ZENTRALER KREDITAUSSCHUSS

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Committee of European
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Consultation Paper on High Level Principles on Outsourcing
KWG § 25 a

Dear Sir or Madam,

We welcome the opportunity to comment on your Consultation Paper concerning High Level Principles on Outsourcing which was published on 30 April 2004.

Executive Summary

- In order to ensure convergence in lieu of divergence in terms of the various supervisory standards in the field of outsourcing, we kindly ask you to consider coordination between the forthcoming principles (hereinafter HLPs) and the concurrent work in this field which is being conducted by CESR and IOSCO (cf. item 1).

- In addition to the waiver for purchase agreements, the forthcoming regulatory definition of outsourcing should equally exclude agreements that are exclusively procurement based (e.g. rental agreements, leasehold agreements, etc.) as well as measures that are not geared towards the long-term (cf. also item 2).

- Since the corresponding risk situation is more favourable in cases where areas are outsourced to EU companies that are subject to supervision, such cases should become subject to less stringent requirements (cf. also item 3). Intra-group outsourcing should not be treated as an instance of outsourcing.

- Whilst complying with the requirements of a European level playing field and in order to take account of the host of different business models and of the idiosyncrasies of submarkets, waivers for the application of these HLPs should be made possible (cf. also item 4).

- When outsourcing areas to companies that work for a large number of institutions, waivers should be envisaged concerning the renunciation of individual instruction and control rights on the part of the outsourcing institution (cf. also item 8).

First of all, we should like to point out that, already today, when it comes to outsourcing, Germany has a very high level of supervision. This is owed to the 1997 introduction of section 25 a, subsection 2 German Banking Act [KWG] and it is also due to the corresponding more detailed implementing provisions adopted by the German regulator BaFin (Bundesanstalt für Finanzdienstleistung) in 2001. We welcome the fact that the formulation of European-wide HLPs will now create a level playing field for credit institutions within in the EU thus facilitating cross-border outsourcing solutions. At the same time, however, it is of special importance that the HLPs provide national supervisors with a framework for accommodating the wide variety of differences in the business models of institutions with their very own risk profile and which also take account of the idiosyncrasies of local submarkets.

Market needs are subject to increasingly rapid changes. Together with the general business climate, this leads to a situation where banks increasingly have to capitalise on their own core strengths. This means that they may have to outsource to specialised service companies those functions which do not form part of said core competency of their own business or functions which lack the critical mass necessary for delivering these functions in-house. Hence, for the banking community, it is of crucial importance that regulatory provisions shall confine themselves to setting out the broad terms thus granting banks that degree of autonomy which is essential for the flexible responses needed by the market. As a general principle, entrepreneurial freedom should not become curtailed due to regulatory provisions on outsourcing. In order to ensure an efficient implementation and handling both on the part of supervisory authorities as well as on the part of the institutions subject to supervision, mandatory legal provisions should be strictly geared towards the real and relevant risks and they should remain limited to an appropriate level.

After the foregoing preliminaries, we would like to submit the following more specific comments on the individual regulatory proposals:

1. Consultation with CESR

First of all, we should like to point out that the Committee of European Securities Regulators (CESR) currently holds a mandate by the EU Commission concerning the drafting of recommendations for the implementation of Directive 2004/39/EC on Markets for Financial Instruments which shall also contain special provisions on the outsourcing of functions by investment firms. For the companies concerned, it is indispensable that the regulations in the general field of prudential banking supervision as well as supervision in the field of securities shall be consistent with each other. This will avoid the creation of two different legal regimes that would have to be applied in parallel. We therefore strongly recommend close consultation between CESR and CEBS in matters concerning outsourcing of areas and functions to another company.

Furthermore, also the International Organization of Securities Commissions (IOSCO) is currently working on Standards regarding outsourcing. In this respect, too, we perceive a strong need for consultation in order to prevent a subsequent drifting apart/divergence of supervisory standards or, moreover, the need for a subsequent adjustment that would, once more, shift the goalposts for institutions.

2. Definition of outsourcing

The definition of outsourcing should only cover those functions that are transferred on a permanent basis or which, at least, take place over a sustained period of time. Otherwise, even the assignment of individual tasks (e.g. the preparation of a valuation report) would have to be regarded as outsourcing. Such an approach would make the implementation of the outsourcing rules unrealistic. Its benefits would bear no relation to the necessary expenses. What is more, it would create inappropriate obstacles for the assignment of such jobs.

Furthermore, we feel that an amendment of the language is necessary. There needs to be a clarification that an instance of outsourcing as contemplated by the HLPs shall only apply to those cases where the activity etc. in question is specifically connected to the execution of a banking or investment firm transaction.

For an easier distinction between cases of material outsourcing on the one hand and non-material outsourcing on the other hand, it would be extremely helpful if, by way of example, case groups were listed or if at least more detailed guidelines for their identification were provided.

We welcome the fact that the definition of outsourcing shall not cover purchasing contracts i.e. purchase and/or service agreements used by an institution to procure standardised products. In our view, however, the scope of this derogation is not wide enough. We would welcome an additional amendment clarifying that the same exclusion from the regulatory scope of the HLPs shall apply to any further procurement agreements, such as rental and lease agreements. Furthermore, the question whether the purchase in question concerns ready-made, i.e. standardised goods or custom-made goods and services is irrelevant. The field of software development is but one example where this becomes evident. Software development does not form part of a bank's core business areas. For efficiency reasons, such functions are regularly transferred to third parties. In our view, they should thus not fall under the outsourcing definition. Besides the purchase of standard software, institutions regularly commission customized applications geared to their individual business needs. Yet, this practice does not necessarily give rise to any higher risk. The question whether a software is standardised or whether it is custom-made is not mission critical for the security of a banking operation. What is, however, mission critical for the security of a banking operation is that before being deployed in day-to-day banking operations, such software will be carefully tested by management with a view to its orderly functioning and in terms of potential security issues.

Beyond this, there should also be a clarification that the definition of outsourcing as contemplated by the HLPs neither covers temping agency staff who -for the duration of their engagement- are fully integrated into an institution's operations and logistics. Said full integration into the organisation creates a situation where there is no longer any difference between an institution's regular staff and its temporary workers.

3. Outsourcing to institutions subject to supervision/intra-group outsourcing

We feel that, from the point of view of risks, less stringent formal requirements are warranted in those cases where functions and areas are outsourced to EU companies which themselves need to hold a banking license or similar permits for these functions and areas. After all, such EU companies are thus already fully covered by supervision through competent authorities. By way of example, this applies whenever a contractual clause grants individual inspection rights and it equally applies to the commitment to stipulate a contractually binding clause to the effect that the outsourced areas shall be subject to the same standards as the outsourcing institution.

Under risk aspects, in those cases where the outsourcing company is a company that is already subject to the supervisory authority, we feel that it would be appropriate to exclude intra-group outsourcing to subordinate companies and similar constellations (e.g. joint ventures) from the scope of the definition of outsourcing. Such a kind of interpretation would be appropriate since these outsourcing cases already comply with the HLPs. The outsourcing service provider companies will be regularly bound by the senior company's instruction right. Hence, there is no danger that the senior executive management's ability to manage and monitor the business will be impaired or that the latter will lose control over the orderliness of the outsourcing institution's business being conducted or the financial services being provided. Furthermore, in any case of these outsourcing companies, the supervisory authority's right to require an inspection of the business and its ability to supervise the business is guaranteed. Due to the growing importance of intra-group outsourcing, from the point of view of risk mitigation, coverage of intra-group outsourcing under the outsourcing rules would create little value added. Quite the contrary: Such an approach would frequently burden institutions with considerable and costly administrative logistics.

4. Regulation of waivers for certain areas of activity

Certain business types require cooperation between several companies. Such cooperation tends to be based on the division of labour. In certain cases, the formal application of outsourcing HLPs would lead to a significant complication, higher prices and red tape that might potentially also disrupt dovetailed processes without generating any material benefits to compensate for such disruptions. This would be the case where -owed to the specific nature of the workflow behind the respective business transaction– an involvement of third parties is inevitable for a complete and economically viable execution of the transaction or where this is needed due to the specific, structurally essential division of labour within a banking group. We thus propose that particularly the following business types shall be specifically excluded from the HLP's scope: Function of the clearing houses for the purposes of clearing and settlement during securities transactions, use of securities trading systems by institutions, the authorisation centres for electronic cash transactions as well as the central bank function within one banking group, the involvement of lead managers, arrangers or agents for syndicated loans and similar case groups.

Furthermore, in order to take adequate account of the wide variety of institutions' business models within the EU, there should be a specific provision stipulating that national supervisory authorities may issue further waivers for those areas that are under their jurisdiction. Flexible solutions that also provide scope for derogations are the only way for an adequate reflection of the respective risk situation at hand. One approach that, at least in Germany, has proven successful is that the German

regulator BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht) and the banking industry agree derogations for specific, individual cases or case groups where the risks associated with outsourcing are not relevant in terms of the prudential supervision law.

5. Setting up a central interface

Pursuant to the presentations on HLP V, the institution shall set up an internal unit that is responsible for supervising and management of each outsourcing measure. One single central unit alone will, however, generally lack the expertise necessary for an efficient simultaneous supervision and management of all service companies at once. It would thus appear judicious to construe this provision along the lines that one central unit shall keep track of the overall picture in terms of each and any outsourcing activity whilst the ongoing coordination and monitoring shall be incumbent upon the respectively competent authorities that are in possession of the necessary expertise.

6. Trouble reports

Under HLP VI, there is the requirement that all serious problems in relation to the service provider shall be brought to the attention of the supervisory authority. This would, in practice, lead to redundant, additional red tape. One approach that has proven successful in this regard in Germany is that material shortcomings shall be reported in the annual audit report of the outsourced area and thus brought to the attention of the supervisory authority. Furthermore, in Germany an auditor is held to give immediate notice to the supervisor whenever circumstances occur which may have a materially adverse impact on the development of the institution (Section 29, subsection 3 - German Banking Act [KWG]).

7. Fixing of the Service Level

Concerning HLP VIII, there is a provision stipulating the need to prepare a Service Level Agreement (SLA). In the case of outsourcing of activities which require a comprehensive service specification, such an SLA is prepared separately, in addition to the agreement. However, for other activities which require a far less specific service description, a service description under the outsourcing agreement is sufficient. In our understanding, this provision means that the preparation of a separate SLA in addition to the outsourcing agreement is not mandatory. The issue of a separate SLA will, in the final analysis, depend on the individual circumstances and on the respective jurisdiction, as long as it is secured that the service will be rendered on the basis of a written agreement.

8. Provisions on service providers providing services to several outsourcing institutions

Under HLP X, the Consultation Paper stipulates that supervisory authorities should manage and monitor concentration risks. This appears to be based on the understanding that outsourcing to service providers providing services to several authorised outsourcing institutions will be associated with a higher risk. Yet, it also needs to be taken into account that service providers providing services to several outsourcing institutions generally have a higher degree of know-how concerning the outsourced area than service providers who provide services to just one outsourcing institution. What is more, whenever a service amendment occurs (i.e. due to changed regulatory or technical provisions), the resulting changeover costs as regards the individual outsourced activity are considerably lower meaning that such an adjustment will be encumbered by far less problems. Based on the foregoing remarks, we would welcome a more detailed specification of the nomenclature, i.e. a more concrete specification of what is involved by *managing* concentration risks (cf. HLP X).

For service providers that have assumed the same service for a number of institutions, any individual instruction right as well as any granting of independent inspection rights for an internal review in each outsourcing institution may lead to highly problematic consequences. Such individual rights would have an extremely negative impact on cost efficient transfer of functions to units that are capable of handling economies of scale. Therefore, in order to rule out any unlimited or excessive individual review and instruction rights for each individual institution, a derogation should be included for service providers providing outsourcing services to several outsourcing institutions.

9. Cancellation of the outsourcing measure by supervisory authorities

Concerning HLP IX, paragraph 7 requests that the supervisory authority shall be entitled to initiate cancellation of the outsourcing agreement. In our understanding, this provision stipulates that the supervisory authority shall, however, not hold any individual right of its own allowing it to proactively cancel the outsourcing agreement. After all, the supervisory authority, first and foremost, holds considerable rights of intervention *vis-à-vis* the outsourcing institution itself. Secondly, any right of termination on the part of the supervisory authority will very likely engender considerable problems under contractual law; from the point of view of civil law it will frequently prove unfeasible.

10. Outsourcing to service providers abroad

In the event of outsourcing of areas to service providers abroad, there need to be comprehensive contractual safeguards that fully ensure inspection and monitoring rights of the supervisory authority. Concerning the issue of the exercise of supervisory competencies beyond their own territorial jurisdiction, we propose the establishment of rules for a regime concerning cooperation of national supervisory authorities. This should guarantee that the authority which has the easiest access becomes involved and it should also prevent duplication of work as far as inspections by different authorities are concerned.

11. Expansion of intervention rights

Pursuant to item 7 of the Consultation Paper's Cover Note, there are plans to lay down specific criteria which would warrant intervention. We feel that the stipulation of such intervention criteria would be redundant. Already today, the legislator has granted competent supervisors comprehensive intervention rights *vis a vis* institutions; once the European Union sees implementation of Basel II's second pillar, this intervention list will be further expanded.

12. Editorial suggestion: Bullet point notes

In order to facilitate quotes and reference to individual provisions under the HLPs, we would furthermore suggest numbering the basic HLPs; we also propose numbered bullet point notes for the individual subsections of the text.

We would very much appreciate consideration of the foregoing arguments in the forthcoming proceedings.

Yours faithfully,
For
ZENTRALER KREDITAUSSCHUSS
Deutscher Sparkassen- und Giroverband
For and on behalf

Dr Thomas Schürmann