Verband der Auslandsbanken
in Deutschland e.V.
Association of Foreign Banks in Germany

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Banking supervision – aligning EU rules on capital requirements to international standards ("Banking Package")

Proposal for a directive amending Directive 2013/36/EU

Positions of the Association of Foreign Banks in Germany

The Association of Foreign Banks in Germany welcomes the opportunity to provide comments on the EU Commission's recent Banking Package.

Our Association represents over 200 German subsidiaries and/or branches of internationally active banks, investment firms and asset managers, including the biggest banking groups worldwide as well as smaller ones. Likewise, our members' local German subsidiaries or branches encompass all size classes and forms of incorporation: Some are large EU IPUs, some are medium-sized or small, and they operate as subsidiaries, EU branches or third country branches. As a consequence, our focus as an Association lies in lobbying for fair market access and operating conditions regardless of the business model, size or form of establishment.

Our comments on the planned directive focus on two aspects. First, we want to comment on the proposed provisions on cross-border services of non-EEA institutions to EU clients. Second, we have analysed the regulation of non-EU banks' third country branches in the EU (TCBs) in detail and want to share our findings and propose some amendments that could lead to a better functioning and avoid unintended consequences.

Third, the process of drafting RTS in accordance with Art. 8a (6)(b) CRD has made fatal flaws of the level 1 text evident, which lead to requirements for international groups of investment firms that are impossible to comply with. In order to avoid unintended outcomes, the review of CRD should be used for correction.

I. Direct provision of banking services in the EU by third country undertakings

Art. 21c of the draft CRD sets out the requirement to establish a branch for the provision of banking services by third country undertakings to EU clients in the

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EU. In essence, this translates into a prohibition of cross-border services rendered by third country undertakings in a cross-border manner into the EU. The draft Art. 21c also provides for an exception from the general rule as regards the reverse solicitation of services.

The planned provision should be amended to take into account the following:

1. Transitional effects on already existing contractual agreements

The overall transitional period of the planned directive before the entry into force of the said ban on cross-border services is too short to account for already existing contracts between non-EU undertakings and EU clients. This implies the risk that existing contracts could be subject to disruptive effects, to the detriment of both the non-EU as well as the EU parties of the contracts concerned. The EU legislator should be cognisant of existing national regulation which explicitly allows for cross-border business activities and has been and is being used for establishing client relationships. Such national legislation will have to be modified or abolished once the directive is transposed. However, market participants have relied on the present legal situation. Such legitimate trust in legal certainty should be protected. Otherwise, EU clients would be exposed to unintended consequences, as well as their contractual partners from outside the EU.

We therefore propose and encourage the introduction of a grandfathering provision which protects contractual agreements existing at the time of the entry into force of the national law transposing Art. 21c and which allows for ongoing servicing of contracts until the end of the contractual term.

2. Avoiding unintended consequences for institutional funding

The current wording of draft Art. 21c does not take into account possible detrimental effects of a prohibition of cross-border contractual agreements on the funding of institutions established in the EU.

Where one financial counterparty provides funding to another financial counterparty, this is often not regarded as a client relationship. However, from a legal point of view, the provision of interbank liquidity (funding) is the granting of credit from the one party and the taking of deposits of the other party of the relationship. That means that Art. 21c, if it came into force unchanged, would expose these contracts which form the basis of institutional funding to legal uncertainty.

This could in turn jeopardise interbank markets as well as intra-group funding. The problem could arise and cause unintended consequences. In normal situations, international money markets are a backbone of liquidity allocation. They become even more important in times of idiosyncratic or systematic crises. In the latter context, the legislative goals of BRRD with regard to access to liquidity and funding for recovery and/or resolution purposes would be at risk if Art. 21c was not amended.

The factual background of the problem described above is relevant for the banking and investment firms sector, but it also exists in the insurance industry and in the asset management sector.

As a consequence, we recommend a clarification of draft Art. 21c so as to avoid legal uncertainty for institutional funding.

Draft Art. 21c should be clarified by stating that contractual agreements between financial counterparties as defined in Art. 2 no. 8 of Regulation (EU) No. 648/2012 (EMIR) are deemed to be entered into by way of reverse solicitation. This would specifically address the problem described, but not jeopardise the overall legislative goals of Art. 21c.

II. Regulation of non-EU banks' third country branches in the EU (TCBs)

The draft Title VI to be introduced in CRD according to the Commission's proposal sets out rules for the prudential supervision of third country branches (TCBs) and relations with third countries.

In this respect, we would like to draw your attention to the following aspects, which translate in specific proposals for amendments of the draft:

1. Classification of TCBs / Retail Deposits

Art. 48a of the draft CRD lays down criteria according to which TCBs are classified as class 1 or class 2 TCBs. The consequence of this is that class 2 TCBs are to enjoy less strict supervisory rules than class 1 TCBs. In other words, class 1 TCBs are deemed to have a riskier business model for which more requirements are deemed necessary.

Art. 48a (1)(b) states that a TCB is class 1 if its authorised activities include taking deposits and other repayable funds from retail customers. This provision should be amended to include a *de minimis* threshold, as follows:

TCBs should not be regarded as class 1 if they fulfill either of the following criteria:

- They take deposits and other repayable funds exclusively from their own employees, or
- The total number of client accounts with deposits and other repayable funds taken from retail customers does not exceed 500.

The reasoning for this is that a lot of TCBs focus mainly on wholesale business, i.e corporate financing and/or trade financing. So in general, their business model does not rely on retail business as a source of funding or income, which qualifies them as low-risk in this respect.

Nevertheless, TCBs regularly service a very limited number of retail customer accounts, for the following reasons:

First, they often employ staff that is seconded from the head undertaking for a limited time (e.g. two years), mostly for managing and support but also for educational purposes and cultural exchange. In order to facilitate the relocation of that staff to the EU and back, they often open retail accounts for payment and related services exclusively for their own employees. This makes great sense from a practical point of view, but does not involve any marketing of the service to the general public. It should be possible to continue such support for own employees without being regarded as class 1 TCB.

Second, some TCBs offer that service also for a very limited amount of expatriates from their home countries where they are seconded to corporate clients' establishments in the EU. For example, if a production site of a third country enterprise is located in Germany, and managerial staff is seconded for a limited period of time from that third country to that production site, TCBs offer payment accounts to that managerial staff upon request as a part of the overall relationship management to wholesale clients and their managers. Again, these services are not marketed to the general public. Therefore, we advise to introduce a quantitative threshold for retail deposits taken of 25 million Euro because this would enable TCBs to continue servicing a very limited number of accounts as needed.

2. Intra-EU cross-border activities of TCBs

Art. 48c (3)(d) of the draft CRD states that the authorisation of a TCB must clarify that the third country branch may only conduct the authorised activities within the Member State where it is established and expressly prohibits the third country branch from offering or conducting those same activities in other Member States on a cross-border basis.

This translates into a ban on any cross-border activities within the EU, including a ban on business on the basis of reverse solicitation. We clearly disagree and strongly advise against such a radical prohibition of intra-EU cross-border services.

Draft Art. 48c (3)(d) should either be deleted or at least amended in a way that enables TCBs to provide cross-border services within the EU where such services are provided on the basis of reverse solicitation, i.e. on the client's request.

Our proposal is justified for the following reasons:

First, a ban on intra-EU reverse solicitation for TCBs would have the quite strange effect that the provision of banking services via reverse solicitation would be prohibited for TCBs, but allowed for their head undertakings domiciled in third countries. As a result, business supervised in the EU would be curtailed and instead invited to be provided directly from third countries where no EU supervision is exercised. This does not seem to make sense from a prudential point of view.

Second, draft Art. 48c (3)(d) will result in severe constraints for TCBs to participate in the EU-wide interbank money markets, as well as funding arrangement between the TCBs and EU subsidiaries of the head undertaking, creating possible distortions in ongoing group management and particularly in times of stress. This is because the granting of liquidity between banks is, from a legal point of view, the granting of credit on the part of the liquidity providing institution and the taking of deposits on the part of the liquidity accepting institution. There is also the concern, that under a prohibition of cross-border borrowing within the EU, TCBs would be cut off from intra-group liquidity management. Both effects are detrimental to both the ongoing funding and liquidity management and the feasibility of recovery and resolution in times of stress.

Third, the proposed ban on cross-border services for TCBs will cut off small Member States' real economies from financing through TCBs and from pan-EU syndicated financing involving TCBs. TCBs fulfil important functions in accompanying foreign direct investment in the EU area. Foreign investors in the EU are thus served and supported on the basis of business relationships already existing and established in the country of origin. In addition, the TCBs make a significant contribution to trade financing. In order to be economically viable, most credit institutions from third countries serve one region at a time with their EU TCB. For example, many TCBs located in Germany have regional responsibility for the German-speaking DACH region. On the other hand, it would not be economically viable to set up independent branch offices in all EU states, operating only in the respective domestic market. Third country branches in the economically strongest EU countries (Germany and France) would presumably continue to be viable even with a purely domestic business. However, in the case of a ban on any activity in other, smaller EU states, foreign investment projects in these smaller EU states as well as foreign trade financing at addresses in these smaller EU states would no longer be accompanied. This means that the prohibition of reverse solicitation may inhibit and damage the real economy, especially of smaller Member States, because the critical mass for an economically viable operation of TCBs is not reached there.

Ultimately, the proposed wording would create pressure to convert existing TCBs into subsidiary institutions equipped with an EU passport, or alternatively to transfer the existing business to already existing subsidiary institutions in the EU area and to close the TCBs or downgrade them into EU branches. While this can be argued to be positive from a supervisory point of view, we can only warn against this effect. The decision to create a subsidiary will - in view of the fully harmonised regulation and freedom to provide services in the EEA - not be based on regulatory considerations, but on aspects such as legal certainty, tax burden and other non-harmonised location conditions. The expected distribution can be reliably predicted from the existing subsidiaries of third country credit institutions. For example, all large Chinese banks have exactly one subsidiary in the EEA, each in Luxembourg. We fear that a relocation of activities would benefit just very few locations, while being detrimental to many.

Finally, the EU legislator should also not lose sight of the fact that a ban on intra-EU reverse solicitation interferes strongly with the European fundamental freedoms of customers, who are deprived of the possibility to choose a banking relationship of their choice. This, too, has an impact on foreign direct investment that should not be underestimated.

In our opinion, the above-mentioned arguments speak strongly in favour of allowing authorised TCBs to conduct business throughout the EU, at least on the basis of reverse solicitation.

3. Requirement of a MoU in line with EBA's model MoU

Art. 48c (3)(e) of the draft CRD effectively requires the conclusion of a memorandum of understanding in line with the EBA model MoU to be in place between the competent authorities of the Member State where the TCB is to be located and the head undertaking's home country authorities. However, if such model MoU is non-existent, authorisation for the TCB in question shall be refused.

We do not oppose to that rule with regard to new applications for authorisation for TCBs that are planned to be newly established in the coming years. However, according to the draft, also those TCBs that have long been established in the EU will be required to apply for a new authorisation subject to the new rules once these are in force. That means, existing TCBs already established and authorised are put at risk of losing their authorisation and not being able to reapply for it due to missing MoUs. This is disproportionate and not appropriate.

In the case of German TCBs, there are some that are at stake because the conclusion of MoUs between German competent authorities and home country authorities is unlikely. However, these branches are regulated under the German "subsidiary approach", i.e. for alle means and purposes of supervision they are treated exactly like subsidiaries. This means they already operate under full CRD and CRR application as well as AMLD regulation etc., in a completely identical way as if they were subsidiaries. That regulation is in fact much stricter than that proposed in the draft CRD provisions that are presently discussed.

We therefore advise to include a grandfathering provision allowing for the retention of existing authorisations of TCBs if these would not be renewed solely on the basis of the lack of a relevant MoU, provided that the TCB's already existing authorisation is subject to full application of CRD and CRR as well as AMLD under national law.

III. Treatment of international investment firm groups

Pursuant to Art. 8a(1) CRD, investment firms have to convert and apply for a licence as credit institution in the event that they themselves or the group which they form part of exceeds a balance sheet total of € 30 billion on an individual or consolidated level.

Just recently EBA has published two final draft RTS (2021/17 and 2021/18) specifying that EBA intends to understand the definition of a "group" as covering all undertakings regardless of their location, i. e. worldwide. This in turn puts international investment firm groups in a situation where they are disproportionately disadvantaged compared to EU groups and become subject to reporting requirements that they cannot in any circumstance comply with.

Art. 8a(1)(b) states that the balance sheet total assets of a group have to be calculated on a monthly basis. This data is not available for investment firm groups with a parent undertaking in a third country, where parts of a group are located in third countries with local GAAP that cannot be readily reconciled for every group undertaking and every local GAAP into IFRS/IAS, especially not on a monthly basis.

Furthermore, the goal of creating a level playing field that is put forth in EBA's final draft RTSs has been missed spectacularly. It is neither appropriate nor necessary to require the conversion of EU activities of a group into a credit institution where these EU activities pose no significant importance to the stability of the financial system as defined by the € 30 billion threshold defined in Art. 8a(1) CRD. The whole approach by EBA is highly questionable. The outcome is the exact opposite of a level playing field: Medium-sized undertakings are forced to convert to credit institutions, thereby exacerbating regulatory costs which puts investment firms with non-EU parent undertaking in a competitive disadvantage.

We therefore strongly suggest to modify Art. 8a(1)(b) CRD by clarifying that only an aggregate balance sheet total of the group within the EU can trigger the conversion of an investment firm into a credit institution. This can be done by inserting the following:

„(b) the average of monthly total assets calculated over a period of 12 consecutive months is less than EUR 30 billion, and the undertaking is part of a group in which the total value of the consolidated assets of all undertakings in the **EU** group that individually have total assets of less than EUR 30 billion and that carry out any of the activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU is equal to or exceeds EUR 30 billion, both calculated as an average over a period of 12 consecutive months."