BANKING, FINANCE AND CAPITAL MARKETS

German Risk Reduction Act New Licence Requirements for Financial Holding Companies and Intermediate EU-Parent Undertakings

On 29 July 2020, the German federal cabinet adopted the draft of a law implementing Directives (EU) 2019/878 and (EU) 2019/879 on the reduction of risks and the strengthening of proportionality in the banking sector (Risk Reduction Act – "**RiG**").

The RiG serves to implement the so-called EU Banking Package and is expected to come into force by the end of 2020. The EU Banking Package consists in particular of amendments to the following European legal acts: the Capital Requirements Regulation (in the new version "**CRR II**"[1]), the Capital Requirements Directive (in the new version "**CRD V**"[2]), the Bank Recovery and Resolution Directive ("**BRRD**"[3]), and the Single Resolution Mechanism Regulation ("**SRMR**"[4]).

The changes by the EU Banking Package are many and include, among other things, certain facilitations for small and non-complex institutions, exceptions for development banks (e.g. for Germany's development bank for agribusiness, *Landwirtschaftliche Rentenbank*, and the development institutions of the federal states), changes to capital adequacy requirements (e.g. exemption of certain software assets from the capital deduction obligation but additional capital deduction obligations for e.g. minimum payment commitments in pension schemes), a maximum leverage ratio, new regulations on the risk measurement of investment shares held in the banking book, and also changes to certain large exposure regulations.

In addition, the draft of the RiG contains new provisions on licence requirements for Financial Holding Companies and on the establishment and licensing of so-called Intermediate EU-Parent Undertakings, which are to be incorporated into the German Banking Act ("KWG-E"). These new provisions are the subject of this newsletter.

1. LICENCE REQUIREMENT FOR FINANCIAL HOLDING COMPANIES

With the new section 2f KWG-E, the RiG implements Article 21a of CRD V which was introduced by the EU Banking Package and – for the first time – also subjects financial holding companies and mixed financial holding companies to licence requirements and supervision by the Federal Financial Supervisory Authority ("**BaFin**"). The KWG does not (no longer) define to what companies exactly this provision applies. Instead, the KWG refers in section 1 (35) to definitions of the (directly applicable) CRR II which partly refer to further definitions of the CRR II, however partly also to other legal acts.

The chains of definitions are complex and their wording is not always clear. A clear distinction whether or not a holding is subject to licensing can therefore be difficult in some cases, which may raise the question of compliance with the constitutional requirement of certainty (Article 103 (2) of the German Basic Law (*GG*), *nulla poena sine lege*) in view of the threat of a fine in section 56 (2) No. 3a KWG-E.

"**Financial Holding Company**" means a holding company in the form of a financial institution, the subsidiaries of which are exclusively or mainly institutions or financial institutions (Article 4 1. (20) CRR II). "**Financial institution**" means an undertaking other than an institution[5] or a pure industrial holding company, the principal activity

[1] Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012.

[2] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures.

[3] Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC.

[4] Regulation (EU) 2019/877 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 806/2014 as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms.

[5] "**Institution**" means a credit institution or an investment firm (Article 4 1. (3) CRR II). "**Credit institution**" means an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account (Article 4 1. (1) CRR II). "**Investment firm**" means an investment firm as defined in point (1) of Article 4(1) of Directive 2004/39/EC ("**MiFID**", now 2014/65/EC), excluding credit institutions, *local firms* (definition please refer to Article 4 1. (4) CRR II) and certain other firms "*which are not permitted to hold money or securities belonging to their clients and which for that reason may not at any time place themselves in debt with those clients*" (for more details, see definition under Article 1 1. (2) CRR II).

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of which is to acquire holdings or to pursue certain financial activities[6] (Article 4 1. (26) CRR II). The term "**mainly**" means that at least one subsidiary of the holding company is an institution, and refers to a situation where more than 50 percent of the equity, consolidated assets, revenues, personnel of the financial institution (or another indicator deemed relevant by the competent authority) are associated with subsidiaries of the financial institutions that are institutions or financial institutions. Competent authority is – depending on whether it is a *significant* group[7] – the European Central Bank ("**ECB**") or BaFin.[8]

A "**mixed Financial Holding Company**" (illustration 1) means a holding company which together with its subsidiaries, at least one of which is a regulated entity which has its head office in the Community, and other entities, constitutes a financial conglomerate (Article 4 1. (21) CRR II in connection with point (15) of Article 2 of Directive 2002/87/EC[9]). A **financial conglomerate** has a regulated entity at the head of the group[10], or at least one of the subsidiaries in the group is a regulated entity. In addition, the group or subgroup must have at least one insurance company and one company in the banking or securities sector[11]. Finally, the activities of the insurance undertakings on the one hand and the banking and securities undertakings on the other hand must be *significant*[12] on a consolidated or aggregated basis.

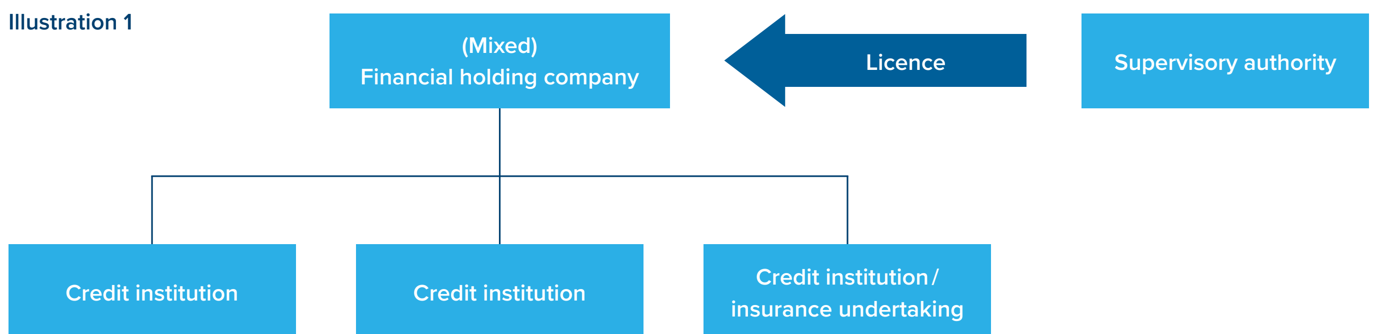
(Mixed) financial holding groups are, pursuant to the requirements of Article 11 et seq. CRR II, subject to consolidated supervision. This implies that the supervisory requirements are applied to the group as if it were a single entity. The consolidation requirement currently does not apply to the holding company itself, but to the subordinate institution with the largest balance sheet total.[13]

The new regulation is intended to make it possible to hold (mixed) Financial Holding Companies directly responsible for ensuring compliance with consolidated prudential requirements (cf. recital (3) of CRD V). For this purpose, section 2f KWG-E provides for a licence requirement for (mixed) Financial Holding Companies with their registered office in Germany and (mixed) EU parent Financial Holding Companies[14] that are part of a group that is supervised by the supervisory authority on a consolidated basis.

Competent authority is – depending on whether it is a *significant* group – the ECB or BaFin.[15] The requirements for the granting of a licence are stipulated in section 2f KWG-E. With the application, the Financial Holding Company must submit the following documents, among others:

- Group organisation chart showing all parent and subsidiary companies and information on the registered office and type of activity of each group company;
- Documents concerning the reliability and professional competence of managers;

Illustration 1



[5] "**Institution**" means a credit institution or an investment firm (Article 4 1. (3) CRR II). "**Credit institution**" means an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account (Article 4 1. (1) CRR II). "**Investment firm**" means an investment firm as defined in point (1) of Article 4(1) of Directive 2004/39/EC ("**MiFID**", now 2014/65/EC), excluding credit institutions, *local firms* (definition please refer to Article 4 1. (4) CRR II) and certain other firms "*which are not permitted to hold money or securities belonging to their clients and which for that reason may not at any time place themselves in debt with those clients*" (for more details, see definition under Article 1 1. (2) CRR II).

[6] i.e. to pursue one or more of the activities listed in points 2 to 12 and point 15 of Annex I to CDR V.

[7] The financial holding company and its subordinated companies are jointly referred to as the financial holding group (section 10a (1) sentence 1 KWG).

[8] Cf. section 6 KWG in connection with Article 6 (4) of the Council Regulation (EU) No. 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions dated 15 October 2013 ("**SSM Regulation**").

[9] Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council.

[10] See above footnote 7.

[11] Section 1 (2) of the German Supervisory Act for Financial Conglomerates (*Finanzkonglomerate-Aufsichtsgesetz*, "**FKAG**").

[12] Cf. section 8 FKAG regarding the threshold values.

[13] Article 11 2. subparagraph 2 CRR II in connection with Article 111 (4) of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC ("**CRD IV**").

[14] "**EU parent financial holding company**" means a parent financial holding company in a Member State which is not a subsidiary of an institution authorised in any Member State or of another financial holding company or mixed financial holding company set up in any Member State (Article 4 1. (31) of the Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 ("**CCR**". "**EU parent mixed financial holding company**" means a parent mixed financial holding company in a Member State which is not a subsidiary of an institution authorised in any Member State or of another financial holding company or mixed financial holding company set up in any Member State (Article 4 1. (33) CRR).

[15] Article 4 (1) lit g, in connection with Article 6 (4) SSM Regulation, in connection with section 6 KWG.

- If a credit institution is part of the group, also information on the holders of qualified participating interests (section 32 (1) sentence 2 no. 6 KWG);
- A meaningful presentation of the internal organisation and the allocation of responsibilities within the group.

The supervisory authority may request such further information as it deems necessary for the assessment of the application. The licence shall be granted if the documents do not indicate any obstacle to an effective supervision of the group on a consolidated basis (section 2f (4) KWG-E).

In the absence of the necessary licence, the Financial Holding Company's supervisory authority may, for example, prohibit the exercise of voting rights in institutions of the group or prohibit distributions to shareholders. Furthermore, the supervisory authority may temporarily designate another institution of the group as the parent company of the group which thereby becomes subject to the consolidated supervisory responsibilities.

The new regulation will become effective as of 28 December 2020. For already existing financial holding companies, the RiG provides for a transitional period until 28 June 2021 (see section 64a (1) KWG-E).

2. OBLIGATION TO ESTABLISH AN INTERMEDIATE EU-PARENT UNDERTAKING

Section 2g KWG-E provides more regulations for financial holding groups with links to third countries. The provision serves to implement Article 21b CRD V. If at least two institutions of the group with headquarters in a state of the European Economic Area ("**EEA**") have the same parent company with headquarters in a third country (i.e. outside the EEA), a so-called Intermediate EU-Parent Undertaking must be established (IPU).[16] This obligation applies to all groups whose total value of consolidated assets within the EEA reach a threshold of EUR 40 billion.

Pursuant to section 2g (3) KWG-E, banks and licensed Financial Holding Companies are eligible as Intermediate EU-Parent Undertakings. In exceptional cases, also investment firms may assume the role of an Intermediate EU-Parent Undertaking.[17] In that case, the Intermediate EU-Parent Undertaking requires a licence from the supervisory authority in accordance with section 2f KWG-E.

This new regulation primarily affects banking groups from the US or Asia that have subsidiaries in an EU member state. However, in the event of an **unregulated Brexit** – as seems to be underway – the new regulation will also cover groups whose parent companies are domiciled in the United Kingdom.

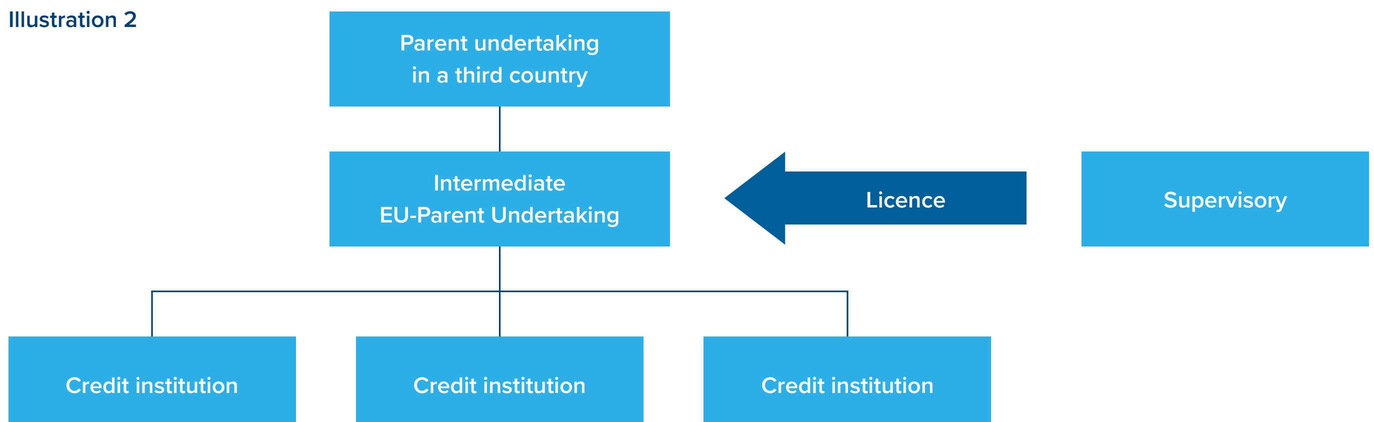
Groups whose total value of assets have already reached the threshold of EUR 40 billion on 27 June 2019 must establish an Intermediate EU-Parent Undertaking by 30 December 2023 (section 64a (2) KWG-E).

3. CONSEQUENCES FOR THE PRACTICE

Especially financial holding companies will have to carefully examine which new obligations arise for them due to the introduction of the RiG. Despite the transition periods, necessary implementation measures should be initiated soon. In particular, the establishment of Intermediate EU-Parent Undertakings will lead to structural changes in the group structure and pose organisational and technical challenges. And in view of the current COVID-19 pandemic and the Brexit underway, licence procedures are likely to take longer rather than shorter.

Appropriate measures should therefore be carefully prepared and initiated in good time.

Illustration 2



[16] Cf. section 2g KWG-E.
[17] Cf. section 2g (3) KWG-E.

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Imprint

This publication is issued by
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Ganghoferstrasse 33 | D-80339 Munich
Registered under HR B 155350 at the Regional Court Munich/VAT Reg. No.: DE811218811

For more information see:
https://www.beiten-burkhardt.com/en/imprint

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