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BACK-BRANCHING – THE ROLE OF BRANCHES IN THE UNITED KINGDOM IN ACCESSING THE EEA MARKET

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Mathias Hanten and Moritz Maier *

Contents

* A discussion under Chatham House Rule at the Brexit lecture at the Institute for Law and Finance on 29 November 2017 initiated this Paper. A representative of a Significant Institution raised and affirmed the question whether branching back should be compliant with European law. A senior representative from an NCA strongly disagreed with this view and provided his own line of argument. The discussion became quite intense, with numerous arguments pro and contra back-branching being put forward. The main arguments in favour of branching back were based on CRD IV and the concept of the freedom to provide services. European law did not expressly prohibit or limit branching back. The main arguments against branching back were based on the legal duty of lawmakers and regulators to ensure coherence, i.e., a consistent application of harmonised European law throughout the Banking Union. This discussion was what prompted the authors to write an article, which was then published in Wertpapier-Mitteilungen 2020, p. 1293. However, the intensity of discussion, the European focus and the emergence of new arguments suggested switching to English and converting the original article into an enhanced and further developed working paper. The Banking Package, partly based on EBA's Report to the European Parliament, the Council and the Commission on the Treatment of Incoming Third Country Branches under the National Law of Member States, in accordance with Article 21b (10) of Directive 2013/36/EU (CRD IV), delivered new thoughts but did not expressly cover the branching back topic, though it is under discussion among credit institutions and regulators.

This Working Paper intends to spur further discussion on the subject of branching back.

In addition, it is intended as a late commemorative publication on the occasion of ILF's 20th anniversary. We are grateful to Professor Andreas Cahn for accepting to include our paper in the ILF Working Paper Series.

I. Introduction

The withdrawal of Great Britain ("**UK**") from the European Union ("**EU**") on 31 January 2020 is the first application of Article 50 Treaty on European Union ("**TEU**") and thus a political and European legal novelty and an object lesson for dealing with the withdrawal of a European Economic Area ("**EEA**") Member State. While the political negotiations on the exit modes were mainly concerned with the border between Ireland and Northern Ireland, the retention of residence rights and the future modalities of the movement of goods, the financial sector played a subordinate role. This is particularly evident in the Brexit withdrawal agreement between the UK and the EU. It does not make a single explicit statement on the structure of the relationship between the EU and UK in financial services in a post-Brexit environment.[1]

From a prudential point of view, Brexit is a culmination point for all questions of third country access to the EEA. How should credit institutions from the UK - now a third country - be granted access to the EEA[2] and vice versa? How can it be ensured that, with regard to market access from the UK to the EEA, each Member State acts in a convergent manner and no arbitrage effects arise?[3] How can the regulators improve convergence in the EEA given the different supervision in the participating member states under Article 17 of the Single Supervisory Mechanism ("**SSM**") and those that do not participate? To what extent can tasks be outsourced to the UK?[4] Can the concept of 'reverse solicitation', i.e. the use of the (passive) freedom to provide services under Article 57[5] et seq. of the Treaty on the Functioning of the European Union ("**TFEU**"), improve cross-border activities? How can customer relationships, i.e. contracts as well as assets and liabilities, be transferred if the registered offices relocate from the UK into the EEA?[6]

All these questions of third country access become particularly relevant in the Brexit context because, as a consequence of the withdrawal of UK from the EEA, the advantages of the European passport regime are no longer applicable. The European passport regime is required and specified under

[1] See Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community, OJ L 29, 31.1.2020, pp. 7-187 and Council Decision (EU) 2020/135 of 30 January 2020 concerning the conclusion of the Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community, OJ L 29, 31 January 2020. OJ L 29, 31 January 2020, pp. 1-6.
[2] Exported with *Hanten/Sacarcelik*, Die Auswirkungen des Brexit auf den Marktzugang von Kreditinstituten und Wertpapierfirmen, WM 2018, 1872.
[3] With regard to Brexit-related regulatory arbitrage at financial services institutions *Ceyssens/Tarde*, EuZW 2019, 805, 809 et seq.
[4] In detail *Herz*, EuZW 2017, 993, 994 et seq.
[5] *Hanten/Sacarcelik*, After the Sunset: The Impact of Brexit on EU Market Access for Banks and Investment Firms, EBI Working Paper Series 2017 No. 22, 16 March 2018, p.14 et seq.; from a Swiss perspective Ammann, Der europäische Marktzugang für Schweizer Banken, 2020 (Diss. St. Gallen), p. 526 et seq.
[6] For further details see *Hanten*, IJFS 2019, 28, 30 et seq.

European law by Article 33 et seq. of Capital Requirements Directive IV/V ("**CRD IV/V**"[7]) and Article 34 et seq. of the Markets in Financial Instruments Directive II ("**MiFID II**"[8]). It allows credit institutions to provide supervised banking and financial services into other Member States on the basis of the licence granted by their home state without the need of an additional licence granted by the host state. In this respect, the European passport can be regarded as a legally prescribed equivalence, underlying all relations of the Member States relevant to financial supervision.[9] Previously, however, the EU legal framework restricted provisions on third country branches ("**TCBs**") to one general principle only, cf. Article 47(1) CRD[10]: Member States must not be subject to TCB provisions, which result in a more favourable treatment than that accorded to European passport branches. The draft CRD VI published in October 2021 in the context of the Banking Package 2021 for the implementation of the Basel III standards shows, however, that the regulation of TCBs will also be subject to much stricter control and harmonisation in the near future.[11]

The Working Paper deals with a specific scenario of third country access, which is caught between the conflicting regimes of the European passport and individual national regulations of third country access: back-branching. The following observations will be limited to the practice-relevant activities of the credit institutions determined by Capital Requirements Directive ("**CRD**") and Capital Requirements Regulation ("**CRR**"). In contrast, the European passport and the third country access modalities under the MiFID II, Undertakings for Collective Investment in Transferable Securities ("**UCITS**"), Alternative Investment Fund Managers Directive[12] ("**AIFMD**"), Solvency II[13] or Payment Services Directive II[14] ("**PSD II**") provisions will not be considered more closely. This limitation was necessary, as all Directives take a completely different approach to third country access

[7] Directive 2013/36/EU ("CRD IV") as amended by Directive (EU) 2019/878 of 20 May 2019 ("CRD V"). In the following, the connotation CRD IV is used to refer to reasons for consideration that are only contained in this Directive. CRD IV refers to the consolidated version of the CRD as amended.

[8] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

[9] For further detail on the same issue in post-Brexit environment *Ceyssens/Tarde*, EuZW 2019, 805, 805 et seq.; see also Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, Equivalence in the area of financial services from 29 July 2019, COM (2019) 349 final, available at https://ec.europa.eu/transparency/regdoc/rep/1/2019/EN/COM-2019-349-F1-EN-MAIN-PART-1.PDF, last accessed on 1 May 2020.

[10] Article 47 CRD was modified by CRD V, implementing certain notification requirements relating to TCBs to EBA.

[11] Cf. Proposal for an EU-Directive amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU as of 27 October 2021, Article 1 par. 8, draft of a new Title VI – Prudential Supervision of Third Country Branches and Relations with Third Countries.

[12] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

[13] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

[14] Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC.

modalities. This ranges from a definite and fully harmonised concept, e.g. the AIFMD, to concepts which are completely silent on the third country access, e.g. PSD II.[15] Furthermore, due to the UK's European legal heritage, the current supervisory situation in the UK might still be regarded as equivalent to the legal situation in the EEA. Nevertheless, the following explanations assume that it will not be possible to reach special equivalence agreements between the UK and the EU or individual Member States any time soon that deal separately with the operation of banking business and the provision of financial services.

There is nothing to indicate that such equivalence agreements will be concluded in the near future between the UK and the EU or individual Member States, as the withdrawal agreement, among other things, makes clear. The fact that the closing of such agreements is complex is shown, for example, by the fact that neither the General Agreement on Trades in Services ("**GATS**")[16] nor the Agreement on the Free Movement of Persons between the Swiss Confederation and the European Union contains regulations on 'financial services'.[17] In addition, experience suggests that the British supervisory authority could go back to a 'light touch' approach to optimise market access, for which the Financial Conduct Authority was known and appreciated before the financial crisis.

The EU and the UK have at least agreed in a joint statement to develop a framework for cooperation on supervisory issues.[18] This is intended to enable transparency and a joint dialogue in the process relating to the issuance, suspension or withdrawal of equivalence decisions, as well as a constant exchange in relation to supervisory initiatives. But while the joint statement on supervisory cooperation is intended to lay the foundation for a more stable equivalence process, defining the framework would still require further negotiations. The outcome is therefore uncertain at this time,

[15] European Parliament Research Service, Understanding Equivalence and the single passport in financial services; Third country access to the single market, February 2017, available at- https://www.europarl.europa.eu/RegData/etudes/BRIE/2017/599267/EPRS_BRI(2017)599267_EN.pdf, last accessed on 1 May 2020; European Parliament, In depth analysis by the Economic Governance Support Unit, Third country equivalence in EU banking and financial regulation, August 2019, available at- http:// www.europarl.europa.eu/RegData/etudes/IDAN/2018/614495/IPOL_ IDA(2018)614495_EN.pdf, last accessed on 1 May 2020.

[16] On the implications of a no-deal Brexit for the financial sector in the context of GATS, the paper by *Herbert Smith Freehills*/European Banking Federation ("EBF"), WTO Implications on Banks in Case of No-Deal Brexit, October 2019.

[17] The fact that free trade agreements with the EU can by no means be concluded in a few months, as the advocates of a "hard" Brexit always claim, is clear even on a cursory glance at the current state of negotiations on various agreements; the overview can be found at https://ec.europa.eu/trade/policy/countries-and-regions/negotiations-and-agreements/#_being-negotiated, last accessed on 1 May 2020. As an EU-internal seminar presentation (slides 19 et seq.) of 10 January 2020 shows, the Member States have so far only agreed on general key points for future cooperation with the UK, such as maintaining the EU supervisory standard; the presentation can be found at https://ec.europa.eu/commission/sites/beta-political/files/seminar_20200110_-_data_protection_adequacy_-_financial_servi-ces_en.pdf, last accessed on 1 May 2020.

[18] Joint ESA Supervisory Statement on the application of the Sustainable Finance Disclosure Regulation dated 25 February 2021.

and the current stage reached cannot serve as a robust basis for the provision of banking services between the UK and the EEA.[19]

II. Definition and Classification of Back-Branching in the Context of Branches in the UK

'Brexit made the UK a third country'. The starting point of almost every consideration of continuing to provide banking services from the UK to the EEA despite Brexit aims to relativise this thesis. In seeking ways to enable cross-border service provision with as little regulatory effort as possible, this thesis can develop into an almost insurmountable obstacle for credit institutions from both the UK and the EEA. Although emphasising the UK's third country status might be accurate from a generic angle, it at the same time narrows down the view on its actual impact and significance. The UK's qualification as a third country does not necessarily prohibit cross-border provision of banking or financial services subject to regulatory supervision.

In back-branching, the 'third country border' is crossed even twice, first from a Member State 'out' to the UK and then at the same time from the UK 'back' to the EEA. In more specific terms, back-branching means that a credit institution domiciled in a Member State establishes a branch in the UK or maintains its – pre-Brexit passporting – branch and carries on its business back into the EEA from this branch. The place of destination of the service provided may be either the Member State in which the head office of the institution is located or any other Member State or third country. Providing services from the UK to a further third country is still excluded here.

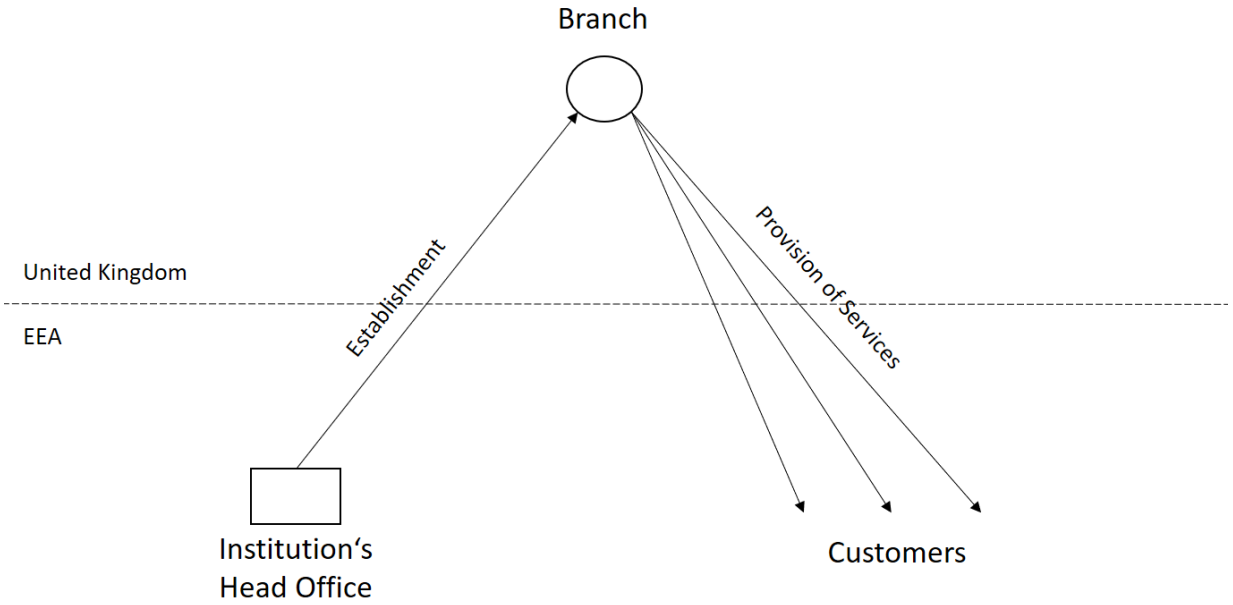

Figure 1: Back-Branching

[19] Nevertheless, it is the authors' conviction that a common framework will be important to create a reliable environment for trade between the UK and the EU in financial services and to ensure a close ongoing dialogue in financial sector regulation. The joint statement can be considered as a first step on this path.

From an economic and strategic perspective, back-branching offers a way to continue using the great advantages of the London financial centre and local resources which had been centralised in the UK for EEA business. Against this background, some credit institutions have started to turn away from an 'all-in strategy' in the EEA, considering allocating activities in the EEA to several spots while wanting to keep substantial resources in London.[20] The relocation costs are considered too high and the availability of personnel and the regulatory environment outside the UK are seen as too problematic. In addition, specialist skills are often pooled in London and cannot be transferred to another location on an equal footing. Furthermore, institutions in a more independent UK are hoping to develop existing and new business relationships in other regions of the world, for example the USA, and also in Asia and Africa. This is the reason why there is still a need for resources in the London financial centre. Lastly, internal company and group conflicts can be mitigated if an existing location in the UK is largely retained and only an additional location is added or expanded.

While the economic basis for back-branching is obvious, the regulatory location is more fragmented. From a Member State's perspective, the UK branch is to be categorised as a TCB. For the establishment of such a branch in a third country, neither German nor European financial supervisory law provides specific requirements under current legislation. Although Sec. 53 of the German Banking Act (KWG) determines the activity of a branch from a non-member country in Germany, there is no complementarity rule for the establishment of a branch outside the EEA by institutions supervised by the German Federal Financial Supervisory Authority ("**BaFin**"). Permission from the supervisory authority of the home country, in this case BaFin or the ECB, is not required. European financial supervisory law until now was silent on this and restricted its measures to the prohibition on giving preferential treatment to TCBs over the European passport branches.

Even the harmonisation of the supervision of TCBs being planned at EU level will, at least based on current knowledge, not contain any requirements for the establishment of branches by EEA institutions in third countries. The draft of the new version of Title VI of what will come to be known as CRD VI, which was published as part of the already mentioned Banking Package 2021 for the implementation of the Basel III standards, does not contain any regulations addressing this issue. The establishment of branches by EEA institutions in third countries is and will remain outside the radar of national or European supervision in the EEA for the foreseeable future. Therefore, at most, this

[20] Financial Times, Banking on a back-to-back Brexit, Allowing a key trading process to continue is changing minds on shifting resources, as of 3 November 2017; available at https://www.ft.com/content/4fa2fc60-c093-11e7-b8a3-38a6e068f464, last accessed on 1 May 2020; Handelsblatt, How the financial centre Frankfurt profits from Brexit, The city on the Main will profit greatly from the British exit from the EU - even if many London bankers do not feel like moving, as of 12 November 2018, available at https://www.handelsblatt.com/finanzen/banken-versicherungen/banken/britischer-eu-austritt-wie-der-finanzplatz-frankfurt-vom-brexit-profitiert/23622496.html, last accessed on 1 May 2020.

scenario can be addressed through general organisational requirements, under the German supervisory law primarily according to Sec. 25a KWG. However, at least in Germany, there is so far no evidence of any practical supervisory relevance or established administrative practice.

On the other hand, it is obvious that in the case of a branch being established in the UK, any EEA institution will face regulatory burdens in the British host state in future. The UK had an established TCB regime even before Brexit, which is still in place with minor adjustments in the post-Brexit environment.[21]

III. Financial Supervisory Assessment of Back-Branching

The classification of back-branching mentioned above shows that its supervisory assessment is determined by two independent supervisory regimes. On the one hand, the institution maintaining a branch in the UK is subject to the home country supervision of its own Member State, determined by CRD and CRR. On the other, the branch is also subject to third country supervision in the UK. Against this background, the question of admissibility of the back-branching model also has to be discussed. The starting point for a supervisory assessment is that back-branching is not regulated or even prohibited under European law. However, general supervisory considerations, principles and objectives could argue for or against the admissibility of back-branching.

1. Prevention of Letterbox Companies

One possible reason for refusing back-branching could be to prevent letterbox companies. This issue is the primary focus of European and national regulators with regard to market access of British institutions in the post-Brexit environment. The possible intention of British institutions to set up only an 'empty shell entity' in the EEA while continuing to perform the relevant tasks subject to supervision substantially in the UK is to be firmly blocked from the outset.

This supervisory subject is certainly nothing new and not a specific feature of Brexit. Given the recent history of supervisory law, European supervisory authorities were already confronted with the collapse of the Bank of Credit and Commerce International ("**BCCI**") at the beginning of the 1990s. It became clear that structures in which individual companies merely serve as empty shells for obtaining a licence hold considerable risks, especially in the context of cross-border transactions, or even systemically relevant risks if the institution is of a sufficient size.[22] In response to the BCCI

[21] For the third country branch regime in the UK see PRA, Supervisory Statement SS5/21: International banks: The PRA's approach to branch and subsidiary supervision, last updated: July 2021; available at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2021/ss521-july-2021.pdf?la=en&hash=D45354116A8BB3F7DC567815C61878203300A2B1, last accessed on 21 May 2022.
[22] On the concept of systemically important risks ECB, Financial Stability Review, December 2009, p. 134.

bankruptcy, the European legislator enacted Directive 95/26/EC ("**BCCI Directive**").[23] Besides official cooperation and information regulations, Recital 7 of this Directive already stipulated that an institution's licence was to be refused or withdrawn if it was obvious beyond any doubt that the licence applicant's home legal system had been chosen only to take advantage of regulatory arbitrage. This requirement was intended to prevent letterbox companies as early as 1995. It is still an inherent part of the regulatory framework and is perpetuated by Recital 16 of CRD IV, which is identical in content to Recital 7 of BCCI Directive.

On the occasion of Brexit, BaFin as well as the European Securities and Markets Authority ("**ESMA**") and the EBA saw the need to make reference to this again separately and in print. In this respect, BaFin simply stated that it did not accept letterbox structures.[24] In the ESMA's General Principles to support supervisory convergence in the context of the UK withdrawing from the EU ("**ESMA Convergence Principles**")[25], which are more detailed than the BaFin statement, the rejection of letterbox structures becomes more clear. ESMA explains that outsourcing and delegating tasks or functions pose challenges for both the institution and the competent national supervisory authorities. This is especially true when it comes to critical functions.[26] For this reason, British institutions should be denied access to the EEA market if it is clear that the institution only wants to benefit from the European passport while performing all essential tasks outside the EEA.[27] A similar view is reflected in the EBA's guidelines on outsourcing[28] - although it might be disputed whether internal outsourcing from a company's head office to its branch is even covered by the EBA's guidelines on outsourcing because an application requires a 'third party'.[29]

In addition, the EBA puts the issue of 'empty shells' also in the context of back-to-back booking models and intra-group transactions, i.e. measures aimed at transferring economic risks using parallel transactions from a unit operating within the EEA to a unit in the UK or another third country. Such

[23] *Fischer/Boegl*, in: Schimansky/Bunte/Lwowski, Banking Law Manual, 5th edition 2017, Sec. 125, recital 64.
[24] BaFin, Information for foreign companies, last updated on 16 February 2017, available at https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Reden/re_190115_neujahrspresseempfang_en.html, last accessed on 9 March 2022.
[25] ESMA, General Principles to Support Supervisory Convergence in the Context of the UK Withdrawing from the EU, last updated on 31 May 2017, available at https://www.esma.europa.eu/document/general-principles-support-supervisory-convergence-in-context-uk-withdrawing-eu, last accessed on 9 March 2022.
[26] On the concept of critical functions in the context of the reorganization and winding-up of credit institutions and investment firms, cf. the explanatory memorandum and Article 6 et seq. of Delegate Regulation 2016/778/EU supplementing Directive 2014/59/EU ("Winding-up Directive").
[27] ESMA, Opinion: General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union, 31 May 2017, ESMA42-110-433, recital 27 et seq.
[28] EBA, Leitlinien zur Auslagerung, EBA/GL/2019/02, 25 February 2019, recital 39: Explanatory and very informative on the application of these EBA guidelines in the IT context particularly relevant to Brexit: *Contzen*, CRi 2020. 50, 50 et seq.
[29] From the German point of view, this is also rather moot, as the fiction of an institution under supervisory law according to Sec. 53 par. 1 sentence 1 KWG applies only to branches of companies in the territory of third countries, see *Vahldiek*, in: Boos/Fischer/Schulte-Mattler, KWG/CRR-VO, 5th edition 2016, Sec. 53 KWG, recital 10.

measures, in particular back-to-back booking transactions, are not – also not in connection with Brexit – per se considered by the EBA to be impermissible. However, the EBA stresses that such structures must comply with the supervisory requirements on governance and risk management within the entity operating in the EEA.[30]

The statements and discussions as well as fears of BaFin, the ESMA and the EBA regarding letterbox companies are primarily based on the scenario that an institution will keep its UK headquarters even after Brexit and, at the same time, will - now - establish a TCB in a Member State. In such a scenario, the institution decides to keep the focus of its business activities and resources in the UK. For the provision of business in the EEA (at least) a TCB is required. The location of such a TCB is – given the European passport regime – usually chosen depending on where in the EEA the least restrictive regulatory requirements are imposed on the establishment and operation of such a TCB. Against the background of the not yet fully harmonised supervisory regime for TCBs, the utilisation of arbitrage effects and a "race to the bottom" is still to be feared in this scenario.[31] Counteracting such a development is the central concern of the ESMA Convergence Principles mentioned above.[32] The corresponding risk is likely to be eliminated only by the implementation of CRD VI, which in its current draft version provides for a (far-reaching) full harmonisation of the supervision of TCBs within the EEA.[33]

It cannot be denied that differences in the supervisory regimes of the Member States may also play a role in the choice of location of the back-branching unit located in the EEA and may be taken into account by institutions adopting back-branching schemes. The ESMA is therefore right to point out in its Convergence Principles that letterbox companies should also be prevented if an institution wishes to have essential tasks carried out by a TCB.[34]

However, a key difference from the case of a hollowed-out branch of a UK institution in the EEA, as argued by BaFin, the ESMA and the EBA, is that an institution in the back-branching scenario has its headquarters in the EEA and, thus, is not “just a branch”. In the back-branching scenario, the institution only intends to use its UK TCB to provide cross-border services to the same or other Member States. The question of how the resources between the headquarters located in the EEA and

[30] EBA, Opinion on issues related to the departure of the United Kingdom from the European Union, 12 October 2017, EBA/Op/2017/12, recital 114 et seq.
[31] *Zetzsche/Lehmann,* AG 2017, 651, 659.
[32] ESMA, Opinion: General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union, 31.5.2017, ESMA42-110-433, recital 3 et seq.
[33] Proposal for an EU-Directive amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU as of 27 October 2021, Article 1 par. 8, draft of a new Title VI – Prudential Supervision of Third Country Branches and Relations with Third Countries.
[34] ESMA, Opinion: General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union, 31.52017, ESMA42-110-433, recital 28.

the British TCB are distributed plays at most a subordinate, upstream role in back-branching. It is self-evident that the institution having a registered office in the EEA must fulfil all equipment requirements of its EEA home state to obtain and maintain a supervisory licence,[35] particularly since under the back-branching model supervision within the EEA focuses on the headquarters located in the EEA. The corresponding supervisory requirements result from harmonised national supervisory law, something that, with regard to the letterbox issue, is particularly elaborated by the aforementioned Recital 16 of CRD IV. The competent national supervisory authorities and the ECB can exert sufficient influence for compliance with the regulatory requirements within the framework of the licensing procedure as well as within the periodic and extraordinary audits.

The initial decision that the institution in the scenario of back-branching has deliberately taken for the EEA and its supervisory environment even offers positive supervisory aspects compared with the alternative of establishing only a TCB in the EEA. This is because the institution's business model is clearly not aimed at withdrawing as far as possible from the sphere of influence of the European supervisory authorities due to its choice of being mainly located in the EEA. Rather, the institution seeks to use its resources available in its UK TCB also for its EEA business. Also, this view on the branching-back scenario is by no means contrary to economic incentives. An institution's intention to make use of British resources cannot be equated with the intention to perform tasks which, from a supervisory point of view, can be classified as essential or even critical from a unit located in a third country. Moreover, an institution's business intention to use all its (also internationally) available resources for its business activities all over the world as well as to create and involve centres of competence is legitimate and explicitly recognised at least in German TCB supervisory practice.[36]

Accordingly, the legitimate objective of preventing letterbox companies as required by the supervisory authorities must be considered separately from the question of the permissibility of back-branching.[37] On an established view, there are therefore no legal grounds for rejecting back-branching can be derived from the objective of preventing letterbox structures.

[35] On the relevant requirements under Secs. 32 et seq. KWG *Hanten*, BB 2019, 2769, the procedure was discussed by EBA, Final Report on Draft Regulatory Technical Standards under Article 8(2) Directive 2013/36/EU and Draft Implementing Technical Standards under Article 8(3) Directive 2013/36/EU, EBA/RTS/2017/08 and EBA/ITS/2017/05, 14 July 2017 whereby this EU authority could not and was not allowed to take into account the national peculiarities of nature.

[36] Such questions are discussed in the context of Sec. 53 KWG in particular with regard to the question of whether the TCB itself provides business or merely acts as an intermediary for other (international) units of its headquarters. As a result, the creation and inclusion of centres of competence is explicitly recognised; see *Vahldiek*, in: Boos/Fischer/Schulte-Mattler, KWG/CRR-VO, 5th edition 2016, Sec. 53 KWG, recitals 34 and 52.

[37] So does *Schuster*, ZBB 2019, 297, 304.

2. Regulatory Equivalence and Exemption

As mentioned at the beginning of this Paper, an equivalence agreement between the EEA and the UK will not be concluded in the near future. However, it may be asked whether equivalence and exemption can provide a justification for back-branching. Equivalence and exemption are a legal principle referring particularly to proportionate state action in national constitutional laws and is a principle governing the TFEU. Where supervision is not necessary as a result of the circumstances of the individual case, it might be considered that the competent supervisory authority has a right or obligation to exempt individual service providers from regulatory requirements.

Under current legislation, exemption mechanisms have not been subject to harmonisation in the EEA in the banking sector. When it comes to national legislation, something different applies.

In the German legislative framework, the exemption mechanism, in its inception, is an outgrowth of fundamental rights protection. In particular, based on the freedom of occupation under Article 12 of the Basic Law regulatory state interventions must always be proportionate and may only be justified if they are necessary and appropriate. For legal entities which, like German ones, fall under the personal scope of application of the freedom of occupation, Sec. 2 par. 4 KWG has provided and continues to provide for a corresponding exemption regulation which BaFin may apply in individual cases.

BaFin's corresponding administrative practice has also developed into a BaFin administrative practice with regard to third-country institutions that provide cross-border services requiring a licence to Germany. This administrative practice was then expressly standardised in Sec. 2 par. 5 KWG with effect from 3 January 2018.[38] According to Sec. 2 par. 5 sentence 1 KWG, BaFin may determine in individual cases that a large number of central supervisory requirements are not to be applied to an institution having its registered office in a third country and intending to conduct banking business or provide financial services in Germany by way of cross-border service transactions. This applies as long as the institution, given its supervision by the competent authority in the home state, does not require additional supervision by BaFin for its business conducted in Germany. Such an exemption may include the obligation to obtain a licence under Sec. 32 KWG. If this is the case, the third-country institution does not need a German subsidiary or branch to provide banking services in Germany. Rather, the services can be provided on a cross-border basis – like under the European passport regime.

The authors considered whether this doctrine of exemption could also apply to the back-branching scenario. In this case, banking services would also flow from a third country unit – the UK branch –

[38] *Schwennicke*, in: Schwennicke/Auerbach, KWG/ZAG, 4th edition 2021, Sec. 2 KWG, recital 41a.

to the EEA. However, the exemption under Sec. 2 par. 5 KWG requires "institutions with their registered office in a third country". This, however, is precisely what is missing in the back-branching scenario. With the registered office criteria, the legislator deliberately chose a reference point under corporate law. The branch located in the UK therefore cannot be regarded as such "institution with its registered office in a third country", as it is a legally dependent unit of the institution's headquarters in the EEA. Under corporate law, the UK TCB thus has its registered office at the location of the headquarters, i.e. in the EEA.[39]

This view is also supported by the justification and telos of an exemption under Sec. 2 par. 5 KWG, which is based on the equivalence of supervision in the third-country institution's home state. The equivalence consideration provided for in Sec. 2 par. 5 KWG cannot be applied consistently to an institution located and supervised in the EEA, since a legal equivalence mechanism already exists within the EEA in form of the European passport regime. The case of equivalence between Member States thus does not require any individual consideration but is already regulated by law. Admittedly, the administrative practice regarding Sec. 2 par. 5 KWG also recognises the case where the third-country institution provides the cross-border services through its TCBs located in other third countries. In this scenario, however, the equivalence consideration, according to the BaFin's written administrative practice, is not limited solely to the supervision in the home state of the TCB but is merely *extended* to them.[40] This means that, even in case of inclusion of a TCB, the starting point for the required equivalence assessment remains the supervision of the institution's head office located in a third country.

These considerations make it clear that a legitimisation approach of back-branching is not to be seen in the supervisory equivalence and exemption criteria for third-country units, but rather in the considerations of intra-EU service provisions (see point III.3. below). The focus of the legitimisation is not on the UK branch, but on the supervision of the institution's headquarters, which in the case of back-branching is under the supervision of a Member State.

As an aside, it should also be mentioned that an exemption referring to equivalence criteria should no longer be possible after the implementation of CRD VI anyway. Title VI of CRD VI draft version does not provide for a corresponding exemption regulation under EU law.[41] Due to the (full)

[39] On the question of the registered office of a branch under German commercial law, cf. *Preuß*, in: Oetker, German Commercial Code, 7th edition 2021, Sec. 13d, recital 48. On the qualification of UK TCBs under the European passport regime, see point III.3(b)(ii).

[40] BaFin, Notes regarding the licensing for conducting cross-border banking business and/or providing cross-border financial services, as of April 2005, point 2(a); *Schwennicke*, in: Schwennicke/Auerbach, KWG/ZAG, 4th edition 2021, Sec. 2 KWG, recital 41d.

[41] Cf. Proposal for an EU-Directive amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU as of 27 October 2021, Article 1 par. 8, draft of a new Title VI – Prudential Supervision of Third Country Branches and Relations with Third Countries.

harmonisation of the TCB's supervision intended by CRD VI, the German equivalence and exemption regulation in Sec. 2 par. 5 KWG will probably also have to be removed – at least according to the current stage of discussion influenced by the Banking Package 2021.

3. EU Law Principles for the Supply of Cross border Services

Against the background of the above considerations, a central legal yardstick for permissibility of back-branching is the realisation of the fundamental freedoms of the European internal market. Certainly, the relevant considerations here only cover those cases of back-branching in which the UK branch provides services to customers in another Member State. However, this scenario precisely reveals central aspects of cross-border provision of services. Further, its practical relevance cannot be denied either. The following considerations are devoted to the question of the extent to which the back-branching scenario is to be seen as an application of the cross-border provision of services in general and is thus covered by the protection of fundamental freedoms under EU law.

a) The Object and Legal Form of the Freedom to Provide Services under Article 56 et seq of TFEU in the Financial Sector

The freedom to provide services according to Article 56 et seq. of TFEU, as a fundamental freedom under EU law, includes an unconditional prohibition on restrictions on the free movement of services within the EEA. It gives those holding it, the providers of services, a subjective right to do so, which can be asserted in particular against Member States and EU institutions.[42] The main case of application of the freedom to provide services is the provision of a service in another Member State by a natural or legal person with EU nationality established in the EU.

According to the settled case law of the European Court of Justice ("**ECJ**"), banking and financial services are covered by the freedom to provide services under Article 56 et seq. of TFEU.[43] In the case of provision of such services, it may also be taken into consideration the freedom of movement of capital under Article 63 et seq. of TFEU also exists in addition to the freedom to provide services. If the scope of application of both the freedom to provide services and the free movement of capital are affected, ECJ case law holds that it must be determined which fundamental freedom dominates.[44]

[42] *Müller-Graff*, in: Streinz, EUV/AEUV, 3rd edition 2018, Article 56 of TFEU, recitals 13 and 60 et seq.
[43] See ECJ WM 1996, 714, recital 11 - Svensson and Gustaysson v Ministre du Logement et de l'Urbanisme, WuB I E 6. -1.96 Hailbronner, ECJ WM 1997, 1697, recital 17 - Parodi v Banque H. Albert de Bary et Cie., WuB I L 6 Article 59 EC 2.98 M. Ulmer, ECJ Sig. 2006,1-923, para. 29 - Bouanich v Skatteverket; ECJ WM 2003, 1072 para. 39 et seq. - EU Commission v UK, WuB II N. Article 56 EC 1.03 p. Schmahl; ECJ ECLI:EU:C:2005:645, recital 34 - Trapeza tis Ellados AE v Banque Artesia; ECJ WM 2000, 1862, recital 29 - Staatssecretaris van Financien v B.G.M. Verkooijen.
[44] ECJ WM 2006, 1949, para. 34 – "Fidium Finanz v BaFin", WuB I L 1. Sec. 32 KWG 1.07 *M. Hanten*; ECJ Sig. 2010, 1-6649 paragraph 33 - Dijkman and Dijkman-Lavaleije v Belgische Staat. Analogous with regard to the bankruptcy of freedom of establishment and free movement of capital ECJ Sig. 2009, 1-8591 paragraph 37 - Glaxo Wellcome GmbH & Co. KG v Fi-nanzamt Munchen II.

With regard to classical banking activities, a predominance of the freedom to provide services was affirmed in this context in the "Fidium case" taking account of the German Banking Act (KWG).[45] In the Fidium case, the ECJ also emphasises that the freedom to provide services and the freedom of capital are closely related, "but are intended to regulate different situations and each has a different scope of application".[46] For that reason a clear distinction must be made between these fundamental freedoms. Accordingly, only the freedom to provide services under Article 56 et seq. of TFEU is referred to in the following.

In the area of supervised banking and financial services, freedom to provide services is legally established and developed by the European passport regime.[47] According to Article 33 et seq. of the CRD IV, the Member States have to ensure by national law that CRR credit institutions authorised and supervised by the competent authorities of another Member State are allowed to provide services according to Annex I of the CRD IV on the one hand by way of cross-border provision of services through branches, and on the other by way of directly provided services in other Member States if the activities in question are covered by their authorisation obtained in their home country. Under German supervisory law, these CRD IV provisions are implemented by Sec. 53b KWG with regard to what is referred to as the outbound case, i.e. the establishment of a branch of an institution supervised by BaFin in another Member State, by Sec. 24a KWG, and with regard to what is referred to as the inbound case, i.e. the recognition of a branch of an institution supervised in another Member State in Germany without an independent authorisation requirement.[48] An inadmissible restriction of the freedom to provide cross-border services covered by the European passport through independent authorisation requirements in the individual Member States is prevented by the mutual recognition of the respective home Member State authorisation.

b) Back-Branching as a Case of Application of the Freedom to Provide Services and the European Passport

It has to be considered to what extent the scenario of back-branching is covered by the freedom to provide services under Article 56 et seq. of TFEU or possibly even directly by the EU passport regime. If this were the case, back-branching would be protected by the freedom to provide services at least if services were provided to another Member State via the TCB located in the UK, and for this reason alone it would be regarded as an admissible form of cross-border service provision.

[45] C-452/04 Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht, judgment of 3 October 2006
[46] ECJ WM 2006, 1949 para. 28 - Fidium Finanz v BaFin, WuB I L 1. Sec. 32 KWG 1.07 *M. Hanten*.
[47] This also applies to the statements in Recitals 2 and 5 of CRD IV, which place the European passport primarily in the context of the freedom to provide services.
[48] Section 53b KWG - Company based in another state of the European Economic Area

aa) Scope of the freedom to provide services in the case of third country supplies

The inclusion of back-branching under the protective effect of the freedom to provide services could be ruled out simply because the scope of application of Article 56 et seq. of TFEU was excluded from the outset. The territorial and personal scope of application of the freedom to provide services is determined by the factual element of crossing the border within the EEA.

However, this element of crossing the border within the EEA does not depend on the fact that an internal EEA border is actually crossed directly. Rather, the scope of application is primarily based in the scenario in which the residences of the persons or companies involved in the service relationship are from different Member States.[49] This becomes particularly clear when the service is provided in a third country, i.e. spatially and territorially outside the EEA. As an example of this, the legal literature cites a case in which a French resident provides services to a German resident in his home in Switzerland.[50] The application of the freedom to provide services to such a scenario could be rejected since Article 56 par. 1 TFEU speaks of the free movement of services 'within the Union' and the fundamental freedoms relate to the realisation of an internal market within the territories of the Member States.[51]

Nevertheless, the element 'within the Union' is not to be interpreted territorially. This point of view is borne out by the case law of the ECJ on the identical element of the fundamental freedom of movement of workers in Article 45 par. 1 TFEU. Interpreting the scope of application of the Treaties, which in the current versions of the Treaties is set out in Article 52 TEU and Article 355 TFEU, the ECJ also holds that EU law applies even if there is a sufficiently close connection to the Union's territory.[52] This view has its normative basis from the fact that, according to Article 52 par. 1 TEU, the Treaties apply 'for' the Member States and not only 'in their territory'. In the aforementioned case of the provision of services between two Member States on the third country's territory, the freedom to provide services under Article 56 et seq. TFEU also applies analogously.[53] A factual connection of the provision of services to a third state is therefore not detrimental to the applicability of Article 56 et seq. TFEU. This view applies even if the risk associated with the provision of services, for example in the case of insurance services, is cumulatively located in a third country.[54]

[49] *Khan/Eisenhut,* in: Vedder/Heintschel von Heinegg, Europäisches Unionsrecht, 2nd ed. 2018, Article 57 TFEU, recitals 7 et seq.; Kluth, in: Calliess/Ruffert, EUV/ TFEU, 5th ed. 2016, Article 57 TFEU, recitals 9 et seq. and 24 et seq.; Tiedje, in: von der Groeben/Schwarze/Hatje, European Union Law, 7th edition 2015, Article 56 TFEU, recitals 21 et seq.
[50] *Kluth*, in: Calliess/Ruffert, EUV/ TFEU, 5th ed. 2016, Article 57 TFEU, recital 35 et seq.
[51] Representing without own statement Kluth, in: Calliess/Ruffert, EUV/ TFEU, 5th ed. 2016, Article 57 TFEU, para. 35.
[52] ECJ NZA 1996, 971, recitals 14 et seq.
[53] *Randelzhofer/Forsthoff*, in: Grabitz/Hilf/Netteshiem, The Law of the European Union, Article 56 TFEU, recitals 19 et seq. (10/2019); more restrictive, as the definition of the territorial scope of the guarantee of freedom to provide services is based on bilateral and multilateral agreements; *Khan/Eisenhut*, loc. cit. (footnote 49), Article 57 TFEU, recital 9.
[54] *Müller-Graff*, op. cit. (footnote 42), Article 56 TFEU, para. 31.

The application of the freedom to provide services under Article 56 et seq. TFEU is thus not excluded simply because the UK is involved as a third country in the provision of services by back-branching. The territorial and personal scope of application of the freedom to provide services is open to back-branching to another Member State, since - with regard to the institution as the service provider and the service recipients with a permanent residency, registered office or domicile also in the EEA - the provision must be assumed to be cross-border 'within the EEA'. In this respect, the detour to the UK as third country is excluded.

bb) Branch as a legally dependent part of the headquarters

With regard to the question of the application of the rules on cross-border provision of services in the scenario of back-branching to another Member State, it must also be considered how the institution headquarters located in the EEA and the institution's branch located in the UK are to be qualified under the European passport regime. Headquarters and the branch could be regarded as separate legal entities. This idea is based on an analogy of the institution fiction of Sec. 53 par. 1 sentence 1 KWG.[55] The branch was to be regarded as an independent institution with its registered office in UK as a third country. Consequently, the European passport, i.e. the provision of services within the framework of cross-border trade in services, was not applicable to the case of the provision of services in another Member State through the UK branch. According to the EBA report on TCBs, this – German – view does not seem to be in line with the view held in the vast majority of Member States.[56] The EBA calls it the 'subsidiary-like approach'.

However, this view is contradicted by the fact that the branch in the UK does not have a stand-alone legal personality but rather qualifies as part of the EEA headquarters under corporate law and would therefore not exist legally without that headquarters.[57] The fiction as an institution according to Sec. 53 par. 1 sentence 1 KWG is, as already mentioned above, foreign to EU law and limited to German supervisory law. A commercial law-based view on the classification of a TCB is also confirmed from a supervisory perspective within the scope of supervision of the competent European supervisory authorities, i.e. in the case of significant institutions within the scope of the supervision of the ECB and in the case of insignificant institutions within the scope of the supervision of the competent

[55] If a company with its registered office abroad maintains a branch in Germany that conducts banking business or provides financial services, the branch is deemed to be a credit institution or financial services institution. If the company maintains several branches in Germany, they count as one institution.
[56] EBA calls it "subsidiary-like approach"; other member states seem to acknowledge that the TCB is not a separate legal entity and must therefore be treated in the light of the equivalence of the regulatory regime of the TCB's head office., TBC report, p. 16.
[57] Consistent from a tax law perspective ECJ Sig. 2003, I9409 paragraph 32 -Bosal Holding BV v Staatssecretaris van Financien.

national supervisory authorities.[58] It is true that the supervisory authorities of the Member States differ in terms of the intensity of supervision with regard to branches of institutions with their headquarters in the EEA,[59] specifically for Germany. However, it should be noted that BaFin as the nationally competent home supervisory authority claims to supervise an institution under the German supervisory law in its entirety, i.e. including branches in other Member States as well as branches in third countries, and, if necessary, to take action locally.[60] Any additional supervision by the competent third country authority does not contribute to this extensive supervisory claim of BaFin as the competent Member State supervisory authority.[61]

The comprehensively claimed right of European supervisory authorities to exercise supervision, which is interpreted differently in the individual Member States but in principle exists, does not violate the main principles of international administrative conflict-of-law rules. It is true that according to its principles there is no general obligation under international law – apart from administrative acts which affect the highly personal status of a person, such as granting of nationality – to mutually recognise acts of third countries. State acts are therefore limited in their effect to their national territory unless otherwise agreed under international law or a national legal recognition regulation.[62] However, the comprehensive claim to supervision by European supervisory authorities does not, in particular, attach to the TCB and its supervisory treatment by the third country but to the headquarters of the institution located in the relevant Member State's sovereign territory and to the existing supervisory obligations under domestic European supervisory law. These supervisory obligations of an institution located in the EEA do not end at the border of a third country, but also extend to branches of the institution, primarily on the basis of risk considerations.[63] The branches are thus subject to at least indirect supervision by the competent European supervisory authorities, while headquarters located in the EEA are required to comply with their prudential obligations also in respect of their TCBs. Third country prudential obligations come in addition to these domestic obligations but do not replace them.[64]

In summary, the TCB is therefore to be regarded as a legally dependent component of the CRR credit institution, which in turn supports the applicability of the freedom to provide services pursuant to

[58] On the division of tasks between the ECB and national authorities, see *Tutsch*, in: von der *Groeben/Schwarze/Hatje*, Europaisches Unions-recht, 7th edition 2015, Article 25 of the ESCB/ECB Statute, recitals 32 et seq. *Gören*, Der Einheitliche Aufsichtsmechanismus bei der Europaischen Zentralbank (Single Supervisory Mechanism) (Diss. Christian-Albrechts-Universitat zu Kiel), p. 137 et seq.; ECJ, judgment of 8 May 2019 - C-450/17 P, EuZW 2019, 559; BVerfG WM 2019, 1538; NJW 2019, 3204.
[59] EBA Report on TCB, p. 16 ff; p. 31-52.
[60] *Nemeczek/Pitz*, WM 2017, 120, 127; *Schuster*, ZBB 2019, 297, 304.
[61] *Schuster*, ZBB 2019, 297, 304.
[62] In detail *Ohler*, Die Kollisionsordnung des Allgemeinen Verwaltungsrechts: Strukturen des deutschen Internationalen Verwaltungsrechts, 2005, pp. 50 et seq.
[63] *Schuster*, ZBB 2019, 297, 304.
[64] For practical systematics see for example *Nemeczek/Pitz*, WM 2017, 120, 127.

Article 56 et seq. TFEU. Therefore, also against the background of the legal categorisation of the TCB, no reasons are apparent why services provided from the UK TCB to another Member State should not participate in the freedom to provide services.

cc) Recognition of the tripartite scenario underlying back-branching within the EEA

Applicability of even the specific European passport regime to back-branching to another Member State is also supported by the fact that the tripartite scenario underlying back-branching is not unknown in the context of the European passport, at least within the EEA between three Member States. In connection with interpretation questions on the free movement of services and the general interest in the Second Banking Directive, the EU Commission confirms that the free movement of services and, by this, the European passport regime, is also applicable to a service provision through a branch located in a second Member State to a third Member State.[65]

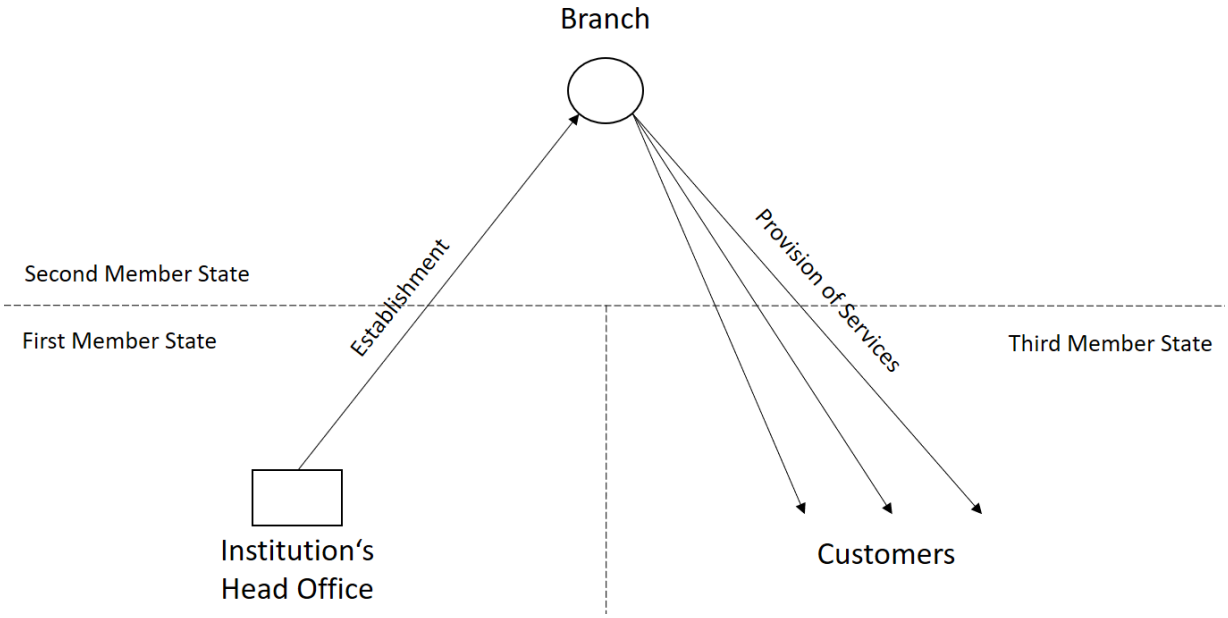

Figure 2: European passport in the tripartite scenario within the EEA

The only difference between this form of service provision and back-branching is that the services in the tripartite scenario within the EEA are provided by a branch located in another Member State, whereas in the case of back-branching a TCB provides the service. However, the literature emphasizes that in the case of the three-way situation within the EEA, the supervision of the branch by the second Member State in which it is located is not taken into account for supervisory purposes.[66] Supervision of cross-border activity is thus focused on the headquarters of the institution and the residual supervision in the country of destination of the services provided by the branch. Parallels to

[65] EU Commission, Communication 97/C 209/4 on the interpretation of the Second Banking Directive on the freedom to provide services and the general good, OJ No. C 209/6, 13.
[66] *Vahldiek,* op. cit. (footnote 21), Sec. 53b KWG para. 66.

the comprehensive right of supervision in the case of TCBs, both in the scenario of back-branching and in the recognised three-branch structure as discussed here, are evident. In both scenarios, the supervisory focus is only on home country supervision and the target country. This consideration also argues in favour of including the back-branching scenario under the scope of application of the freedom to provide services under Article56 et seq. TFEU and even under the EU passport regime.

4. Interim Conclusion

The assessment above shows that, from a strictly legal view, there is no evidence of any reasonable grounds against back-branching being allowed. The financial supervisory authorities' legitimate concern to prevent the emergence of possible letterbox companies in the EEA by Brexit restructuring measurements is not relevant for back-branching. Institutions wishing to use back-branching as a form of service provision into the EEA have already decided to locate their headquarters in the EEA and have thus undergone a comprehensive licensing procedure in a Member State. It is therefore obvious that their equipment, organisation and activities must comply with European supervisory standards and are not affected by the back-branching model.

Rather, it must be assumed that a service provision to another Member State using a TCB located in the UK in the post-Brexit environment is still covered by the freedom to provide services under Article 56 et seq. TFEU and even subject to the EU passport regime. Irrespective of a supplementary supervision by the UK as a third country, the TCB is to be classified under both corporate law and supervisory law as an inherent part of the institution supervised by an EEA supervisory authority. Additionally, under the European passport regime, the focus of supervision is directed to the home country of the institution and, if at all supplementary, to the residual supervision in the target country, while a detour to another country – be it a Member State or a third country – is excluded.

IV. European Banking Supervisory Authorities' View of Back-Branching

Against the background of the financial supervisory legal assessment of back-branching provided under III., the attitude of the European banking supervisory authorities towards this type of service provision is surprising. The ECB categorically rejects the permissibility of back-branching scenarios without making any prudential arguments.

1. Opinions of the European Central Bank regarding Banking Supervision

On its website under the category 'Supervisory practices', which was last updated in January 2021, the ECB publishes questions and answers on the 'Relocating to the euro area'. To the question "Can

I continue to provide services to customers in the EU from a branch in London post Brexit?", the ECB answers as following:

"*The ECB and the national supervisors believe that the purpose of branches in third countries is to meet local needs. The ECB and national supervisors do not expect that branches in third countries perform critical functions for the credit institution itself or provide services back to customers based in the EU.*"[67]

In its Newsletter of 14 August 2019, the ECB also mentions back-branching in connection with its assessment of the status quo of the institutions' Brexit plans as follows:

"*Some banks in the euro area still need to continue adjusting their business and booking models in line with their commitments. This includes significantly adjusting the practice of back-branching, i.e. servicing EU clients from branches in the United Kingdom after Brexit, even when there is no local business need for them to do so.*"[68]

The ECB opinions cited above formulate a negative stance towards back-branching. For supervisory policy considerations, there is apparently a desire to prevent banking activities within the EEA from being conducted by units which are not located in an EEA Member State but in a third country. No legal justification for this is given. The political supervisory motive cannot be identified directly. Perhaps the ECB's attitude can be explained by a fundamental reluctance to operate branches in third countries, which may be due to the fact that branches in third countries located in the euro area are not subject to supervision by the ECB under the SSM, but are only supervised under national supervisory law.[69] However, as indicated, this - political - justification cannot be maintained for TCBs of CRR credit institutions, as they are indeed subject to supervision under the SSM.

Another explanation for the ECB's negative stance might, in a more general sense, lie in recurring regionalisation (not to say nationalisation) efforts. Particularly in the context of Brexit and the protectionist policy of the former US administration led by President Donald Trump, a push to reduce and reverse globalisation approaches through, among other things, restrictive financial market supervision has become clear.[70]

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[67] ECB, Questions and Answers: Relocating to the euro area, 2 August 2018, available at https://www.bankingsupervision.europa.eu/banking/relocating/html/index.en.html, last accessed on 9 March 2022.

[68] ECB, Newsletter article "Brexit: stepping up preparations", 14 August 2019, available at https://www.bankingsupervision.europa.eu/press/publications/newsletter/2019/html/ssm.nl190814.en.html, last accessed on 1 May 2019.

[69] See *Wagner*, in: Grieser/Heemann, Europaisches Bankaufsichtsrecht, 2nd ed. 2020, pp. 223, 247.

[70] See in detail *Lupo-Pasini*, Duke Journal of Comparative & International Law 2019 (Vol. 30:91), 93, 93 et seq., on the role of the ECB p.115 et seq. A rejection of back-branching fits remarkably well into a national or - better - EU-oriented, protectionist supervisory policy.

2. Argumentation with Regard to the Purpose of a Third Country Branch

The only concrete argument for the ECB's opposition to back-branching is that it assumes (literally: 'believes') that the sole (as the likely compulsory interpretation of the ECB's opinion in the context of back-branching) purpose of TCBs is to meet local demand for services in that country. Furthermore, the ECB does not expect (verbatim: 'ECB and national supervisors do not expect') TCBs to perform critical functions for credit institutions or provide services 'back' to EU resident customers.[71]

This opinion of the ECB is already substantively incomprehensible. In regions of the world further away from the EEA, for example in Africa, North America or Southeast Asia, it is a common and regulatorily accepted practice for TCBs of institutions located in the EEA not only to meet local demand but also to act as the hub of the institution's activities in the region in question. Apart from satisfying local demand, this relates to further nodding activities such as establishing business contacts for customers from the institution's home region, observing the regional market and in particular (underpinning of) the processing of financing inquiries from home state customers with reference to the respective region. The latter activities in particular can only be sensibly carried out locally by a TCB, irrespective of the customer's territory, as only these branches have the necessary knowledge of the region. In this context, the term 'region' is to be understood broadly and can encompass various jurisdictions and supervisory regimes, with the TCB naturally being required to comply with the respective regulations of the target countries. It is not possible to explain why, in the post-Brexit environment, the permitted activities of UK-based TCBs are to be regarded as fundamentally different.[72] This is also true especially since, as already mentioned, the provision of services by cross-regional centres of competence is not unknown even to the German and thus the EEA supervisory context.[73]

Moreover, there is no legal basis for a restrictive regulatory interpretation of a TCB's role, at least in the context of back-branching. The CRD guidelines (Recital 23 of the CRD IV and Article 47 et seq. of the CRD IV/V) do not contain any references to a territorial or market-related restriction of the activity of branches located in third countries. As already mentioned, there is no parallel provision to Sec. 53b KWG for German institutions' TCBs that would restrict their scope of activity.

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[71] ECB, Questions and Answers: Relocating to the euro area, as of 2 August 2018, available at https://www.bankingsupervision.europa.eu/banking/relo-cating/html/index.en.html, last accessed on 1 May 2020. With regard to exports of cross-border services (C.II.2), it should be emphasized once again that the ECB classifies the provision of critical functions by branches as "back" to the provision of services to EU-based customers, i.e. it does not equate it with the provision of services to EU residents.

[72] So does *Schuster*, ZBB 2019, 297, 304.

[73] Cf. *Vahldiek*, in: Boos/Fischer/Schulte-Mattler, KWG/CRR-VO, 5th edition 2016, Sec. 53 KWG, recitals 34 and 52.

3. Practical Consequences of ECB's Negative Stance

Even if the ECB's opposition towards back-branching is not well-founded from a supervisory perspective, it must nevertheless be at least the starting point for making recommendations to institutions affected by Brexit, especially in advisory practice. An institution cannot be advised in good conscience to choose a method of service provision not considered permissible by the ECB without prior consultation and legal clarification with the competent supervisory authority.

The ECB's negative stance therefore currently has at least the practical consequence that resources available in the UK are no longer used by institutions for the EEA business in the sense of back-branching. In any case, since many institutions are keen to avoid doing anything that might put them at odds with the financial supervisory authority over the permissibility of back-branching, especially in the tense Brexit situation, this option is quickly discarded. Although this situation may be welcomed by the European financial supervisory authority on the basis of supervisory policy considerations, it is unsatisfactory given the legal uncertainty associated with it. Further, in the case of the provision of services into another Member State, it violates the freedom to provide services according to Article 56 et seq. TFEU.

But even if back-branching, based on a – non-mandatory – restrictive interpretation, were not regarded as an application case of the freedom to provide services under Article 56 et seq. TFEU and the European passport, the only conclusion that could be drawn from this is that back-branching is not regulated under either European or national law. A normative basis under supervisory law for rejecting back-branching as inadmissible by the supervisory authorities would still be lacking. If it were actually implemented and enforced, the ECB's dismissive stance on back-branching would infringe the institution's fundamental rights and freedoms. This means that such prohibition on back-branching would have to based on national or European law in order to comply with the rule-of-law principle. Currently, however, no such legal basis for that exists in German and European law. [74]

What is not to be regarded as inadmissible on a normative basis must be permitted in principle against the background of the legal system of fundamental rights and fundamental freedoms. Back-branching can therefore not be regarded as impermissible and prohibited without an explicit prohibition norm.

The ECB's view that back-branching is not permitted, which is disseminated by the internet and the media, is ultimately at odds with basic principles of European and constitutional law, such as the reservation of the law and regulatory clarity. In this context, the relevant ECB statements should not be seen as mere expressions of an opinion. Rather, they can be deemed to be legally relevant to the

[74] On the reasons for financial supervision, see *Thiele*, Finanzaufsicht (Habil.Georg-August-University in Gottingen), p. 91 et seq.

extent they are an indication of European financial supervision practice and, as such, are intended to have a legal effect on the institutions affected by Brexit. In 2017, the ECJ ruled that such statements by EU institutions, if they are to have legal effect, also have to be accessible to the EU judiciary for the purpose of monitoring the legality of the proceedings, irrespective of the channel through which they are disseminated.[75]

In addition, also the effect of the ECB's negative stance on the SSM system as a whole cannot be ignored. In this closely interconnected administrative network with the national authorities of the Member States, the ECB has a central, leading function. Not only through the direct supervision of 'significant institutions' on the basis of Article 6 of Regulation (EU) No. 1024/2013 ("**SSM Regulation**") but also through the indirect supervision of nationally competent authorities and their supervisory actions, the ECB lays down all essential guidelines for banking supervision[76] within the framework of the SSM as a whole, supplemented only by the guidelines of the EBA. Statements made by the ECB – irrespective of their legal qualification or basis – are thus of considerable significance for the entire SSM. The question of the competence related foundation of such ECB statements is therefore even more crucial.[77] In any case, in the light of the ECB's competences, it is no longer possible to speak of appropriate supervisory action within the SSM if the ECB provides neither a comprehensible and workable framework nor any differentiated recommendations for actions to be taken by the national supervisory authorities with regard to back-branching.

As a final consequence, the positive financial supervisory assessment of back-branching and ECB's negative stance in contrast leave both institutions and supervisory authorities helpless in the absence of a solution. However, from the authors' perspective, this legal uncertainty cannot simply be ignored by general, legally unfounded and possibly even illegal official statements.[78] If the ECB wishes to assert its opinion, it may submit its position to the European legislature and seek a change in EU secondary law. In any case, no such tendency can be discerned so far in the context of the CRD VI reform. Even if the harmonisation efforts of TCB supervision contained therein are not directly related to the back-branching issue, the ECB or the EU legislator could use this current legislative project also to regulate the issue discussed in this Paper on a legally certain basis.

[75] ECJ, ECLI:EU:T:2017:128, recital 43 - NG v European Council.
[76] Please see European Central Bank (November 2014), "Guide to Banking Supervision", ISBN 978-92-899-1414-7 and Tröger, Tobias and Tönningsen, Gerrit. "Verteilung der Aufsichtskompetenzen in der Bankenunion" Zeitschrift für Bankrecht und Bankwirtschaft, vol. 32, no. 2, 2020, pp. 77-87, available at-https://doi.org/10.15375/zbb-2020-0203.
[77] Going into detail about the competent challenges and fuzziness of the SSM against the background of the L-Bank ruling: Tröger, Tobias and Tönningsen, Gerrit. "Verteilung der Aufsichtskompetenzen in der Bankenunion" Zeitschrift für Bankrecht und Bankwirtschaft, vol. 32, no. 2, 2020, pp. 77-87, available at- https://doi.org/10.15375/zbb-2020-0203.
[78] This can also be seen as the overall tenor of the considerations of *Schuster*, ZBB 2019, 297, 304.

V. Conclusion

Back-branching can be viewed, from both an economic and a corporate policy perspective, as a sensible component of many institutions' Brexit strategy. Various institutions have already relocated their headquarters to the EEA or retained their headquarters already located there but still also seek to use their resources located in the UK to provide regulated banking services to the EEA. Although the UK in the post-Brexit environment qualifies as a third country with all the associated restrictions and consequences, back-branching still offers a practicable and comparatively simple way to achieve this goal.

The analysis shows that there is, at least under the current legislative environment, no supervisory regulation that argues against back-branching. Although the legitimate regulatory objective of preventing letterbox companies must be taken into account when considering the adequacy of the equipment of the institution's main branch located in the EEA, this aspect, at the very least, has no effect on the regulatory assessment of the back-branching model.

If services are provided into another Member State in a back-branching scenario, there are good arguments for the applicability of the freedom to provide services under Article 56 et seq. TFEU, and even the European passport. In this context, particularly the supervision of the TCBs located in the UK by the competent home Member State supervisory authority and the recognised tripartite scenario within the EEA, which is comparable to the back-branching scenario, must be considered. As a result, the ECB's rejection of back-branching is contrary to valid European supervisory law and to the fundamental protective effect of the freedom to provide services according to Article 56 et seq. TFEU.

It should also be noted that the ECB's negative stance for institutions is associated with considerable encroachments on fundamental rights and freedoms and that therefore a prevention of back-branching would at least require a normative basis. The ECB cannot ignore this fact by rejecting back-branching in its statements without any regulatory justification. What is not prohibited on a regulatory legal basis must continue to be permitted in principle, also in the regulatory environment of the financial markets.

Institutions should therefore at least consider back-branching scenarios as a sensible option because the resources available in the UK can still be used for the EEA business. This hold even more true as legislative initiatives for a prohibition of back-branching are not yet discernible at either the European or national level, not even in the current CRD VI reform intention of the Banking Package 2021. Against this background, the ECB's opposition to back-branching, for which there is no apparent regulatory justification, should be reconsidered. If the ECB's negative stance on back-branching were to be implemented, this would at least require an amendment of EU secondary legislation.

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