



Fédération Bancaire Européenne
European Banking Federation
Le Secrétaire Général

N°0537
COK

E-mail

Mr José María Roldán
Chairman
Committee of European Banking Supervisors
Banco de España, Alcalá 50
28014 Madrid

CP02@c-eps.org

Brussels, 30 July 2004

Subject: Consultation Paper on the High Level Principles on Outsourcing

Dear Mr. Roldán,

The European Banking Federation (FBE) welcomes the opportunity to comment on the consultation paper on the high level principles on outsourcing. Convergence of supervisory practices in the EU is of fundamental importance to achieving the objectives of the Single Market and in that context the high level of cooperation within CEBS which has contributed to this initiative is welcome.

We agree that the paper provides a robust summary of the issues related to supervision of outsourced activities. However, we also feel that banks already have strong risk management procedures in place to manage outsourcing service agreements. Therefore, while we acknowledge that this is a work in progress, we also believe that CEBS should ensure that a move towards convergence of practices is in the interests of both industry and supervisors and does not stifle the development of outsourcing within the banking industry.

We would urge CEBS to take great care not to develop overly-prescriptive procedures which could result in interference in the contractual relationship between the bank and the service provider. It is important that the supervision of outsourcing agreements should form part of the ongoing dialogue between the bank and its supervisor.

The European banking industry believes that the following principles should guide any work on supervision of outsourcing:

- Outsourcing is and should remain a bank's decision, based on economic grounds, after a careful risk and cost/benefit analysis;
- The bank must retain the responsibility for the final quality of the services it outsources through managing the contractual and commercial relationship with the outsourcing service providers.
- The High Level Principles must not become an obstacle to the development of new and innovative models in the banking industry in the future.

Please find below our detailed comments. We look forward to working closely with CEBS to develop this area further.

Yours sincerely,

Nikolaus BÖMCKE



Fédération Bancaire Européenne
European Banking Federation

FBE comments on the Consultation Paper on High Level Principles on Outsourcing

The FBE believes that supervisory convergence in Europe is a priority and in this context we feel that the CEBS consultation paper provides a welcome first step towards that objective.

CEBS' paper provides a good summary of the current practices of both banks and supervisors in the treatment of outsourcing arrangements. We feel that it would be useful, however, for the paper to make explicit reference to the following Basel Committee documents as sources of guidance currently used by banks to perform their risk analysis and for supervisors to evaluate the adequacy of the risk analysis:

- “Sound Practices for the Management and Supervision of Operational Risk”, February 2003;
- “Framework for Internal Control Systems in Banking Organisations”, October 1998;
- “Framework for the Evaluation of Internal Control Systems”, January 1998.

An institution should retain the prerogative and power to decide whether to outsource or not, on the basis of its own risk and cost/benefit analysis carried out prior to outsourcing. In addition, ongoing monitoring by the bank of its outsourcing arrangements is required to ensure associated risks are managed effectively.

The FBE recommends that no further risk analysis guidance is required other than that contained in the international regulatory regime from the Basel Committee on Banking Supervision outlined above. Furthermore, the FBE believes that all outsourced processes should be captured by the Basel Committee's operational risk framework. This should be clarified by CEBS in the final High Level Principles.

It is important to recognise that the notions of outsourcing and of “core and strategic activities” have evolved in recent years in line with the pace of change in the banking industry and will continue to evolve. The way in which these notions are understood should not be limited or frozen at one point in time by overly-prescriptive regulatory definitions.

1. Further Work

As stated in our covering letter, the FBE acknowledges that the High Level Principles are a work in progress and, in that context, urges CEBS to be very cautious in trying to develop the concepts of “core and strategic activities”. On the question of the materiality test, we also encourage CEBS to design a test which is not complex and which is directly related to activities “that can affect the ability to meet the regulatory responsibilities or to continue the business”. We look forward to seeing future work in both these areas.

The FBE would recommend to CEBS that further work should also be carried out on risk transfer mechanisms with a view to providing clarification on when

operational risk is considered to be truly outsourced and if, subsequently, it becomes a credit risk. In particular, consideration should be given to how operational risk losses relating to outsourced activities are absorbed.

For example, where an outsourcing service level agreement specifies an error rate or tolerance level, the agreement must clearly state whether the bank or the service provider must cover any losses incurred above the agreed tolerance level. If the bank is obliged to reimburse the outsourcing service provider for these losses then the associated operational risk should be considered to remain within the bank. This should also be the case where the additional costs arising from losses above the tolerance level are covered by the bank through periodical price adjustments. The bank should be able to clearly show how the operational risk arising from these transactions is covered.

Only where fixed prices have been agreed and the service provider has an agreement to cover the additional losses could it be concluded that the operational risk has been fully outsourced. This is a very rare situation in our view, which turns the operational risk into a kind of counter-party risk on the outsourcing provider.

1. Part 1: Definitions

The FBE agrees that there are a number of possible definitions of outsourcing and that it is difficult to agree a definition which would be acceptable across the EU. However, if there is to be consistent treatment of outsourcing in the Single Market, then there must be a pan-European definition.

The FBE believes that the definition provided is too generic in nature to facilitate the objective of convergence referred to in CEBS' introductory comments. Such a definition would inevitably encourage supervisors to develop more precise guidelines at national level and would therefore render this initiative obsolete. The definition of outsourcing should only refer to a typical banking activity or function. Furthermore we believe that the definition should emanate from the outsourcing institution's perspective. It should be based essentially on the transfer of an internal function or activity by a financial institution to a third party entity.

If CEBS intends to include a precise definition in the paper, then the following difficulties should be taken into account:

- Intra-group outsourcing

The FBE does not agree that intra-group outsourcing should 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. We, therefore, regard specific regulation for intra-group outsourcing to be a burdensome and costly formality without any measurable added value in terms of risk management.

- Thresholds

Supervisors must ensure that the threshold for regulated outsourcing does not drop below "material outsourcing" at which point it should not be a supervisory concern. We believe the drafting proposed by CEBS of "the provision of goods, services or facilities on a structural

basis” is a step in the right direction but still requires substantial refinement:

1. *Services* - It should be expressly clarified that the provision of basic utilities to a banking group does not fall under the outsourcing definition;
2. *Goods* – The use of the term “goods” may be misleading. Contracts for the supply of goods should remain outside the definition of outsourcing. Only where a bank entrusts a third party to examine the quality and fitness of goods for their use within the institution and its services is it relevant within the definition;
3. *Facilities* – Where data centres or warehouses are run on external servers this may indeed be outsourcing. However, if an institution leases network capabilities from a world wide active network service provider there should be no reason to submit the activity of such a network service provider to banking supervision.
4. *Exclusion of purchasing contracts* – The FBE agrees with the exclusion of purchasing contracts from the definition. A good example of this would be software development. Software development is not a characteristic activity of a bank. It should, in our view be excluded as a “purchasing contract”. On the other hand, deciding whether the software is suitable for use within the institution is a typical function. Therefore, the respective internal units which instruct the developer and ensure internal testing and approval of the developed applications could be regarded as falling under the outsourcing definition.
5. *Advisory or consultancy services* – These types of services should not be considered as outsourcing even if they are closely related to a typical activity. In such situations the bank relies on the expertise of the third party in a specific field, but is not required or expected to have such expertise internally. As the HLPs are currently drafted, consultancy and advisory services would fall under the definition of non-material outsourcing. The FBE does not believe such services should be treated as outsourcing at all.

- Duration or permanence

The definition of outsourcing requires an element of duration or permanence. Outsourcing takes place on an ongoing basis and one-off provision of services should be explicitly excluded from the definition.

- Cooperation within the banking industry

Long-standing practices of cooperation within the banking industry should be distinguished from outsourcing arrangements, e.g. syndication of loans, cooperation in the transfer of funds from one bank to another through various intermediate banks, correspondent banking, opening of nostro accounts and the use of common market platforms such as clearing houses, trading platforms etc.

2. High level principles addressed to institutions

I. Strategic and core management responsibility cannot be outsourced.

The High Level Principles state that CEBS does not expect to see outsourcing of strategic or core management responsibility “except for in exceptional cases”. The FBE believes that this is an excessively conservative view to take. As stated above in respect of developing a definition, firstly without clear thresholds in place there will be no consistency of treatment of “strategic and core” nor of “material” outsourcing as referred to in Principle III. Secondly, as already stated these concepts in outsourcing are both relative to the size and complexity of the institution and are also evolving to changing market practices. For example, financial institutions operating a virtual model outsource most non-customer facing activities and even certain customer-facing activities through call centres, etc. In some jurisdictions the only restriction relates to the internal audit function. It is unclear how these institutions would function if the proposed restrictions were enforced.

Furthermore, complex financial institutions often provide important financial services, including securities services, to other companies (banks and non-banks). The FBE therefore considers that CEBS should introduce a distinction between outsourcing to authorised financial institutions as opposed to outsourcing to unauthorised financial institutions or other entities. In cases where the 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, we consider that it should be possible for processes that fall into another bank’s view of “strategic or core” activities to be outsourced.

III. An outsourcing institution should take particular care when outsourcing material activities, i.e. activities of such importance that any weakness or failure in the provision of these activities could have a significant affect on its ability to meet its regulatory responsibilities and/or to continue in business. In such cases the outsourcing institution should pre-notify its supervisory authority.

The FBE believes that the rule “an institution may not outsource services and activities that are covered by the institution’s authorisation unless the outsourcing service provider has an authorisation which is comparable...” is overly-restrictive. We agree that the full activity cannot be outsourced to a non-licensed provider, but 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.

We understand that supervisory authorities need to be kept informed of major changes in the way an institution is doing business. That does not, however, imply that the changes should have to be authorised by these bodies. We recommend

that the term “pre-notify”, which is ambiguous, be dropped and replaced by “duly inform”.

VII. All outsourcing arrangements should be subject to a formal and comprehensive contract.

The FBE agrees that outsourcing arrangements should be subject to a formal written agreement which should be proportionate to the risks involved.

We also agree that, in the agreement, the outsourcer should reserve the right to audit *in situ* the outsourced process. However, an outsourcing institution should be able to decide whether it conducts the audit of the outsourced activity itself or whether it relies on the audits of the outsourced functions conducted by the internal audit department or by an independent audit firm. This is of particular importance in situations where the institution has outsourced to a multi-client service provider. Multi-client 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.

3. Other supervisory principles on outsourcing

IX. 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.

The FBE considers it too far-reaching to give the supervisory authority the right to cancel an outsourcing agreement. This would represent intervention between parties in a contracted agreement and, in our view, is not legally acceptable. The right to information of the supervisory body can only stem from the auditing rights given to the credit institution by the outsourcing agreement. The auditing provision in the agreement would have to stipulate that auditing rights may be exercised by the supervisory body on behalf the credit institution.

X. Supervisory authorities should take account of concentration risk, where one outsourcing service provider provides outsourcing services to several outsourcing institutions.

The FBE believes that concentration risk in outsourcing is inevitable as banks will opt for service providers with a ‘best in class’ reputation. We, therefore, encourage CEBS to develop its ideas on “concentration” risk whereby a number of financial institutions outsource all processes of a particular type to one or two outsourcing service providers. Individual supervisors’ validation and review of single outsourcing contracts will not cover this risk. We would suggest that CEBS investigate the feasibility of a “global assessment” of outsourcing arrangements to be made across jurisdictions to identify service providers who could pose higher risks to institutions.