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Simplified Exemption Procedure for Swiss Banks under the German Banking Act

This paper provides an overview of the simplified exemption procedure and seeks to analyse the implications of the newly proposed CRD VI.

It covers administrative aspects, the scope of exemptions (KWG, WpHG as well as Money Laundering Act), reporting and audit requirements, CRD VI and gives an outlook to further developments.

A. Introduction

Any financial institution wishing to conduct one or more of the banking activities specified in section 1 of the German Banking Act (KWG) in Germany is required to obtain an authorisation from the German Federal Financial Supervisory Authority (BaFin) pursuant to section 32 KWG and subject to the European passporting rules. This licensing requirement also applies to undertakings having their registered office in another country, i.e. non-EEA Member States, and willing to conduct or offer such activities through a branch in Germany. This applies to Swiss banks operating in Germany.

However, an existing license granted by the home country, in this case Switzerland, can, subject to certain conditions, be recognised by BaFin and pursuant to section 2(5) KWG, BaFin may exempt individual companies not only from the authorisation requirement but also from the specific provisions of ongoing supervision under the KWG. Note that, the financial institution is eligible for this exemption only if, in the supervisor's opinion, it does not require supervision given the nature of its service offerings.

Currently, several Swiss financial institutions and credit institutions provide banking activities in Germany under the exemption option of section 2(5) KWG.

Since 2014, when Switzerland and Germany entered into a Memorandum of Understanding (MoU) covering procedural aspects for cross-border business in the financial industry, banks in Switzerland have been able to obtain this licensing exemption for their cross-border business into Germany also by way of the so-called Simplified Exemption Procedure (SEP), agreed upon in the MoU, which is available in addition to obtaining the exemption under the KWG described before. As a result, Swiss banks have been able to access the German market directly from Switzerland and to acquire new German clients, without needing to go through a German-licensed credit institution as intermediary.

In 2021, though, this access had been briefly interrupted due to certain open issues regarding the exemption procedure which the supervisory authorities in Germany and Switzerland were able to clarify in December 2021. BaFin thus now appears ready again to process applications for the exemption of banks in Switzerland in accordance with the procedure under section 2(5) KWG as well as the SEP.

As we have learned, reasons for the interruption were no issues related to Brexit but a controversy - now resolved – as to whether certain reporting requirements on which BaFin insists are provided for by section 271 of the Swiss Criminal Code (SCC). This problem meanwhile seems to be resolved as the competent Swiss authority (FINMA) has confirmed that the SCC reporting requirements have been accepted. It was also reported that the forthcoming amendments to CRD VI will currently not be taken into account in the current administrative procedure.

This paper provides an overview of the SEP and also seeks to analyse the implications of the newly proposed CRD VI.

B. Administrative Aspects

The SEP as provided by the MoU, is based on international law, but also has its foundation in the German law which are the following: (i) section 2(5) KWG as well as (ii) section 91 of the Securities Trading Act (Wertpapierhandelsgesetz – WpHG). Like section 2(5) KWG, section 91 WpHG also provides for an exemption from compliance with its provisions for an undertaking having its registered office in a third country and intending to provide investment services in Germany.

The procedure for the SEP is as follows:

- Under the SEP, a Swiss bank seeking an exemption needs to submit an application to BaFin.
- Further, the Swiss bank has to obtain an approval from FINMA before applying to BaFin. In this regard, FINMA must always issue a supervisory declaration (Aufsichtsbescheinigung) to BaFin attesting that the institution in question is a licensed bank permitted to provide the banking and financial services for which the exemption is sought.
- FINMA issues the aforesaid attestation only when certain requirements are met:
  - (i) The Swiss bank will need to perform and document a 'Risk Analysis' addressing the underlying risk and mitigating controls for the envisaged German cross-border business.
  - (ii) The statutory auditor of the Swiss bank has to assess the appropriateness of the 'Risk Analysis' and formally report to FINMA.
- The Swiss bank must also evidence appropriate mitigation of legal and reputational risks as well as observance with the requirements set out in the MoU and related documents.

C. Scope of the Exemption

One of the key questions for any bank seeking the exemption is whether the exemption pursuant to section 2(5) KWG does only exempt from the provisions listed therein or whether it also provides for far-reaching exemptions from other organisational provisions like section 91 WpHG, anti-money laundering laws, consumer protection laws, etc.

I. KWG

When MiFID II was implemented back in 2018, the issues surrounding the impact of MiFID II on the exemption procedure under the MoU went through several rounds of discussions and it was noted that MiFID II would bring stricter requirements given its focus on stringent consumer protection rules. In addition, section 2(5) KWG states that "*the Federal Financial Supervisory Authority may determine on a case-by-case basis that for an institution domiciled in a third country that intends to carry on banking business or provide financial services in Germany by way of cross-border provision of services on a commercial basis or to an extent that requires business operations to be conducted in a commercial manner, §§ 1a, 2c, 10 to 18, 24, 24a, 25, 25a to 25e, 26 to 38, 45, 46 to 46c and 51 paragraph 1 do not apply in their entirety as long as the institution does not additionally require supervision by the Federal Financial Supervisory Authority with respect to its business conducted in Germany due to its supervision by the competent authority in the home country. On the basis of an exemption pursuant to sentence 1, it may also determine that § 24c shall not apply to the institution either.*"

In light of the above, it is certain that under section 2(5) KWG, the Swiss banks under the SEP are only exempt from the provisions of KWG itself. Pursuant to existing laws, a positive decision under the SEP does not provide further reaching exemptions, i.e. exemption from German consumer protection laws.

II. WpHG

As already stated above, section 91 WpHG provides that an exemption relieves only from compliance with its provisions and does not have further reaching consequences either. The relevant text of section 91 WpHG states that "*Subject to the requirements of Title VIII of Regulation (EU) No. 600/2014, BaFin may determine in individual cases that section 63 (2), sections 72 to 78, 80 (1) to (6) and (9) to (13), sections 81, 84 to 87 (1) sentences 2 to 4 and subsections (3) to (8) of this Act are not applicable to an undertaking whose registered office is in a third country and which intends provide investment services in Germany under the freedom to provide cross-border services on a commercial basis or on a scale that requires commercially organised business operations, provided that the undertaking does not need to be supervised additionally by BaFin in respect of the investment services it provides in Germany because it is supervised by the competent authority in its home country. This exemption may be subject to conditions, in particular that the undertaking enables monitoring and review of compliance with the requirements that are equivalent to sections 6 to 15, 88 and 89*".

This implies that, like pursuant to the KWG, the Swiss banks under the SEP are only exempt from the provisions of the WpHG itself and that the legislation does not provide for exemption from other laws.

III. Money Laundering Act (Geldwäschegesetz – GwG)

Neither KWG or WpHG, nor the GwG itself provide for any kind of exemption with regard to requirements under the GwG. This seems to be a moot point, since formally, i.e. from a strict reading of the law, cross-border services do not trigger anti-money laundering (AML) requirements under the GwG as its obligations require a physical presence in Germany, c.f. section 2(1) GwG. However, BaFin requests Swiss banks, seeking to do cross-border business into Germany under an exemption, to comply with German AML rules. At this juncture it is interesting to note that a German public authority wants a specific legal set of rules to be applied without any legal basis per se. This notwithstanding, as a result, Swiss banks doing cross-border busines into Germany are required to comply with the German AML rules under the GwG as per BaFin's request.

The legal challenge to justify the resulting de facto extension of the application of the GwG solely on the basis of a supervisory authority decision still remains.

However, in the end, this question will most probably not come before the German administrative courts. Firstly, the relevant objections need to be brought as interim measures, since objections to BaFin's administrative orders have no suspensory effect and the Court's ruling in interim measures must not anticipate the final decision. In short, any dispute would be an uphill battle and – given the German business mantra in the financial services industry "Never mess with the regulator" – banks are not very keen on taking legal action against their regulators. Secondly, the matter would become obsolete with the passage of time, as we can see in sub E.

D. Reporting and Audit Requirements

Under the MoU, a Swiss bank applying for the exemption is required to perform and document a 'Risk Analysis' addressing the underlying risk and mitigating controls for the intended German cross-border business. In this regard, the statutory auditor of the Swiss bank has to assess the appropriateness of the 'Risk Analysis' and formally report to FINMA issuing the attestation which is then submitted to BaFin. The 'Risk Analysis' has to report, among other things:

- Current and future business strategy;
- Governance, internal control system;
- in the case of German client relationships, identification of cases where the customer's assets might derive from qualified tax offences under German criminal law.

Moreover, Swiss banks, as mentioned above, must comply with German consumer protection laws and AML regulations, compliance with which is subject to annual audits by a Swiss auditing firm. It is interesting to note that BaFin expects a foreign statutory auditor to audit and report on German law requirements.

E. CRD VI

Recently, the European Commission (COM) published its so-called Banking Package 2021 that includes proposals to amend the Capital Requirements

Directive (CRD) as well as the Capital Requirements Regulation (CRR) (hereinafter referred to as the "Proposal"). The Proposal deals primarily with the following three topics:

- Rules on the management and supervision of ESG;
- Harmonisation of certain supervisory powers;
- A new approach to the supervision of third country branches (Third Country Branch (TCB) Package).

The TCB Package will have far-reaching implications for the Swiss and the German banking sector. In particular, the TCB Package will require undertakings in third countries to set up a branch in a member state in the European Union (Member State) and seek authorisation under Title VI of the CRD for that branch as a condition prior to commencing any banking activities in that Member State. In essence, this will amount to a ban on cross-border banking services from third countries into the European Union (EU). It further means that the institutions currently holding an exemption from the licensing requirement according to § 2(5) KWG, might no longer be authorised to actively solicit or even provide services into Germany after implementation of the TCB Package.

I. Potential Changes

1. General

As mentioned before, the TCB Package seeks to stipulate that undertakings in third countries will be required to set up a branch in a Member State and to seek authorisation to conduct banking business in that Member State. This results in a ban on cross-border banking services from third countries into the EU. However, the TCB Package provides for an exemption from such requirement for those third-country undertakings that provide banking services for counterparties in a Member State only upon request of the customer, i.e. through reverse solicitation of services.

2. Exemption Procedure

Since the TCB Package does not provide for an exemption similar to what is provided under the KWG, section 2(5) KWG would no longer be compatible with European law and will therefore have to be repealed. As a result, and dependent on transitional provisions, institutions exempted under section 2(5) KWG (or its predecessor, section 2(4) KWG) might not enjoy grandfathering under German administrative or even constitutional law.

3. Simplified Exemption Procedure

As per the TCB Package, it is a condition for granting an authorisation that the authority (in this case BaFin) maintains a memorandum of understanding with the home state authorities (in this case Switzerland) that ensures the exchange of information. Even though there is already an MoU between Switzerland and Germany in place, a proposed new MoU requirement for the purposes of accessing information on TCBs may still create problems, because it remains open as to whether the existing MoU between Switzerland and Germany meets the requirements of the TCB Package. As a result, in case the existing MoU will not be sufficient pursuant to the TCB Package, then the said MoU, which is the basis for the SEP, may not be valid in future.

II. Results:

In Summary, there is a concern that the Swiss banks doing cross-border business into Germany, without licensed branch office in Germany, but under an exemption pursuant to section 2(5) KWG might have to establish a physical entity, i.e. a branch office, in Germany for continuing business with their customers in Germany - and would have to obtain a license for the same. As per the Proposal, existing TCBs will have a transitional period of 12 months following the 18-month transposition period of the TCB Package to obtain the authorisation. This will also enable the TCBs to spread out the transitional costs over the stipulated period of time.

F. Our Opinion

I. Reverse Solicitation

Under the newly proposed EU law, one viable solution for Swiss banks to continue providing banking services in Germany could be the provision of such services on a reverse solicitation basis only. For this, a more precise definition of 'reverse solicitation' would be helpful. The current Proposal does not stipulate any definition other than the rule - no authorisation is required when a retail client or a professional client in the EU approaches an undertaking in a third country exclusively on its own initiative for the provision of any service under the Proposal. This would mean that the respective Swiss bank will not be able to market any categories of products, activities or services other than those that the client had solicited. With such limitation, a Swiss bank would be able to continue banking operations to its existing customers within the existing scope.

II. Bilateral Agreement (New MoU)

Furthermore, another feasible solution for Swiss banks to continue providing banking services in Germany could be based on a potential new MoU to be entered between Germany and Switzerland which would follow the content of the current MoU and be in line with the TCB Package. It is interesting to note that this would put Switzerland and United Kingdom (UK) in a similar situation now that the UK is no longer bound by the EU law and future market access between the EU and the UK in the area of financial services remains for the most part unaddressed under the UK–EU Trade and Cooperation Agreement. In light of this, we believe that both Swiss and UK banks will now each pursue ambitious liberalisation and expansion of mutual market access in the area of banking and securities services based on the MoUs to be entered with the EU. It should be noted, however, that such exemption procedure – as provided for under a potential future MoU – would be in conflict with certain rules of secondary EU law which does not allow for such an exemption. That means, before any bilateral agreements are entered into in the future, there needs to be a change in secondary law.

III. Setting-up a Licensed Entity in Germany

If neither, reverse solicitation nor the new proposed MoU, are acceptable solutions for dealing with the changing regulatory landscape, the third option for any Swiss bank doing business in Germany would be to set-up a licensed entity in Germany. The requirements for this are currently regulated by German national law. However, the TCB Package will require a revision of those rules.

Note that, currently there are three modes available for Swiss banks to undertake business in Germany:

(i) setting-up a licensed corporation in Germany
(ii) setting-up a branch in Germany
(iii) setting up a licensed corporation in another Member State and use the EU passporting rules to provide cross-border services into Germany.

The most favourable option would have to be determined on a case-to-case basis.

IV. Further Developments

The TCB Package only provides for a minimum harmonisation, i.e. each Member State legislator is free to impose stricter rules upon implementation of the EU directives into national laws. This means that further legislative developments, not only at the EU, but also at national level, will have to be closely monitored with a keen eye on the transposition of the TCB Package into the German national law. This should not, however, prevent Swiss banks doing cross-border business into Germany on the basis of a section 2(5) KWG exemption to start immediately with their consideration and analysis as to how to continue their current activities in the German market, since we expect a major impact on these activities of the Swiss banking industry from the changing regulatory framework.

The most reasonable course, then, is to hope for the best and prepare for the worst AND make good use of the remaining time before the changes in law become effective.

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