject to MiFID II and not the new regime. This is somewhat anomalous, as MiFID II does not regulate a number of those activities. (We have flagged which Annex I activities are within the scope of MiFID II in the Appendix.) This is presumably inadvertent, but it does raise the question of whether the regulatory perimeter may change for non-EU payment service providers and electronic money issuers too.

On its face, therefore, the new authorisation requirement would not only cover deposit-taking: it would cover a variety of activities undertaken by non-banks (including corporates, funds, structured finance vehicles and even insurance companies) including lending, financial leasing and/or guarantees and commitments to EU persons, and would also any Annex I services banks and large investment firms provide to EU clients. We have summarised application in the following table:

Entity type: Activities triggering licensing requirements

Bank	Any Annex I activity
Large investment firm	Any Annex I activity Dealing on own account or underwriting financial instruments
Other	Lending

And not just branches… cross border services trigger the licensing requirement

A further key question is whether, and when, a cross-border activity triggers the licensing requirement. Today, this is a national law question with considerable variation in whether, and when, cross-border service providers trigger licensing.

Although here, as in many areas, the proposal is unclearly drafted, it appears to seek broadly to harmonise the territorial scope of the regime with the intended end point of MiFID II, which introduced a regime for third country investment firms with effect from 2018. Proposed Article 21c(1) states that a branch is required in order "to commence or continue conducting" the activities above "in the relevant Member State". Article 21c(2) then carves out from the branch licensing requirement the situation where a client approaches the non-EU provider "at its own exclusive initiative" – both for the purpose of the relevant service or activity for which the client approached the provider, and a relationship "specifically related to" the provision of that service or activity (but not other services or activities). This is commonly referred to 'reverse solicitation'.

Although it is not entirely clear from the legislation, recital (3) of the draft and the proposal paper (p13) suggests that the Commission intends that any services provided into the EU within the scope of the licensing requirement should attract the requirement for a branch, other than where the provider can rely on reverse solicitation. Whether such a draconian approach will survive the EU legislative process and subsequent transposition into local law is an open question: a similar approach in MiFID II was ultimately watered down so as not to prevent Member States permitting some level of access by third country providers beyond reverse solicitation.

Implications for non-EU providers

As a general comment, if implemented, the proposal would impose licensing requirements on a range of non-EU providers which provide cross-border services to EU situs clients and counterparties across an array of products and services extending far beyond traditional banking products. Non-bank providers would be unlikely to be able to meet the licensing requirements discussed below (as they have no home state license, which is one of the conditions to licensing), so would presumably need to exit the market: bank providers would likely face exit or licensing. In some cases (particularly long-term lending arrangements) exit may be difficult.

The corollary of this proposed regulatory overreach is that, without a more reasonable approach to the perimeter, the proposal would also be likely to result in some significant legal difficulties for providers dealing with EU market participants. Reverse solicitation is not a stable basis for operating cross-border business (not least as it is almost impossible to evidence conclusively), but for many providers the costs of licensing a branch are not likely to be justified by the business they undertake, particularly into smaller Member States. A perimeter that captures all incoming services but reverse solicitation would therefore inevitably oust foreign providers, which in turn would likely negatively affect the flow of credit and services into the EU.

A more thoughtfully designed regime would recognise the need for exemptions permitting the flow of wholesale business, in particular. Examples might include:

a) interbank business – e.g. should a U.S. correspondent bank need an Austrian branch to do correspondent banking business with an Austrian bank?
b) custody and subcustody relationships
c) guarantees offered by an insurance company
d) intragroup relationships.

In addition, the licensing requirement would appear to apply to relationships originated lawfully before the regime came into force. Firms could reasonably expect some coverage to permit such relationships to continue without the need for a license – or at least to wind down in an orderly way.

Licensing

EU law, national licenses

The proposals are matters of European law, but would require licensing on a Member State by Member State basis – so a provider that triggered licensing requirements in France, Germany and Spain, for example, would face obtaining three branch licenses, not one, at the same time. There is no provision for 'passporting' or other rights that would permit a TCB in one Member State to provide services into another (other than on a reverse solicitation basis) – indeed it would be a condition of a branch license that the branch must not provide services into another Member State.

When would providers need a license? Would there be transitional relief?

The proposal would require TCB authorisation as a precondition to providing the licensable services described above 12 months after transposition and implementation of the Directive (which, with a transposition deadline currently indicated for 18 months after the Directive's entry into force, we would expect no earlier than 2025). Non-EU providers within scope of the licensing requirement would need to establish a presence and apply for and obtain a TCB license in the preceding twelve months in each relevant Member State. This could be challenging, particularly for providers requiring licenses across a number of Member States. Further, there is no mechanism in the Directive for the processing of applications before the Directive comes into effect, though presumably national legislatures could provide for this.

Licensing process

Complementing the requirement to seek (re-)authorisation, the proposal sets a floor of minimum authorisation requirements for TCBs. These include:

- Authorised activities must be within the permitted activities contemplated by the home state license of the applicant, i.e. the activities conducted by the TCB may no more than match those of the head institution. It is this condition that would render unregulated providers (e.g. credit funds) ineligible for a license;
- The authorisation must be limited to activities within the Member State and expressly prohibits cross-border services into other Member States. It is unclear how this relates to reverse solicitation which is clearly permitted for the head office and is left open for TCBs;

- The authorising host national competent authority (NCA) must have concluded an MoU with the home supervisory authority;
- There must be no reasonable grounds to suspect that the TCB would be used to facilitate money laundering.

The proposal contemplates applications for authorisation supported by a programme of operations (business plan) and details of the structural organisation and risk controls of the branch. The proposal leaves the detail of the application process to secondary legislation, but based on comparable experience it is likely that an application would involve a high degree of disclosure about the branch's business, governance, senior management, systems and controls and dependencies on other parts of the firm; the applicant's wider business and that of its group; the applicant's capital and liquidity position and risk controls; and its controllers. For applicants which are not qualifying branches (see below) there would likely be information required on the home regulator and its willingness to cooperate with the national competent authority. Obtaining a license would be likely to be time-intensive.

Categories of TCB and subsidiarisation requirement

In order to provide a degree of differentiation among TCBs, the proposal establishes a tiering system based on a TCB's activities and size, and a subsidiarisation requirement for TCBs which are of systemic importance.

Class 1 and Class 2 branches

TCBs would be classified into two classes:

a) Class 1 branches are those which meet any of the following conditions: (i) assets booked locally are EUR 5bn or more in the preceding year; (ii) the branch has authorisation to take retail deposits locally; (iii) the branch is not a 'qualifying branch' (see below).
b) The remainder would be designated as class 2 branches.

Qualifying branches

The proposal introduces a centralised equivalence assessment of the third country regulatory regime at EU level. TCBs with head offices in countries whose regulatory regimes have been assessed as 'equivalent' by an implementing act of the Commission would be qualifying third country branches, which would render them eligible for class 2 for smaller TCBs and less stringent prudential requirements. The qualifying conditions are based on the home country having equivalent prudential standards and supervisory oversight; equivalent confidentiality requirements; and not being listed as a high-risk country that has strategic deficiencies in its regime on anti-money laundering and counter terrorist financing under EU anti-money laundering legislation.

The equivalence assessment for qualifying branch status would be unilateral, being initiated by the Commission. It seems likely that, as with other equivalence assessments provided for under EU financial services legislation, it could be used for political, as well as regulatory, purposes.

Subsidiarisation

The proposal introduces a subsidiarisation mechanism for TCBs which engage in cross-border activities in breach of internal market rules, or which are systemically important in the EU or in a Member State. For the purpose of determining systemic importance, the proposal contemplates two possible assessments:

a) a discretionary assessment of systemic importance by an NCA based on a series of factors to be set out in secondary legislation; and
b) a mandatory assessment of systemic importance by an NCA (or, in limited circumstances, EBA) with respect to a TCB or TCBs within the same group whose aggregate assets booked in the EU exceed EUR 30 billion (calculated on average either over the three preceding years or in absolute terms in three out of five years prior to the assessment).

According to the Commission, there are currently only three non-EU banks that would be subject to the assessment of systemic importance. That number may rise, however, as non-EU providers 'onshored' claims on EU customers as a result of the new licensing requirement.

The mandatory assessment process could result in a subsidiarisation requirement, a requirement to restructure so as to cease to qualify as systemic, additional supervisory requirements, or no action. The proposal contemplates a three month period to comply with the output of a recommendation, which would seem challenging for the hive-out of a systemic banking business.

Ongoing requirements

TCBs would be subject to a number of bank licensing requirements. It is not clear whether the Commission intends that they would also be subject to other sectoral legislation were they to conduct activities regulated under that legislation, such as investment or payment services.

Key requirements include the following:

Minimum prudential requirements

Certain minimum prudential requirements are set for TCBs across the EU. These would have limited effect on many branches that already are subject to such rules under the national law of their host Member States.

Capital endowment requirement: The minimum capital endowment for each TCB would differ between class 1 and class 2 branches.

a) Class 1 branches: minimum capital endowment of 1% if average liabilities over previous three years subject to a floor of at least EUR 10m.
b) Class 2 branches: minimum endowment of EUR 5m.

Eligible instruments for these purposes would include (a) cash and cash equivalents; (b) EU government or central bank securities; (c) other instruments to be specified by the EBA. The instruments would have to be held in an escrow account with a bank in the host Member State over which the national resolution authority is given security.

Liquidity requirement: Application of the liquidity coverage ratio regime of CRR to class 1 TCBs. These would have to hold a reserve of high-quality liquid assets in escrow and secured in the same way as the capital endowment (which would likely render those assets ineligible to meet home state liquidity requirements). This requirement could be waived for qualifying TCBs.

Internal governance: As regards internal governance, TCBs would have to appoint two managers of good repute and sufficient skill and knowledge. They would also have to apply internal governance guidelines broadly mirroring the framework for CRR credit institutions. There is a significant focus on outsourcing and back-to-back operations post Brexit. Nevertheless, delegation of critical/important functions to the head office would be possible.

Booking requirements: TCBs would have to maintain a comprehensive and precise registry of its assets and liabilities. TCBs would also be required to have policies on booking arrangements which provide a clear rationale for the booking arrangements and set out how those arrangements align with the TCB's business strategy. Compliance with the booking requirements would need to be independently assessed and a "written and reasoned opinion… regularly prepared and addressed to the [NCA]".

Reporting: TCBs would be subject to a stringent set of harmonised reporting requirements, including information on their head undertaking. EBA will develop common reporting templates for this purpose. Class 1 TCBs would have to submit reports at least biannually and class 2 firms at least annually. The reporting obligations would apply earlier than the rest of the TCB regime, i.e. the day after expiration of the transposition period of 18 months.

The key information that would need to be reported includes:

a) Assets and liabilities held on the TCB's books;
b) Confirmation of its own compliance with the requirements of the Directive and compliance by its head undertaking with the prudential requirements applicable to it;

c) Details of the head undertakings business strategy in relation to the TCB and its recovery plans and its impact on the TCB;
d) The services of the head undertakings provided to EU clients on a reverse solicitation basis.

Supervision

The proposal also sets out supervisory processes and powers.

SREP: NCAs would have to include TCBs in their annual Supervisory Review and Evaluation Process (SREP) as regards the regulation applicable to them under the CRDVI.

Supervisory powers: NCAs would have a minimum set of powers vis-à-vis TCBs in their jurisdiction. They would be obliged to ensure that TCBs comply with their regulatory requirements and have sufficiently robust risk management. NCA would be given a set of tools to achieve this, including to require a TCBs to hold an additional capital endowment amount or additional liquid assets, reinforce its governance, risk control, booking arrangements, or reduce the risk inherent in its activities, products and systems.

AML supervision: A particular focus is on anti-money laundering supervision. NCAs would be required to cooperate with the respective national AML supervisor and notify the EBA in case of an increased AML risk. Importantly, a reasonable suspicion that a money laundering offence has been committed or that there is a heightened money laundering risk may be grounds for withdrawal of the TCB's authorisation.

What next?

The Commission proposal marks the start of the legislative process and is likely to be the subject of significant lobbying. However, if adopted in its current form, it would have a significant impact both on cross-border service providers and existing TCBs, in particular those in class 1 and those which have been hitherto subject to more 'light-touch' regulation in their host Member State.

The strict limits imposed on cross-border services call into question the business model of many providers which have so far been able to rely on waivers or exemptions in certain Member States and may now need to apply for authorisation or exit the market. Most international banks would have to re-engineer their Brexit operating models, and we would expect significant numbers of exits from the EU market.

For those that remain, the Commission notes that the prudential regulation suggested is similar to that already in place in many Member States and would thus result in limited change and cost. However, in particular the relatively onerous reporting requirements, which include significant reporting on activities of the head office, would likely present a challenge for many TCBs that would have to adapt or broaden their reporting standards and data collection. Further, those TCBs that would be subject to the assessment of systemic importance could ultimately be required to subsidiarise in very short order.

What is clear is that the proposal adds to the uncertainty faced by third country banking groups doing business in the EU, particularly since Brexit has led to unprecedented scrutiny of their operations. While internationally other regulators apply similar regulation to TCBs, these powers would be new to EU regulators and there is little clarity as to how they will be used.

Overall, Brexit appears to have cast a long shadow over the proposals: it seems clear that the Commission intends to increase the regulatory costs of accessing the EU, for better or worse.

Appendix

Annex I activities

Bold activities are those which require a license when undertaken by any person in the EU.

Italicised activities are those which Article 47 provides to be subject to MiFID II when undertaken by a non-credit institution. We have indicated with an asterisk where that activity is not in fact regulated under MiFID II, and indicated what, if any, other EU law regulatory framework applies.

1.	**Taking deposits and other repayable funds.**
2.	**Lending including, inter alia: consumer credit, credit agreements relating to immovable property, factoring, with or without recourse, financing of commercial transactions (including forfeiting).**
3.	**Financial leasing.**
4.	*Payment services as defined in point (3) of Article 4 of Directive (EU) 2015/2366 of the European Parliament and of the Council* [Regulated under the Payment Services Directive].*
5.	*Issuing and administering other means of payment (e.g. travellers' cheques and bankers' drafts) insofar as such activity is not covered by point 4* [Unregulated].*
6.	**Guarantees and commitments.**
7.	*Trading for own account or for account of customers in any of the following:* a) *money market instruments (cheques, bills, certificates of deposit, etc.);* b) *foreign exchange* [Unregulated];* c) *financial futures and options;* d) *exchange and interest-rate instruments;* e) *transferable securities*.
8.	*Participation in securities issues and the provision of services relating to such issues.*
9.	*Advice to undertakings on capital structure, industrial strategy and related questions and advice as well as services relating to mergers and the purchase of undertakings.*
10.	*Money broking*[Unregulated].*
11.	*Portfolio management and advice.*
12.	*Safekeeping and administration of securities.*
13.	*Credit reference services* [Unregulated].*
14.	*Safe custody services* [Unregulated where custody of assets other than financial instruments].*
15.	*Issuing electronic money* [Regulated under the Electronic Money Directive].*

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