

# Brexit preparedness for financial services: the German response

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The House of Commons recently rejected the Withdrawal Agreement. While the UK Parliament is still debating how to leave the EU, a hard Brexit remains an option. To prepare for this possibility, the UK, EU Commission and EU27 have taken measures to minimize disruption in various areas. The need for regulatory changes depends on whether the UK will leave with or without a deal. In the event of a no deal, the German Government recently proposed a Draft German Brexit Act which aims to uphold certain aspects of the current passporting regime for UK financial service providers post 29 March 2019.

## Deal Scenario

The current draft of the Withdrawal Agreement (WA) sets out arrangements for the UK's departure from the EU and Euratom. While it contains numerous provisions on a wide range of issues, financial services are not specifically addressed. Still, Part IV of the WA is of great importance for this sector. Firstly, it provides that there shall be a transition period running from Brexit day until 31 December 2020 (Article 126 WA). Secondly, during this period EU law and its acquis shall continue to apply to the UK as if it were a Member State (Article 127(1) WA). Lastly, the Joint Committee may extend the transition period by adopting a single decision (Article 132(1) WA). So, the WA would secure the continuation of the status quo in relation to financial services during the transition period, including the EU passporting regime.

## From passporting to partial equivalence after the transition period

The EU passporting regime grants Member State financial service providers unrestricted rights to offer financial services throughout the EU under the license granted by their home country and under the supervision of their home country supervisory authority. Due to the EU law principle of mutual recognition and harmonized market access, there is no need to open a local subsidiary and have it licensed in order to provide services in another Member State.

Once the transition period has ended, the UK would become a third country. UK financial institutions would lose their automatic passporting rights, and hence their market access to the EU and *vice versa*. To prepare for this change, the EU and the UK have opted for the regime of equivalence in the draft political declaration on the framework for the future relationship (Point 38 of the Future Framework). This would enable the EU Commission to recognize the UK regulatory and supervisory rules as equivalent to the corresponding EU rules. The EU Commission would have to verify that the UK has legally binding requirements, ensures effective supervision and achieves the same results as required by EU rules. The equivalence assessment would start following Brexit day and be concluded by June 2020.

The benefits reaped from the equivalence regime will probably be far less attractive than those under the automatic passporting regime. Equivalence decisions can only be taken in the areas where it is explicitly provided for under EU legislation. For example, equivalence is not provided for under CRD IV, which means

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that UK banks can only offer services in Member States in which they are licensed. Other legislative acts include a third-country equivalence regime limited to specific areas, such as MiFID II/MiFIR in relation to investment services. Furthermore, equivalence may only be granted partially, for a limited period, or only to a limited number of a non-UK country's supervisory authorities. Hence, UK financial service providers would potentially gain only restricted market access in limited areas, which could be revoked at a moment's notice. This is why the UK's 'Chequers plan' (a UK Government white paper on Brexit published in July 2018) proposed to introduce a regime of "enhanced" equivalence. However, the Future Framework agreed so far falls short thereof.

Similar to the UK's notion of "enhanced" equivalence, the Association of German Banks (*Bundesverband der deutschen Banken e. V.*) has issued a proposal to revise the equivalence regime so that decisions would be made on the basis of reciprocity and to extend its scope *inter alia* to CRD IV services. This is, however, still to be debated at the EU level.

## No Deal Scenario

In the event of a hard Brexit, the UK's passporting rights will immediately cease at 11 pm GMT on 29 March 2019. UK entities' market access to the EU will most likely depend on country-specific rules in force on that date. To avoid major market disruption and instability, the EU has published notices and called upon its Member States to prepare for the eventuality.

## EU Brexit preparedness

The series of Brexit preparedness notices published by the EU Commission reminds stakeholders that, in the event of a hard Brexit, UK entities would no longer hold an EU passport. This would result in the cessation of the application of CRD IV, CRR and PSD II to UK providers of banking and financial services, of MiFID II and MiFIR to UK investment service providers and of Solvency II to UK insurance/reinsurance providers (extending to online sales).

In order to provide cross-border services into the EU, UK entities would have to apply for authorization in each Member State in which they want to operate. Each entity would be assessed on its own merits by the relevant authority. EU subsidiaries of UK entities would need to be licensed. The notices state that in order to continue using their subsidiaries to provide services, UK entities would need to adhere to the rules of the respective Member State. Moreover, UK subsidiaries of EU-licensed entities would still be required to abide by EU law when conducting their business in the UK.

The EU Commission urges UK entities to assess contracts relating to the provision of financial services on an individual basis as they might be unable to fulfill all of their contractual obligations without their EU passport.

## Grandfathering provisions of EU Member States: the German example

On 4 January 2019, the German Government initiated a legislative process regarding a draft act supplementing the act on tax-related provisions concerning the withdrawal of the UK from the Union (Draft German Brexit Act, *Brexit-Steuerbegleitgesetz*) which would be directly applicable in Germany in the event of a hard Brexit. The draft act has two aspects. On the one hand, it entails Brexit-related amendments to German tax law. On the other hand, it contains amendments to several financial services acts introducing a possible transition period during which UK financial service providers could continue to provide services (banking and financial services) and wind up existing contracts in Germany until the end of the transition period (insurance). The amendments regarding financial services are subsidiary to a potential harmonized response on EU level.

As to the tax-related amendments, the draft aims to insure that current fiscal privileges relying on the UK's EU and EEA membership will, post-Brexit, continue to apply to those fiscally relevant actions which were executed pre-Brexit. This entails amendments to the Income Tax Act (*Einkommensteuergesetz*), the Corporation Tax Act (*Körperschaftsteuergesetz*), the Transformation Tax Act (*Umwandlungssteuergesetz*) and the Foreign Tax Act (*Außensteuergesetz*).

As to financial services, the draft act would amend the German Banking Act (*Kreditwesengesetz, KWG*) and the Insurance Supervision Act (*Versicherungsaufsichtsgesetz*), empowering the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzaufsicht, BaFin*) to grant companies domiciled in the UK, which have

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hitherto operated cross-border in Germany or have a German subsidiary, to continue their existing business. According to the draft act, it is at the discretion of BaFin to order the application of the EU passport regime in whole or in part to UK-licensed entities for a transitional period not exceeding 21 months starting on Brexit day. BaFin can do so, for example, by means of a general decree with effect for all UK entities concerned.

The application of the EU passport regime to banking transactions or financial services can only be considered insofar as the activity is closely related to pre-Brexit contracts. The explanations annexed to the act make it clear that such a close connection is to be presumed if the activity is legally or economically linked to existing contracts. The draft would thus give affected UK-based companies the opportunity to continue their business in Germany pursuant to section 32(1) KWG within the transitional period. For insurance services, the draft is narrower and only permits those insurance contracts which were agreed pre-Brexit to be continued and wound up during the transition period. According to the explanations, this means that UK insurers have to terminate existing contracts with German counterparts and wind them up or to establish a subsidiary in Germany and have it licensed within the transition period.

With regard to the German Covered Bond Act (*Pfandbriefgesetz*), the draft act proposes protection for British assets covered pre-Brexit. These may continue to be used as coverage until their maturity. In the Building Societies Act (*Gesetz über Bausparkassen*), the additions grant protection for existing investments in the UK and for the security of claims under real estate liens. The amendments made to the Investment Ordinance (*Anlageverordnung*) and the Pension Fund Supervisory Mandate (*Pensionsfonds-Aufsichtsverordnung*) mean that German insurance companies and pension funds may keep assets located in the UK as part of their security assets to fulfill their obligations towards the insured pensioners, in so far as these assets have been acquired prior to 30 March 2019.

In summary, the Draft German Brexit Act would address directly the consequences of a hard Brexit for financial services by upholding parts of the existing passporting regime for the benefit of UK financial service providers operating in Germany for a transitional period of up to 21 months post-Brexit. During this period, certain aspects of market access might remain as if UK financial service providers were still holding an EU passport. This, however, would be limited to services agreed upon before Brexit and areas contained in the draft. The time allotted would give UK entities opportunity to adhere to the German requirements applicable to third country entities. Consequently, the Draft German Brexit Act facilitates grandfathering but offers less market access than the pre-Brexit EU passporting regime.

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