

EBA Publishes Final Guidelines on Outsourcing Arrangements

Overview

On 25 February 2019, the European Banking Authority (the **EBA**) published its Final Report on EBA Draft Guidelines on Outsourcing Arrangements (the **Guidelines**). The Guidelines outline the standards that the EBA expects firms to uphold in relation to their outsourcing arrangements, as well as its supervisory expectations and processes. The Guidelines were subject to a period of public consultation and now address some of the issues raised by stakeholders during that process.

The Guidelines have been produced by the EBA pursuant to the Capital Requirements Directive and will replace and update the existing guidelines that were issued in 2006 by the Committee of European Banking Supervisors (CEBS) (the **2006 Guidelines**). The Guidelines represent a more harmonised approach to outsourcing that will now apply to certain credit institutions and investment firms, as well as payment institutions and electronic money institutions, whereas the 2006 Guidelines only applied to credit institutions. In addition, the Guidelines extend to outsourcing to cloud service providers (**CSPs**) and incorporate EBA's 2017 Recommendations on Outsourcing to Cloud Service Providers' (the **Cloud Guidelines**).

WHEN do the Guidelines enter into force?

The Guidelines will take effect on 30 September 2019 (the **Effective Date**) and will apply to all outsourcing arrangements entered into, reviewed or amended on or after the Effective Date (with the exception of an outsourced banking or payment activity to a third country service provider which requires a cooperation agreement between competent authorities).

In relation to existing outsourcing arrangements, the Guidelines specify transitional provisions which state that *documentation of all existing outsourcing arrangements* (other than arrangements with cloud service providers) should be completed in line with the Guidelines following the first renewal date of each arrangement but by no later than 31 December 2021.

WHO is subject to the Guidelines?

The Guidelines apply to credit institutions and investment firms which are subject to the Capital Requirements Directive and to payment institutions and electronic money institutions (collectively **Firms**).

HOW are Firms affected by the Guidelines?

The Guidelines are significantly more prescriptive than the 2006 Guidelines and some of the key changes implemented in the Guidelines include:

- **'Critical or important functions' assessment:** The Guidelines impose stricter requirements on outsourcing arrangements where 'critical or important' functions are being outsourced and the definition of 'critical or important functions' is based on the wording of MiFID II. The Guidelines contain a list of considerations that Firms should consider when determining whether a function is critical or important.
- **Outsourcing arrangement registers:** Firms must maintain a comprehensive internal register of all outsourcing arrangements which distinguishes between critical and non-critical outsourced functions.
- **Sub-outsourcing:** Firms must be aware of the degree and nature of sub-outsourcing by their outsourced service providers (**OSPs**) and include such information in their outsourcing registers. Firms must know certain facts about sub-outsourced activities, such as the location of the sub-outsourced service provider.
- **Focus on FinTech and cloud service providers (CSPs):** The Guidelines are particularly concerned with the ability of CSPs to adequately protect data confidentiality and to adhere to relevant data protection regulatory requirements.

WHAT are the main requirements of the Guidelines on Outsourcing?



The Guidelines are divided into five titles as follows and each title is dealt with in more detail below:



TITLE I: PROPORTIONALITY: GROUP APPLICATION AND INSTITUTIONAL PROTECTION SCHEMES

- **The Principle of Proportionality**
 - ✓ Firms should consider their size and internal organisation, and the nature, scale and complexity of their activities to ensure that governance arrangements are consistent with individual risk profile of the Firm.
- **Outsourcing by groups and institutions that are members of an institutional protection scheme**
 - ✓ Firms should apply the Guidelines on a sub-consolidated and consolidated basis having regard to the prudential scope of consolidation.



TITLE II: ASSESSMENT OF OUTSOURCING ARRANGEMENTS

- **Classification of outsourcing arrangements**
 - ✓ In establishing whether or not an arrangement with a third party falls under the definition of 'outsourcing', regard must be had to whether the function would normally fall within the scope of functions to be performed by the Firm itself (even if the Firm has never carried out this function) and whether that function is being performed by a service provider on a recurrent or ongoing basis.
 - ✓ The definition of 'outsourcing' is broader than the definition under the 2006 Guidelines – examples of activities that are excluded from the definition include the procuring of services that are legally required, such as statutory audits and market information services, such as the provision of data from credit rating agencies.
 - ✓ The Guidelines set out (i) considerations to aid in the determination of whether a function is a 'critical or important' function; and (ii) where the function is 'critical or important', a list of factors to be considered e.g. the potential impact of any disruption to the outsourced function to provide the services agreed, the size and complexity of the business area affected, the ability to transfer the outsourcing arrangement to another service provider.



TITLE III: GOVERNANCE FRAMEWORK

- **Sound governance arrangements and third-party risk**
 - ✓ Firms are required to implement a holistic, institution-wide risk management framework extending across all business lines and internal units to identify, assess, monitor and manage all risks including risks arising from arrangements with third parties and cyber risks.
- **Sound governance arrangements and outsourcing**
 - ✓ The outsourcing of functions cannot result in the delegation of a management body's responsibilities and Firms must clearly assign where and to whom the responsibility lies for the documentation, management and control of outsourcing arrangements and processes.
 - ✓ The Guidelines prohibit outsourcing to the extent that the firm becomes an 'empty shell' or a 'letter-box entity'.
- **Outsourcing policy**
 - ✓ The Guidelines build on the outsourcing policy requirements of the 2006 Guidelines and detail, the matters that an outsourcing policy should cover including business continuity planning, due diligence practices, etc.
- **Conflicts of interest**
 - ✓ Firms are expected to identify, assess and manage conflicts of interest regarding outsourcing arrangements and should ensure that the conditions, including financial conditions, for the outsourced service are at arm's length (including where intra-group outsourcing arrangements are in place).
- **Business continuity plans**
 - ✓ Firms must have business continuity plans in place for critical or important functions that are outsourced, and such plans should be tested periodically.
- **Internal audit function**
 - ✓ A firm's policy must include an audit function of outsourced services that follows a risk-based approach.
- **Documentation requirements (outsourcing registers)**
 - ✓ A register of all outsourcing arrangements must be maintained at institution and group level, where applicable, and distinguish the outsourcing of critical or important functions, to which additional documentation Requirements apply. A prescriptive list of information requirements to be included in the register is specified in the Guidelines.



TITLE IV: OUTSOURCING PROCESS

This Title is the most prescriptive and sequentially sets out the steps involved in establishing an outsourcing arrangement as follows:

- **Pre-Outsourcing analysis**
 - ✓ This step relates to the assessment of whether the arrangement is a 'critical or important' function; the supervisory conditions; identification of risks and conflicts; and due diligence on the OSP.

- **Contractual phase**
 - ✓ The Guidelines place an increased focus on factors to be reflected in sub-outsourcing arrangements; the location of the OSP; security of data and systems and access, information and audit rights and termination rights.
 - ✓ The Guidelines are prescriptive about what factors should be set out in an outsourcing agreement, particularly with respect to critical or important functions including a requirement that firms' and competent authorities should have an 'unrestricted right' to inspect and audit the OSP.

- **Oversight of outsourced functions**
 - ✓ Firms are instructed to monitor, on an ongoing basis, the performance of all OSPs following a risk-based approach, with the focus being on oversight of outsourced critical or important functions and ensuring the integrity and security of data and information. This could be achieved by receiving reports; using tools such as key performance indicators and key control indicators, as well as service delivery reports amongst others.

- **Exit Strategies**
 - ✓ Detailed exit plans should be developed, documented and tested (e.g. by carrying out an analysis of the potential costs, impact, resources and timing implications of transferring to another provider).



TITLE V: GUIDELINES ON OUTSOURCING ADDRESSED TO COMPETENT AUTHORITIES

Competent authorities should have regard to any outsourcing that materially affects the conditions of a Firm's initial authorisation. Competent authorities should have a range of actions at their disposal, such as the ability to limit or restrict a Firm's outsourcing or require the cancellation of an outsourcing contract, where it perceives an unacceptable level of either operational, reputational, step-in, or concentration risk, is present.

How Can William Fry Help?

William Fry is a recognised leading advisor to regulated entities in relation to outsourcing arrangements. We can assist you in relation to:

- compliance with the EBA Guidelines on Outsourcing Arrangements;
- reviewing and updating outsourcing policies and procedures to ensure they comply with the Guidelines;
- reviewing and updating outsourcing agreements and SLAs/KPIs with OSPs;
- providing training and advice concerning the management and mitigation of outsourcing risk;
- assisting management and boards to comply with their newly imposed regulatory requirements concerning oversight and monitoring of critical and important outsourced functions; and
- advising on regulatory inspections and enforcement in relation to outsourcing.

Contact Our Financial Regulation Unit

For further information, please contact any member of the William Fry Financial Regulation Unit.



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