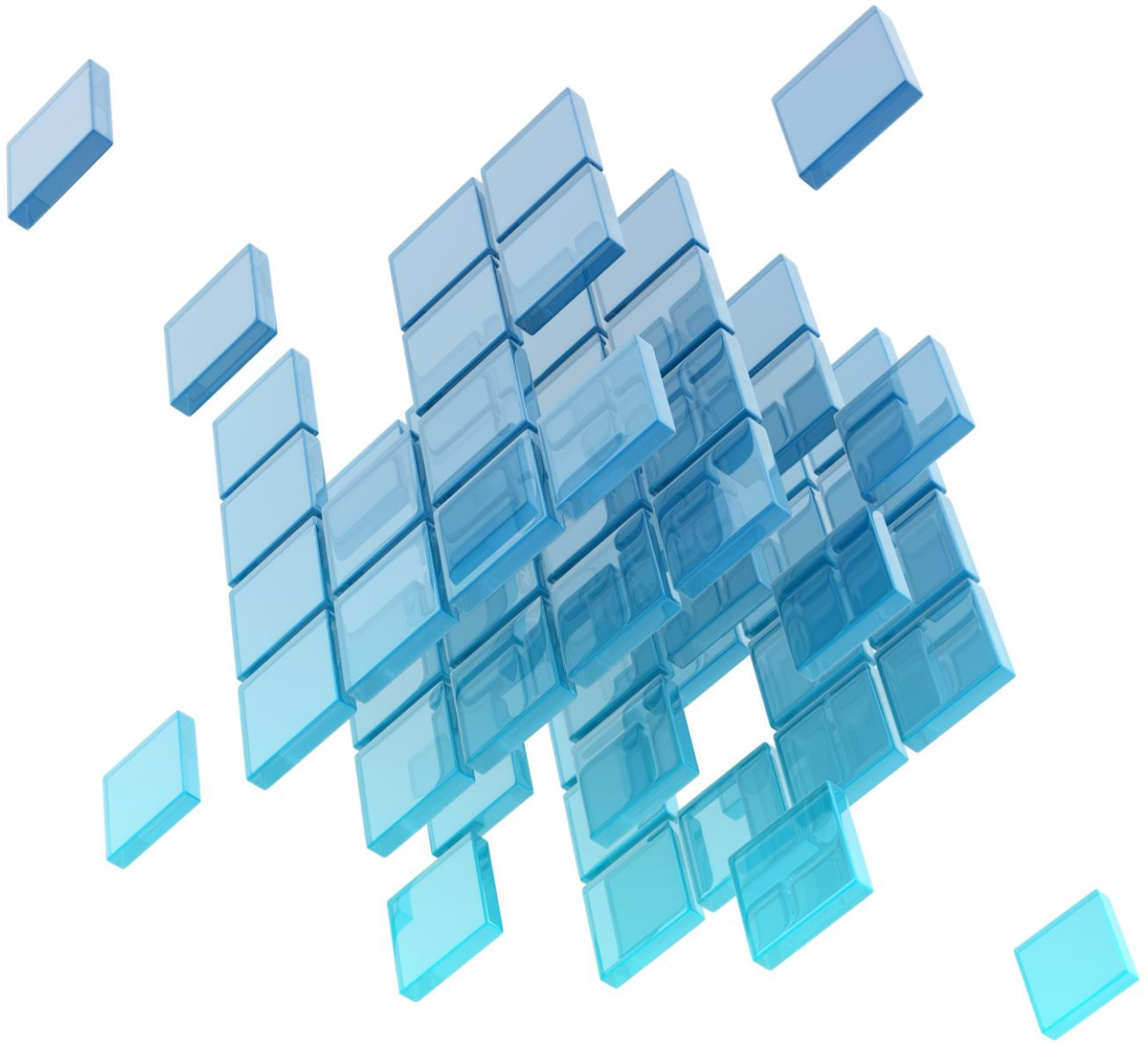


ALLEN & OVERY



Final EBA outsourcing guidelines: *A review*

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Overview

The European Banking Authority (**EBA**) has published final guidelines on outsourcing (the **EBA Guidelines**).ⁱ The EBA's predecessor, the Committee of European Banking Supervisors (**CEBS**) had previously released outsourcing guidelines (the **CEBS Guidelines**),ⁱⁱ which will be repealed by the EBA Guidelines from 30 September 2019 (though one point regarding the approach to third country outsourcing will only apply from 31 December 2021). The EBA Guidelines also incorporate and replace its prior recommendations on the use of cloud service providers.ⁱⁱⁱ

Please also see our client briefing 'Final EBA Outsourcing Guidelines: Impact on firms' Brexit contingency plans' of March 2019 for our analysis of the effect of the EBA Guidelines in the context of Brexit.

ⁱ EBA Guidelines on Outsourcing (EBA/GL/2019) of 25 February 2019.

ⁱⁱ CEBS Guidelines on Outsourcing (GL02) of 14 December 2006.

ⁱⁱⁱ EBA Recommendations on outsourcing to cloud service providers (EBA/REC/2017/03) of 28 March 2018 – these aspects are not considered here as the EBA did not intend to change these recommendations in making the EBA Guidelines.

Additional scope and detail

The most material impact of the EBA Guidelines is in the depth of detail with which firms must now comply. In every respect, the EBA has built out the CEBS Guidelines, substantially increasing firms' compliance burden, as well as expanding the scope from credit institutions to cover all firms within the EBA's remit, being CRD IV^{iv} institutions, payment services institutions and e-money institutions (together being **firms**).

One substantive new requirement is also beyond the control of firms themselves. Where an outsourced service relates to activities that would require authorisation or registration with National Competent Authority (**NCA**) if they were conducted in the EU, there is a requirement for co-operation agreements between each NCA that supervises a firm and the supervisory authority of its non-EU (**third country**) service provider which takes effect from 31 December 2021.

Review and update of outsourcing agreements

Unlike the non-binding CEBS Guidelines, the both firms and NCAs must make "every effort" to comply with EBA Guidelines (with NCAs, but not firms, having the option to take a 'comply or explain' approach).^v Firms are therefore obliged to review both new and existing arrangements in light of the EBA Guidelines. In doing so, firms should account for proportionality when applying the EBA Guidelines, considering their nature, risk profile and business model, as well as the scale and complexity of their operations. Firms should focus on their outsourcing policies, procedures and agreements, as complete, compliant, documentation should be in place following the first renewal date of each outsourcing after 30 September 2019 and, in any event, no later than 31 December 2021.^{vi} Firms must inform their NCA if the review of any critical or important function is not complete by this date.^{vii} Documentation of existing

arrangements for outsourcings of critical or important functions should also be completed by this date. Although this gives firms time to implement the EBA Guidelines, we recommend that reviews, particularly in light of arrangements to manage the impacts of Brexit, are considered internally and, where appropriate, with relevant NCAs, as soon as possible due to the potentially significant degree of work required to comply.

Group application

The EBA Guidelines apply to all firms on an individual basis and, for CRD IV institutions, also on a sub-consolidated and consolidated basis, where applicable. Outsourcing can be centrally organised and run by a member of a group on behalf of its affiliates or the members of an institutional protection scheme. However, where this is the case, individual firms that will benefit from the outsourcing will need to be able to input into this process and to receive relevant information, such as summaries of performance monitoring reports and pre-assessment reports. (Please also refer to 'intra-group outsourcings' below).

Consistency

The EBA Guidelines are intended to be consistent with, and apply subject to, outsourcing provisions implemented under MiFID II,^{viii} CRD IV, PSD2,^{ix} and the BRRD.^x

^{iv} Capital Requirements Directive 2013/36/EU.

^v Article 16 EBA Regulation (EU) 1093/2010.

^{vi} This does not apply for outsourcings to cloud service providers as such reviews should have already been conducted under the EBA Recommendations on outsourcing to cloud service providers.

^{vii} In this briefing, "functions" are those activities outsourced by firms to service provider and "services" are the services provided to the firm by that outsourced service provider. "Critical or important" functions are those functions that meet the materiality test set by the EBA. These terms are distinct from the meaning in the context of recovery and resolution rules and legislation of "critical functions" (e.g. deposit taking) and "critical services" (being services which support critical functions).

^{viii} Recast Markets in Financial Instruments Directive 2014/65/EU.

^{ix} Revised Payment Services Directive 2015/2366/EU.

^x Bank Recovery and Resolution Directive 2014/59/EU.

Main changes to the CEBS Guidelines & key themes

The EBA Guidelines substantially revise and expand upon the CEBS Guidelines in the detail of requirements. However, the breadth of the EBA Guidelines is not significantly greater, and in some respects, the EBA Guidelines reduce burdens on firms by amending the approach taken under the CEBS Guidelines. The main developments made by the EBA Guidelines are considered below.

Scope of firms: The EBA Guidelines apply to a broader range of firms. In addition to credit institutions and those investment firms that are subject to CRD IV (together, **institutions**), the EBA Guidelines will also apply to payment institutions regulated under PSD2 and e-money institutions regulated under the E-Money Directive.^{xi} Institutions will also need to consider the application of the EBA Guidelines on a group-wide basis due to the consolidation provisions of Article 109(2) CRD IV, requiring parent undertakings to ensure that internal governance arrangements, processes and mechanisms in their subsidiaries are consistent, well integrated and adequate for the effective application of the EBA Guidelines, even if those subsidiaries are not directly bound by CRD IV.

Scope of outsourcing: The meaning of an outsourcing (as opposed to a purchase of products or services) is not materially changed, however the EBA Guidelines provide more detail than previously, helping to define the scope more clearly (though this was introduced following the EBA's consultation so might not align precisely with industry expectations). Similarly, more detail is given on the meaning of a "critical or important" function (previously a "material" function) and this definition is designed to align with the equivalent phrase as used in MiFID II (whilst they might not be subject to MiFID II, this also applies to payment institutions and e-money institutions, though MiFID II's requirement and guidelines are not themselves imported).

Management responsibility: The EBA builds upon CEBS work in placing full responsibility for outsourcings with the firm's management body, with a new requirement for it to approve, regularly review and update the firm's outsourcing policy, as well as ensuring its implementation. A broad approach to governance is required as the EBA Guidelines require firms to account for other existing guidelines, such as the EBA's guidelines on internal governance (amongst others). Though much of the work involved in this will be delegated in practice, this nonetheless requires an enhanced degree of top-level oversight.

Degree of control: Firms are required to retain the ability to control their activities and the services they provide to

their clients, including in respect of environmental, social and governance or "ESG" standards and obligations – this is achieved by exercising sufficient oversight of service providers and maintaining the ability to exit the arrangement where needed (please refer to 'Exit strategies' below).

Intra-group outsourcings: These are not considered to be less risky than outsourcing to third parties, and can entail conflicts of interest that might not otherwise be present, however, the EBA recognises the benefit that the group context can grant greater control over the service provider. In a departure from the EBA's approach to branches in respect of Brexit planning, the EBA Guidelines note that firms' branches are not considered to be separate entities from their head office (including those in third countries). However, the EBA contradicts this approach in the introductory text to its final report (which incorporates the EBA Guidelines) and so we anticipate that the principles established under the EBA Guidelines may remain relevant in this context.

Sub-outsourcing: Sub-contracting by service providers remains possible, however, as with other aspects of the EBA Guidelines, the approach set out by CEBS has been expanded upon. Specific terms for the firm's agreement with the service provider are required, in effect ensuring that the service provider's agreement with the sub-contractor enables the firm, its NCAs and resolution authorities to have the same ability to oversee and control the outsourcing as if it had not been sub-contracted.

Empty shells: Closely tied to the continued requirements for the management body to retain responsibility for a firm's activities (including those that are outsourced), the EBA emphasises that outsourcing arrangements must not create "empty shells" that lack the substance to remain authorised – essentially core functions, such as the management body's responsibility, the relationship with and obligations to clients, and the conditions of authorisation are not permitted to be affected by outsourcing.

Outsourcing policy: Following the trend, the requirements on outsourcing policies are more detailed, with new obligations regarding the division of responsibilities between the management body, business

lines and internal control functions, as well as the planning, implementation and monitoring of outsourcings. The potential effects of outsourcing critical or important functions must be addressed, and should be documented in the decision-making process.

Pre-assessment: The EBA Guidelines establish a granular process for the pre-assessment of potential outsourcings, including detailed supervisory conditions, as well as documented, in-depth risk and due diligence assessments (with the EBA clarifying following its consultation that the due diligence requirements apply to all outsourcings, including for functions that are not critical or important and for intra-group outsourcing). This is likely to require firms to re-visit their pre-approval procedures for outsourcings. Whilst the most onerous pre-assessment obligations are reserved to the outsourcing of critical or important functions, this represents a significant shift by the EBA away from CEBS' express intention not to impose restrictions on entering into non-material outsourcings.

Standard of service: Although firms will no longer be required to ensure providers operate to the same standard as if the activity had been done in-house, the new obligation to ensure "appropriate performance and quality standards" is not expected to reduce the standard required to be met.

Outsourcing Agreements: Whilst all outsourcings currently require a written agreement setting out the parties' respective rights and obligations, the EBA Guidelines specify several matters that should be addressed, only some of which are reserved solely for outsourcings of critical or important functions. These requirements are much more detailed than those noted in the CEBS Guidelines, particularly in respect of audit standards and termination rights. However, in some cases prior obligations are relaxed:

- Certain requirements that were mandatory for all outsourcing agreements under the CEBS Guidelines will now only expressly apply to outsourcings that are critical or important, including obligations to:
 - clearly define the operational activity to be outsourced;
 - set precise quantitative and qualitative performance parameters such that the service provider's ability to meet these parameters can be assessed in advance;
 - allow the firm, its NCAs and resolution authorities, access to its data and to the service provider's external auditors, and unrestricted

rights to inspect and audit that data (though this requirement can extend beyond only critical and important functions based on the proportionality of doing so in the particular case); and

- inform the firm of material changes in the service provider's circumstances that could have a material impact on the services.

In our view, all of these points are standard provisions of outsourcing agreements and should be retained in all but the most exceptional circumstances.

- Further, there will no longer be a requirement, even for critical or important outsourcings, to give the service provider the option to inform the firm's NCA of material changes in the service provider's circumstances that could have a material impact on the services. This is a welcome development as it ensures that the firm is the first recipient of this information and so can act upon this as fast as possible.
- The outsourcing policy is no longer required to address the drafting of the outsourcing agreement. However, in our view, it will remain useful to maintain internal guidance on how to contractually deal with issues that may be identified in the planning process.

Risk management: Changes introduced following the EBA's consultation stipulate a "holistic institution-wide risk management framework" as part of sound governance that looks across business lines and internal units in their management of outsourcings. Increased prominence is also given to business continuity and operational resilience (building in part upon regulatory experience with recovery and resolution regimes), as well as confidentiality and compliance with the GDPR.^{xii} It may be possible to rely on group level arrangements where these are suitable for the firm's situation. Procedures should be tested periodically, and reviewed by the internal audit function.

Exit strategies: Exit strategies must be planned in advance, reviewed as appropriate, and, in the case of critical or important functions, documented. The CEBS Guidelines required firms to retain sufficient competence to be able to resume direct control of any outsourced activities in extreme cases. In contrast, the EBA Guidelines only apply similar requirements to critical or important outsourcings, now giving firms the option to transfer, reintegrate or discontinue the function. The revised requirement better reflects what is possible in practice, especially for specialised functions.

Recordkeeping: A register of information on outsourcings should be maintained, and detailed new requirements for this register are set out in the EBA Guidelines (though many of these will be met by common practice in any event). More detail is required regarding critical or important functions.

Third country service providers: Whilst CEBS was of the view that “no special rules are needed in relation to the geographical location of an outsourcing service provider”, the EBA Guidelines require additional care to be taken when outsourcing to service providers in third countries, especially regarding confidentiality, data protection and the ability for NCAs to effectively supervise the firm. The EBA relies on the proportionality principle to apply stricter requirements where the service provider is located in a third country (and this is particularly the case in respect of critical or important functions). Notably, specific requirements apply where outsourcing relates to a function that would require authorisation or registration in the firm’s Member State, such that third country providers must be authorised and supervised in their local jurisdiction and, from 31 December 2021, a co-operation agreement between the firm’s NCA(s) and the service provider’s supervisory authorities will be required and must cover specified issues (e.g. access to information).

Updating NCAs: Firm’s registers of outsourcing should be available to NCAs upon request, and firms should notify NCAs in advance prior to outsourcing critical or important functions, providing at least the register information and potentially also related documentation such as the outsourcing agreement. NCAs should be informed of developments for any outsourcing that could have a material impact upon the firm’s ability to continue its business activities.

Effective Supervision: The EBA Guidelines move some responsibility from firms to NCAs for ensuring that outsourcing arrangements can be effectively supervised. The EBA Guidelines require firms to have a sufficiently transparent organisational structure, and to provide information to NCAs, to enable effective supervision, but it is NCAs that must satisfy themselves of their ability to supervise firms in relation to the outsourcing of critical or important functions. This new balance provides more clear guidance to firms on how they can assist NCAs to conduct their role.

Scope of Supervisors: In line with their role under the BRRD, resolution authorities are to be given equivalent access and audit rights as NCAs. Firms will be obliged to refer to powers of contractual stays in outsourcing agreements for critical and important functions and to inform their resolution authority of new critical outsourcings (as defined under the BRRD).

Risk Concentrations: Competent authorities are mandated to identifying risk concentrations at individual service providers, based on the data provided by supervised entities, and determining whether any concentrations pose a risk for the stability of the financial system.

NCA Responsibilities: In contrast to the shift of responsibility from firms to NCAs for ensuring that effective supervision can be maintained in light of an outsourcing, it is firms, not NCAs, that will be required to ensure that the NCA or resolution authority can give directions to the service provider (this applies for outsourcings of critical or important functions only). In practice, we would anticipate that NCAs will continue to check that this is provided for in the outsourcing agreement and so do not expect this to give rise to a material change in how NCAs operate on this issue.

Further, NCA will no longer be obliged to justify an instruction to terminate an outsourcing agreement by reference to the guidelines. This removes what would in practice have been an administrative hurdle of limited value as the reason for this instruction should be clear in the circumstances (given that this power is generally used in exceptional situations only) and, in any case, this detail does not give the firm (or the service provider) a substantively improved ability to challenge the instruction.

It is perhaps less easy to understand the removal of the NCA’s obligation to consider whether instructions given to service providers by the NCA (or, now, resolution authority) can be reliably enforced without conflict with instructions issued by other bodies. A conflict of this type is most likely to arise where the service provider is supervised by a third party, e.g. another NCA or third country regulator. By its nature, this is difficult for firms to deal with alone and so would normally be best addressed by MoUs between the relevant authorities (if required in the circumstances).

^{xi} E-Money Directive 2009/110/EC.
^{xii} General Data Protection Regulation 2016/679.

Changes in the EBA's approach following consultation

The EBA's position has changed materially in some limited aspects as a result of feedback received to its consultation paper. Some of these are noted in the discussion in *Main changes to the CEBS Guidelines & key themes* above.

Beyond these, the EBA prescribes that robust governance arrangements should be present, even for outsourcing arrangements that are not considered critical or important. The rationale for this being that Article 74 CRD IV includes a specific mandate for the EBA to

develop guidelines on governance and operational structure, of which outsourcing arrangements are a part.

The EBA dropped its proposed obligation on firms to involve a service provider in its business continuity and disaster recovery planning. Although the EBA does not specifically suggest why this obligation has been removed, our expectation is that this would have been operationally too difficult in practice or meaningless in reality, depending on the particular issue involved.

Upcoming changes

CRD V & IFR/IFD: The effect of the EBA Guidelines is expected to be unchanged by the introduction of CRD V.^{xiii} Similarly, although certain CRD IV institutions will in future, instead be subject to prudential and governance requirements under the proposed Investment Firms Regulation^{xiv} and Directive,^{xv} this proposed legislation does not alter the EBA's remit over these firms.

Omnibus Regulation: However, on the European Commission's drafting of the proposed Omnibus Regulation,^{xvi} the EBA's remit would cease to cover firms that are subject to the Investment Firms Regulation and Directive, rather than CRD V (i.e. all but the largest MiFID firms would be out of scope). As this regulation is currently pending trilogue negotiations among the European Commission, the European Parliament and the Council of the European Union, we would anticipate that this effect may be revised.

Brexit: If the UK leaves the EU with both sides having ratified the Withdrawal Agreement, then the proposed transitional period until December 2021 will take effect and so the EBA Guidelines will apply in the UK from 30 September 2019, per the EBA's proposed timing.^{xvii} The position is less clear where the Withdrawal Agreement is not ratified. The PRA^{xviii} and the FCA^{xix} have both confirmed that existing guidelines published

by EU authorities will continue in effect following Brexit in the event of such a 'no deal' scenario. However, if this occurs on 29 March 2019, per the current timetable, then this will not extend to the EBA Guidelines as these will not be in effect at the point at which Brexit occurs. Instead, the PRA^{xx} and the FCA^{xxi} will consider their approach to the EBA Guidelines and may issue further statements in future. In the meantime, the PRA^{xxii} and FCA^{xxiii} have clarified that the CEBS Guidelines will continue to be relevant for UK-authorised firms.

^{xiii} Directive 2013/36/EU, as expected to be amended by the final agreed text pursuant to Commission Proposal COM(2016)854.

^{xiv} The regulation that is expected to be implemented pursuant to Commission Proposal COM(2017) 790.

^{xv} The directive that is expected to be implemented pursuant to Commission Proposal COM(2017) 791.

^{xvi} The regulation that is expected to be implemented pursuant to Commission Proposal COM(2017) 536.

^{xvii} Article 127(1) and (3) of the draft Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community, as endorsed by leaders at a special meeting of the European Council on 25 November 2018.

^{xviii} Bank of England and PRA Statement of Policy, Interpretation of EU Guidelines and Recommendations, February 2019 at paragraph 2.1.

^{xix} FCA PS19/5, Brexit Policy Statement, February 2019, at paragraph 10.9 and Appendix 3 paragraph 8.

^{xx} Bank of England and PRA Statement of Policy, Interpretation of EU Guidelines and Recommendations, February 2019 at paragraph 2.5.

^{xxi} FCA PS19/5, Brexit Policy Statement, February 2019, at Appendix 3 paragraph 16.

^{xxii} Bank of England and PRA Statement of Policy, Interpretation of EU Guidelines and Recommendations, February 2019 at paragraph 2.2.

^{xxiii} FCA PS19/5, Brexit Policy Statement, February 2019, at Appendix 3 paragraph 8.

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