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Cross-border lending in the EU: Key regulatory considerations

1. Introduction

Historically, Europe has been a bank-dominated market where bank loans are traditionally seen as the main source of financing for both businesses and individuals. This strong bank-dependent ecosystem has provided a fertile ground for the exponential growth of the banking sector in the EU that has particularly grown in size in the aftermath of the 2008 global financial crisis. One of the major catalysts for this, was the creation of the EU Banking Union in 2014 which was aimed to provide the basis for the stabilisation as well as further integration of the EU banking sector.

The broader financial services sector in the EU has in the meantime managed to become increasingly interconnected, with consumers and businesses having access nowadays to a variety of financial services at their fingertips. The lending space has also experienced the emergence of new entrants that are opening new avenues for consumer and SME financing in particular by offering new flexible financing products like revenue-based-financing and buy-now-pay-later.

But what are some key regulatory concerns that impact all categories of lenders that are active in cross-border transactions in the EU? Find out in our article below.

2. The existing EU regulatory framework

The banking regulatory framework in the EU is based on two main pillars created as part of the EU Banking Union: the Capital Requirements Regulation (CRR)[1], and the Fourth Capital Requirements Directive (CRD IV). Whereas CRR primarily deals with prudential requirements that apply to credit institutions and certain investment firms, CRD IV (among others) provides the legislative basis for the authorisation of credit institutions in the EU. To that end, CRD IV is the only piece of EU legislation that outlines detailed authorisation requirements as well as regulated activities that only credit institutions are permitted to engage in.

Two main banking services, deposit taking and lending, are both included in the list of banking activities that shall be subject to mutual recognition in all EU Member States but are not defined in great detail. Besides specifying that the latter service also covers consumer credit arrangements, credit agreements relating to immovable property, factoring (with or without recourse) as well as financing of commercial transactions (including forfeiting), CRD IV does not provide any further guidance on the scope of the authorisation obligation.

Based on the mutual recognition and the passporting regime that are both anchored in the CRD IV framework, credit institutions authorised in one EU Member State are allowed to passport their license into another EU Member States and offer their services either on a cross-border basis (*by exercising freedom of services*) or through local branches in target jurisdictions (*by exercising freedom of establishment*). That being said, EU authorised credit institutions can freely engage in cross-border lending activities and borrow capital to borrowers in different EU Member States.

3. Regulation at the EU Member State level

While authorised credit institutions are able to explore the full potential of the EU Single Market in a relatively easy way, entities that are not authorised as credit institutions and that are looking to engage in lending activities, are faced with a very fragmented regulatory landscape in the EU.

[1] In the current amended version based on the Regulation (EU) 2019/876 (CRR II)

Confusing regulatory landscape

Whilst the scope of consumer lending activities is defined in a pretty consistent way at member state level, the approach that national lawmakers have taken to the regulation of commercial lending is entirely different. Namely, since CRD IV is merely a Directive, that needs to be transposed into national law, many EU Member States have decided to play "the gold-plating card" when defining the scope of regulated commercial lending activities at member state level, by taking into consideration primarily their local needs. This inconsistent course of action by national lawmakers, has led to the creation of a quite puzzling regulatory landscape in which the same entity that is providing services to corporate borrowers in more than one EU Member State, may be subject to authorisation in one, but not in the other EU Member State.

Germany

For instance, in Germany, the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht "BaFin"*) follows a very strict interpretation of the German Banking Act (Kreditwesengesetz "KWG") as a result of which almost all lending activities (regardless of whether on a business-to-business or a business-to-consumer basis) are deemed as regulated lending business (*Kreditgeschäft*). There are however some exemptions from the general authorisation obligation (*Erlaubnispflich*) the most important of which are: (i) the exemption for intra-group loan arrangements, as well as (ii) the exemption that applies to the granting of qualified subordinated loans (*qualifizierte Nachrangsdarlehen*). Whereas the former is quite common in other EU Member States as well, the qualified subordinated loan structure is rather a German specific concept, under which, the lender contractually agrees to be put behind all other creditors in the insolvency hierarchy in the case of the borrower's insolvency. Due to a high level of risk associated with this structure some unregulated lenders (especially the new entrants into the heavily regulated German market) are also increasingly exploring some alternatives including: (i) factoring based financing, a structure in which the lender basically purchases outstanding receivables of a small business/SME in exchange for the provision of an upfront payment of their value (at a discount), as well as (ii) the fronting bank model, in which, an unregulated lender cooperates with an authorised credit institution that grants the loan to the borrower, and subsequently sells the legal title to the loan to the unregulated lender (in the form of a secondary loan sale).

Ireland

On the other hand, entities that are active in the commercial lending space in some other EU Member States are treated quite differently. For instance, in Ireland, lending to corporate borrowers generally does not constitute a regulated activity *"banking business"* under the Central Bank Act 1997 that is subject to mandatory authorisation by the Central Bank of Ireland. This is however not the case, where an unregulated lender does so in combination with deposit taking or where it is acting contrary to the general prohibition by holding itself out as a banker or as carrying out banking business. Further, non-regulated lenders providing financing to sole traders and small and medium enterprises whose financing arrangements fall under the scope of the Consumer Protection (Regulation of Retail Credit and Credit Servicing Firms) Act 2022, are also not able to operate entirely outside the regulatory perimeter since they are required to observe and comply with the new regulatory requirements (including the possible authorisation obligation) that came into operation on 16 May 2022.

Finding alternatives

The list of EU Member States whose national laws diverge from the EU legislation in a similar way to the ones mentioned above, is rather long which makes the cross-border operation of non-regulated lenders across the EU very difficult. The regulatory complexity combined with the changing economic environment in Europe, has led many to explore alternative options that sit outside the perimeter of the banking regulatory framework.

4. Regulatory treatment of private credit

The rise of private credit

In recent years, the private credit market has experienced remarkable growth: as an asset class, private credit has become roughly ten times larger than in 2009, nearing almost USD 2 trillion by the end of 2023[2]. Sparked by changing interest rates that have managed to lure record amounts of disposable capital into the hands of private credit fund managers, the private credit market has started to play an important role in leveraged finance, private equity, real estate and infrastructure as well as the venture capital space.

The EU has also witnessed a surge in the lending activity of private credit funds, that unlike other non-bank lenders, were able to leverage a harmonised regulatory framework applicable to alternative investment funds (**AIFs**) that is based on the Alternative investment Fund Managers Directive (AIFMD).

Private Credit Funds

The AIFMD framework is by far the most important piece of EU legislation that regulates the activities of alternative investment fund managers (**AIFMs**) in the EU, the term capturing managers of all investment funds that invest in alternative classes (i.e. other than only in transferable securities). AIFMD and its accompanying secondary legislation, serves as a single rulebook for AIFMs operating in the EU which also provides the legal basis for the authorisation regime for AIFMs as well as the catalogue of services that they are allowed to provide. The targeted amendments made to the existing framework made through the new Directive (AIFMD II), that are yet to be transposed at the Member State level, provide a better legal basis for loan originating AIFMs operating in the EU.

To that end, authorised AIFMs are allowed to grant loans either: (i) directly, through AIF as an original lender, or (ii) indirectly, through an SPV or another third party that originates the loan for or on behalf of the AIF or the AIFM. In the case of the second alternative, AIF or AIFM are generally involved in the structuring of the loan. The AIFMs that engage in loan origination activities are however required to comply with new requirements on risk retention, conflict of interest and risk management. The framework per-se does not distinguish between commercial and consumer lending, but EU Member States are allowed to restrict (or ban altogether) lending by AIFMs to consumers in their respective jurisdictions.

Passporting rights

Based on a single license obtained in their home EU Member State, AIFMs are allowed to engage in loan origination activities across the EU on a cross-border basis conditional upon completing the mandatory notification procedure. With the latest AIFMD II reform, that was initiated as part of the EU Commission's revised Action Plan on Capital Markets Union, the EU lawmakers are intending to facilitate access to alternative sources of financing for corporate borrowers in the EU that go beyond traditional bank financing that was dominating the financing landscape in the EU for decades.

[2] McKinsey "The next era of private credit" September 24,2024,
link: https://www.mckinsey.com/industries/private-capital/our-insights/the-next-era-of-private-credit#/

5. Reform of the banking framework on the horizon

EU Banking Package 2021

In October 2021, with the aim of ensuring better resilience of the EU banking sector, faster recovery from the COVID-19 pandemic and smoother transition to climate neutrality, the EU Commission has adopted the Banking Package which also entailed the revision of the existing CRR/CRD framework. Conscious of the diverging approach to the regulation of banking services (in particular in terms of commercial lending) at member state level, the EU Commission was particularly keen to limit access to the EU Single Market for non-EU authorised entities that are providing financing to EU customers. This was seen as a necessary step given that third-country entities, that sit outside the scope of the prudential regulation and supervisory remit of EU financial supervisory authorities, may eventually become the source of threats to the financial stability of the EU or some of its Member States (the scenario, that we have already witnessed in the wake of the 2008 financial crisis).

Restricting the provision of cross-border banking services

In accordance with the new Capital Requirements Directive (CRD VI), the following entities will no longer be able to accept deposits or lend funds (including the provision of guarantees and commitments) to EU-based clients on a cross-border basis:

- **Non-EU credit institutions**, (i.e. entities that would qualify as credit institutions under EU law);
- **Non-EU investment firms**, which (i) deal on their own account, or (ii) underwrite financial instruments, and which (i) have assets exceeding EUR 30 billion or (ii) carry out investment services in volumes exceeding EUR 30 billion;
- **Other deposit takers**, that are taking deposits from EU based customers but do not fall into any of the above-mentioned categories.

Exemptions

This general restriction does not apply however to a small group of cross-border activities carried out by non-EU authorised entities that (i) provide interbank services (i.e. services provided to credit institutions), (ii) provide intra-group services (services provided to entities belonging to the same group), as well as those that (iii) provide core banking services on a reverse solicitation basis.

The scope of the last exemption, that was in many other areas of the EU financial regulation for many years a lifeline for non-EU financial institutions, is now codified in Art. 21c CRD VI, in a very narrow way similarly like under the MiFID II framework and the new Markets in Crypto-Assets Regulation. That being said, non-EU entities will be able to provide core banking services under this exemption solely on a non-solicitated basis i.e. exclusively where an EU customer approaches a non-EU entity with the request for the provision of the banking service.

Branch requirement

In-scope non-EU entities whose activities do not fall under any of the above listed exemptions will be required to establish an EU branch and obtain authorisation as an authorised third country branch (**TCB**) from the NCA in the EU Member State of their incorporation. Under the CRD VI framework, TCBs will be required to comply with minimum authorisation, prudential and reporting requirements, and the Member States are required not to apply provisions at national level which result in a more favourable treatment of TCBs than branches of EU authorised institutions.

Timeline

After long trialogue discussions, CRD VI (together with the accompanying Regulation, CRR III) has been finalised and published in its final version in the EU Official Journal on 19 June 2024. Member States are required to transpose CRD VI into national law by 10 January 2026 that shall start to apply as of the following day. There is a 12-month transitional period for authorisation obligation for TCBs that will apply first as of 11 January 2027.

Nonetheless, CRD VI provides for a grandfathering period for contracts concluded before 11 July 2026: where a non-EU entity simply continues to service its existing cross-border arrangements, without entering into new ones after the cut-off date, it will not be subject to the authorisation obligation.

Practical effect

The new authorisation obligation for non-EU authorised lenders in particular, will have a big impact on the part of the financing industry that relies on cross-border facility agreements of non-EU lenders. This will be the case especially due to the fact that non-EU entities providing financing to corporate borrowers on a cross-border basis were treated differently in different EU Member States: In Germany, this activity generally falls under the authorisation obligation, but the German BaFin has a power to grant exemptions to non-EU entities conditional upon fulfilment of certain conditions. In Ireland, (as explained in more detail above) commercial lending per-se generally does not trigger authorisation obligation, hence operation on a cross-border basis was fairly easy for non-EU commercial lenders.

The new framework, will provide for a better harmonisation of the regulatory treatment of foreign lenders who shall use the remaining time wisely and explore their options by (i) considering (among other things) the selection of a jurisdiction where they would establish their TCB; (ii) trying to rely on one of the available exemptions; or (iii) restructuring their existing set up by for instance partnering with an EU authorised AIFM that is allowed to engage in lending activities, or migrating their activity to an intra-group entity or a cooperation partner that is an EU authorised credit institution.

6. Conclusion

Against the backdrop of everything mentioned above, it would probably be an understatement to conclude that the regulatory framework applicable to cross-border lending activities in the EU is fairly complex. Entities that are not authorised as EU credit institutions, or EU AIFMs, and that are engaging in lending activities on a cross-border basis can face a number of regulatory barriers primarily at the EU member state level due to the diverging regulations of commercial lending in particular. Foreign lenders active in the EU will soon enough be impacted by a new wave of regulatory restrictions coming their way as part of the CRD VI reform that will increase the costs and complexity of doing business in the EU for them.

These regulatory constrains however, appear to have a rather limited impact on the level of activity in the lending market in the EU: whereas bank lending has been recently slightly constrained by high interest rates, the private credit market is witnessing significant expansion boosted by the increase in activity of both private credit funds as well as new entrants like revenue-financing-providers and other non-bank lenders that are disrupting the financing business. In the coming period, it remains to be seen what practical effect the latest regulatory reforms will have on the industry and whether the EU lawmakers will consider taking any further steps that would impact the operation of non-bank lenders in the EU.

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