

**6 April 2006**

**Feedback to the public consultation on  
“High Level Principles on Outsourcing” (CP02)**

1. In April 2004, CEBS published a consultation paper (CP02) on high level principles on outsourcing. The consultation period ended on 31 July 2004. Twenty three responses were received, all but one of which were published on the CEBS website.
2. Due to a new structure for CEBS publications the concept of high level principles has been replaced by standards.
3. The project of establishing standards for outsourcing was warmly welcomed, although the need for coordinating of such approaches with similar exercises by CESR and CEIOPS – and the Joint Forum at the global level – was flagged by several respondents. Taking these comments fully into account a new version of the standards has been aligned to the highest degree possible with regulation under MiFID, using the “Draft Commission Directive 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” as published on the COM Homepage on 6 February 2006.
4. The following is a summary of the main comments made in the public consultation, followed by a feedback table which includes proposals for changes to the outsourcing standards in order to properly reflect the public consultation.

**Main Comments**

5. On the basic contents of CP02, the standards were generally accepted by the industry. However, there was some divergence of opinion on the details, and some standards were considered to be too tight or not elaborate enough.
6. Many comments focused on the definitions provided. The borderline between outsourcing and purchasing was well received, though an even more precise definition was requested.
7. Similarly many respondents asked for more guidance on “strategic and core management responsibility and functions” (HLP I). This was similar to many comments on the need for a more detailed definition of material

vs. non-material activities (HLP III). Some commentators argued that core management functions and material activities were in fact the same and found the different wording confusing. Using risk management as an example of a core management function was widely opposed because the function of risk management is very wide and pertains to different management levels. Some commentators argued for a definition of risk management.

8. Other comments focused on who is the outsourcing service provider. According to the definition of outsourcing, and hence the application of the standards, there should be no difference between outsourcing at an intra-group level and external outsourcing. However, some argued that intra-group outsourcing should not be regulated. This was (i) because in a group it is common to streamline and economise on tasks via specialised entities, and (ii) the parent institution has a responsibility to ensure and maintain general risk management and related organisational and structural standards at a group-wide level. In these circumstances many respondents argued that intra-group outsourcing represents a significantly lower risk. However, supervisory authorities do not endorse this position, although some relaxation of the rules for intra-group outsourcing might be contemplated.
9. Some respondents opined that multi-service providers as known from the co-operative sector for non-consolidated entities in non-consolidating groups should not be subject to the supervisory outsourcing regime, because banks do retain powers of instruction, control or inspection towards these multi-service providers.
10. According to some comments, a further distinction should be made between outsourcing to a licensed institution and a non-licensed institution. If banking services, which require a banking licence, were outsourced to an entity within the EU, the provider would equally have to be a regulated entity established and licensed according to the relevant national legislation. There should be a clear reference to which standards should be fulfilled in this case. If, however, the provider is not an EU-regulated entity, (e.g. a third country provider) the supervisory authority should ensure that there is no "prudential arbitrage" and that equivalent standards are maintained.
11. Overall, the industry appeared to be most unhappy with the right of the Supervisory Authority to cancel an outsourcing contract. Not only did many respondents find it much too far-reaching for the supervisors to directly interfere, this standard probably raises concerns as to the legality and enforceability of such a provision. It was instead suggested that a clause should be included in the outsourcing contract providing for "the right of the outsourcing institution to renegotiate or terminate the contract due to an intervention from the supervisory authority."
12. Finally, the standards reflected a supervisory concern over chain outsourcing (in the sense of sub-outsourcing). The industry has suggested that this could be overcome with a general prohibition on sub-outsourcing in the first outsourcing contract (HLP XI).

### **Main answers by CEBS:**

13. In the introduction the emphasis is put on cross-sectoral alignment and alignment with MiFID. Specific wording on the character of the Standards has been included.
14. The set of definitions has been broadened and slightly changed. The most notable change is from a three-tier approach to a two-tier approach, illustrated by the definition of "material activities". Other definitions included are one on "senior management".
15. Following the serious legal concerns of commentators and some members, the requirement of pre-notification is dropped and replaced by the outsourcing institution's obligation to "adequately inform" its supervisory authority about material outsourcing. The present wording also seems to be in line with the draft Directive text which demands pre-notification only in exceptional circumstances.
16. Intra-group outsourcing and cross-border outsourcing is not exempt from these Standards and does not enjoy special treatment in itself, but the wording has been aligned with the draft Directive text.
17. The Standards have been amended by the inclusion of the obligation of the service provider to protect secrecy and confidential information.
18. It was felt that provisions relating to chain outsourcing should be mainly directed towards outsourcing institutions which should consider adequately the associated risks. Thus, this Article was moved into Part 2 "Standards addressed to institutions".

**Standards on outsourcing**  
**Analysis of responses to CP02 and redrafting suggestions**

<b>Draft Text – CP02</b>	<b>Received Comments</b>	<b>Analysis</b>	<b>Redrafted text</b>
<b>Scope of CP02</b>			
<b>General remarks</b>			
High Level Principles		Due to CEBS definition of its tools and products the former high level principles are now called Standards.	Now: Standards
Legal quality of the consultation paper	CEBS is asked to state in which cases supervisory authorities will not intervene and that CEBS' principles are exclusive and binding for national supervisory authorities.	The CEBS Charter refers to the legal quality of CEBS' tools and products and states in its Article 4.3 that "[...] the members will introduce [guidelines, recommendations and standards] in their regulatory/supervisory practices on a voluntary basis." Further clarification is provided by the Lamfalussy report where it is written that "the outcome of this work would be non-binding although clearly it would carry considerable authority."	See new text in the introduction
Cross-sectoral consistency	Consistency between the several efforts to come to multilateral agreements with regard to outsourcing (CEBS, CESR's MiFID Level 2 advice, Joint	CEBS has guaranteed a close co-operation between CESR and the Joint Forum. Since the end of the consultation process and the first analysis of the comments	See e.g. note in the first paragraph and definition of outsourcing (Standard 1.a).

	<p>Forum Principles, Basel) should be ensured.</p> <p>There should be no additional rules apart from the Basel Committee's operational risk framework.</p>	<p>received, CEBS has engaged into 3L3 cross-sectoral consistency efforts. The process of finalizing these standards was delayed which allowed for sufficient time to liaise with the other 3L3 committees (especially CESR) to align CEBS' efforts for consistent L3 standards for banks, which – if conducting investment services – are also subject to MiFID regulation.</p> <p>The effects of all efforts to align are highlighted below.</p>	
<p>Three-tier approach: strategic or core activities (Principle I)/non-strategic but material activities (Principle III)/non-strategic and non-material activities (Principle IV).</p>	<p>There are many comments on the three-tier approach. Some think that as long as the banking or other supervisors regulate the entity acting as the outsourcing service provider, processes that could fall into another bank's view of "strategic or core" activities could be outsourced. Only outsourcing to non regulated entities should fall under the regulators' scrutiny. Some respondents also think that principles for outsourcing should be according to risks.</p> <p>Or that a more pragmatic approach should be taken which would allow a credit institution to outsource any of its activities, on condition that it is capable of</p>	<p>The three-tier approach proved difficult to define and was replaced by a two-tier approach.</p> <p>CEBS opted for a broad scope of application which leaves room for national particularities.</p>	<p>See new definition on material activities (Standard 1.f) and Standards 1 to 5.</p>

	controlling the attendant risks.		
<b>Definitions</b>			
Outsourcing	<p>The borderline between outsourcing and purchasing is well received, though an even more precise definition is requested.</p> <p>Some respondents remark that the definition of outsourcing should only refer to typical core banking activities.</p> <p>Other respondents mention explicitly what should not constitute outsourcing and argue for lists of examples.</p> <p>There were also demands to list examples of services not falling within the ambit of outsourcing. This would support standardization.</p>	<p>For the purpose of aligning CEBS' standards with similar efforts of other institutions the proposal is to use the definition of outsourcing as provided in the Consultation Paper of the Joint Forum. In conjunction with CEBS' definition of purchasing this results in a comprehensive definition.</p> <p>Limiting the definition of outsourcing to typical core banking activities would be inconsistent with the standard's aim of providing a generic definition.</p> <p>Not every standardized activity, however, may be fit for outsourcing, e.g. because it constitutes a core activity of the authorised institution and therefore should be within the boundaries of these standards.</p>	<p>See Standard 1.a: "Outsourcing is defined as a authorised entity's use of a third party (either an affiliated entity within a corporate group or an entity that is external to the corporate group) to perform activities on a continuing basis that would normally be undertaken by the regulated entity, now or in the future."</p>
Purchasing	<p>Suggestion for definition for standardized product: if the service or product can be provided to several institutions in a similar or identical way.</p>	<p>The definition is following the Joint Forum definition.</p>	<p>N/R</p>
Materiality	<p>It is suggested to use a two tier classification of material and non-material activities instead of the three-tier approach</p>	<p>The three-tier approach proved difficult to define. A two tier approach as suggested was instead chosen.</p>	<p>See Standard 1.f.</p>

	<p>(strategic or core activities/non-strategic but material activities/non-strategic and non-material activities).</p> <p>Respondents ask for a clear definition of "material". They also argue that the application of the materiality test should be clear.</p>		
<b>I</b>			
Strategic and core management responsibility and functions cannot be outsourced.	<p>Respondents would like to have clarity on the terms "strategic" and "core" and ask for a definition. Some perceive strategic and core as the same whereas others ask for further explanations on the distinctive elements.</p>	<p>For the sake of clarity in the context of outsourcing, a distinction should be made between functions and responsibilities. Functions can be the subject of an outsourcing agreement, but the responsibilities for tasks associated to functions can not be outsourced. It is worth mentioning that several expressions are not defined in the Standards, e.g. the term "core" as used in Standard 3. Examples provide some guidance on their meaning, while at the same time allowing room for the interpretation and application of such terms by the supervisory authorities.</p>	<p>See Standards 3: "Outsourcing arrangements can never result in the delegation of senior management's responsibility."</p>
	<p>According to some commentators it should be possible for processes that are considered "strategic or core" to be outsourced, if the</p>	<p>The new two-tier approach allows for this kind of outsourcing under certain conditions.</p>	<p>N/R</p>

	outsourcing service provider is an institution authorised by, and under direct supervision of a supervisory authority of an EU member state or a country with equivalent standards.		
	The assumption that risk management is a core management function meets with opposition. Risk-management functions should not be regarded as "core" or strategic as a whole. Risk-management processes are localized and only the strategic decisions shouldn't be outsourced.	There is disagreement with the prohibition of the outsourcing of risk management. Another issue of discussion is the use of risk management as an example for core management function; comments state that the function of risk management is wide and may be allocated at different management levels.	N/R
<b>II</b>			
The ultimate responsibility for proper management of the risks associated with outsourcing lies with an outsourcing institution's senior executive management.	What is senior operational level? Intra-group outsourcing should be allowed under less stringent conditions than third party outsourcing, at least within banks in the European Union	Senior management should be understood in the sense of the Dir 2000/12/EG.	See Definition in Standard 1.g.
Intragroup outsourcing	Intra-group outsourcing should not be regulated. The parent institution has a responsibility to ensure and maintain general risk management and related organisational and structural standards on a group-wide level. Intra group or in-house outsourcing needs definition. Services provided by a group entity to an institution should	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	See Standard 4 note 5.



	<p>not be considered similar outsourcing as to third parties.</p> <p>There should be a distinction between intra-group outsourcing and outsourcing to authorised or unauthorised financial institutions.</p>	the particularities into account.	
Cross-border outsourcing	<p>If banking services, which require a banking license, are outsourced to an entity within the EU, the provider will equally have to be a regulated entity established and licensed according to the relevant national legislation. It should be clearly referenced which standards should be fulfilled in this case. If, however, the provider is not a EU-regulated entity, (e.g. a third country provider) it has to be ensured that there is no "prudential arbitrage" and that equivalent standards are maintained.</p>	The materiality-based approach to outsourcing does not require special rules for cross-border outsourcing. The same considerations as for intragroup outsourcing apply.	See Standard 4 note 5.
<b>III</b>			
Outsourcing of material activities	<p>It must be permissible to outsource single elements of activities which are covered by the banking licence to a non-licensed service provider, provided such element is not in itself subject to a licence requirement.</p>	Outsourcing of material activities is subject to a materiality test and proportionality.	N/R.
Pre-notification	Pre-notification should not be mandatory, only if it is used as a	Some supervisors expressed concerns about pre-notification	See Standard 4.3 and

	prior-approval for outsourcing.	for legal and administration reasons. The requirement of pre-notification was thus changed into the request for adequately information, which needs to be done in accordance with national law.	Standard 4 note 2.
Outsourcing of services and activities that are covered by the institution's authorization	This principle is considered overly strict and an impediment to outsourcing opportunities for institutions. It is considered especially not understandable why licensed banks should only outsource to banks similar kind and not to investment firms or specialized institutions holding limited banking license.	Outsourcing to non-licensed institutions is possible subject to conditions. "Authorization" covers activities according to Annex I of Dir 2000/12/EC.  Contacts with CESR brought up the question whether all Annex I activities should be covered or only those related to deposit taking and credit business.	See new Standard 4.
Distinction between important and less important activities	What is important and less important?	This distinction is unclear and has been removed.	N/R.
<b>IV</b>			
There should be no restrictions on the outsourcing of non-material activities of an outsourcing institution.	Respondents remarked that the focus should be on the process of outsourcing and not on restrictions of outsourcing possibilities.	CEBS is of the opinion that the Standards deal with the process of outsourcing. The Standards apply to all kinds of outsourcing.	See Standard 5.
<b>V</b>			
The Outsourcing institution should have a policy on its approach to outsourcing, including contingency plans and exit strategies.	It is argued that an outsourcing plan should not apply if an institution is intending not more than two outsourcing projects.  Opposition to idea of a centralisation via the requirement of the general	The Standards distinguish between different forms of outsourcing and make their application subject to the kind of outsourcing. The number of outsourcing projects can, thus, not be a decisive factor.	N/R.

	<p>policy. The respondent argues that it will not lead to increased efficiency if one unit has to manage and control the outsourcing but the management of the outsourcing unit should remain responsible.</p>	<p>The requirement is that of a general policy for a credit institution. How this policy is drafted, is left to the outsourcing institution.</p>	
<b>VI</b>			
<p>An outsourcing institution's policies should require it to manage the risks associated with its outsourcing arrangements.</p>	<p>CEBS is asked to explain how banks should alert supervisors when an outsourcing contract starts to deteriorate. Some suggest that reporting of serious problems in the annual report to the supervisor should be considered enough, since there is the management's responsibility.</p>	<p>It is not CEBS' intention to be overly descriptive. The communication policy between credit institution and its supervisory authority should be determined between these two.</p> <p>No material changes ("principle" changed into "article").</p>	N/R.
<b>VII</b>			
<p>Outsourcing contract</p>	<p>Some respondents want even stronger wording with regard to the outsourcing institution's and supervisory authorities' rights on audits of the outsourcing service provider; whereas others explain that multi-client service providers often produce one single audit report established by an independent audit firm to all clients instead of being subject to unsystematic auditing by each client's audit departments.</p>	<p>The current wording provides for these possibilities. CEBS does not think that more precise wording is necessary.</p>	
<p>List in subtext</p>	<p>The contract list should not be</p>	<p>The list in the subtext of</p>	N/R.

	considered exhaustive.	Standard 8 is not exhaustive.	
Secrecy provisions	The outsourcing contract shall comprise secrecy provisions stating that the outsourcing service provider must be obliged to keep the same level of secrecy as the outsourcing institution.	Remarks that outsourcing contracts shall contain secrecy provision stating that the outsourcing service provider must be obliged to keep the same level of secrecy as the outsourcing institution will be incorporated.	See Standard 8 and Standard 8 note 2.e.
<b>VIII</b>			
Service level agreement (SLA)	According to some separate SLA should not necessarily always be a requisite, e.g. in the case of non-complex activities a description of the service in the contract should be sufficient. CEBS guidelines should accordingly indicate that the service required should be detailed in written form.	The Standards do not contain any obligation that the SLA needs to be in writing.	N/R.
<b>IX</b>			
Supervisory authorities should aim to establish a right to information, and to conduct, or order, on-site inspections in an outsourcing service provider's premises.	This statement can be problematic in some EU countries from a contractual perspective. Details on how this principle will be put into practice by supervisory authorities need to be clarified.	Supervisors feel that this is a necessary prerequisite. The Standards are open as to how this may be achieved.	N/R.
Cancellation rights	The right of cancellation of an outsourcing agreement by the supervisory authority is widely opposed. Not only many do find it much too far-reaching for the supervisors to directly interfere	This cancellation right may, indeed, go too far and not be legally feasible. It is, thus, dropped. It, however, is essential for some supervisors to be able to interfere in an	See Standard 8 note 2.j.

	in an outsourcing contract, but this standard raises concerns as to the legality and enforceability of such a provision, too.	outsourcing relation.	
<b>X</b>			
Supervisory authorities should take account of concentration risk, where one outsourcing service provider provides outsourcing services to several authorised outsourcing institutions.	In several responses it has been pointed out, that a certain concentration in outsourcing is inevitable, since the banks will opt for service providers with a 'best in class' reputation, specialized providers are generally very well equipped, dispose of a better know-how and are well-organized.	No material changes.	Footnote deleted.
<b>XI</b>			
Supervisory authorities should take account of the risks associated with "chain" outsourcing (whereby the outsourcing service provider subcontracts elements of the service to other providers).	<p>It is argued that multi-service providers – either as superior entities, to subordinate entities, or as non-consolidated entities in non-consolidating groups – should not make these outsourcing arrangements subject to the supervisory outsourcing regime. This is because banks retain powers of instruction, control or inspection towards the multi-service provider.</p> <p>It is suggested that supervisory authorities may request a prohibition of chain outsourcing in the primary outsourcing contract.</p>	<p>The standards reflect the supervisory concern over chain outsourcing or sub-outsourcing. The industry has suggested that this could be overcome with a general prohibition on sub-outsourcing in the first outsourcing contract. This, however, appears to be overly strict and forgets that responsibilities do not change when many service providers are involved.</p> <p>The primary responsibility for a decision on chain outsourcing should remain with the credit institution.</p>	Moved forward into Part 2 and is now Standard 10.

