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EU proposal to regulate third country providers of financial services

Where are we on CRDVI?

November 2022

One year after the European Commission unveiled its Banking Package 2021, the Council has now agreed its position on the amendments to the Capital Requirement Directive, the EU framework regulating the banking sector (CRDVI). The European Commission had proposed a far-reaching prohibition on cross border services and a harmonised framework for third country bank branches (the Proposal) that we summarised in our **client note in November 2021**.

In this note, we discuss the key changes the Council's compromise text (the Compromise Text) makes to the Proposal and where this leaves non-EU providers of financial services in the EU.

Where did we start?

Current regulation of third country banks in the EU

There is currently no harmonised EU regime on the supervisory treatment of non-EU providers of financial services and the regulation of third country branches (TCBs) is largely a matter of national law. The divergent approaches of Member States to authorising and supervising non-EU banks, which provide services in the EU, has caused concern among EU authorities for a number of years.

Summary of the Proposal

To address this, the Proposal's comprehensive harmonised framework for TCBs consisted of five key elements:

- a requirement to establish a branch in each Member State where services are to be provided coupled with a ban on cross-border services into the EU from a third country (except on a reverse solicitation basis);

- harmonised minimum standards for the authorisation of branches;
- a tiering system for TCBs, based on their activities and size;
- harmonised minimum prudential requirements and reporting obligations; and
- a subsidiarisation mechanism for systemically important TCBs.

Where does the Council stand – key differences?

Prohibition of cross-border services – a stay of execution?

The most controversial element of the Proposal was the proposed broad ban on the cross-border provision of financial services into the EU (except when based on reverse solicitation). This cross-border element was subject to substantial disagreement between Member States.

The Compromise Text deletes the prohibition and instead mandates the EBA and ESMA to submit a joint report on "the merit and modalities of harmonising the conditions under which third country groups may be required to set up a branch in a Member State and seek authorisation…to provide banking services in that Member State" by the end of 2025.

The Compromise Text would retain the status quo and the regulation of cross-border services into a relevant Member State would remain subject to national law (for now).

The regulatory perimeter – much narrower scope

The Proposal's scope extended beyond core banking services (explained in detail in our last client note). Licensing requirements were applied to a vast array of services often provided by non-banks, including financial leasing, guarantees and commitments to EU persons.

The Compromise Text drastically narrows the perimeter. The amended definition of "third country branches" only captures branches of (i) non-EU banks that are established to provide both deposit-taking and lending activities in the respective Member State, and (ii) branches of non-EU large investment firms within the definition of Article 4(1)(1) of Regulation (EU) 575/2013 that engage in dealing on own account or underwriting services.

The following table illustrates the differences in scope:

Entity type	Bank	Large investment firm	Other
Commission Proposal: Activities within the perimeter	Any Annex I activity	Any Annex I activity Dealing on own account or underwriting financial instruments	Lending Financial leasing Guarantees and commitments
Compromise Text: Activities within the perimeter	Providing both deposit-taking and lending services	Dealing on own account or underwriting financial instruments	Out of scope

Subsidiarisation mechanism watered down

The Proposal's subsidiarisation mechanism contemplated a Union-wide mandatory assessment of systemic importance where a TCB (or TCBs, within the same group) booked aggregate assets in the EU in excess of EUR 30bn. Such assessment could result in a requirement to obtain authorisation as a subsidiary or a restructuring requirement.

The Compromise Text scales back that assessment trigger. National competent authorities (NCAs) are to assess systemic importance in respect of their Member States only. They are given discretionary powers to require (i) subsidiarisation; (ii) restructuring of activities, or to (iii) impose additional prudential requirements in respect of TCBs established in their Member State.

What does this mean for third country branches?

While leaving cross-border business untouched for now, the Compromise Text closely follows the Proposal in harmonising authorisation and minimum prudential requirements that so far have been subject to national law. That means change is still afoot for TCBs operating in the EU.

Minimum authorisation requirements for TCBs

The Compromise Text makes only limited changes to the authorisation requirements in the Proposal and a number of concerns remain. Most importantly:

- A TCB's authorisations must be covered by the third country authorisation of its head undertaking, ie the TCB may not conduct activities for which its head institution is not itself authorised. There is no exception for the scenario where the third country regime does not provide for such a licence.
- The authorisation will be limited to activities within the Member State and expressly prohibits cross-border services into other Member States. The Compromise Text however carves out reverse solicitation and services provided for intragroup liquidity purposes to 'sister' companies or branches in the EU.
- The authorising host NCA must have concluded an MoU with the home supervisory authority. This may cause problems for some TCBs where no such MoU is in place.

Tiering system and equivalence regime

The Compromise Text retains the tiering system for TCBs based on their activities and size. 'Class 1' TCBs will be subject to more onerous prudential requirements while 'Class 2' TCBs will benefit from lighter requirements.

Under the Compromise Text a TCB will be designated as 'Class 1' if: (i) it has local assets of at least EUR 5bn in the preceding year; (ii) it has authorisation to take retail deposits and such deposits exceed EUR 100m or make up at least 10% of its liabilities; or (iii) its head office is based in a country listed as high-risk from a money laundering and counter terrorist financing perspective or whose regulatory regime has not been assessed as 'equivalent' by the Commission or whose home state supervisor is not subject to appropriate confidentiality requirements (ie not a "qualifying TCB").

Minimum prudential requirements

The Proposal included a number of minimum prudential requirements for TCBs across the EU. The Compromise Text makes only limited changes to these. Since many branches are already subject to similar requirements under the national law of their host Member States, their impact will depend on whether TCBs are currently subject to a 'light-touch' regime.

The key requirements include:

- Capital endowment requirement: The Compromise Text raises the minimum capital endowment for Class 1 TCBs from 1% of average liabilities over the previous three years to 2%. For Class 2 branches it remains at EUR 5m.
- Liquidity requirement: The liquidity coverage ratio regime of CRR to is to apply to Class 1 TCBs. Class 2 TCBs need to deposit liquid assets sufficient to cover their net liquidity outflows for a minimum stress period of 30 days. The requirements may be waived for qualifying TCBs
- Internal governance: The Compromise Text adds the requirement that TCBs need to comply with rules on remuneration in CRDVI, including the requirement on remuneration policies and limits on bonus for bank managers. This choice is notable at a time when the UK is considering revoking the controversial bonus cap.
- Booking requirements: The focus on booking arrangements with comprehensive record-keeping obligations is retained in the Compromise Text.
- Reporting: The Compromise Text keeps in place the relatively onerous harmonised reporting requirements for TCBs, including the significant level of detail to be provided relating to the head office's operations.

When might these changes come in?

With the Compromise Text, the Council has indicated its readiness to enter into negotiations with the European Parliament (EP) to agree on a final text as part of the EU legislative process. The EP has yet to adopt its position. Its Committee on Economic and Monetary Affairs is due to vote on the file in December 2022. It remains to be seen how long the authorities will then take to reach an agreement but given the significant changes proposed by the Council, negotiations may take some time.

The Proposal would give firms two and a half years after the legislation enters into force to comply with the authorisation and prudential requirements (a transition period comprised of 12 months after an 18 month transposition deadline for Member States). The Compromise Text extends this by a year, so we would expect the new authorisation requirements to apply no earlier than late 2026.

So what now?

It would be mostly be good news for both cross-border service providers and many existing TCBs if the proposals set out in the Compromise Text were to be agreed. With the prohibition on cross-border services axed and the number of TCBs that would fall under the new definition much reduced, the impact will be much less drastic than feared. In addition, the threat of imminent subsidiarisation is somewhat alleviated.

Nevertheless, the minimum conditions for authorisation and ongoing prudential requirements are still likely to present a challenge for TCBs already established in the EU.

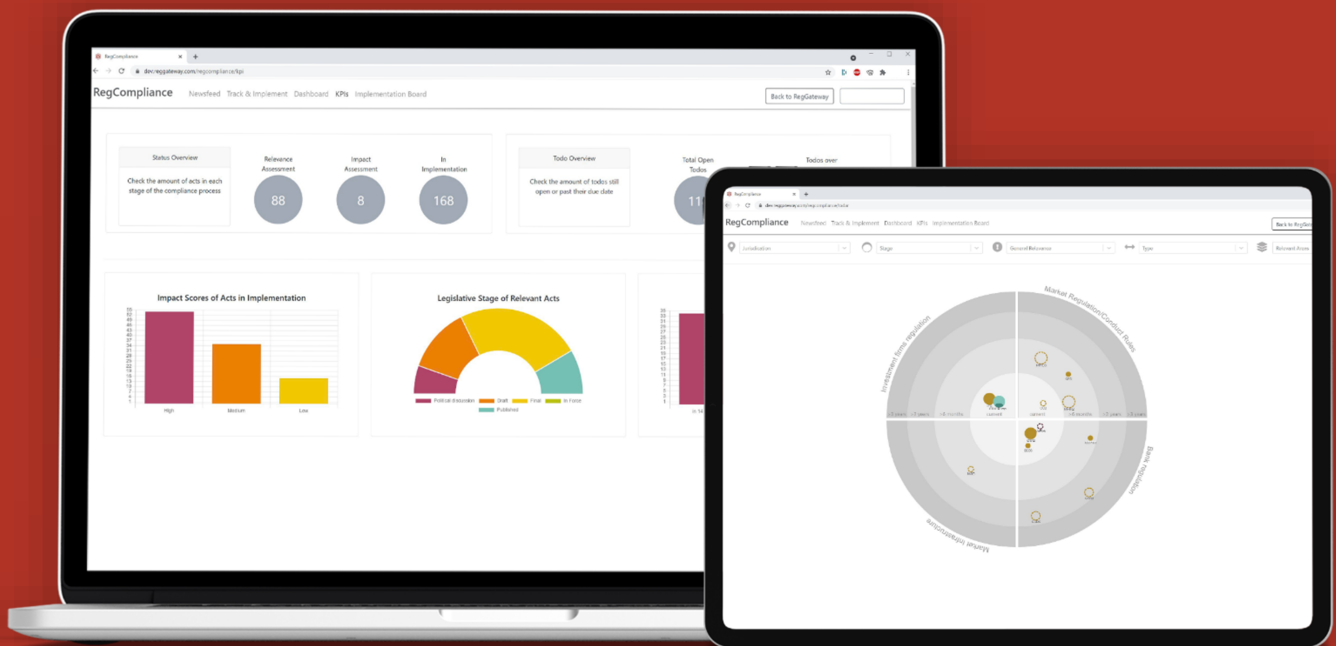
The Compromise Text provides for grandfathering of existing authorisations. However, NCAs have discretion to decide that authorisations granted before the end of the transition period will remain valid only insofar as those authorisations comply with the minimum requirements. That means many existing TCBs may need to apply for re-authorisation to continue their operations, with

the associated authorisation difficulties discussed above.

The requirement that authorisations must limit the provision of services to the Member States of establishment of the TCB also remains problematic. It means that no ‘passporting’ is available to TCBs to provide services from one Member State to EU persons located in another Member State.

While the Council Text exempts services provided based on reverse solicitation, TCBs would not be able toprovide cross-border services within the EU beyond that. There is also no fully-fledged intragroup exemption since the Council Text carves out only those services provided for intragroup liquidity purposes. This may require firms to restructure their business models.

While we may not have final texts for quite some months, it seems clear that some form of harmonisation for TCBs will emerge. Third country groups will need to maintain a watching brief and prepare for the upcoming changes for their EU branches and implications for their current EU set-up.



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