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EU proposal to regulate third country providers of financial services: a further update on CRDVI

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The CRDVI proposals appear to have taken something of a back seat for firms following the Council's compromise text. Following the Commission proposal (the **Proposal** - discussed **here**) and the Council compromise text (the **Compromise** summarised **here**), in February 2023, the European Parliament issued its report (the **Report**) on the draft. Whilst not quite as far reaching as the original Proposal, the Report is still far from welcome for non-EU banks. We summarise the key elements below, how the Proposal, the Compromise and the Report compare, and where they leave 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.

Key elements of the Proposal

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

- a prohibition on cross-border services into the EU from a third country (except on a reverse solicitation basis);
- a requirement to establish a branch in each Member State where cross-border services are to be provided;
- a tiering system for TCBs, based on their activities and size;
- harmonised minimum standards for the authorisation of branches;
- harmonised minimum prudential requirements and reporting obligations; and
- a subsidiarisation mechanism for systemically important TCBs.

Where does the Parliament stand? Key differences between the positions

Prohibition on cross-border services

The most controversial element of the Proposal was the proposed for prohibition on the cross-border provision of financial services into the EU without a branch license (except when based on reverse solicitation). Our paper on the Proposal discusses this at some length. The Compromise text deletes the prohibition and instead mandates the EBA and ESMA to submit a joint report by the end of 2025 – effectively retaining the status quo on cross-border licensing.

The Report retains the prohibition– albeit that it limits it in various respects. Specifically, it:

- limits its application to non-EU banks and large investment firms within the definition of Article 4(1)(1) of Regulation (EU) 575/2013 (**CRR**) that engage in dealing on own account or underwriting services (**in-scope investment firms**): providers which are not banks (**deposit-takers**) or in-scope investment firms would not be subject to this licensing requirement (though they would of course still need to assess whether they are caught under national requirements);
- limits its scope to a subset of banking, payment and e-money services: the Proposal's scope extends beyond deposit-taking to credit-granting, payment services (regulated under the recast Payment Services Directive) securities and derivatives activities (regulated under MiFID), issuance of e-money (regulated under the recast Electronic Money Directive), and credit reference and safe custody services. The Report removes securities and derivatives activities from the prohibition, but leaves the other activities in scope – albeit only banks or in-scope investment firms conducting such activities would attract the licensing requirement.
- provides for additional exemptions from licensing for intra-group and interbank activities.

Version	Scope – who is caught?	Perimeter – what activities are within scope?	Exemptions
Commission	Any non-EU provider	All Annex I activities	Reverse solicitation
Council	N/A – remains a national law question	N/A – remains a national law question	N/A – remains a national law question
Parliament	Non-EU banks and in-scope investment firms	Deposit-taking; lending; financial leasing; payment services; issuing and administering means of payment; guarantees and commitments; credit reference services; safe custody; issuing e-money	Reverse solicitation; intra-group services; interbank activities;

Whilst the reductions in scope and perimeter are good news for providers which are neither banks nor in-scope investment firms, for banks and in-scope investment firms the Report brings double the woe. They would lose the ability to rely on existing national exclusions to provide services into the EU, and be put at a potentially significant disadvantage to other providers, which would be able to use the national exclusions. For those activities not intrinsically linked to deposit-taking, this would likely encourage restructuring of cross-border activities within non-EU banking groups to take them outside the regime (for example by rehousing lending in unregulated affiliates).

Branch establishment

The requirement to establish a branch where within scope of the licensing requirement is the same under the Report as under the Proposal, save for the narrowing of application and the perimeter as set out above. An amendment to article 47 also derogates from the branch supervision requirements for the provision of services within the scope of MiFID: this is somewhat obscure but appears to be intended to permit the provision of ancillary services within Section B of the Annex to MiFID as part of an investment services offering without attracting the minimum branch requirements.

Tiering system for TCBs

The proposals include a 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. There are only minor differences between the class tests under the three versions.

Harmonised minimum standards for the authorisation of branches

The Proposal establishes detailed minimum standards for the authorisation of branches. The Compromise and the Report diverge only in a few respects. Critically, all versions prohibit the provision of services into other Member States, albeit that the Compromise and the Report both permit cross-border services by way of reverse solicitation and some internal funding. All drafts also require that the applicant be authorised and supervised for the activities undertaken by the branch – potentially raising issues for activities which are unregulated in the home country.

The Report adds a provision empowering Member States to apply stricter requirements to branches than those set out in the draft Directive (Article 48a(3a)). Both the Compromise and the Report permit Member States to apply the EU CRD/CRR framework in full to branches instead of applying the third country branch rules. They also each add a requirement for an MoU to be concluded between the EBA and the relevant home country authority.

The Compromise provides for grandfathering of existing branches: the Proposal and Report do not.

Minimum prudential requirements

The Proposal included a number of minimum prudential requirements for TCBs across the EU. The Compromise and Report make only limited changes to these.

The key requirements include:

- Capital endowment requirement: The Proposal set out a minimum capital endowment for Class 1 TCBs of 1% of average liabilities over the previous three years. The Compromise raises this to 2%; the Report to 3%. For Class 2 branches the Proposal and Compromise set the endowment requirement at EUR 5m; the Report provides the higher of EUR 5m and .5% of average liabilities.
- Liquidity requirement: The drafts are broadly consistent. The CRR liquidity coverage ratio regime 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 drafts are broadly consistent, save that 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.
- Booking requirements: The focus on booking arrangements with comprehensive record-keeping obligations is the same across all drafts.
- Reporting: All drafts include relatively onerous harmonised reporting requirements for TCBs, including the significant level of detail to be provided relating to the head office's operations. The Report adds a requirement for TCBs to report their, and their groups', cross-border investment services undertaking into the EU.

Subsidiarisation mechanism

The Proposal sets out a subsidiarisation mechanism based on 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 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.

The Report broadly follows the template set out in the Proposal, but applies a higher threshold of EUR 40bn.

When would these changes come in?

It remains to be seen how long the authorities will take to reach an agreement but it seems likely that the legislation will be finalised in Q3 or Q4 2023.

The Proposal and the Report 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), albeit that the reporting requirements would apply 18 months after entry into force. The Compromise extends this by a year, so we would expect license applications to be made no earlier than late 2025, and new authorisations from late 2026.

So what now?

We had hoped that the Compromise was a sign that a harmonised prohibition on cross-border services would be unacceptable to Member States. Its reinstatement (albeit in a slightly more workable guise) suggests otherwise. Affected firms should begin to identify which business lines would be caught by the branching requirement, building on their work for Brexit, and consider options for branch establishment, transfer to a passported subsidiary or wind-down.

In our view lobbying efforts should continue to focus on amendments:

- narrowing the range of activities within scope
- permitting cross-border activities undertaken by branches within the EU
- permitting firms to obtain branch licensing for activities not regulated in the home country (e.g. lending)
- grandfathering of existing branches.

For groups with multiple EU regulated entities and an EU balance sheet running near the EUR 40bn balance sheet threshold over which an intermediate parent undertaking (IPU) is required, implications of branching into the EU for IPU planning should also be taken into account.

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