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Committee of European Banking Supervisors Consultation Paper on High Level Principles on Outsourcing

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Comments of UBS Investment Bank

UBS Investment Bank (UBS-IB) welcomes the opportunity to comment on the Consultation Paper on High Level Principles on Outsourcing (CP) published by the Committee of European Banking Supervisors (CEBS) on 30 April 2004. The CP undertakes to (1) articulate high level principles to foster convergence of supervisory approaches and practices on outsourcing across the financial services sectors; and (2) to promote an internationally accepted regulatory definition of outsourcing and a common set of principles.

UBS-IB is the investment bank of UBS AG, employing 16,000 people in offices located throughout 30 countries. UBS AG is a global, integrated investment services firm and bank, domiciled in Switzerland, with offices in over 50 countries worldwide. UBS AG's business is managed through four main business groups and its Corporate Centre.

General Comments

Prohibition on outsourcing of strategic or core activities

1. UBS-IB has concerns regarding the proposal by CEBS to impose a three-tier classification system for assessing suitable activities for outsourcing. Under this system, outsourcing of strategic or core activities is prohibited although no specific criteria are provided. UBS-IB believes this blanket prohibition on outsourcing in the absence of any meaningful definitions of these activities is overbroad and does not give adequate consideration to changing business models, systems innovations and evolving regulatory views and requirements. In order for such a prohibition to be practicable, supervisory authorities would need to provide institutions with details of the characteristics of strategic or core activities to allow those institutions to judge the true impact of the prohibition. In general, whilst we accept that there may be certain activities that should not be outsourced, we would be averse to any form of blanket prohibition as it denies investment firms the opportunity to engage in a dialogue with supervisory authorities on how certain activities are best controlled. This is particularly true given that outsourcing is a relatively new and evolving practice by institutions, and is driven heavily by

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competitive pressures, cost reduction, time-sensitivities, manpower constraints and overhead.

Level of detail and regulatory prescription

2. UBS-IB is supportive of the supervisory convergence work undertaken by CEBS in this area. However, many of the high-level principles proposed by CEBS in the CP are significantly more stringent than those principles and rules operating within certain Member States. For example, the draft principles are considerably more interventionist than the outsourcing regime under which UBS-IB is currently regulated. Nonetheless, it successfully balances the interests of both regulators and financial services firms by encouraging constant dialogue between the two. We believe, therefore, the better approach is to strive for minimum harmonisation by proposing higher-level principles that reflect the current regulatory environment both at the Member State and European level. In this regard, the Committee of European Securities Regulators has recently stated that it does not intend, in its technical advice to the European Commission on the Directive in Markets in Financial Instruments, to propose a complete ban on outsourcing of core business.

Intra-group and extra-group outsourcing

3. The CP does not adequately distinguish between intra-group and extra-group outsourcing arrangements. Under the draft principles, intra-group outsourcing arrangements are subject only to a very limited exemption of certain risk management obligations of senior executive management where the outsourcing institution is a member of a group subject to supervision on a consolidated basis. Intra-group outsourcing arrangements will, by their nature, be under group control. In these circumstances intra-group outsourcing represents a significantly lower risk that does not warrant application of highly prescriptive provisions. As a general rule, UBS-IB believes that principles, and the regulations they engender, should be tailored to the risks inherent in the specified activity. We would therefore urge CEBS to adopt a more proportional approach towards intra-group outsourcing by permitting more flexibility.

Specific Comments

Authorisation of outsourcing service provider

4. In the definition of outsourcing the supplier, or outsourcing service provider, is described as either an authorised or unauthorised entity. We would ask that guidance be provided on whether there would be any circumstances when a supplier would have to be regulated by a supervisory authority.

Definition of "Purchasing"

5. The definition of outsourcing does not cover purchasing contracts which is defined as "the supply of services, goods or facilities without information about or belonging to the purchasing institution coming within the control of the supplier." We seek further clarification as to the accuracy of this definition. In our experience, a contract for the purchase of bespoke software may require the supplier to be provided with significant information about the processes of the purchasing institution, subject of course to appropriate obligations of confidentiality.

Prohibition on outsourcing strategic or core activities

6. We note that one of the examples cited as illustrative of a core management function that cannot be outsourced is risk management. However, "risk management" covers a huge array of functions carried out at all levels within a complex and multi-layered institution such as a global investment bank. Some of these risk management functions may be highly administrative in nature such as the processing of data supporting risk management decisions. Whilst we accept that there may be certain elements of the risk management process that it may not be appropriate to outsource, the determination will depend upon the specific facts and circumstances of each institution and its relationship to its supervisory authority. We believe that establishing an on-going dialogue with supervisory authorities on outsourcing of material activities is beneficial both to the institution and to the supervisory authority. This is particularly true where the outsourcing proposal relates to other regulatory requirements. We believe that this draft principle is unnecessarily inflexible and overbroad, and inhibits positive development of regulation in this area.

Direct access to outsourcing service provider

7. In its discussion on certain limited exceptions applying to intra-group outsourcing arrangements, the CP states that supervisory authorities should have adequate access to the outsourcing service provider. We query the necessity for the supervisory authority to have direct access to the outsourcing service provider if the ultimate responsibility is with senior management of the outsourcing institution that can itself provide the required information. This is especially true where the outsourcing arrangements are with regulated intra-group entities, which pose far less risk than unregulated 3rd parties. Instead, an institution should be required to demonstrate to the satisfaction of the supervisory authority that it has the necessary degree of access to the outsourcing service provider and that any information required by the supervisor to fulfil its regulatory obligations would be made available on request. Alternatively, if the supervisory authority does, in the view of CEBS, require direct access to the outsourcing service provider, then CEBS should provide detail on how this is to be achieved and whether it believes such access must be permitted under all outsourcing arrangements maintained by an institution. As a commercial matter, imposing this requirement upon non-regulated entities may well limit the number of outsourcing suppliers available to an institution.

Restriction on outsourcing authorised services and activities

8. The draft principles prohibit an institution from outsourcing services and activities covered by the authorisation of an outsourcing institution unless the service provider has either an authorisation comparable to that of the outsourcing institution or is acting as its agent. UBS-IB would ask for greater clarity on CEBS intends by reference to a service provider acting in the capacity of "agent". It is not immediately clear why this legal relationship between the service provider and the outsourcing institution is sufficient to mitigate the underlying risk exposure concerns. Moreover, we would also seek guidance on how this threshold criteria will be applied in practice to, for example, authorised activities of financial services firms such as safeguarding assets and holding and controlling client money.

All outsourcing arrangements subject to contract

9. UBS-IB believes that this proposal is overbroad and unduly burdensome by not adequately taking into account intra-group outsourcing arrangements for which a "formal and comprehensive contract" may not, in all cases, be appropriate or necessary. Flexibility should be maintained to allow regulated institutions to determine

the approach that most suits the individual circumstances of any outsourcing arrangement. In particular, this proposal does not adequately consider alternative controls to intra-group outsourcing arrangements, such as whether the outsourcing service provider retains a recognised auditor, its willingness to disclose audit information, or whether it is located in a country where there is applicable legislation on outsourcing.

Direct access to external auditor information of outsourcing service provider

10. The draft principles state that the outsourcing institution should "encourage" outsourcing service providers to make available external auditor information to supervisory authorities. This very prescriptive requirement does not adequately consider what this obligation means in practice. Outsourcing institutions may not be able to compel their outsourcing service providers to comply with this requirement, yet these same institutions risk being held accountable if their outsourcing service providers are disinclined to cooperate. Presumably, this would leave the outsourcing institution no alternative but to terminate the arrangements, which is a sub-optimal result for both parties. Moreover, if the outsourcing service provider should be willing to provide external audit information, we query what this will entail. If the requirement would be for specific tailored reports, this would obviously give rise to additional cost whereas relying on audit reports provided to the management of the outsource provider would create confidentiality issues and raise questions about the extent to which such reports could be relied upon by third parties. For these reasons we would require more detailed proposals on how this is practically to be implemented in order to be able to more clearly assess the impact.

Cancellation of outsourcing arrangements

11. We believe the focus of outsourcing regulation should be on appropriate internal controls, disciplined risk management and accountability by senior executives within institutions. These practices should be further punctuated by frequent dialogue by institutions with their respective supervisory authorities. The CP echoes this principle by stating that senior executive management of the outsourcing institution bears ultimate responsibility for management of outsourcing risks. However, this principles-based approach is frequently undermined by highly prescriptive proposals. In particular, the CP proposes that supervisory authorities should be empowered to cancel existing outsourcing arrangements if outsourcing institutions cannot ensure the exercise or enforcement of supervisory authority. We query the circumstances under which such a right could be exercised, and what procedures should be followed. This highly interventionist measure should, we believe, only be resorted to rarely, and only then after the supervisory authority has made a complete assessment of all extenuating facts and circumstances. We would expect, in any case, that an established on-going dialogue would be occurring between the outsourcing institution and the relevant supervisory authority that would make such an action unnecessary. Hence, both the prescriptiveness and the severity of this measure render it inappropriate for enshrinement in a high-level principle. In the view of UBS-IB, contemplation of such enforcement actions is best left within the discretion of the supervisory authorities themselves.

Sub-contracting by outsourcing service provider

12. We would like further elucidation by CEBS on the extent to which sub-contractors of outsourcing service providers should be governed by the same criteria as the outsourcing service provider itself. For example, it is not clear whether the proposed CEBS principles will apply directly to sub-contractors. If such principles do apply, the external auditors of sub-contractors would also be required to provide information to the relevant supervisory authority. Nor does this section describe whether sub-contractors

would be susceptible to regulation by the relevant supervisory authority. Both of these requirements could be as problematic for sub-contractors as they potentially are for outsourcing service providers. We agree that sub-contracting by outsourcing service providers must be closely monitored so as to leave the outsourcing institution in no worse position than it enjoyed with the outsourcing service provider itself. However, the vague formulation of this principle fails to produce useful guidelines for addressing this issue.

We trust you find this feedback useful.

A handwritten signature in black ink, appearing to read "Philip Price", is superimposed on a background of a dense, stippled pattern.

Philip Price
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Head of Corporate Legal Services