

14 December 2006

**Feedback to the 2nd Public Consultation of
Consultation Paper No. 2 rev "Guidelines on Outsourcing"**

Introduction:

1. On 6 April 2006 CEBS published a revised version of its Guidelines on Outsourcing (CP 02 rev) and asked for responses within a period of 3 months. By the end of the consultation period 13 responses were received which were all published on the website.
2. As regards the background of the respondents all but one are interest groups. The outlier is a big outsourcing service provider. It is worth comparing this to the composition of the first consultation where a third of responses came from individual banks.

Alignment with MiFID:

3. The Outsourcing Guidelines and their timeline have been largely influenced by the developments around the Markets in Financial Instruments Directive (MiFID). Huge efforts have been invested into the process of aligning CEBS Outsourcing Guidelines to the MiFID and it was decided that the Outsourcing Guidelines should not be finalised before MiFID is adopted by the European Commission.¹
4. Having said this, there has been criticism from respondents to this consultation that this alignment is not far reaching enough. The reasons for a different approach, as given in the introduction to the Consultation Paper on the revised Outsourcing Guidelines (CP 02 rev), are not considered sufficient for the use of different language and deviations in substance.
5. However understandable the demand of the industry is, at this point in time it does not appear feasible to agree on one single set of Guidelines for the clientele of CEBS and CESR alike. Nevertheless, since the publication of the revised Guidelines in April 2006 (CP 02 rev) further cooperation with CESR in this respect has resulted in an updated mapping of the

¹ The Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, was published in the Official Journal on 2 September 2006.

outsourcing Guidelines, CESR's Technical Advice on MiFID and the final version of the European Commission MiFID Level 2 measures. Furthermore, CESR has expressed its willingness to concur its position with the principles contained in the CEBS Guidelines and to work with CEBS in this respect.

Main comments:

6. The main comments can be summarised as follows:
7. Respondents ask for the acknowledgment of the potential benefits of outsourcing an activity in terms of risk management. It is noted that in whole the Outsourcing Guidelines underline the potentially higher risks associated with outsourcing services. The respondents then argue, that, while outsourcing should indeed be limited in certain circumstances in order to adequately manage risks, it should be emphasised that outsourcing may actually contribute to mitigate risks. This would be especially the case when the outsourcing service provider provides, for instance, more adequate resources, a more structured organization and internal control.
8. As in the first consultation, there are numerous suggestions to exclude intra-group outsourcing from the application of these Guidelines. The way suggested to do so would be by excluding intra-group outsourcing from the definition.
9. Along the same lines, further demands for exclusions from the scope of application of the Outsourcing Guidelines include: various support functions, back office activities related to the taking of deposits and lending, dealers in point of sales financing, function of clearing and settlement mechanism within the framework of payment transactions and securities settlement.
10. Many comments refer to the requirement to retain core competence at a senior management level and question the reason behind this requirement: is it so that the bank is able to resume the outsourced activity itself or, alternatively, to commission another service provider to perform these activities.
11. The revised Guideline on the supervisory authority's right to interfere in the outsourcing contract is strongly rejected. Respondents demand its deletion. Other respondents do not take such a strong view and ask for explicit inclusion that such a request by the supervisory authority would need to be duly justified.
12. For further comments the reader is referred to the feedback table.

Reaction by CEBS:

13. In redrafting the Outsourcing Guidelines, the comments received have been taken into account to the degree possible. However, many comments have already been made in the first public consultation. The legislative environment has not changed to such a degree in the meantime that

would result in a fundamental change of supervisors' positions. Wherever changes are considered possible from a supervisory point of view, this has been indicated in the feedback document.



Analysis of responses to CP 02 rev

Guidelines on Outsourcing (“OGL”)

Draft Text CP02 rev	Received Comments	CEBS Analysis	New text (proposal)
	General remarks		
<p>For consistency reasons with publications of CEBS and the other 3L3 committees the name of these principles was changed from “Standards” to “Guidelines”. This reflects more accurately their character as a level 3 tool to promote consistency. Guidelines contain further specification of EU legislation, especially where such legislation provides for minimum harmonisation, covering the substance as well as processes.</p>			
Alignment with MiFID	CEBS efforts to align its Guidelines with provisions of MiFID are supported, but some commentators argue strongly for further alignment. CEBS and CESR should use similar language.	The underlying Directives are using different language which is reflected in the different language used by CEBS and CESR. Whenever possible, the same language is used.	OGL 1 a: delete “on a continuing basis”
No stricter rules on national level (Introduction, s.a. OGL 4 note 2)	CEBS should advise the individual supervisory authorities to refrain from setting stricter outsourcing rules than described by the Guidelines, unless national law prohibits this.	These Guidelines are designed to promote an appropriate level of convergence in supervisory practices throughout the EU. At the same time, the Guidelines are principles-	N/R

Draft Text CP02 rev	Received Comments	CEBS Analysis	New text (proposal)
		based and provide national supervisors with an adequate degree of flexibility to take into account domestic rules and specific features of their local markets and to accommodate developments in market practices.	
Risk mitigating effects of outsourcing	The CP underlines the potentially higher risks associated with outsourcing services. While outsourcing should indeed be limited in certain circumstances in order to adequately manage risks, it should be emphasised that outsourcing may actually contribute to mitigate risks, e.g. when the outsourcing service provider provides more adequate resources, a more structured organisation and internal control. CEBS Guidelines should, thus, acknowledge the potential benefits of outsourcing an activity in terms of risk management.	CEBS acknowledges some risk mitigation effects of outsourcing. This needs to be seen in close relation with the risks posed by outsourcing.	N/R
Proportionality	The principle of proportionality should be explicitly mentioned.	The principle of proportionality is a general principle inherent to supervisory actions. At the same time, the industry also needs to respect such principle of proportionality.	Amend introduction by: "The concept of proportionality, as laid down in the provisions of the Directive 2006/48/EC applies also to outsourcing and its policy which will be expected to be related to the size of the institutions as well as to the sophistication and diversification of the outsourced activities. Supervisory

Draft Text CP02 rev	Received Comments	CEBS Analysis	New text (proposal)
			authorities will adapt their approach to outsourcing to ensure it is proportionate to the nature, scale and complexity of the outsourced activities of an institution."
	Specific remarks		
"Outsourcing" (OGL 1 a)	<p>The definition of "outsourcing" is considered too broad and needs clarification.</p> <p>Intra-group outsourcing, cross-border intra-group outsourcing, the outsourcing of non-material activities and the delegation of functions on a continuous basis/of a process should be excluded. "Business as usual" should not be covered by the scope of outsourcing.</p> <p>The principle of proportionality should be mentioned here.</p>	<p>Similar comments as for CP02.</p> <p>Limiting the definition of outsourcing to typical core banking activities would be inconsistent with the guidelines' aim of providing a generic definition.</p>	N/R
"Purchasing" (OGL 1 b)	It is suggested to delete this definition, because this notion does not appear anywhere else in the paper.	This definition is retained for clarity.	OGL 1 b: amend by: The supply of (i) or (ii) is not outsourcing.
"Outsourcing service provider" (OGL 1 c)	<p>The definition is unclear. The terms "supplier of goods" and "supplier of facilities" may be misleading.</p> <p>Others welcome the clarity in this definition that the outsourced activities include those being outsourced on an intra-group basis.</p> <p>One respondent argues that dealers in point of sales</p>	<p>It is felt that additional explanations would not contribute to the understanding of the definition.</p> <p>Limiting the definition of outsourcing service</p>	N/R

Draft Text CP02 rev	Received Comments	CEBS Analysis	New text (proposal)
	<p>financing should explicitly be excluded from the definition of outsourcing service provider, because their activities are only of a secondary nature in relation to the financial institutions and provide only non-material services in the sense of OGL 5..</p>	<p>provider by excluding certain activities would be inconsistent with the guidelines' aim of providing a generic definition.</p>	
<p>"Material activities" (OGL 1 f)</p>	<p>The definition should be narrowed, because not all risk management activities can be considered material.</p> <p>CEBS is urged to adopt the MiFID definition of "critical or important" or at least to modify OGL 1 f by keeping (i) and (iv), but deleting (ii) and (iii), or by keeping (i) and (ii) and deleting (iii) and (iv).</p> <p>Other asks for clarification respectively wonder whether it should not rather be "regulatory requirements" than "regulatory responsibilities"?</p> <p>One commentator requests a more exact definition.</p>	<p>CEBS Guidelines use the concept of "materiality". This is a term which is not used in MiFID, though MiFID – Level 2 regulation does regard operational functions as "critical or important". Material activities as defined in CEBS Guidelines embrace not only critical or important activities, but also the risk management of such activities, other licensed activities and activities with a significant impact on risk management. The deviation from MiFID terminology is thus justified.</p>	<p>OGL 1.f: reorder: [...] (ii) any other activities requiring a licence from the supervisory authority; (iii) any activities having a significant impact on its risk management; and (iv) the management of risks related to these activities.</p>
<p>Core competence at a senior operational level (OGL 2 note 3)</p>	<p>It may prove difficult to fulfil the requirement of retaining "adequate core competence at a senior operational level" for outsourced activities because this competence may no longer exist within an institution after it has been outsourced. Respondents feel that the real issue at stake is the issue of termination of an outsourcing arrangement without detriment to the continuity of its provisions of services to clients.</p>	<p>This requirement is imposed to ensure that the bank is able to resume the outsourced activity itself or, alternatively, to commission another service provider to</p>	<p>N/R</p>

Draft Text CP02 rev	Received Comments	CEBS Analysis	New text (proposal)
		perform these activities. In order to control the outsourcing service provider the institution needs to have core competences.	
No delegation of senior management's responsibility (OGL 3)	This Guideline should not be construed as a potential constraint for intra-group outsourcing. It should be exclusive applied to extra-group outsourcing and this should be made explicit by adding "externally" at the end of the last sentence in OGL 3 note 1.	This OGL needs to be respected in any form of outsourcing.	N/R
No outsourcing of acceptance of deposits/lending (OGL 4.1)	Some respondents would like confirmation that back office services in the respective areas are not covered by this OGL and suggest that OGL 4.1 should be limited to core activities in this context or at all deleted.	The Guidelines prohibit explicitly the acceptance of deposits and lending as activities which must not be outsourced to an unauthorised entity. MiFID Level 2 contains comparable rules only in relation to "portfolio management provided to retail clients" if the service provider is located in a third country. This difference in approach is explained by the CEBS Guidelines' focus on prudential supervision.	N/R
Fulfilment of supervisory tasks (OGL 4.2 d)	Concerns are raised that this requirement may possibly provide authorities with a catch all clause and could effectively constrain outsourcing.	This requirement is replaced by a more flexible formulation.	OGL 4.2.d. the supervision of the outsourcing institution

Draft Text CP02 rev	Received Comments	CEBS Analysis	New text (proposal)
Adequate information (OGL 4.3)	<p>Commentators welcome the replacement of “pre-notify” with “adequately inform”.</p> <p>Commentators are concerned that information requirements could apply not only to material developments.</p> <p>It is also suggested to make information available “upon request of the supervisory authority”.</p>	CEBS believes that the expression “adequately inform” leaves sufficient room for its interpretation by national authorities in line with MiFID Level 2 requirements.	N/R
OGL 4 note 2	<p>Respondents feel that the requirement to adequately inform supervisors about the outsourcing of any material activity, to be broader than the corresponding OGL 4.3.</p> <p>CEBS should refrain from giving examples as in as this may be used as for a box-ticking exercise. Moreover, CEBS should make clear that the supervisor’s entitlement to “impose specific conditions” should not mean that the supervisory authority has the right to determine specific conditions for each outsourcing activity. Supervisory authorities should be allowed to evaluate only a signed contract, but not a proposal.</p>	Note 2 and OGL 4.3 are identically phrased.	N/R
Intra-group outsourcing (OGL 4 note 5)	<p>It is argued, that guidelines for intra-group outsourcing based on the legal entity no longer coincide with, nor are suited to, the reality of large pan-European banks with strong centralised functions and organised in business lines. It is therefore strongly recommended that intra-group outsourcing should be excluded from the scope of regulated outsourcing arrangements at CEBS level. Hence, OGL 4 note 5 should be deleted</p> <p>Other commentators would like to see explicit mentioning that “supervisory authorities may take specific circumstances into consideration for internal outsourcing arrangements” or that the principle of proportionality should be applied.</p> <p>In a similar vein and by construing the concept of consolidating supervision according to the CRD it is argued</p>	From a prudential point of view differences between intra-group outsourcing and external outsourcing do not justify a completely different approach. Any individual case of outsourcing needs to assess according to the principle of proportionality which provides for sufficient flexibility to take the particularities into account. This approach is	N/R

Draft Text CP02 rev	Received Comments	CEBS Analysis	New text (proposal)
	that the acceptance of an outsourcing measure in the context of intra-group outsourcing by the consolidating supervisor should be accepted by the other supervisors. The transition to group level supervision should not be limited to own funds and large exposures but should also cover other areas of banking supervision, e.g. especially outsourcing.	in line with applicable legislation.	
Non-material areas (OGL 5)	<p>Examples of non-material areas are considered helpful for a better understanding.</p> <p>One respondent advocates that the function of the clearing and settlement mechanisms within the framework of payment transactions and securities settlement, the use of securities trading systems through other institutions, the authorisation centres for electronic cash transactions as well as the central bank's functions within a financial network, the involvement of lead managers or agents for syndicated loans and comparable scenarios should be explicitly exempt.</p>	<p>Examples run the risk of pre-empting any discussion.</p> <p>CEBS Guidelines apply to all kinds of outsourcing for prudential reasons. Thus, outsourcing of non-material activities is also within the scope of their application. However, the principle of proportionality is accepted in the application of these Guidelines.</p>	N/R
Monitoring of outsourcing (OGL 6 note 5)	The monitoring and management of an outsourcing arrangement may be split between several units or individuals. Ongoing coordination and monitoring should be undertaken by those units that are in possession of the necessary technical expertise to do so.	Accepted.	OGL 6 note 5: The outsourcing institutions should specify the internal units or individuals that are responsible for monitoring and managing each outsourcing arrangement.
Risk management (OGL 7)	OGL 7 should be limited to "operational" risks associated with its outsourcing arrangements.	No limitation to one specific kind of risk.	N/R

Draft Text CP02 rev	Received Comments	CEBS Analysis	New text (proposal)
	Information about any material development of the supervisory authority is considered excessive (OGL 7 note 1) and should be deleted.	See general remark on risk mitigation effects of outsourcing For the requirement of adequate information of material outsourcing see above.	
Outsourcing contract (OGL 8 note 2)	The requirements proposed in OGL 8 note 2 meet opposition. A distinction should be made between external and intra-group outsourcing. In the latter case a written contract may not be necessary. Some are considered too prescriptive, others too onerous.	This Guideline remained unchanged from the beginning.	N/R
Confidentiality (OGL 8 note 2.e)	Both parties should be obliged to protect confidential information.	The current wording provides for this.	N/R
Cancellation (OGL 8 note 2.j, OGL 11 note 6)	The supervisors' right to ask institutions to cease or terminate the outsourcing contract is perceived too far-reaching and could be contra legem. A majority of respondents asks for its deletion. Some commentators, however, understand the necessity of a possibility to intervene. They exemplify further, however, that this request would need to be properly justified by the supervisory authority.	In order to fulfil prudential supervisory tasks, supervisors must be able to intervene in outsourcing relationships. Every supervisory action must adhere to the principle of legality.	N/R
SLA (OGL 9)	The service level agreement could be part of the outsourcing contract. It may not always be necessary to have a separate SLA and the concept could change in the future. The contract should contain responsibilities of both parties.	A new wording will provide for this possibility.	OGL 9: In managing its relationship with an outsourcing service provider an outsourcing institution should ensure that a written agreement on the responsibilities of both parties and a quality

Draft Text CP02 rev	Received Comments	CEBS Analysis	New text (proposal)
			description is put in place.
Chain outsourcing (OGL 10)	When chain outsourcing, differences between internal and external sub-outsourcing should be considered. One commentator remarks on the unlikelihood of sub-contracting an entire outsourcing contract. This should be reflected in OGL 10.2. Neither should sub-outsourcing be considered similar to a primary outsourcing measure.	The Guideline reflects the supervisory concern over chain outsourcing or sub-outsourcing. The general rules on how to deal with intra-group outsourcing do apply.	N/R
Rights of SA towards 3 rd parties (OGL 11 note 1)	The supervisory authority's rights may be too far reaching as regards accession and instruction rights vis-à-vis the outsourcing service provider and vis-à-vis the external auditor. Access to data is subject to reasonable security procedures. It is perceived unrealistic to demand information from the outsourcing service provider's external auditor. One respondent suggests that information should be given through the outsourcing institution.	Supervisory authorities' rights need to be in accordance with national law.	N/R
Concentration risk (OGL 12)	Commentators consider that the monitoring of concentration risk at the individual institution's level should be the responsibility of the institution's management body only. The monitoring of the concentration risk at a systemic level however may provide important insight. One respondent supposes that activities of so-called multiple client service providers will be left unaffected.	The proposal to delete the supervisory authority's tasks to monitor the concentration risk at the level of the individual institution is accepted.	OGL 12 note 1: Supervisory authorities should seek to identify any concentration risk on a sectoral level and seek to monitor these risks at a systemic level. OGL 7 note 1: insertion: [...] the operational risks and the concentration risk associated with all its outsourcing arrangements. [...]