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NEW EU THIRD-COUNTRY REGIME FOR BANKING BUSINESS

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The European Commission has proposed new harmonised rules for non-EU firms carrying on banking business in the EU, including deposit-taking, lending, payments, foreign exchange and securities and derivatives business. The new rules would restrict the ability of non-EU firms to carry on cross-border banking business into the EU except on a reverse solicitation basis. They would also harmonise the way in which Member States regulate non-EU firms carrying on banking business through EU branches.

If adopted, the new rules would have a significant impact on the ability of many non-EU banks and non-bank firms to continue to deal with EU customers or counterparties on a cross-border basis in reliance on existing Member State regimes. The new rules would also significantly alter the regulatory regime for many non-EU firms currently operating through EU branches.

What is the proposed timing?

The Commission recently **published** its legislative package amending the Capital Requirements Regulation and Directive (CRR3/CRD6), which includes its proposals for these new rules. Interested parties can submit **feedback** on the proposals before 12 January 2022, which the Commission will collate and present to the European Parliament and the Council of the EU to inform their discussions. The European Central Bank (ECB) is also likely to submit its opinion on the proposals.

If these proposals are adopted, Member States would be required to adopt the measures to implement these new requirements within 18 months after CRD6 becomes law and to apply the new requirements on cross-border business and the new reporting requirements for branches from the day after that period elapses. However, the other new rules for non-EU firms with branches in a Member State would not apply for 12 months after the end of that 18-month period although existing branches of non-EU firms would have to obtain reauthorisation in accordance with the new rules by the end of that period (with no transitional relief for pending applications where the supervisor has not yet reached its decision).

Assuming a relatively quick, 15-month legislative process, CRD6 could become law in Q2 2023. In that case, the new restrictions on cross-border business and reporting arrangements for branches would begin to apply in Q4 2024 and the other new rules for EU branches would begin to apply in Q4 2025.

The European Banking Authority (EBA) would be required to consult on and deliver draft regulatory technical standards to specify aspects of the new authorisation regime for branches of non-EU firms within six or, in some cases, 12 months of CRD6 becoming law. The Commission would then adopt these (with or without amendment), but they would not enter into force until the expiry or termination of the European Parliament and Council non-objection period. The EBA would also be required to consult on and adopt guidelines on other aspects of the new authorisation regime for branches within 12 months of CRD6 becoming law.

What is the objective of the proposed rules?

Currently, Member States are largely free to set their own rules as to when third-country (non-EU) firms are permitted to carry on cross-border business with local clients or counterparties. Many Member States only allow a non-EU firm to engage in such business where the business results from the 'own exclusive initiative' of the local client or counterparty (reverse solicitation). However, others allow non-EU

Key issues

- The Commission has proposed new harmonised rules for non-EU firms carrying on banking business in the EU cross-border or via EU branches
- The new rules cover deposit-taking, lending, payments, foreign exchange and securities and derivatives business
- Some investment firms would be exempt if they do not meet the criteria to be treated as non-deposit-taking credit institutions
- Non-EU firms would be prohibited from carrying on cross-border banking business into the EU without a branch (except on a reverse solicitation basis)
- EU branches of non-EU firms carrying on banking business would be subject to new minimum authorisation and supervision rules
- These rules include endowment capital and liquidity requirements and new reporting requirements
- EU branches would be prohibited from conducting cross-border banking business in other Member States
- More burdensome rules apply to EU branches if the firm's non-EU home state is not assessed as equivalent
- EU authorities would have new powers to restructure EU branches as subsidiaries to protect financial stability
- Member States would have to remove or limit existing national regimes providing more favourable treatment to cross-border business or branches
- The new rules for cross-border business and branch reporting could apply from Q4 2024, with the other new rules for branches applying from Q4 2025

firms to obtain a licence, waiver or registration or provide exemptions for some categories of cross-border business. For examples, see our briefing, **The Post-Brexit Patchwork: EU market access rules for UK firms** (November 2020).

These differing national regimes for cross-border business continued to exist even after the 2014 Markets in Financial Instruments Directive and Regulation (MiFID/MiFIR). MiFIR created a harmonised regime allowing firms from non-EU states assessed as having equivalent rules to carry on cross-border business with 'per se' professional clients and eligible counterparties in the EU, subject to registration with ESMA. However, this allowed Member States to continue to apply their national regimes for cross-border business from a non-EU state until three years after any equivalence determination for that state (and there have been no such determinations).

Similarly, Member States are currently largely free to set their own rules as to how to regulate local branches of non-EU firms. They must not treat local branches of non-EU banks and investment firms more favourably than branches of EU firms. MiFID created an optional regime under which Member States could require non-EU firms to establish an authorised branch if they conduct cross-border business with retail clients and 'opted-up' professional clients (otherwise than on a reverse solicitation basis). This sets minimum rules on authorisation, initial capital, organisational, reporting and conduct for such branches. While branches of non-EU firms authorised in one Member State do not have a passport to conduct cross-border business into other Member States, MiFIR does allow a branch authorised under MiFID in one Member State to carry on cross-border business with 'per se' professional clients and eligible counterparties in other Member States where the firm's non-EU home state has been assessed as equivalent for the purposes of the MiFIR regime on cross-border business.

Otherwise, Member States can and do apply very different rules to local branches of non-EU firms and there are only limited supervisory cooperation arrangements between EU supervisors of branches and related group companies in different Member States. EU branches of non-EU banks are subject to supervision by national supervisors, not the ECB, even in Member States participating in the Banking Union.

The proposal would make the provision of banking services by non-EU firms throughout the EU (otherwise than on a reverse solicitation basis) conditional upon the firm having established a previously authorised and supervised physical presence in the EU through a branch (or a subsidiary). The proposal would also harmonise the arrangements for the authorisation, capital, liquidity, governance, reporting and supervision of branches of non-EU firms conducting banking business and create new arrangements for cooperation between EU supervisors of branches and related group companies. The aim is to minimise and to manage the contagion or other risks to the EU financial system that might result from the failure of a non-EU firm providing cross-border services in the EU or operating through a branch in the EU. Where supervisors conclude that the EU branches of a non-EU firm are systemically important to a Member State or the EU, they would also be able to require those branches to be restructured into subsidiaries or to impose other requirements to address financial stability concerns (but such a restructuring would not be triggered automatically where branches reach a size threshold).

The proposals on branches are broadly in line with the EBA's recommendations in its **report on the treatment of incoming third-country branches** (June 2021) and draw on some aspects of the UK and the US treatment of branches of foreign banks. However, the EBA's report and the Commission's explanatory memorandum and impact assessment for the proposal do not address the expected impact of the proposal on non-EU firms that are not credit institutions or on cross-border business by non-EU firms into the EU.

“Currently, Member States are largely free to set their own rules on cross-border business and branches.”

What is the scope of the proposed rules?

The new regime would not just apply to non-EU deposit-taking banks. The new rules would apply to any non-EU firm that carries on any of the following activities in a Member State on a cross-border basis or via a branch:

- The activities listed in Annex I of the Capital Requirements Directive (CRD - see Box 1), which include deposit-taking, lending, payments, spot and other foreign exchange and securities and derivatives business; or
- Dealing on own account in or underwriting the issue of financial instruments where the non-EU firm meets the size criteria for being classified as a non-deposit-taking credit institution under the Capital Requirements Regulation (CRR - see Box 2).

Box 1: Banking business - Annex I CRD

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 [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.
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;
   (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.
11. Portfolio management and advice.
12. Safekeeping and administration of securities.
13. Credit reference services.
14. Safe custody services.
15. Issuing electronic money.

The services and activities provided for in Sections A and B of Annex I to [MiFID], when referring to the financial instruments provided for in Section C of Annex I of [MiFID], are subject to mutual recognition in accordance with this Directive.

"The new rules would apply to deposit-taking, lending, payments, foreign exchange and securities and derivatives business."

The new rules would apply to non-EU firms carrying on these activities in the EU even if the Member State does not impose authorisation requirements on locally incorporated firms carrying on the same activities. For example, some Member States do not regulate commercial lending or spot foreign exchange business. In addition, the new rules do not contain any exemptions corresponding to the exemptions from authorisation available to firms under MiFID, such as the exemptions under MiFID for firms providing services to group companies, firms that deal on own account, insurance companies and collective investment undertakings. This may be inconsistent with the EU's commitments to national treatment of non-EU firms under World Trade Organisation rules and bilateral free trade agreements, at least in relation to branches, unless the EU can establish that the restrictions comply with the terms of the 'prudential carve-out' from those commitments.

There would be a derogation from the new requirements if the non-EU firm is not a credit institution as defined in CRR or a firm that deals on own account in or underwrites the issue of financial instruments and that meets the size criteria to be classified as a non-deposit-taking credit institution in the EU. Firms benefitting from the derogation would instead be subject to the requirements of MiFID relating to EU branches of non-EU investment firms in relation to the activities listed in points (4), (5), and (7) to (15) Annex I CRD. This should, in effect, exempt non-EU investment firms, such as asset managers and broker-dealers that do not meet the size criteria for classification as a non-deposit-taking credit institution, from the new rules on cross-border business and branches.

However, some of the specified activities within the scope of the derogation, such as those relating to payments, 'unconnected' spot foreign exchange and e-money, are not covered by MiFID. Therefore, it is not clear how the derogation is intended to apply to a non-EU firm that carries on those activities in the EU (where the firm is not regarded as a credit institution).

It is also not clear whether the new regime will cover MiFID activities that may not be covered by points (1) to (15) Annex I CRD, such as commodity derivatives business and the business of operating trading facilities (because it is not clear whether the reference to the activities listed in Annex I CRD also includes a reference to the final paragraph of Annex I which states that all MiFID activities also benefit from mutual recognition under CRD). If these activities do fall within the scope of the regime, the new restrictions on cross-border business and the new rules on branches may also apply to non-EU firms that are not regarded as credit institutions and that carry on these activities in the EU, but without the benefit of the derogation that applies to other MiFID business.

There may also be issues about how to apply the aggregation rules when determining whether a non-EU broker-dealer meets the size criteria for being classified as a non-deposit-taking credit institution under CRR, in particular as to the extent to which it is necessary to aggregate the assets of non-EU group companies.

An EU branch of a non-EU credit institution or other firm covered by the new rules is referred to as a 'third-country branch' (TCB) for the purposes of the new regime.

If adopted, Iceland, Liechtenstein and Norway would be also be required to apply the new rules under the agreement governing the European Economic Area.

Box 2: Classification as a non-deposit-taking credit institution under CRR

An undertaking will be classified as a non-deposit-taking credit institution under CRR where:

a. it carries out any of the activities referred to in points (3) and (6) of Section A of Annex I MiFID (dealing on own account in or underwriting the issue of financial instruments);

b. it is not a commodity and emission allowance dealer, a collective investment undertaking or an insurance undertaking;

c. one of the following applies:

   i. the total value of the consolidated assets of the undertaking is equal to or exceeds €30 billion;

   ii. the total value of the assets of the undertaking is less than €30 billion, and the undertaking is part of a group in which the total value of the consolidated assets of all undertakings in that group that individually have total assets of less than €30 billion and that carry out any of the activities specified above is equal to or exceeds €30 billion; orGuarantees and commitments.

   iii. the total value of the assets of the undertaking is less than €30 billion, and the undertaking is part of a group in which the total value of the consolidated assets of all undertakings in the group that carry out any of the activities specified above is equal to or exceeds €30 billion, where the consolidating supervisor, in consultation with the supervisory college, so decides in order to address potential risks of circumvention and potential risks for the financial stability of the EU.

For the purposes of points (c)(ii) and (c)(iii), where the undertaking is part of a third-country group, the total assets of each branch of the third-country group authorised in the EU shall be included in the combined total value of the assets of all undertakings in the group.

What are the proposed restrictions on cross-border business?

The new rules would require non-EU firms to establish an authorised TCB in a Member State before conducting business covered by the regime in that Member State otherwise than on a reverse solicitation basis.

The proposal would require Member States to remove or limit the scope of national regimes allowing cross-border business by non-EU firms in so far as they allow non-EU firms to carry on cross-border business within the scope of the new rules otherwise than on a reverse solicitation basis. The proposal does not state how the new restrictions interact with the MiFIR regime allowing firms from equivalent non-EU states to carry on cross-border business in the EU (although no non-EU state has yet been assessed as equivalent for these purposes).

"Member States would have to remove or limit national regimes allowing cross-border business."

What are the proposed rules for TCBs?

The proposed regime includes new authorisation requirements and supervision arrangements for TCBs and a new mechanism under which the authorities can require the subsidiarisation or restructuring of TCBs to protect financial stability. The new regime would set minimum requirements for TCBs and Member States would be able to impose more burdensome rules, but they would have to remove or limit the scope of national regimes that provide more favourable treatment to TCBs.

The new rules would not make a Commission equivalence assessment a condition for authorisation of a TCB. However, the rules would impose more burdensome requirements on branches from countries not assessed to be equivalent by the Commission (which may affect banks from countries such as the UK and Switzerland if the Commission continues to withhold new equivalence assessments for those countries). Member State authorities would still be able to make it a condition for authorisation of a TCB that they have assessed the firm's non-EU home state regime as having equivalent prudential rules.

New authorisation requirements

The establishment of TCBs would be subject to a new authorisation procedure and new minimum requirements including:

- requirements for *cooperation and information arrangements* with supervisors in the firm's non-EU home state;
- *restrictions on branch authorisation* to activities covered by the firm's authorisation and supervision in its non-EU home state (which may give rise to issues where the non-EU home state does not directly regulate banking business covered by the new regime, such as commercial lending or spot foreign exchange)
- *restrictions on cross-border activities*, prohibiting the branch carrying on authorised activities on a cross-border basis into other Member States (apparently, even on a reverse solicitation basis or if the activity is not regulated in the other Member State);
- requirements to maintain a *minimum endowment capital*, calculated as the higher of 1% of the branch's liabilities or €10m for larger and riskier (class 1) TCBs or €5m for other (class 2) TCBs, in the form of specified assets;
- *liquidity requirements*, which for class 1 TCBs would be the same as the liquidity coverage requirement that applies to EU credit institutions under the CRR (this requirement may be waived for certain qualifying TCBs);
- *internal governance and risk control requirements*, including remuneration requirements and requirements to implement booking arrangements to track the assets and liabilities linked to the business conducted by the TCB in the Member State (class 1 TCBs may be subject to additional requirements);
- *reporting requirements*, including regular reporting as to information on the TCB's compliance with the requirements laid out in the CRD and in national law, financial information in relation to the assets and liabilities of the TCB and other TCBs and EU subsidiary institutions of the group, the non-EU firm's compliance with its non-EU home state solo and consolidated prudential requirements, significant supervisory reviews and assessments of the non-EU firm, recovery plans for the non-EU firm and cross-border services provided in the Member State on a reverse solicitation basis.

Assets held to meet the endowment capital or liquidity requirement would have to be deposited in an escrow account and pledged or assigned to the resolution authority to secure the claims of the creditors of the TCB. This may affect their eligibility as liquid assets under the firm's home state liquidity regime.

Some non-EU firms carrying on banking business through TCBs will also be 'third-country firms' for the purposes of MiFID but not eligible for the derogation from the new regime covering some MiFID business. Therefore, there may be cases where TCBs are subject to both the new rules and the MiFID regime governing branches of non-EU firms. The proposal does not state how, in those cases, the new rules interact with the overlapping rules under the MiFID regime or the conflicting rules under MiFIR allowing such branches to do cross-border business into other Member States where the firm's non-EU home state has been assessed as equivalent under MiFIR.

For these purposes, a TCB would be consider larger and riskier (class 1) if:

- the TCB is not a qualifying TCB:
- the TCB holds assets of €5 billion or more; or
- the TCB is authorised to take deposits from retail customers.

A TCB would be considered a qualifying TCB if the firm's non-EU home state:

- has been assessed by the Commission as having a regulatory and supervisory regime equivalent to CRR/CRD; and
- is not listed as a high-risk third country that has strategic deficiencies in its regime on anti-money laundering and counter-terrorist financing.

More burdensome rules would apply to TCBs if the Commission does not adopt an equivalence decision for the firm's non-EU home state.

New supervision arrangements

Competent authorities would be required to conduct regular reviews of TCBs' compliance with their regulatory requirements, including for AML purposes, and to take supervisory measures to ensure or restore compliance with those requirements.

Competent authorities of class 1 TCBs would be required to include them in the colleges of supervisors of the relevant group, where one already exists, or otherwise set up an ad hoc college where the non-EU group has TCBs in more than one Member State.

New mechanism for subsidiarisation or restructuring of TCBs

Member States would have to ensure that their competent authorities have powers to require the subsidiarisation of TCBs where the TCB:

- engages in "interconnected activities" with other TCBs or subsidiary institutions of the same group or in business with counterparts in other Member States in contravention of EU internal market rules; or
- poses risks to the financial stability of the relevant Member State or of the EU, taking into account systemic risk indicators laid down in the CRD and further detailed in regulatory technical standards.

Competent authorities would have new powers to restructure branches as subsidiaries.

Where all the TCBs of a non-EU firm have aggregate assets of €30bn or more, the competent authorities would have to regularly assess whether those TCBs pose a level of risk to the financial stability of the respective Member State(s) and of the EU analogous to institutions defined as "systemic" under the CRR and the CRD. Where the review indicates that TCBs are systemic, competent authorities may:

- require the TCBs to seek authorisation as an EU credit institution;
- require the TCBs to restructure their activities so that they cease to be systemic or meet the €30bn threshold;
- impose additional Pillar 2 requirements on the TCBs or associated EU subsidiary institutions (eg, additional capital, liquidity, reporting or disclosure requirements); or
- defer taking any action (but then must reassess the position within a year).

If a non-EU group has TCBs or subsidiary institutions in more than one Member State, the review would be carried out by the non-EU group's EU consolidating supervisor (if applicable) or the competent authority that would be the consolidating supervisor if the TCBs were established as subsidiaries (therefore, this supervisor might be the ECB). Otherwise, it would be carried out by the competent authority of the Member State in which the TCB is established. However, if the relevant competent authority fails to carry out the review, the EBA would carry out the review instead. The competent authority responsible for carrying out the review and the relevant competent authorities responsible for supervising the TCBs and subsidiaries of the same non-EU group would collectively take the decision on the action to be taken following a review (subject to a weighted majority vote if consensus cannot be achieved).

What happens next?

The directive is in the early stages of the legislative process and the European Parliament and the Council of the EU may amend the new rules before the directive is adopted. The Parliament and the Council did not adopt previous proposals to impose fully harmonised restrictive rules on cross-border business and branches in the context of the legislative deliberations on MiFID/MiFIR and the 2019 Investment Firm Regulation and Directive. Several Member States wished to retain their national regimes for cross-border business because they allow local firms, issuers and investors better access to the services provided by non-EU firms and wished to retain their national regimes for branches because they provided more flexibility for non-EU firms doing business in their territory. Similar issues may arise in the negotiations on this directive both in relation to cross-border business and the treatment of branches, although there may now be wider agreement on the need for a more harmonised approach. Firms will need to consider the likely impact of the proposals on their EU business strategy and the steps that they would need to take if the proposals were implemented in their current form.

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