

## Accessing the German Market

A briefing for third country credit and financial services institutions

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## Introduction

This briefing describes the possibilities for third country credit and financial services institutions which do not benefit from EU passporting rights to access the German market. (Payment services institutions are subject to similar regulations, however, they are not covered by this briefing.) In case of a so-called hard Brexit, it is not unlikely that the United Kingdom would qualify as a third country and, consequently, also UK-based credit / financial services institutions will be treated as any other third country companies.

Generally, third country entities wishing to offer banking or financial services and do not benefit from EU passporting rights, require a license from the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – **BaFin**) pursuant to sec. 32 KWG of the German Banking Act (**Kreditwesengesetz – KWG**) unless they can rely on an exemption or reverse solicitation rules.

In principle, there are the following modes of access to the German market:

1. establishing a new subsidiary and applying for a license;
2. acquiring an existing German credit / financial services institution already holding a license;
3. establishing a branch;
4. transforming an EU-branch into a third country branch or a subsidiary (in case of UK-based credit and financial services institutions);
5. applying for an exemption pursuant to sec. 2 para. 5 KWG;
6. providing cross-border services relying on reverse solicitation rules;
7. making use of tied agent rules (only applicable with respect to investment broking, placement business or investment advice.)



### 1. Establishing a subsidiary and applying for a license

One option to conduct financial services and banking business in Germany is to set up a subsidiary (e.g. a stock corporation (*Aktiengesellschaft*) or limited liability company (*GmbH*)) in Germany. This new entity has to apply for a license according to sec. 32 KWG (in conjunction with sec. 33 and sec 1 para. 1 for credit institutions and in conjunction with sec. 33 and 1 para. 1a for financial services institutions) to obtain access to the German market. Pursuant to sec. 32 para. 1 KWG, a BaFin license is required for "*anyone wishing to **conduct banking business or to provide financial services in Germany commercially or on a scale which requires commercially organised business operations (...)***".

For a successful application the certain regulatory requirements have to be fulfilled. The most important requirements are:

- (i) evidence that sufficient regulatory capital is available required for business operations as described in the business plan (the minimum amount depends on the respective license applied for; a CCR-credit institution needs a minimum capital in the amount of € 5 million.);
- (ii) submission of a viable business plan including inter alia (a) a description of the business, (b) organisational structure, (c) risk management, (d) planned internal control procedures, (e) staffing and (f) technical infrastructure;
- (iii) submission of details of the management board; at least two managing directors are required, who are professionally qualified with adequate theoretical and practical knowledge of the respective business, managerial experience, trustworthiness and sufficient time to perform their duties (fit and proper test);
- (iv) provision of details concerning the supervisory board, if any with respect to their trustworthiness, expertise and sufficient time to perform their duties;
- (v) the names of the holders of qualified holdings with the amount, trustworthiness, annual accounts for the last three financial years, structure of group and the consolidated accounts for the last three financial years.

It would exceed the given framework to elaborate on all of the license requirements according to sec. 32 para. 1 KWG, but the following essentials shall be emphasised. The required capital for newly founded companies is to be calculated on the basis of projected business figures. It must be comprehensible for BaFin / Bundesbank on which assumptions the budgeted balance sheets are based in detail. German calculation methods have to be taken into account, which may in some cases deviate from international / UK methods. In the case, that parts of the existing business shall be transferred to a new subsidiary, this would trigger capital requirements that go far beyond the legally required initial capital. The requirement of a viable business plan also comprises, whether the previous business model is modified. The requirements according to sec. 32, 33 KWG are described in detail by BaFin (Checklist "Authorisation as a credit institution", 16 November 2017).

According to sec. 25a KWG, a subsidiary (as well as a branch, cf. below) has to meet certain minimum standards with regard to risk management. The risk management design must reflect the scope and complexity of the intended business model in Germany. Although dual hatting and outsourcing are a legitimate ways to structure a business model, empty shells or letterboxes are not tolerated by BaFin or Bundesbank. Any cross-border outsourcing must ensure that the outsourcing of functions and/or activities does not impair the supervision rights of BaFin. As a consequence, any outsourcing agreement has to ensure that BaFin has access to the outsourcing company in the foreign jurisdiction. With respect to dual hatting it is important to comply with sec. 25c KWG requiring that members of the management board dedicate sufficient time to their management tasks.

BaFin and Bundesbank are responsible for the application process, but if a license for a CRR credit institution according to Art. 4 para. 1 CRR is requested, the authorization procedure takes place together with the ECB. Pursuant to sec. 33 para. 1 sent. 1 no. 8 KWG the competent supervisory authority of the foreign the parent company must also consent to the establishment of a German subsidiary.

The presumed duration of the licensing procedure shall not be longer than six month pursuant to sec. 33 para. 4 KWG. However, the processing time does not begin until all relevant documents have been submitted completely.

Of course an authorised German credit / financial services institution would be able to operate from Germany with the EU passport, reaching for customers in other EEA states.

## 2. Acquisition of an existing credit / financial services institution

The acquisition of an existing German credit / financial services institution, already holding a license pursuant to sec. 32 KWG is another possibility to access the German market. In that case an ownership control procedure pursuant to sec. 2c KWG would have to be complied with. Anyone who intends to acquire a significant holding in an institution, either alone or in concert with other persons or undertakings (proposed acquirer), has to notify BaFin and the Deutsche Bundesbank without delay.

The notification requirements include information and documents as listed in sec. 8 to 16 of the German Ownership Control Regulation (*Inhaberkontrollverordnung – InhKontrollV*). The acquirer has to provide the following information and documents:

- (i) general documents and declarations on the acquirer (i.e. with regard to its identity and existence);
- (ii) declaration and documents on reputation;
- (iii) curriculum vitae of owners and directors;
- (iv) information on participatory relationships, group memberships and other opportunities for influence with respect to the acquirer;
- (v) a description of its financial and other interests in the holding;
- (vi) its financial position and credit quality;
- (vii) evidence of the existence and economic origin of the funds used for the acquisition and
- (viii) a business plan and strategic objective of the intended acquisition.

BaFin, Bundesbank and - in case of a CRR credit institution - the ECB are the competent authorities in this matter.

Because of the burdensome regulatory requirements according to sec. 2c KWG, which are comparable with the application process according to sec. 32 KWG and the need for due diligence an acquisition of a credit / financial services institution does not necessarily offer an advantage from a time to market perspective.

## 3. Establishing a branch

Establishing a branch pursuant to sec. 53 para. 1 sent. 1 KWG in conjunction with sec. 53c KWG is another option to access the German market. A domestic branch of a credit / financial services institution domiciled in a third country shall be deemed as a credit or financial services institution. In order to set-up a third party branch in Germany, in principle, the same requirements have to be met which a subsidiary has to fulfil in order to obtain a license according to sec. 32 KWG (cf. above). In particular, the capital, which is to be provided by the head office, corresponds to the initial capital of legally independent institutions, for which the necessary amount is determined by sec. 33 para. 1 sent. 1 no. 1 KWG. Besides the capital requirement a third country branch needs sufficient substance locally. The application has to include sufficient information to assess whether or not the branch is structured in a way to support the size and complexity of the intended business. Empty shells or letterboxes will not be tolerated by BaFin.

## 4. Transformation of an EU-branch into a third country branch or a subsidiary

The transformation of an already existing EU-branch into a third country branch is an option for some UK institutions that have so far conducted business via branches in accordance with sec. 53b

KWG. For this purpose, BaFin has declared that it will in fact examine applications from UK institutions with regard to the establishment of a branch office already now (although the UK does not qualify as a third country now), while it will only grant the license when the UK has become a third state (BaFin, Brexit: FAQs for banks and financial services institutions, updated on 24 March 2017, question 19). The previous business would be assigned to the new branch and a transfer of the business assets would be required.

By assessing the requirements, the management experience of the former director of the EU-branch according to sec. 53b will not correspond reflexively to the management experience required under sec. 25c para. 1 sent. 2 KWG. Not only does this aspect depend on whether the business of the new branch will be considerably more extensive or complex, but also possibly intended or required insourcing of activities and processes, which previously could be outsourced, may influence the regulatory assessment of professional management competences.

Should there have been a branch according sec. 53b KWG, which shall be utilised as a starting point for establishing a new subsidiary, the information on the business organization, risk management, internal control procedures and personnel and technical equipment has to take into account the fact that the new licensee must meet certain minimum regulatory requirements that the previous branch probably does not fulfil.

Converting an already existing branch should be accomplished more quickly than setting up a new branch or subsidiary, given that BaFin is familiar with the main features of the business model, but the progress could also be prolonged if the future business would be considerably more extensive or complex than the existing business (BaFin, Brexit: FAQs for banks and financial services institutions, updated on 24 March 2017, question 4).

## 5. Cross-border services based on reverse solicitation

A license according to sec. 32 KWG is also required in order to provide cross-border services when the German market is being targeted.

No license is required in cases of reverse solicitation. This principle, confirmed by EuGH (e.g. ruling dated 15 March 1994, Rs. C - 45/93), is the right of domiciled persons and companies to inquire on their own initiative services of a foreign supplier. The concept of reverse solicitation permits a credit / financial services institution to provide cross-border services into a particular Member State where that firm has not actively marketed and clients initiate contact with the credit / financial services institution. Reverse solicitation rules are implemented in Art. 42 MiFID II, which permits a third country firm to provide investment services and activities to clients on the exclusive initiative of that client, without requiring authorisation or registration in the EU.

BaFin had already implemented the principle of "reverse solicitation" in its administrative practice. In its note regarding the licensing for conducting cross-border banking business and/or providing cross-border financial services, dated 1 April 2005 (*BaFin Merkblatt – grenzüberschreitend betriebene Bankgeschäfte/Finanzdienstleistungen*), BaFin provides the following guidance: According to BaFin it must generally be assumed that a license is required pursuant to sec. 32 para. 1 KWG, if a foreign company intends to target the market in Germany for the purpose of repeatedly offering the banking transactions listed in sec. 1 para. 1 sent. 2 KWG and/or the financial services listed in sec. 1 para. 1a sent. 2 KWG on a commercial basis to companies and/or persons that have their registered offices or ordinary residence in Germany.

A foreign entity has to have a license in cases in which a foreign

entity acquires new clients in Germany for the banking and/or financial services it offers by making targeted visits to potential clients. If, on the other hand, such visits are made at the client's request, which is often the case, particularly with institutional investors, they would be covered by the reverse solicitation exemption discussed above. If the provision of services to the client has initially commenced at the client's request (and the reverse solicitation exemption therefore applies to the provision of that particular service), the service provider is entitled to continue to inform the client about its services whether or not separately requested by the client. This includes visits to clients (fly-in) as well as mail/fax/email/telephone calls. If potential clients domiciled in Germany are approached by foreign entities by direct mail, fax or email for the purpose of offering banking and/or financial services, the foreign entity requires a license, whereas some specific limitations apply to this rule.

It is expected that BaFin will issue an updated guidance note on reverse solicitation rules.

## 6. Exemptions according to sec. 2 para. 5 KWG

Under German law an exemption from the license requirement of sec. 32 KWG is possible. Pursuant to sec. 2 para. 5 KWG, BaFin can grant an exemption if it holds that there is no need for supervision. This requires that the foreign applicant is effectively supervised in its home jurisdiction by the competent foreign supervisory authority according to international accepted standards. Furthermore, the competent foreign supervisory authority cooperates with BaFin effectively.

With respect to financial services institutions qualifying as investment firms sec. 2 para. 5 KWG promulgates that the priority of ESMA registration pursuant to Art. 46 para. 1 and 47 para. 1 MiFIR has to be taken into account. This means that BaFin can only decide on an exemption in case ESMA has not decided on equivalence yet. Since the CRR does not contain similar equivalence rules an analogy could not be drawn with respect to credit institutions. Whether or not exemptions will be granted to UK credit / financial services institutions is an open question. It will depend on the decision of the UK whether or not to replace the

EU regulatory regime with a deviating national regulatory regime.

## 7. Tied agents (liability umbrella)

Third country financial services institutions which only intend to provide investment broking, placement business and/or investment advice in the German market may consider to act as a so-called tied agent.

According to sec. 2 para. 10 KWG, tied agents themselves are not considered as financial services institutions and thus do not require a license in accordance with sec. 32 KWG. A permission according to sec. 34f of the Commercial Trade Regulation Act (*Gewerbeordnung* – **GewO**) is also unnecessary, because the liability umbrella fully assumes the liability. Thus, the consumer is protected against possible financial damages, which arise due to the activity of the traders (sec. 34f para. 3 GewO). BaFin maintains a public register in which the tied agents are designated as such as soon as the notification has been made. However, tied agents are subject to sec. 14 and 35 GewO. This means that they have to report their business to the responsible trade supervisory board. If the trader is unreliable, the responsible trade supervisory board may, in whole or in part, prohibit the tied agent from the exercise of the business.

In order to become a tied agent a foreign entity would have to set up a subsidiary in Germany (e.g. a GmbH) and find a German credit / financial services institution and contractually agree to work solely for the account and under the liability of such credit / financial institution. In the German market such solutions are often used as an interim solution which allows an entity to start its business almost immediately and apply for a license later. With respect to a third country financial services institution acting as a tied agent could be a first step to enter the German market and establish a physical presence in a cost effective way.

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