BPFI VIEWS ON THE EUROPEAN COMMISSION PROPOSAL IMPLEMENTING BASEL III

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EXECUTIVE SUMMARY

Banking and Payments Federation Ireland (BPFI) warmly welcome the European Commission (EC) proposal transposing Basel iii into EU legislation and its consideration of EU specificities therein. Ensuring full compliance with the internationally agreed standard, while also aiming to limit any significant capital impact on European banks, is a sensible approach and one which we believe will be achieved through the proposed changes to the EU Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD). In particular, BPFI fully support the EC proposal implementing the new standardized approach for calculating operational risk capital by setting the Internal Loss Multiplier (ILM) at 1. As past losses are an unpredictable indicator for future operational risk events, utilizing this Basel iii discretion is appropriate. Most importantly, this will help off-set the capital impact of Basel iii on European banks, while maintaining full compliance with the international agreement. Alongside this, we fully support the EC position to retain the SME and infrastructure supporting factors and the Credit Valuation Adjustment (CVA) exemption from risk capital charges. As co-legislators have consistently sought to strengthen these measures in the EU prudential framework overtime, we do not see any merit in their removal.

More broadly, our members also support efforts towards further harmonizing prudential supervisory powers across EU Member States, which will bring enhanced transparency and strengthened supervision. However, we have some reservations to the changes being proposed with respect to the provision of cross-border banking services and third country branches (TCBs), which we fear could have some unintended consequences for European businesses, financial entities and national regimes if not appropriately addressed during the legislative process. While we understand the rationale behind the proposals, in particular the desire to address divergences in regulatory and supervisory approaches across Member States, we believe some of the proposals are disproportionate given the limited risks involved with TCBs[1] and cross-border activities. These include:

- **Limiting the choice of financial services offered to EU businesses** by restricting access to third country providers, which will have wider implications for the cost of funding due to increased regulatory obligations.
- **Potentially capturing critical activities such as Euro liquidity TCBs and intra-group funding**, which we fear may not have been fully taken into consideration when drafting the proposal.
- **Creating legal uncertainty for existing cross-border banking relationships**, while weakening the attractiveness of the EU to outside investment compared to other jurisdictions like the US, UK and Switzerland.
- **Overhauling well established national regimes** with that of a much more restrictive approach, which relies too heavily on reverse solicitation.

[1] According to the EBA 2021 report on TCBs, the total assets of these entities is estimated to be €510bn, which makes up a relatively small portion of the assets of EU headquartered institutions which stood at €30tn in March 2021

- **Creating an un-level playing field** between EU and non-EU entities in areas where the EU entity is not required to be authorised (e.g. in some Member States corporate lending and financial advice and spot FX are not regulated).
- **Lacking proportionality and clarity** with regard to the subsidiarisation and cross-border requirements.

Below we have set out some policy recommendations on how to ensure a more proportionate regulatory framework is achieved, while ensuring EU and national authorities have appropriate visibility over TCBs in line with the ECs original intention.

What is being proposed?

Restrictions to cross-border activities – Art 21c

As part of the legislation transposing Basel iii into EU law (e.g., CRR3 & CRD6), the EC also put forward new proposals imposing a requirement to establish a branch for the provision of "banking services" by non-EU firms. Specifically, the draft legislation includes a new provision (Article 21c) in the CRD, which would require certain non-EU firms to establish a branch in the EU to continue, or start, providing certain activities in the EU, with the only exemption from this being where the services are provided on the basis of "reverse solicitation". This new Article 21c applies this requirement to entities referred to in Article 47 (1) and (2) CRD, which conduct the activities referred to in Article 47 (1). Simply put, the new regime would apply not only to non-EU deposit-taking entities, but rather to any non-EU firms that undertake the following activities in a Member State on a cross-border basis or via a branch:

- the activities listed in Annex I of the CRD, which include deposit-taking, lending, M&A advisory, payments, spot and other foreign exchange and securities and derivatives business; or
- dealing on own account or underwriting the issue of financial instruments where the non-EU firm meets the Class 1 size criteria for being classified as a credit institution under IFR and is a non-deposit-taking entity under CRR (e.g. carries out MiFID activities 3 &6, the total assets are above €30bn, has assets below €30bn but is part of a group with assets above €30bn).

New subsidization requirements for Third County Branches – Art 47 & 48

Alongside the proposed changes to cross-border activities, the draft CRD legislation also contains a separate proposal that would provide National Competent Authorities (NCAs) the power to require subsidiarization of TCBs at least where the branch 1) engages in business with other EU branches, related EU institutions or conducts cross-border activities in breach of internal market rules, or 2) is systemically important in the EU or in a Member State (Art 48j).

In order to assess the "systemic importance" of a TCB, the proposal includes a €30bn asset threshold to trigger a mandatory assessment by the NCA as to potential subsidiarization, in conjunction with more discretionary supervisory powers to determine the interconnectedness of the TCB, which may also result in subsidiarization.

If such a test is passed, the NCAs can:

1. require the TCB to seek authorization as a credit institution;
2. require the TCB to restructure its activities to reduce its systemic importance (e.g., reduce its balance sheet); or
3. impose additional Pillar 2 requirements on the TCBs.

Ireland's national regime – "Safe harbour"

Currently many Member States have "national regimes" in place which permit non-EU firms to carry out cross-border activities in a Member State without establishing a locally authorised branch once certain requirements are met. Most notably under MiFID/MiFIR, Member States can choose whether or not to require non-EU firms conducting retail or wholesale business to establish a local branch even in the case where an equivalence decision has not been granted2.

In Ireland, the current national regime is commonly referred to as the "safe harbour exemption"3. It permits non-EEA firms carrying out wholesale investment services and activities to professional clients and or eligible counterparties without establishing a branch, once certain requirements are met:

- the third country where the firm is established is not on the Financial Action Task Force (FATF) list of non-cooperative jurisdictions and which is not subject to authorisation and supervision for providing investment services to wholesale clients in Ireland.
- co-operation arrangements are in place between the Central Bank of Ireland (CBI) and the competent authorities of the third country that include provisions regulating the exchange of information for the purpose of preserving the integrity of the market and protecting investors.

Simply put, the regime allows Irish corporates access to the most tailored risk management and hedging services globally, which can very often be from non-EU based entities. This would also include underwriting and placing newly issued securities with investors and helping make secondary markets in these securities after they are listed. Additionally, non-EU investment banks also provide large corporate, government and institutional clients in the EU, like Ireland, with corporate finance and other advisory services under the "safe harbour" exemption.

Due to the broad nature of Article 21C and its association with MiFID activities, the current draft would require Member States, such as Ireland, to remove national regimes allowing for cross border business by non-EU entities in so far as they permit such activity, other than on a reverse solicitation basis.

The role of non-EU banks in the EU (and Irish) economy

The provision of cross-border services and use of TCBs play important roles in the EU economy for a variety of different reasons. Many non-EU entities are deeply embedded in the EU economy through long-term funding projects or the provision of financial services. Specifically, TCBs and cross border services are used for business strategy purposes, operational efficiency, and group-wide risk management. Equally, these services help channel global capital flows into financing EU infrastructure projects and diversifying funding within the EU economy. They also have a critical role to play through providing loans and underwriting investment grade and high yield debt issuance and equity by deploying capital and liquidity more efficiently than subsidiaries, with reduced transaction costs for customers.

From an Irish perspective, its openness to cross-border services and the "safe harbor" mechanism in particular has played a key role in the attractiveness of Ireland as a location of choice for a range of products including regulated investment funds, securitisations, debt securities offerings and other structured products. With Ireland playing a leading role in these areas (not just in the EU but globally)

[2] Note as of today the European Commission has not granted equivalence under MiFID/MiFIR and as such, national regimes continue to apply.
[3] Reg 5 EU (Markets in Financial Instruments) Regulations 2017

it is crucial that national regimes are continued to play an integral role in the development of its financial services eco-system.

Below are two case studies demonstrating some of unintended consequences faced by non-EU entities and the importance they play in the EU economy.

Case study – EU Corporate manufacturer which sells products inside and outside the EU

To support its global operations, the EU Corporate manufacturer raises finance internationally with the majority of investors based in China, the EU, Japan, North America and the UK. This Corporate is listed in Germany, the UK, and in the US. It issues bonds globally, including benchmark bond issuances in Euro and US-dollar markets, a Euro Medium Term Note program plus local capital market programs in China, South Africa, South Korea, and Thailand. The Corporate also has ABS programs in Asia, the EU, North America and the UK.

As part of its global supply chain, the Corporate relies on raw materials from outside the EU. It has over 30 factories, both inside and outside of the EU, and it wants to buy another factory in India. It also wants to continue to attract the best engineers from around the world to work in its headquarters in the EU. The introduction of Art21c of the CRD6 proposals would potentially severely impact the ability of the corporate to conduct its global operations, including the following aspects:

Large Financing

The Corporate is planning to expand its activities in the US. To fund this operation, it needs to refinance its existing multi-billion, multi-currency revolving credit facility (RCF) which supports its working capital and development in the EU and abroad. Given the size and purpose of the RCF, it wants the flexibility of having several of its EU subsidiaries as additional sub-borrowers under the facility.

International banks from the EU, UK, US and Asia are committed to the current facility which allows the Corporate the option to draw on Euro and US dollar funds as required.

However, as a result of the Article 21c proposals, it may find that the non-EU lenders in its current facility are unable to commit to the new RCF (or continue under the current one) as they do not have an EU branch. Even where major international banks have an EU branch, they might not have one in the particular member state where the Corporate is based. Furthermore, very few, if any, of the non-EU lenders would have branches in all the member states where the sub-borrowers are located.

As a consequence, the Corporate would therefore find itself restricted to a smaller lending group of banks, which may also reduce pricing tension and an increase in the cost of funding of large multi-currency (or non-Euro) facilities. As we have seen during Covid and the initial scramble for liquidity in Q1/Q2 2020, it is vital for European corporates to have access to the major global financial institutions and their liquidity in particular in stress situations.

This case also reflects the limitations of reverse solicitation as a solution to conduct stable business activity under. While the Corporate might be able to obtain its funding on the basis of reverse solicitation in the case of this example, however it should be noted that (i) the exemption is generally fragile and (ii) it limits the flexibility of the non-EU lenders to achieve the best result for the client.

Case study – TCB used for ECB liquidity purposes

In order to ensure access to ECB liquidity lines and the safe deposit of collateral at the central bank, certain entities were required to establish branches inside the Eurozone to support this ECB requirement. Having access to such central bank liquidity is essential for commercial banks and helps ensure financial stability within the Eurozone through short-term funding lines. As many of these branches were established to support non-EU entities gaining access to ECB liquidity, having to establish a subsidiary to continue this non-client facing activity seems disproportionate considering the upfront and ongoing costs (e.g. capital, liquidity, reporting, governance) associated with establishing such an entity.

For example, as a consequence of the UK's departure from the EU, a number of branches have become TCBs unintentionally and could fall under the scope of these new requirements, which we believe was never the intention of the EC proposal. Rather, as we understand, the intention of the proposal was to ensure supervisors have greater visibility of TCBs' client facing activity.

What is the impact of the proposals?

Firstly, if implemented, this proposal would represent a major change to the existing framework regulating cross-border business into the EU and Ireland, rather than a clarification of the existing framework as described in the proposal.

Having not been accompanied by a full impact assessment, the proposal has the potential to have many unforeseen consequences, but we are particularly concerned about the following impacts on EU financial institutions, corporates and the wider business environment:

- A **reduction of choice** for EU financial institutions, corporates and governments when looking to access international capital and cross-border services, ultimately impacting the liquidity of the EU markets. Under the proposal EU corporates seeking to raise funds in non-EU niche markets would be forced to rely on limited advisers/brokers with a branch in the EU, rather than relying on local expertise in the non-EU jurisdiction. Similarly, restrictions for EU corporates from FX markets which are used primarily for hedging purposes, could be significantly disrupted by the proposals.
- **Captures critical activities for Euro liquidity and intra-group funding,** which we fear may not have been fully taken into consideration when drafting the proposal. In certain situations, branches were established in the EU for the purpose of obtaining access to ECB euro liquidity lines. However, with the UK's departure, these existing branches – whose sole purpose is to interact with ECB and support financial stability – have now become TCBs and could unintentionally be required to subsidiarise, which will come at a significant upfront and ongoing expense. Equally, we believe the legal drafting relating to intragroup transactions – which are commonly used for funding and risk management functions – remains unclear and if not rectified would create unnecessary inefficiencies for global banks who would be forced to raise funds in local markets. Non-EU entities need to be able to utilise their full balance sheet in order to support continued lending into the EU economy.
- The **EU would become a less attractive destination** for cross-border services, particularly compared to regimes in other jurisdictions like the UK, US and Switzerland. In each of these jurisdictions, third country firms are permitted to conduct cross-border business with clients without the establishment of a branch. As the EU is looking to establish a diverse capital market, we believe this approach would send the wrong signal to international financial services about the EU's and Ireland's openness for foreign capital and invites the possibility of retaliation directed at the EU banking sector by regulators in other jurisdictions.
- **Overhauls well-established national regimes**, like that in Ireland, introduced by Member States to provide clarity while protecting consumers / depositors, with a new approach that creates significant legal uncertainty. For example, reliance on reverse solicitation to provide

investment services to EU clients is not without difficulties as outlined by ESMA in January 2021 where it highlighted the emergence of certain questionable practices. As such, this exemption will be insufficient for businesses currently providing cross-border services to continue as a consequence of the difficulties in demonstrating that a transaction resulted from the “exclusive initiative” of a client. It will also result in non-EU entities being unable to provide clients with the products and services most suited to their needs, leading to worse client outcomes.

- **Creates an un-level playing field** due to the interaction between Art 21c and Art 47 and the new requirement to seek authorisation in order to conduct certain activities in a Member State for non-EU entities even if EU entities are not required to be authorised (e.g., in some Member States corporate lending and financial advice and spot FX are not regulated). Similarly, we are concerned that the threshold criterion could create level-playing field challenges between non-EU firms due to the lack of attention on activities within the proposal. For example, a situation may arise where a small non-EU entity may continue to benefit from national regimes, but a larger non-EU entity would not because of the size of its balance sheet, yet the product or service of the former may in fact be more complex.
- **Conflicts legally with existing rules**, like those laid down in MiFID, for branches as the exemptions are not aligned. At the same time, the proposal looks to conflict with MiFIR Article 46, which provides that national regimes governing third-country firms continue to apply unless, and until, there is an equivalence decision in respect of the relevant third country. For example, there is a derogation within the proposal for non-EU firms that (a) are neither banks nor large investment firms and (b) do not carry-on own account dealing or underwriting or, if they do, not meet the size criteria for classification as a non-deposit-taking credit institution. Firms benefiting from the derogation would be subject to MiFID rules on branches, rather than the proposed rules on cross-border business and branches. However, it is unclear how the derogation is intended to work in respect of activities falling outside the MiFID regime. Equally, it is unclear how the classification of non-deposit taking credit institutions can be readily applied to non-EU entities as the requirements laid down in Art 4 (1) of CRR relate specifically to entities with an EU presence and balance sheet.
- The **lack of proportionality and clarity** with regard to the subsidiarisation and cross-border requirements. For example, we are concerned that the two new requirements (e.g. Art 21c & Art 47) depend too much on automatic triggers (e.g. €30bn threshold & potential removal of national regimes) and provide insufficient transition arrangements for impacted entities. The current drafting would suggest that firms would need to stop conducting cross-border business unless they had been granted a branch license or subsidiary authorisation in each relevant Member State by one year after the date of application. At the same time, the interconnectedness test that can be used to determine the systemic importance of the TCB lacks clarity and could create uncertainty for businesses. When it comes to the requirements imposed on new branches, we believe these are disproportionate. Currently, there would be requirements to maintain a minimum endowment capital, and unlike the US, there is no cap on the amount of such capital for well-rated banks. This endowment capital would also not be readily available for use if needed, while we believe the organisational, risk control, and reporting requirements for branches are overly burdensome for the type of activity being undertaken.

Policy recommendations

In order to address the concerns listed above, while retaining the overarching objective to strengthen the regulation and supervision of TCBs/cross border services, we would recommend EU policymakers insert more proportionality into the framework through the following changes:

1. **The scope of Art 21c should only apply to "core banking activities" as defined in Annex 1 CRD (e.g. points 1, 2, 3 & 6 of Annex 1 CRD) while MiFID type activities should be excluded.** This approach would align with the EC's overarching objective of ensuring financial stability of entities carrying out core banking activities through harmonized prudential requirements.
2. **The new requirements relating to TCB subsidiarization should take into consideration the activity carried out by the TCB**, even if above €30bn. More specifically, we would suggest that EU policymakers exempt any TCBs that are established for the purpose of gaining access to ECB Euro liquidity and do not undertake any client facing activity. These entities help support financial stability and in no way pose any prudential risk that would justify having to establish an EU subsidiary. We would also recommend exempting any intra-group funding from the €30bn threshold calculation, as this would fall under the prudential regime of the third country jurisdiction.
3. To ensure greater proportionality, **we would also recommend that NCAs are permitted to waive the new branch requirements** if 1) the non-EU entity is headquartered in a jurisdiction with equivalent prudential standards, 2) the third country where the firm is established is not on the FATF list of non-cooperative tax jurisdictions, 3) cooperation arrangements are in place with NCAs and third country competent authorities relating to the sharing of information and 4) the activities are only conducted with professional clients. We would also recommend amending the threshold for credit institution authorization for Class 1 investment firms to clarify that it is based on EU assets, which would better align with the threshold for TCBs as laid down in the EC proposal.
4. **The proposed assessment of systemic importance of TCBs should be more proportionate and streamlined.** For instance, we would welcome further clarity around the interaction between the two mechanisms laid down in Art 48j and Art 48k (e.g., between the €30bn criterion and that of "interconnectedness"). We would also recommend supervisors having more discretion with regard to determining "interconnected activities", which should be based on the size and complexity of the entity and not solely on whether it is interconnected with other EU or non-EU branches/subsidiaries. Similarly, we believe that the capital, liquidity, internal governance and reporting requirements applied to any TCBs should be proportionate to the activities they are undertaking. At the same time, entities that are required to subsidiarize or create an EU branch should be given sufficient time to do so once agreed with NCAs.

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