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European Banking Authority
Floor 46, 1 Canada Square
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[NON-CONFIDENTIAL]

RE: EBA/CP/2018/11 – European Banking Authority's Consultation Paper on Draft Guidelines for outsourcing arrangements

Introduction

The Bank of New York Mellon Corporation (BNY Mellon) is a global investment services and investment management company dedicated to helping its clients manage and service their financial assets throughout the investment lifecycle.

As one of the world's largest investment services and investment management firms, BNY Mellon welcomes the opportunity to respond to this important consultation paper.

BNY Mellon operates in Europe through: (i) branches of The Bank of New York Mellon (a New York state chartered bank) and (ii) directly established and duly authorised subsidiaries established in certain EU jurisdictions and branches of those entities operating in core EU member states. We are the world's largest custodian bank and asset servicing company, who also engage in investment / asset management services in EMEA through our multi-boutique model.

BNY Mellon provides services to clients and end-users of financial services globally, holding USD$32.2trillion in assets under custody and USD$1.8trillion in assets under management.[1]

BNY Mellon provides services to clients and end-users of financial services globally. Accordingly, BNY Mellon is keen to ensure global financial markets operate fairly and consistently, and that common standards are implemented in a way that ensures a level playing field.

[1] As of December 2017.

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Executive Summary

Outsourcing arrangements – both intragroup and third-party - are widely used by banks and investment managers as they contribute to the efficiency and the competitiveness of business models. By accessing skills and services externally, the ability of firms to offer market-wide services can be increased in a way which contributes to operational efficiency.

Against this background, it is crucial that the guidelines strike the right balance between necessary safeguards to ensure that outsourcing arrangements rightly have sufficient oversight and governance, while preserving the flexibility to adapt to fast-moving economic and technological developments.

There is a need for regulatory convergence in this space given how fast technology markets in particular are changing. In particular, the global context in which many financial services institutions operate in should be taken into account. We welcome the fact that these guidelines will provide increased convergence within the EU, which should promote the goals of the Capital Markets Union – but also urge policymakers to continue to take into account other national and regulatory approaches across the globe (for example, in the guidelines' treatment of third-country regulators) in order to retain and further promote the competitiveness of EU financial markets.

Given the 'fundamental precept'[2] agreed by IOSCO that the assessment of materiality 'is often a subjective and depends on the circumstances of the … firm',[3] we support the proposals to enhance how firms assess criticality and importance. However, flowing from this, we would expect that the majority of the provisions should therefore be limited to critical and important functions in order to properly comply with the policy intent of the guidelines in a proportionate manner.

Moreover, we take this opportunity to highlight the importance of outsourcing to EU and international cross-border groups, which have long-held practices of intra-group outsourcing in addition to third-party outsourcing. As a result, firms involved in intra-group outsourcing may already have significant governance and controls in relation to their intra-group arrangements. We would ask the EBA to recognize and consider this in formalizing these guidelines, not in the least in view of centralized functions which act as a service provider for the other entities of the group and / or serve a purpose in wider global recovery and resolution planning.

Further, with respect to third-party arrangements, arrangements between regulated financial services entities should be treated differently that those between regulated financial services entities and unregulated entities. The latter do not currently benefit from the same strict regulatory and supervisory framework as the financial sector and recognition of this distinction seems prudent when considering the policy goals of these guidelines.

[2] Principles on Outsourcing of Financial Services for Market Intermediaries, IOSCO, 2005. https://www.iosco.org/library/pubdocs/pdf/IOSCOPD187.pdf
[3] Ibid.

We also consider in detail technical matters related to the application of these guidelines, including the need for additional transitional time to move towards full and proper implementation. In particular, we suggest a period of an additional 2 years with respect to both deadlines:

- the date of 30 June 2019 for compliance for outsourcing arrangements entered into on or after this date should become 30 June 2021

- the date of 30 December 2020 for all other outsourcing arrangements should become 30 December 2022.

This will allow firms to properly and fully implement these important reforms in a robust manner.

Responses to Specific Questions

Our responses to the specific questions raised are contained in Annex 1 below.
BNY Mellon would be delighted to engage further as helpful on our response and / or in regards to future developments on this important topic.

Yours sincerely,

Veronica Iommi
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ANNEX 1 – Responses to Specific Questions

Q1: Are the guidelines regarding the subject matter, scope, including the application of the guidelines to electronic money institutions and payment institutions, definitions and implementation appropriate and sufficiently clear?

The proposed definition could do with significant clarification, particularly to ensure alignment with other cross-referenced regulation to ensure that the scope of the reforms remains proportionate. Only critical or important outsourcings should be subject to the guidelines.

In particular, a narrower and clearer definition would help guide firms with respect to scope. The link to MiFID II does not appear fully consistent: the Commission Delegated Regulation (EU) 2017/565 supplementing MiFID II only applies to the outsourcing of "critical or important" functions and not to all outsourcing arrangements as proposed by the EBA in these current guidelines. Moreover, Art 30.2(a)-(b) of the Delegated Regulation clearly limits the scope of those functions that should be considered to be "critical or important" in a manner which appears much narrower than the EBA proposed definition in Title 4, 9.1 of 'critical or important'.

Moreover, the words "any arrangements" and "that would otherwise be undertaken by the institution" appear to suggest that all third-party arrangements can be considered outsourcing, except for the very few exemptions mentioned in paragraph 23. Read against the remainder of the guidelines which focus on critical / important outsourcings as set against the proportionality principle, we do not see why this provision is included. We encourage the EBA to expand on the exemptions listed in paragraph 23, including making explicit that the exemptions list is non-exhaustive. These amendments would greatly assist firms in properly and robustly targeting their implementation in a way which is consistent with the underlying policy intent and spirit of the guidelines.

A further technical point on scope: the definition of 'sub-outsourcing' refers to the 'transfer' of activities, processes or services, which does not align with the definition of 'outsourcing' in the paper, which refers to 'performing' these services. The former should be substituted with the later to ensure the definition of sub-outsourcing does not go above and beyond that of outsourcing itself.

Finally, for the extension to investment firms, the definition linked to CRDIV could benefit from alignment with the new definition of investment firms currently proposed by the New Prudential Regime for Investment Firms ('NPIFR'). It is important to align this reform with the underlying CRDIV definition such that it is clear which investment managers (systemically large or otherwise) will fall in or out of scope and the timing for doing so based on the progression of the NPIFR package.

Q2: Are the guidelines regarding Title I appropriate and sufficiently clear?

It is clear that the Guidelines apply at group consolidated level and at solo level (i.e. the subsidiaries of a cross-border EU group must fulfil the requirements).

However, with respect to intragroup insourcing, we would appreciate further clarity with respect to the application of the proportionality principle. We appreciate that critical or important outsourcings could contribute to risk (whether intra-group or not). We would also, however, argue that the internal controls and governance around intragroup outsourcing (particularly as uplifted by these guidelines) reduce these inherent risks to a considerable degree. In terms of commercial practice, we do highlight that the governance of intragroup arrangements within firms has long been a matter for consideration within the financial services sector. Thus, at a minimum, we believe that the Guidelines should recognize the degree of integration reached within many financial services groups, where centralized functions at group level act as a service provider for the other entities of the group and / or serve a purpose in wider global recovery and resolution planning. In this context, the proposed requirements on documentation, due diligence, concentration risk and exit strategy may prove to be less relevant from an intra-group perspective and could be removed.

Further, with respect to third-party arrangements, we believe that arrangements between regulated financial services entities should be treated differently than those between regulated financial services entities and unregulated entities. Unregulated entities do not currently benefit from the same strict regulatory and supervisory framework as the regulated financial sector. For this reason it seems appropriate that unregulated third party entities should be treated with a higher degree of oversight to ensure consistency with the principles underlying financial regulation (investor protection and financial stability).

Q3: Are the guidelines in Title II and, in particular, the safeguards ensuring that competent authorities are able to effectively supervise activities and services of institutions and payment institutions that require authorisation or registration (i.e. the activities listed in Annex I of Directive 2013/36/EU and the payment services listed in Annex I of Directive (EU) 2366/2015) appropriate and sufficiently clear or should additional safeguards be introduced?

While we acknowledge the merits of the proposed safeguards, we think that the Guidelines should nevertheless recognize the regulatory framework of third countries. Among others, the existence of equivalence decisions with EU regulation, and of a well-established cooperation with EU supervisors should be recognized, in order to avoid undue discrimination of well-regulated third countries (e.g. Canada, Japan, Switzerland, USA, etc.), particularly for recovery and resolution planning purposes.

Moreover, the requirement to appoint a 'Key Function Holder' with management responsibility for designated aspects of the policy appears similar to current management responsibilities. We would seek clarity on how supervision of management responsibility arrangements may be altered under these new proposals, particularly given that ultimate decision-making may be taken down the chain of (sub-) outsourcings.

Whilst we recognise the requirement of the guidelines that parent outsourcers must take some level of responsibility for oversight and management of their chain outsourcings, the requirement should be proportionate and take into account of the commercial reality of the need for some reliance on decisions made down the chain. In particular, we note that a clear division of tasks and responsibilities should be allocated as an alternate to a Key Function holder where the proportionality principle applies. Moreover, we urge the EBA and national competent authorities to recognize that the level of visibility that non-financial services firms may wish to provide may be more limited than generally expected in the financial services industry (where the degree of supervisory intensity has historically been more intense). Guidance on how to manage these matters while complying with the policy intent and spirit of the guidelines would be very welcome.

We also urge the EBA to maintain alignment between the definition of EU and third-country firms. It cannot be that global companies with significant intra-group arrangements are otherwise limited as to their cross-border access because a particular National Competent Authority ("NCA") has not yet completed an MoU with their counterparts. This is particularly the case for recovery and resolution planning purposes, which is conducted at a global level for international firms and supervised by both parent and local regulators.

Q4: Are the guidelines in Section 4 regarding the outsourcing policy appropriate and sufficiently clear?

The policy guidelines in this section are extensive, and – whilst reflecting current practice for many larger firms – will be onerous to audit for compliance with these guidelines.

In particular, we are of the view that some of the requirements in paragraph 34 are too detailed for such a policy document adopted by the management body. For instance, paragraph 34(e) concerning exit strategies and termination processes, should instead be included in other process documents such as internal guidelines and/or handbooks; especially as exit strategies and termination processes will need to be determined on an outsourcing-by-outsourcing / contract-by-contract basis.

However, at minimum, if the EBA decides to retain paragraph 34:

- section (c)(ii) should clarify that changes should be communicated only where they have relevant impacts on the outsourcing management, and
- section (e)(i) and 34(e)(ii) should be clearly limited to critical/important outsourcings only.

Q5: Are the guidelines in Sections 5-7 of Title III appropriate and sufficiently clear?

The conflicts of interest section could do with clarification. How the guidelines would be made operational with respect to intragroup and intra-affiliate outsourcing is not clear. General market practice is to consider 'at arm's length' terms adequate. Clarification on the EBA's expectations for how NCAs should be supervising this section of the provisions would be welcome.

With respect to audit rights and the guidance on the internal audit function (particularly paragraph 42), we believe that firms should retain the ability to apply these on a risk-based approach, undertaken by internal audit, outsourced auditors or a combination of these. This will allow for the best leveraging of enterprise and appropriate independence and oversight in ensuring controls are robust.

Q6: Are the guidelines in Sections 8 regarding the documentation requirements appropriate and sufficiently clear?

The requirement for an outsourcing register is one of the core changes within the guidelines and we recommend the EBA consider this requirement much more comprehensively before moving ahead. Indeed, this is a new requirement for some jurisdictions, e.g. Germany. Whilst it is appropriate for firms to have a holistic view of their outsourced functions, the register should be revised to capture only information relevant for supervisory purposes. We also strongly urge the EBA to consider limiting the register to critical and important functions only in order to reflect the policy intent and spirit of the guidelines.

This is a significant uplift at group level and with respect to legal entity line of sight (as opposed to records of business line outsourcings). Further, we flag that it is not clear whether service providers would provide this information. We comment further on detail which we believe could be removed from the Register (excel) template in Q15.

As evidenced in the proposed excel template in Annex 1 to the guidelines, we also request clear guidance about the uses of the register given the proposed scope:

- **Supervisory use and transmission:** The ways in which the information in the register is to be used for supervisory purposes, including clear guidelines about the transmission and sharing of the register between jurisdictions and how this would be communicated to firms and alignment of reporting requirements to the frequency of the overall supervisory cycle (rather than immediately at any time 'on request')

- **Commercial confidentiality provisions:** guarantees about any commercially confidential information that may be contained within those registers, as the register will be privy to potentially highly sensitive matters.

Q7: Are the guidelines in Sections 9.1 regarding the assessment of criticality or importance of functions appropriate and sufficiently clear?

This is another major reform under the guidelines and we request significant clarification of the proposals before they are finalised. As per our answer to Q1, clarity is needed on the underlying definition of which outsourcings are in scope to adequately assess the criteria for criticality and importance. Currently, it appears that very few outsourcings would fall outside the definition due to the very wide scope.

Further, the definitions of materiality and other criteria are inconsistent between the core paragraphs of 49 and 51 for the purposes of assessing materiality and importance. We recommend that these two criteria are amalgamated and streamlined in order to give greater clarity as to relevant factors. As one specific example, for the sake of clarity in paragraph 51, we suggest replacing the wording "relating to" with "which form part of" in the sentence: "*Outsourcing arrangements regarding activities, processes or services relating to core business lines and critical functions should always be considered as critical or important for the purpose of these guidelines".* The choice of the wording is crucial as "relating to" could mean that all activities and processes potentially linked to core business lines are to be considered included in the definition. The risk is that the number of critical /important activities to assess could dramatically increase.

Q8: Are the guidelines in Section 9.2 regarding the due diligence process appropriate and sufficiently clear?

The underlying assumption that financial institutions are always in a strong bargaining position in relation to service providers should be re-visited such that the compliance burden falls more equally between these two parties. This is particularly with respect to the provisions on sub-outsourcing.

We also query the inclusion of the elements related to ESG and human rights which are proposed to fall within the due diligence process, as they are already covered more appropriately in other primary regulation, in particular, the new sustainable finance package. These appear duplicative and inclusion in the guidelines increases the regulatory workload for both financial institutions and NCA's without any clear positive benefit.

Q9: Are the guidelines in Section 9.3 regarding the risk assessment appropriate and sufficiently clear?

At a broad level, paragraph 57 refers to the need to include all contracts and arrangement with third-parties 'regardless of whether or not those arrangements are considered outsourcing arrangements' within the scope of compliance with the guidelines. We strongly

urge the EBA to reconsider this statement, as it drastically widens the scope of the proposals. Given that the guidelines also include a list of excluded activities and a complex set of assessment criteria for materiality/importance, we query why the scope has been widened this way for risk assessment requirements.

Related to this, Section 9.3 also poses particular difficulties in the context of sub-outsourcing. In practice, institutions are not likely to be granted access to the relevant information by the 'intermediate' outsourced service providers to conduct granular risk assessments of potentially multiple sub-outsourcers.

We therefore believe that the risk assessment of outsourcing activities should be a burden shared by service providers in order to better monitor the ecosystem from a broad perspective. It may not be feasible for the institutions to do this through the whole chain of external subcontracting agreements.

The inclusion of concentration and step-in risk appears duplicative given other regulatory requirements that cover these fields (e.g. business continuity planning, recovery and resolution, etc). These factors should be removed.

Finally, the draft guidelines also requires banks to perform scenario analysis on their operational risk for each outsourcing arrangement, where scenarios of possible risk events should be considered. We believe that this requirement is too prescriptive and that it should be instead outcome-based on a risk-based assessment, in order to meet the underlying test of materiality and criticality. Regulatory convergence will be required where appropriate, for example, with developments in some jurisdictions on operational resiliency.

Q10: Are the guidelines in Section 10 regarding the contractual phase appropriate and sufficiently clear; do the proposals relating to the exercise of access and audit rights give rise to any potential significant legal or practical challenges for institutions and payment institutions?

These parts of the guidelines should be limited to critical and important outsourcings only. Clarity is needed to ensure that these guidelines can be implemented in practice. Often, big service providers are used as part of a chain outsourcing, that is, small vendors or other enterprise solutions group together to make one offering to market, rather than each having their own offering (for example, in the cloud market). In these cases, the guidelines should apply to master agreements only.

Further, as industry consistently outlined during the previous consultation on the EBA Cloud Guidelines, the audit and access rights provisions remain challenging to implement given the approach of some service providers. Indeed, service providers usually limit rights of inspection and auditing in terms of frequency and the extent and terms upon which it can take place including notice required, times when it can take place, what can be viewed and

so on; and we rely on sub-contractors to pass on contractual terms on audit and access matters. Therefore, we believe that para. 66 should recognize that the obligations can be undertaken by the provider on behalf of its subcontractor, rather than by the financial services institution. Moreover, the assumption in para. 69 that financial institutions will be able to oblige providers to undertake the obligations in para. 66 should be re-visited by the EBA.

Similarly, para.70-72 and para.76 are challenging provisions to comply with without clear guidance about how financial institutions should make these guidelines operational. In particular;

- Para.72a on access rights is not practical in terms of the access that would be granted to financial services by service providers and should be removed.

- Para. 72b should be limited to ‘necessary’ rather than ‘unlimited’ rights of inspection to better reflect the proportionality principle: aside from service providers being unwilling in some cases to provide access, for security and resiliency purposes data may be held in various locations leveraging encryption and data partitioning techniques. Therefore, physical access should be specific to the sites where the service provided is deemed most relevant to the regulated entity. Alternatively, the EBA could consider whether physical access could be replaced by other audit arrangements (e.g. certification of compliance with standards and audit by independent third parties).

- Finally, para.76 on penetration testing appears duplicative to the pre-existing EBA Guidelines on ICT Risk Management under the SREP Cycle (2017) and we would therefore request that this provision is struck out. Indeed, where the agreement is between two already regulated financial services entities, it is not clear why the current regulatory framework of these guidelines is deficient.

A policy option providing a solution is further consideration of third party certification / reporting and pooled audits. We would welcome further guidance on the use of these where performed jointly under specific conditions. This would be very helpful, remove any ambiguity and persuade service providers to accept the mandatory terms prescribed (and any standard clauses the EBA may develop in these fields). We understand that is it the intention of the EBA with these guidelines to allow industry to place some reliance on these types of arrangements. The EBA should give greater clarity on the extent of this given the market reality of the role of the service providers themselves in this field.

In terms of promoting technical best practice, the guidelines need to make clear that institutions can leverage the providers’ certifications and standards. This includes but should not be limited to:

- ISO 27001,
- ISO 27002,
- ISO 27018, and
- ISAE 3402.

Q11: Are the guidelines in Section 11 regarding the oversight on outsourcing arrangements appropriate and sufficiently clear?

Section 11 appears to have inconsistencies in drafting with respect to timing (e.g. 'with immediate effect', 'reasonable timeframe' and 'as quickly as feasible').

We recommend these are aligned, suggesting in particular that the wording "if necessary with immediate effect" be replaced with "within as quickly reasonably practicable" to ensure there is no unintended consequence on operational efficiency.

We would also appreciate clarification on the scope of 'impediments capable to alter performance' (para 81): this appears to suggest only impediments that meet the criticality/importance test, in align with our obligations with respect to operational resiliency.

Q12: Are the guidelines in sections 12 regarding exit strategies appropriate and sufficiently clear?

Exit strategies, at the top-down, strategic level, need to be distinguished from exit plans, more detailed operating manuals for on-the-ground implementation of the guidelines. The latter may be already developed and covered by recovery and resolution, business continuity (e.g. per Title III Section 6 of the guidelines), etc. While it is important to define, document and oversee exit strategies at a group level (bearing in mind the guideline's requirements to have legal entities involved in development and able to feed in local requirements), requiring separate specific entity-by-entity plans under this guidance would be overly burdensome given the other requirements already imposed on firms with respect to exit strategies. We therefore request that the guidelines make clear the distinction between exit strategies and plans.

Para.89 limits the scope of requirements of section 12 to critical and important outsourcings, which we believe is the right approach. However, the testing requirement in para. 90 still does not appear to meet the proportionality principle. It is not clear what testing would be sufficient to meet this requirement above and beyond business continuity planning, and recovery and resolution requirements. We therefore believe that this requirement can be deleted.

Q13: Are the guidelines in Section 13 appropriate and sufficiently clear, in particular, are there any ways of limiting the information in the register which institutions and payment institutions are required to provide to competent authorities to make it more proportionate and, relevant? With a view to bring sufficient proportionality, the EBA will consider the supervisory relevance and value of a register covering all outsourcing arrangements within each SREP cycle or at least every 3 years in regard of the operational and administrative burden.

We are keen to emphasise the importance that the notification requirements for the register do not turn into a 'right to object' to outsourcings. Whilst oversight and governance must remain appropriate, commercial factors must also be allowed to remain to play a part in firms' decision making. Allowing NCAs to take these decisions would be inconsistent with accepted market practice and potential could lead to inconsistent supervisory practise undermining the goals of the Capital Markets Union.

Institutions should be required to notify supervisors of an outsourcing only where a function becomes critical or important, and on an ex post basis as appropriate. This reflects leading market practice in key EU jurisdictions with respect to outsourcing at this point in time (e.g. Ireland). The time-criticality of many outsourcings must be recognised. Given the delay in the time-to-market that may be caused by a lengthy de-facto authorization process, which other sector entities may not bear, it is important that notification remain notice only.

A requirement for mandatory ex ante notification before a contract is 'committed' to is not clear: whether this, for example, would include the need to notify where a contract is issued but not yet put formally in place, or where any call-off arrangements exist and are exercised (by way of a master agreement or other arrangements).

However, if the EBA expect otherwise, ex ante notification of critical functions should be limited to a description of the planned outsourcing arrangement given that detailed documentation will have to be further completed and made available to NCAs. It would be unduly burdensome and overlapping to require full documentation under the proposed Register at the preliminary stage of ex ante notification.

Related to this, for the guidelines to be sufficiently clear and effective they should contain a specific request for competent authorities to implement the notification requirements consistently across the EU in order to avoid regulatory arbitrage.

We also re-emphasise all points we have made under Q6.

Q14: Are the guidelines for competent authorities in Title V appropriate and sufficiently clear?

Broadly, yes.

However, the EBA and other European Supervisory Authorities should take a role in ensuring these guidelines are applied consistently between NCAs to ensure that there is supervisory alignment in practical terms, including on interpretation of issues such as the definition of concentration risk.

Q15: Is the template in Annex I appropriate and sufficiently clear?

Some columns are overly wide or superfluous compared to the requirements of the guidelines. Moreover, it is not clear how firms may supply relevant additional documentation.

In particular, we highlight:

- Colum C (subcategory type of service)
- Column F (third party sensitive data)
- Column K –L (service provider address, country of registration)
- Columns n-p (parent company and whether part of group, countries of performance of sub-outsourcing)
- Columns r-s (governing law and full project cost)
- Column w (next audit date)
- Columns AA-AC (examples of alternates, specific data nature, time critical operational assessment)

For example, the next audit date may not be set, while examples of alternative service providers need not be given specifically if appropriate business continuity plans are in place (and indeed may mislead supervisors).

Further, the time critical operational assessment is not otherwise required in the guidelines (indeed it is not clear what this is assessing), while it is not clear why supervisors need the governing law of each sub-outsourcing.

The need for full project cost is commercially sensitive information and it is not clear what supervisors might use this for: removal of this or strong guarantees about use and transmission of this information is needed.

We recommend that these provisions within the register are removed so that firms can follow a single consistent template across jurisdictions whilst keeping flexibility about how they may disclose additional documentation which may be relevant for regulators dependent on supervisory requests.

We also recommend that the tab relating to product lines and services provided is not exhaustive, such that firms can adapt this as necessary to their lines of business and business models.

Q16: Are the findings and conclusions of the impact assessments appropriate and correct; where you would see additional burden, in particular financial costs, please provide a description of the burden and to the extent possible an estimate of the cost to implement the guidelines, differentiating one-off and ongoing costs and the cost drivers (e.g. human resources, IT, administrative costs, etc.)?

The cost-benefit analysis underestimates the implementation costs of the guidelines. Significant costs are likely to be high with respect to ensuring compliance is robust, appropriate, proportionate and adequately documented, and may require additional headcount and IT spend.

To re-negotiate contracts, grandfather existing arrangements and properly prepare for Day 1 of the guidelines we therefore strongly recommend that extra transitional time be given for implementation; particularly bearing in mind the impact of a range of other major reforms on financial institutions at present.

As in our introduction, we therefore suggest a period of an additional 2 years with respect to both deadlines:

- the date of 30 June 2019 for compliance for outsourcing arrangements entered into on or after this date should become 30 June 2021, and
- the date of 30 December 2020 for all other outsourcing arrangements should become 30 December 2022.

This will allow firms to properly and fully implement these important reforms in a robust manner.