Cross-border business considerations in the private banking and wealth management industries

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Given the size of the country, Luxembourg's financial services industry is based mainly on cross-border business. The wealth management and private banking industries are no exception as the local players' clientele stands in increasingly distant places such as the Middle East, Latin America, or Asia.

The pressure for global tax transparency and regulatory compliance—especially in Europe—has caused a significant shift from offshore to onshore wealth. For instance, over the last couple of years, hundreds of affluent individuals living in Luxembourg's neighboring countries have made the choice to transfer their assets to their country of residence in order to avoid any potential conflict with their local governments. Interestingly, during this process of "onshorization", some Luxembourg banks and Family Offices (FO) have made the bold choice to set up a branch abroad in order to follow their clients in their country of residence rather than losing them to the local competition. These affluent customers would then carry on benefiting from Luxembourg's excellence in financial engineering and access to a wider range of investment vehicles.

However, the increasingly protectionist measures from governments in Europe should not lead us to forget that free movement of goods, people, capital and services within the EU—including financial services—is a fundamental right laid down in the Treaty on the Functioning of the European Union (TFEU). These "Four Freedoms" remain the cornerstones of the internal market. This is very important to remember, especially for the tax and regulatory compliant (U)HNWI and wealthy entrepreneurs whose business activities are usually global with assets and family members split in different countries (e.g., children residing or studying abroad). **These clients, who are in essence mobile and travel the world, usually like to be served, wherever they may be, by the same trusted advisers.**

In Europe, the "Free Provision of Services" (FPS) principle applies to wealth managers and private bankers crossing borders to serve their clients abroad. This principle allows Customer Relationship Managers (CRMs) of a European entity to meet or serve their client in another country, even when the financial institution does not have a permanent establishment locally.

However, **European governments increasingly impose stricter rules to the general European FPS principle**. CRMs should be permanently aware of the latest regulatory and tax developments not only in their home country, but also in their clients' country of residence. As a consequence, private banks and wealth management firms should rethink their cross-border operating model and may now more than ever take advantage of digital and mobile solutions in order to avoid any non-compliance issues which may impact their business and reputation.

Increased regulatory requirements

In the aftermath of the financial crisis, the regulatory pressure on the wealth management and private banking industries has increased. Regulatory frameworks such as national regulations on consumer protection, the Foreign Account Tax Compliance Act (FATCA) and investor protection rules including MiFID have an impact on the cross-border banking operating business model, and affect its efficiency and profitability. Observations show that the cross-border banking operating model remains unchanged despite the changes in the local and international regulatory frameworks. This approach can lead to significant risks of non-compliance.

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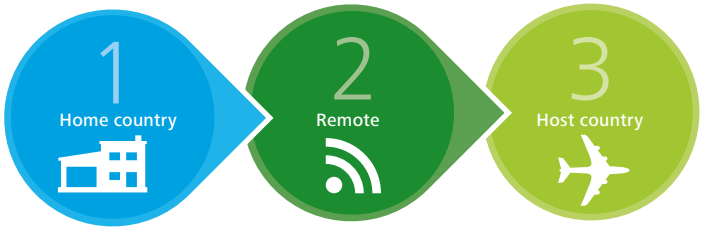
Cross-border private banking considerations

The EU free movements law is about the free movement between Member States, and its application therefore requires the existence of a cross-border element. It is considered that there is a cross-border element as soon as the service provider and the service recipient are not located within the same Member State. In the case of the free movement of services, it used to imply that either the service recipient or the service provider had to travel to another Member State. Since the development of internet and other distance communication tools, it is however now also possible for the service to travel directly between Member States.

In practice, private banks intending to prospect new —or serve existing—customers abroad may either set up a branch in the client's country of residence or may provide services across borders remotely or by allowing CRMs to travel to the client's country of residence. While in Europe, the EU CRMs benefit from the freedom of provision of service, this principle does not apply beyond the 28 EU countries. The benefit of the freedom to provide services within the EU will ease the cross-border provision of services, but local differences remain. The local regulations may prevail and differ from one country to the other. Some national supervisory authorities require foreign private banks to set up a local branch or subsidiary to carry out business on their territory.

Cross-border business may be carried out actively or passively depending on the origination of the business relationship. A CRM would typically start an active cross-border business relationship when intentionally contacting a client remotely by phone or email or meeting in person abroad.



The wealth manager provides its products and services to **the client in the bank or FO's country**

The wealth manager provides its products and services from its home country **remotely to the client who stays in its country of residence**

The wealth manager provides its products and services **in the client's country of residence or any other country**

The CRM would passively carry out a cross-border business activity when a client initiates the business relationship by contacting the banker. While in some countries this so-called "reverse solicitation" principle may allow for more flexibility in serving a potential customer, providing evidence of passive contact may prove challenging.

Finally, an important element of cross-border private banking is the location of the provision of service. The main client groups concerned by cross-border banking are the (U)HNWI and wealthy entrepreneurs carrying out business globally. Four distinct cross-border situations may occur and involve taking into account one or more different legal, tax and regulatory frameworks. Indeed, cross-border business is usually understood as a CRM travelling to his client's country of residence to meet in person and develop a business relationship. However, as these customers are highly mobile, the contact with the bank's CRM may occur in person at the bank's head office. Contact may also be made by the CRM remotely from his office with distance communication tools including email, mail or telephone (e.g. cold-calling prospects). Finally, a CRM who may want to meet his client in the bank's foreign branch may put his employer at risk as the foreign authorities may consider the contract to have been signed in a permanent establishment (the branch) and therefore should be governed by its foreign laws and regulations. In addition, the CRM may consequently be considered as an employee of the foreign branch and be taxed under the foreign tax regime.

All these different aspects of cross-border banking are crucial since they dictate which supervisory scheme and local regulations apply.

EU passport

Article 56 TFEU prohibits Member States from restricting the provision of services within the EU. This right has been implemented through various secondary EU legislations, the most important in terms of financial services today being the Directive 2004/39/EC and the Directive 2013/36/EU, which respectively define the access to the "EU passport" for investment firms and credit institutions.

This EU passport grants credit institutions and investment firms established in a Member State the right to provide services within the EU either with the establishment of a branch or through the direct "Free Provision of Services" (FPS). This passport and the relevant Directives significantly eases the cross-border provision of services through a partial harmonization of the relevant law (standards fixed at the EU level) and the application of the legal framework of the Home Member State in key areas (for example in terms of authorization), at the exclusion of the legislation in the Host Member State. The scope of this Home Member State control will typically be wider in case of FPS, as there is no establishment in the Host Member State.

In case the relevant rules have not yet been harmonized and the Home country control principle does not apply, the Directives require Member States to guarantee the access to the service activity and the freedom to exercise such activity throughout the territory. The Treaty also generally forbids Member States from restricting the free movement by imposing their national requirements on cross-border service providers unless the Member State can demonstrate that the measure is necessary to ensure the respect of one of the limited justifications allowed and that the measure is proportionate. In 2013, the ECJ stated that combating money laundering and terrorist financing constitutes a mandatory requirement justifying restrictions on free movement of services[1].

Risks related to cross-border business

The regulatory environment affecting the cross-border provision of financial services has increased in recent years, and as a result threatened the continued existence of certain institutions. G20 governments recently signed an agreement to deter cross-border tax evasion. The agreement required governments to share information and cooperate in audits to detect companies and customers attempting to evade taxes.

This growing trend of regulatory requirements reinforces the need of private banks and wealth management firms to review their compliance procedures and adapt their cross-border operating model to reduce regulatory risk and protect their clients' interests.

1 *Jyske Bank Gibraltar – Case C-212/11:* "EU law does not preclude Spanish legislation which requires credit institutions, operating in Spain without being established there, to forward directly to the Spanish authorities information necessary for combatting money laundering and terrorist financing"

Cross-border regulations also have a big influence on private banks' business models. Cross-border regulations include national rules governing the sale of financial services, which includes marketing, consumer protection, distance selling, and financial advice to consumers. These regulations vary from country to country, which adds to the already complex regulatory environment.

This complex regulatory environment and the differences between countries mean that banks have to adapt their products and customers due diligence frameworks, which should take into account the specific regulatory requirements of the client's country of residence. This causes a further increase in operating costs, with a direct impact on the industry's profitability.

Looking ahead

Mitigating the regulatory risks associated with cross-border banking services is complex but essential in order for players to remain competitive. The complexity of cross-border business activities stems from the individual country requirements concerning investment suitability, cross-border regulation and tax transparency. The complexities of the regulation as well as the differences from country to country are the main risks that should be mitigated.

One solution is to increase the awareness of CRMs in this specific field, as they are the ones who cross the borders and who put their bank's image and reputation forward on a daily basis. However, as CRMs are highly mobile, the regulatory compliance should be as well.

Country-specific regulatory knowledge solutions should provide clear instructions to CRMs about the permissible services and products under national and international regulations. The solutions should be tailored in line with the banks' business development policies, as each financial institution will approach customers in a specific way.

The cross-border business regulatory awareness solution should ideally be digital and easily portable, as CRMs do not always have the opportunity to prepare for a client meeting from their office's desktop but rather prepare "on the go".

Last but not least, one should not forget that regulatory compliance is only one angle of cross-border private banking and wealth management; cross-border tax issues and compliance should also be taken into account in order to adequately serve customers.