Direct Provision of Banking Services in the EU by Third Country Undertakings: ABBL position on the EU Commission Proposal amending the Capital Requirements Directive

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Executive Summary

The ABBL welcomes the underlying objective of the Commission's proposal amending the Capital Requirements Directive on the direct provision of banking services in the EU by third country undertakings, which aims at protecting the financial stability of the EU and of its Member States. Notwithstanding this, the ABBL would like to draw the attention on some of the **unexpected or unintended consequences** of this far-reaching proposal, which it fears could:

- **Significantly restrict the flow of financial services and products** that third country providers could offer going forward to EU banks and other clients
- **Create a legal uncertainty** which may eventually negatively impact the attractiveness of the EU market for third country service providers
- Prove to be **inconsistent** with existing well-established EU financial regulatory frameworks, notably the MIFID/MIFIR regime allowing third country firms to provide investment services on a cross border basis to eligible counterparties and professional clients.

Against this background, the ABBL would welcome **a more proportionate framework** compatible with the Commission's objectives, along the following priorities:

- The new regime for Third Country Branches (hereafter **TCBs**) regime should not unduly jeopardize well-established relationships with trustworthy third countries. Therefore, **EU Members States should keep the discretion to waive the new requirements on TCBs** under certain conditions
- **The scope** of the new regime **should be targeted on core banking activities** attached to the prudential definition of a credit institution, i.e. "*to take deposits or other repayable funds from the public and to grant credits for its own account*"
- **The principle of proportionality** should be applied to the proposed **prudential requirements** in terms of TCBs' classification, capital endowment, internal governance, and reporting requirements.

- **The assessment procedure of TCBs' systemic importance,** leading to potential corrective measures (i.e. subsidiarisation, restructuring or additional Pillar 2 requirements) **should be streamlined, i.e.:**

    - The process for taking corrective measures should be **gradual,** meaning that subsidiarisation would be the **last resort measure** where imposing additional Pillar 2 requirements or restructuring have not been sufficient

    - In line with **the logic of the TCB model**, the activities of which are limited to the EU host Member State where they operate, the allocation of supervisory responsibilities should **privilege National Competent Authorities (hereafter NCAs). In this respect** the EBA should stick to its primary function of standard-setter and not substitute itself to NCAs

    - The positive assessment of systemic importance should be a mere condition enabling NCAs to take corrective measures, if needed, **without establishing any automaticity.**

Detailed Comments

1. Article 21c would cause uncertainty and regulatory inconsistency

Article 21c proposes that non-EU undertakings must establish an EU branch to provide certain services into the EU, except where they are provided on a "reverse solicitation" basis. The scope of this article, which is defined by cross-reference to Articles 47.1 and 47.2, applies widely to all firms providing any of the activities listed in CRD Annex I[1]. Therefore, **Article 21c would dramatically restrict the flow of credit and other financial services into the EU from firms operating on a cross-border basis** without an EU branch and would oblige at the same time non-bank service providers and presumably also most banks to exit the EU market and unwind contractual arrangements, which may potentially be impossible**.** Hence, the following types of wholesale banking business would in particular be impacted: credit/lending and trade finance activities, correspondent banking business, custody and sub-custody relationships and guarantees and commitments related activities.

Article 21c would also have **an impact on a variety of activities undertaken by non-banks** (such as corporates, funds, or insurance companies), including for instance at the level of lending, financial leasing activities and/or guarantees to EU persons. In this context, non-bank service providers often do not hold a license in their home state, meaning that they would in any case not be able to obtain a license under Article 21c (as this is one of the conditions to licensing).

Even if a third country firm were to meet the conditions to licensing, **the costs of licensing a branch are not likely to be justified by business volumes, in particular in smaller EU Member States.** (In light also of the proposed restriction to provide services outside of the Branch Member State).

[1] In particular, the following activities, carried on by an undertaking established in a third country on a cross border basis, would trigger a licensing requirement:
- any Annex I to CRD activity for credit institutions
- any Annex I to CRD activity and dealing on own account and underwriting financial instruments for large investment firms
- lending for non-banks

More generally, the requirements to license a branch in each of the EU Member States in which the third country firm is active will prove to be a way too costly and time-consuming exercise with no specific added-value for a number of non-EU financial service providers, **which may then be led to simply cease servicing at least smaller EU jurisdictions, if not the entire EU market** (if their projected business volume does not justify the costs of their establishment).

Moreover, we note that Article 21c, read together with Article 47.2, would, in addition to the manifest ambiguity concerning the activities falling into the proposed regulatory perimeter, **conflict with the MIFIR/MIFID II provisions** allowing third country firms to provide investment services on a cross border basis to eligible counterparties and professional clients. Indeed, MIFIR (Articles 46 to 49) sets out two regimes:

- **The EU regime**, where the EU Commission has assessed the third country's legal and supervisory arrangements as equivalent to the EU ones. This regime allows a third country firm, once registered, to provide services in all EU Member States with a "one-stop shop" approach (without further licensing formalities and afterwards ongoing obligations in each of the 27 EU Member States) at least to certain categories of clients

- **The national regimes**, in the absence of an equivalence decision taken by the EU Commission

We believe that **the MIFIR/MIIFD II rules constitute a robust and predictable framework** which proved to be reliable and yet flexible enough to achieve the underlying objective of the EU Commission while not generating any of the above prejudicial consequences. This is the reason why such regime should not be overruled by the proposed Article 21c. As Annex I of CRD also covers a number of investment services, the proposal under scrutiny will entail that the same service may be differently treated from a regulatory perspective depending on the license status of a third country firm. This adds to an unnecessary additional complexity which will also create a lot of confusion and regulatory uncertainty at the level of EU financial service recipients.

With regard to **reverse solicitation**, practical experience demonstrates that it **is not a stable basis for operating cross-border business,** not least as it is almost impossible to evidence conclusively. It is complex for a third country firm to ascertain, and document, for each service the situation of reverse solicitation, thereby creating a material legal insecurity. It is equally difficult for such firms to delineate the boundaries of the prohibition to market new categories of investment products or investment services in light of the varying interpretation of the ESMA's position on reverse solicitation.

Finally, it is worth bearing in mind that, despite their far-reaching consequences for market participants, the provisions of Article 21c **have not been subject to any public consultation or any impact assessment, which could at least have led to the above-mentioned issues being discussed in further detail**.

For all these reasons and for the sake of clarity, **the ABBL recommends the deletion of the proposed Article 21c**. **Similarly, Article 47.2 should also be deleted (see point 2.3 of this paper).**

If nevertheless the Commission feels that the underlying objective cannot be achieved without a new prudential and supervisory regime for Third County Branches, then **at least this regime should be largely, if not completely aligned with the current regime under MIFIR/MiFID II** (see point 2.1 of this paper).

2. The scope of the new regime for Third Country Branches should be reviewed

2.1 In-scope activities should be limited to core banking services

Articles 47.1 and 48c of the proposal set out the scope of the new authorisation and regulatory requirements applicable to Third Country Branches (hereafter **TCBs**). Specifically, Article 47.1(a) states that the requirements would apply to any of the 15 activities listed in Annex I of the CRD. These activities, which are heterogeneous in terms of nature, risk and regulatory framework, can be classified into two categories:

- **Core banking activities** attached to the CRD/CRR definition of a credit institution, i.e. "to take deposits or other repayable funds from the public and to grant credits for its own account"
- **Other services**, such as portfolio management and advice (regulated by MIFID II), payment services (regulated by the Payment Services Directive), issuing electronic money (regulated by the Electronic Money Directive) or money broking (no EU regulation).

Keeping in mind the Commission's primary objective to ensure financial stability through relevant prudential regulation, we believe that the new requirements for TCBs **should be targeted on core banking activities, i.e.:**

- Taking deposits: activity 1 of Annex I
- Lending: activity 2 of Annex I
- Leasing: activity 3 of Annex I
- Guarantees and commitments: activity 6 of Annex I

Furthermore, the new TCBs regime should not unduly jeopardize well-established relationships with trustworthy third countries. Therefore, we believe that Members States should keep the discretion to waive the new requirements on TCBs where the following conditions are cumulatively met:

- The prudential and supervisory framework of the third country is deemed equivalent to the EU framework
- The activities of the third country bank are carried out exclusively with professional clients present in the EU Member State; (in order to create some alignment with the current MIFIR/MIFID II regime)
- The third country bank must report relevant activities to the National Competent Authority of the EU Member State.

2.2 TCBs belonging to an EU banking group should be either out of scope of, or exempted under the new regime

We believe that TCBs belonging to a European banking group (within the meaning of CRD V) that is ultimately consolidated and supervised in the EU, **should be either out of scope of, or exempted,** under the new regime. These entities are indeed not primarily targeted by the new regime and the proposed exclusion would be neutral from the supervisory and prudential perspectives.

2.3 The derogatory regime foreseen in Article 47.2 is inconsistent with existing EU regulations

Article 47.2 introduces an exemption to the new TCB regime for third country firms that are neither banks nor large investment firms, providing activities 4, 5 and 7 to 15 of Annex I. As mentioned in point 1 of this paper, these firms would then become subject to the MIFID II rules on authorisation. However, there is no reason to subject payment services (activity 4 of Annex I), issuing and administering other means of payment (activity 5 of Annex I), credit reference services (activity 13 of Annex I), Issuing electronic money (activity 15 of Annex I) to the authorisation rules under MiFiR/MIFID II. **This is inconsistent as MIFIR/MiFID II have a clear scope delimited to only investment services/financial instruments.**

In addition to the **ambiguous articulation of Articles 21c and 47**, it is not clear at all how these new CRD provisions would interact with other areas of EU financial services legislation or potentially override the equivalenc regime under MiFIR.

2.4 Existing relationships should be out of scope

In order to mitigate the risk of market disruption or contractual restrictions, relationships originated before the entry into force of this new regime, should be out of scope of the new licensing regime. Moreover, there should be **a longer transition period for already existing TCBs** as these would have to be re-authorised under the new proposal.

3. Prudential requirements for TCBs should be subject to proportionality

3.1 The principle of proportionality should apply to TCBs

Compliance with prudential requirements is likely to be onerous for third country firms in terms of costs and resources. In case they have limited business volumes in certain EU Member States (for instance in the smaller ones), third country firms are likely to simply cease their activities in such markets. Therefore, **a proportionality approach** should be applied not only in terms of capital endowment requirements but also in terms of internal governance and reporting requirements, depending in particular upon the respective business volume in the relevant EU Member States or the numbers of EU branches held by the same third country firm (in this latter case, with a possibility, among others, **to mutualise certain functions or processes** between several branches considering that these are subject to harmonised licensing requirements).

3.2 Criteria for classifying TCBs as Class 1 lack proportionality

- **Size criterion**

  The threshold of EUR 5 billion total assets seems disproportionately low in comparison to the exsiting framework applicable to "Small and non-complex credit institutions", and needs to be raised in order to avoid any undue overburdening of TCBs.

- **Retail deposits criterion**

  According to the proposal (Article 48a), a TCB taking deposits from retail customers is automatically categorised as a Class 1 TCB. We believe that this criteria should be reviewed to better take into account the actual volume of retail deposits. In other words, **a materiality threshold** should be introduced in order to ensure that the framework applicable to TCBs remains sufficiently risk-based.

3.3 Liquidity requirements for Class 1 TCBs should be consistent with the CRR

According to Article 48f of the proposal, liquid assets held by TCBs must be deposited in an escrow account pledged in favor of the resolution authority. However, the pledge requirement does not seem compatible with the ultimate objective of liquidity requirements, i.e. to cover and anticipate potential outflows. In the same vein, the pledge would lead to the relevant assets as being considered to be "encumbered" and does prevent their eligibility for the purpose of meeting the Liquidity Coverage Ratio. These provisions **are not coherent** and need to be amended.

4. The assessment procedure of TCBs systemic importance should be streamlined (Articles 48j / 48k CRD)

4.1 Background

The proposal introduces a **dual procedure**, where National Competent Authorities (hereafter **NCAs**) are empowered to assess the need to impose TCBs subsidiarisation or other corrective measures, i.e. restructuring or additional pillar II prudential requirements:

- **The first procedure** empowers NCAs to require subsidiarisation where a TCB **(Articles 48j.1 CRD**):
  - Engages in "interconnected activities" with other EU branches or related EU institutions or
  - Engages in business with counterparts in other EU Member States in contravention of EU rules or
  - Is deemed systemic and poses significant risks to the financial stability of the EU Member State or of the EU.

- **The second procedure** consists of a periodic assessment of TCBs' systemic importance **(Articles 48k CRD)** triggered when the aggregate assets of EU branches are > EUR 30 billion, potentially leading to subsidiarisation or corrective measures.

4.2 The proposed mechanism is overly complex and disproportionate

Firstly, we note that **the articulation** between both assessment procedures is unclear and creates regulatory uncertainty.

Secondly, we observe that some assessment critieria triggering corrective measures are not proportionate:

- The **criterion of "interconnected activities"** set out in Article 48j.1(a) would target any TCB that is interconnected with other branches or subsidiaries within the third country banking group. The criterion of interconnectedness does not per se pose any particular risks and third-country groups which operate via multiple branches or via a branch and a subsidiary should only be subject to structural measures if authorities detect significant risks related to their business models

- The threshold of EUR 30 billion triggering the assessment of systemic importance should **be aligned to the EUR 40 billion threshold** applied in the context of the existing IPU requirement, which already takes into account situations where cumulated branch assets reach a significant volume

- It is inappropriate to provide for an EBA RTS for specifying systemic risk indicators. Given the important consequences that these might trigger, it is essential that the latter are set out in a level 1 text.

Thirdly, we strongly believe that the allocation of supervisory responsibilities should **privilege NCAs:**

- This follows **the logic of the TCB model**, the activities of which are limited to the EU host Member State where they operate. Consequently, while cooperation between NCAs is welcome, any final decision on corrective measures should remain a national decision

- In the context of the **periodic assessment of systemic importance,** designating the leading NCA by aggregating TCBs' assets (as if the latter were subsidiaries) is not appropriate. This would shift essential decision-making powers away from NCAs to a **"hypothetical consolidating supervisor"**. Such a mechanism is not warranted as it would not be in line with the current competences of the SSM, which does not include a mandate regarding the supervision of branches

- Finally, **we do not welcome** the **appointment of the EBA as a potential lead Competent Authority**. Even if it shall only serveas a last resort option, this possibility should be excluded and the EBA should stick to its primary function of standard-setter and not substitute itself to NCAs. In any case, the introduction of clear-cut criteria should avoid any scenarios where the competent supervisor can't be determined.

4.3 Proposal for a streamlined procedure assessing TCBs systemic importance

For the sake of clarity, the two procedures proposed by the Commission should **be merged into a single procedure abiding to the following guiding principles:**

- **NCAs** or where applicable, the consolidated supervisor designated according to Article 111 of the CRD, should conduct the assessment procedure of systemic importance. To do so, they should collaborate and exchange information

- Triggering the assessment procedure should be decided based on **a range of indicative factors** specified in the Level 1 text, e.g. the size of the TCB on a solo basis

- The process for taking corrective measures should be **gradual,** i.e. subsidiarisation would be the **last resort measure** where imposing additional Pillar 2 requirements or restructuring have not been sufficient

- Decisions to take any corrective measure (i.e. subsidiarisation, restructuring or additional Pillar 2 requirements) should always be subject to a positively defined justification. More specifically, **the burden of proof should be on NCAs** that should be obliged to motivate their decision – not the other way around

- Accordingly, the positive assessment of systemic importance should be a mere condition enabling NCAs to take corrective measures, if needed, **without establishing any automaticity**

- **Decisions on corrective measures shall be taken by each NCA for the relevant branch under their remit.**

About the ABBL

The ABBL is the largest professional association in the financial sector, representing the majority of financial institutions as well as regulated financial intermediaries and other professionals in Luxembourg, including law firms, consultancies, auditors, market infrastructures, e-money and payment institutions. This makes us truly representative of the diversity of the Luxembourg financial centre, placing us in a unique position, able to give the entire sector a voice at both national and international level.

We provide our members with the intelligence, resources and services they need to operate in a dynamic financial market and in an increasingly complex regulatory environment. We facilitate an open platform to discuss key industry issues and to define common positions for the entire sector.