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A Review of the UK and EU Approaches to Third Country Branches and Subsidiarisation

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1. Background

Financial centres around the world have been hosts to branches and representative offices of international banks since as early as the 19th century. The term "branch" refers to a local establishment of a foreign financial institution, such as a bank. They are typically subject to local authorisation requirements. Branches have no separate legal personality from their parent entity. They are also financially integrated from the parent entity, meaning that a branch does not need to have its own balance sheet and typically will not have separate capital requirements. However, certain jurisdictions require foreign banks to establish local subsidiaries, which do have their own legal personality. As such, they do not directly benefit from the balance sheet of their parent entity and are subject to more stringent governance requirements including requiring local boards.

Regulators and legislators have long been grappling with the merits of permitting foreign branches as against requiring subsidiarisation. The UK has traditionally been open to hosting branches of international banks. The Prudential Regulation Authority (PRA) has bespoke rules regulating such branches, and has published a supervisory statement on its approach to authorisation and regulation of them (the PRA Supervisory Statement). The Financial Conduct Authority (FCA) has also published a document setting out its approach to international firms more broadly.

However, events such as the failure of the California-based Silicon Valley Bank (SVB) and the subsequent transfer of Silicon Valley Bank UK (the UK subsidiary) to HSBC have provided direct evidence of the benefits of subsidiarisation for the integrity of the UK's financial system, promoting a rethink as to whether subsidiarisation is the preferred approach. See our March 13, 2023 alert "Bank of England Resolves Silicon Valley Bank UK Through Sale to HSBC."

To this end, the SVB transfer was followed by reports that the Bank of England (BoE) and PRA are considering forcing foreign banks to replace their branches with subsidiaries. In July 2024, the PRA published a consultation paper setting out proposed targeted amendments to the PRA Supervisory Statement, which included the introduction of some additional indicative criteria that the PRA would consider when determining whether it would be appropriate for an international bank to operate in the UK as a branch rather than a subsidiary.

The consultation closed on 30 October 2024, but the PRA has not yet published its response. Nonetheless, it seems likely that this consultation is the current extent of the PRA's movement towards preferring subsidiarisation, and a ban on branches is unlikely at this stage. This seems like a sensible approach because, whilst subsidiaries provide certain benefits in terms of financial stability, an outright ban on branches would significantly undercut the PRA's new secondary statutory objective of international competitiveness and growth.

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Meanwhile, in the EU, as of November 2024 member states host 95 third country branches collectively. In recent years the EU has been considering and refining its rules relating to local establishments of international banks. As part of the banking package implementing the final Basel 3.1 standards, there will also be new rules which harmonise the authorisation and supervisory requirements for third country branches, which so far have been subject to disparate national requirements of varying levels of prudence and scope.

In this article, we compare the UK's approach to regulating third country bank branches and subsidiaries with the requirements being implemented in the EU, and the implications this has for banks looking to establish and provide services in these jurisdictions.

2. The UK's Approach to Third Country Branches

Requirements for Authorisation

As regards bank branches, UK authorisation requirements apply where deposits are accepted or when investment services are provided "in the UK". The Financial Services and Markets Act 2000 does not provide further detail on when services are deemed to be provided "in the UK", but generally a bank accepting deposits or providing investment services out of a UK office would be *de facto* in-scope and therefore require UK authorisation. As discussed above, international banks have the option to apply for such authorisation either as a branch or via a stand-alone subsidiary.

The PRA Supervisory Statement sets out a hierarchy of requirements in respect of its expectations for effective supervision of authorised branches and subsidiaries of international banks.

Authorisation Regime for Branches

Generally, the PRA expects international banks operating via branches to focus primarily on wholesale banking activities. It employs a tailored regulatory approach which recognises that, while PRA authorisation covers the whole entity, it is suitable to rely on the supervisor from the home state for certain supervisory functions.[1] As a result, the PRA's demands for information relevant to its statutory objectives will vary depending on the context and the home jurisdiction supervisor.

In order to obtain branch authorisation, international banks need to meet PRA expectations regarding:

- **Supervisory equivalence.** This includes an assessment of the home jurisdiction's prudential supervision regime, taking into account its (i) regulatory framework, (ii) powers, (iii) general approach to supervision of individual firms and consolidated groups, (iv) information sharing with the PRA, (v) confidentiality, and (vi) the competence and independence of supervision. The PRA will make an assessment of whether a home jurisdiction supervisor is sufficiently equivalent and whether its regime is consistent with the UK regulatory framework in delivering appropriate outcomes in light of the PRA's statutory objective, and these assessments are reviewed periodically by the PRA.
- **Supervisory cooperation.** This is typically underpinned by the PRA entering into a memorandum of understanding with the relevant home jurisdiction supervisory authority. The degree of cooperation expected will be commensurate with the size of the firm, the degree of cross-border integration and the systemic nature of any wholesale branches operating in the UK.
- **The efficacy of arrangements for resolution.** This includes an assessment of the credibility and practicability of the home jurisdiction's approach to resolvability and execution of resolution, in line with the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions. The home resolution authority's readiness to share resolution plans with the PRA is also a key factor.

Any branch or purported branch which conducts "material retail activity" or "systemically important wholesale activity" would not be eligible for branch authorisation, and would be required to subsidiarise in order to provide (or to continue to provide) banking services in the UK. Broadly, these are defined as:

- **Material retail activity.** Given their pronounced impact on financial stability, foreign banks which carry out "material" amounts of retail business are usually required to establish subsidiaries in the UK instead of operating via a UK branch, further isolating UK retail operations from international risks. In practice, this means activity consisting of (i) more than £100 million in Financial Services Compensation Scheme (FSCS)-eligible deposits from retail and SME customers in the aggregate, (ii) over 5,000 retail and SME customers, (iii) total potential liability to FSCS for covered deposits in excess of £500 million, or (iv) planned growth which falls outside of the PRA's risk appetite.
- **Systemically important wholesale activity.** Factors to be considered include (i) wholesale assets in excess of £15 billion including those traded or originated in the UK but remotely booked to another location, (ii) any critical functions the branch undertakes in the UK, and (iii) overall complexity and inter-connectedness of the business undertaken. Where the branch is deemed to be systemically important, the PRA may be provided sufficient assurance over its supervisability by reference to the factors listed above, being higher degree of supervisory equivalence and cooperation, and greater assurance over resolution arrangements.

[1] Notably, UK authorisation for a branch (whether by the PRA or FCA) covers the activities of the firm as a whole. It is therefore able to provide services to UK customers from its parent entity and its branches, provided that such services are in-scope of UK regulation in most circumstances.

In addition, the PRA places particular emphasis on effective supervision (discussed further below). It is one of the threshold conditions to authorisation and an issue that is particularly pronounced for international banks which have global business models, global booking models and, accordingly, dependencies and decision-makers which are international in nature and consequentially pose particular issues from a supervision perspective. The home jurisdiction regulatory regime of a branch is required to have outcomes-based equivalence with the UK regime. There must also be effective supervisory cooperation and assurance over resolution arrangements.

Effective Supervision

In assessing effective supervision, the PRA will consider the following factors on an on-going basis:

- **The PRA must receive ample cooperation** along with comprehensive financial and regulatory insights into the firm's associated international risks and fiscal standing from both its group or head office and pertinent foreign regulatory bodies.
- The banking group with which the entity is affiliated must possess both the **capability and intent to support** its UK presence.
- When the entity's governance structure includes individuals holding positions within the broader banking group, such governance must prove **effective in addressing the entity's UK-specific risks**. Conversely, when governance is exercised by individuals solely dedicated to the entity, these individuals must wield significant influence within the overarching broader international banking group.
- **Booking arrangements** must be clear, transparent and effective, and the firm must appropriately manage risks that it originates, receives and transfers out to affiliates.
- **Operational resilience** measures implemented alongside other group entities must be adequate. For branches, the PRA will evaluate the robustness of the home country's operational resilience framework against UK standards, including the adoption of the Basel Principles on Operational Resilience and the entity's adherence to its domestic regime. The PRA will also seek assurance that operational disruptions at the group level do not pose excessive risk to the overall group, thereby affecting UK operations.
- There must exist a **plausible group resolution strategy** or plans for either supporting or orderly winding down of the entity, aligning with the Bank of England's resolution objectives.
- When the group operates on a large scale in the UK, with both a branch and subsidiary deemed systemically important, the PRA typically anticipates separate governance for each to prevent conflicts in risk booking. However, a comprehensive understanding of UK risks may take precedence in such scenarios.

3. The UK's Approach to Subsidiarisation

International banks which do not meet the requirements for a branch, either due to issues involving effective supervision or due to being above the quantitative or qualitative thresholds set out above, would be required to establish a subsidiary to provide banking services in the UK.

For subsidiaries of these international banks, the PRA applies a supervisory approach similar to that for UK domestic banks, with adjustments for the international context. The PRA must still consider the connections between the subsidiary and its broader corporate group. However, when this group operates primarily outside the UK, the PRA generally possesses limited insight into the group's risk profile.

Key aspects of the supervisory regime for subsidiaries include:

- **Capital and liquidity requirements:** Subsidiaries are subject to UK-specific capital and liquidity requirements. The PRA expects these entities to be self-sufficient in terms of capital and liquidity, without relying on support of their parent entity.
- **Governance:** The PRA requires subsidiaries to have independent governance structures appropriate to their size, nature, and complexity. This includes having a local board of directors, robust risk management processes and effective internal control mechanisms.
- **Risk management:** The UK subsidiary must establish and maintain risk management policies, including risk assessment procedures, that identify risks in its operations and set its risk tolerance. Furthermore, when group risk decisions could affect the UK entity, incorporating the views of local representatives is critical.
- **Operational resilience:** Subsidiaries must meet the PRA's operational resilience rules so as to withstand disruptions, with clear plans for maintaining critical functions.

The PRA expects that UK subsidiaries within international banking groups should aim to be structural profitability on their own (or to be integral to the group's overall financial health). These subsidiaries should not function merely as cost centres relying on regular capital influxes from the parent entity to offset ongoing expenses. They must instead have the capability to generate at least a portion of their own capital (or contribute to the capital generation of the wider group), ensuring that the day-to-day operational costs are met through generated revenues (which might stem from service fees charged to other group entities or through internal pricing and funding strategies). The PRA may also require firms to demonstrate that they can, if required, count on financial support from their parent company and that there is a definitive strategy in place for providing this support.

Ring-fencing

The PRA places greater expectations for banks with retail banking operations, and this would extend to any subsidiaries established by international banks. Any banks (which would include international bank subsidiaries) with retail banking activity above certain thresholds are subject to the UK's ring-fencing regime, which broadly provides that the legal entity within a banking group that provides core retail activities cannot also provide other activities such as investment and international banking. The regime effectively insulates a bank's essential banking services — like deposits, payments and lending to individuals and small businesses — from potential losses incurred by their investment and international banking operations. This separation is typically achieved by transferring the retail operations into a distinct entity within the banking group, subject to its own set of capital and liquidity requirements to safeguard its stability and resilience.

For activities below the ring-fencing thresholds, the PRA does not particularly seek greater separation of retail operations. However, it does anticipate more detailed disclosures regarding financial and operational interdependencies (including cross-subsidisation) between the retail segment and wholesale activities, whether occurring within the same entity or across affiliated group companies.

4. The EU's Approach to Third Country Branches and Subsidiaries

Under the current regulatory regime in Europe established by the Capital Requirements Directive (CRD), deposit-taking activities carried out within EU territories are subject to authorisation requirements. The CRD is silent on the point of cross-border services, leaving some scope for providing services on a cross-border basis, at the discretion of individual EU member states. EU member states also have broad discretion in establishing rules for authorisation and supervision of third country bank branches (*i.e.*, branches of institutions with their registered seat outside of the EU), subject to the principle that they do not treat third country bank branches more favourably than EU credit institutions.

In December 2023, the EU published its near-final banking package, which includes an amending directive making significant amendments to CRD (CRD VI), inter alia, introducing new EU-specific requirements which harmonise the provision of "core banking services", the exemptions to the provision of these, minimum authorisation requirements for third country branches and a new power to require subsidiarisation.

Requirements and Exemptions to Authorisation

"Core banking services" are defined in Article 21c of CRD VI as:

- Accepting deposits and other repayable funds.
- Lending, which encompasses consumer credit, credit agreements for real estate, factoring (with or without recourse), and financing commercial transactions (including forfeiting).
- Offering guarantees and commitments.

Initially, the Commission's draft for CRD VI suggested a comprehensive prohibition on cross-border services, covering a wide range of activities detailed in CRD's annex, such as leasing, payment services, e-money services and even some investment services. However, in the final iteration of Article 21c of CRD VI, these are no longer included.

Crucially, CRD VI will harmonise exemptions available for core banking services provided in the EU. These exemptions include:

- Interbank services, or services provided to another credit institution.
- Intragroup services.
- Reverse solicitation, with its parameters "codified" in Article 21c and closely reflecting those established under Markets in Financial Instruments Directive II (MiFID II).
- Services ancillary to core MiFID II services and activities. For example, related deposit-taking and the granting of credit or loans, are also excluded.

The proposed legislation also includes a grandfathering clause for "existing contracts" to protect the rights of clients already acquired. This implies that contracts initiated six months or more prior to the conclusion of the transitional relief period, expected around the third or fourth quarter of 2025, can still be serviced cross-border without the obligation to establish a branch.

Authorisation Regime for Branches

Under CRD VI, third country branches will be categorised into three distinct tiers:

- **Qualifying third country branches:** those whose home jurisdiction having been assessed as having a regulatory regime and supervision equivalent to that under CRD (as amended by CRD VI), and not being a high-risk jurisdiction for anti-money-laundering purposes.
- **Class 1 branches:** those with locally booked assets exceeding €5 billion in the previous year, accepting retail deposits constituting at least 5% of total liabilities, having retail deposits surpassing €50 million or that are not qualifying third country branches.
- **Class 2 branches:** qualifying third country branches that do not meet the thresholds to be classified as Class 1. These face less stringent regulatory demands.

Third country branches will have an authorisation that is limited to activities permissible in the bank's non-EU home country and subject to its supervision. They will also be subject to new

minimum authorisation requirements, which include cooperation and information-sharing obligations for their home state regulator, minimum capital requirements, liquidity stipulations and internal governance and risk control requirements.

CRD VI further enables member states to enact stricter regulations on third country branches or subject them to the same standards as domestic credit institutions. If a member state has previously granted more lenient conditions to third country branches, these provisions may have to be realigned to meet CRD VI's fundamental requirements.

Also, third country branches will not be able to passport their services into other EU member states (except for intragroup funding transactions concluded with other third country branches of the same entity and for transactions based on reverse solicitation). Therefore, a third country entity looking to provide services in multiple EU member states would be required to obtain branch authorisation in each for the respective member states (or choose the route of subsidiarisation).

Notably, third country branches will remain within the purview of the national competent authority (NCA) of each EU member state in which they operate, and will not be subject to direct supervision by the European Banking Authority (EBA).

The EU's Approach to Subsidiarisation

Under the new powers introduced by CRD VI, third country branches that are part of a larger banking group may be subject to subsidiarisation requirements, in cases where:

- The third country branch has breached regulatory requirements on carrying on cross-border business in other EU member states (*e.g.*, on the basis of active solicitation or outside of the exemptions set out above).
- The third country branch has total aggregate assets in the same non-EU member group of over €40 billion, or the assets booked to the branch exceed €10 billion.
- The third country branch meets certain systemic risk indicators set out in CRD VI and poses a risk to the financial stability of the host member state or the EU generally.

CRD VI empowers EU member states to force the subsidiarisation of these third country branches. However, this process would not be unilateral; it will require prior consultation with the EBA and supervisory bodies from the branch's home jurisdiction.

Any such subsidiarisation would be considered if a third country branch meets specific criteria suggesting a significant footprint in the financial landscape. For instance, if the collective assets of third country branches within a banking group reach €40 billion, or if the assets held by a single branch within an EU member state amount to €10 billion or more, regulatory intervention may be triggered.

5. Conclusion

The regulatory regimes governing third country bank branches and subsidiaries in both the UK and EU continue to be subject to significant evolution in response to the challenges posed by Brexit and broader global financial stability concerns.

While the UK continues to maintain a relatively open approach to hosting international bank branches, recent events, such as the SVB collapse, have prompted regulators to rethink the balance of benefits between bank branches and subsidiaries. The PRA's ongoing consultations signal a cautious shift towards stricter oversight of third country bank establishments.

In the EU, the developments under CRD VI represent a move toward greater rigor and harmonisation between member states in the regulation of bank branches. By introducing uniform standards and granting NCAs the power to require subsidiarisation under specific circumstances, the EU aims to promote financial stability across member states while addressing system risks more effectively.

The ongoing developments to both of the UK and EU frameworks reflect the growing emphasis on operational resilience, effective supervision and clear accountability. However, they also highlight the difficulty of aligning these objectives with market accessibility and international competitiveness. Financial institutions must navigate these requirements carefully, and be prepared for increased scrutiny.