

Final EBA Outsourcing Guidelines: Impact on firms' Brexit contingency plans

March 2019

Overview

The European Banking Authority (**EBA**) has published final guidelines on outsourcing (the **EBA Guidelines**)¹, repealing previous outsourcing guidelines issued by the Committee of European Banking Supervisors (the **CEBS Guidelines**)². The EBA Guidelines will apply from 30 September 2019 (though one point regarding the approach to third country outsourcing will only apply from 31 December 2021).

In an important step-change, the EBA Guidelines will apply to a broader range of financial institutions – the CEBS Guidelines apply solely to EU credit institutions whereas the EBA Guidelines apply additionally to investment firms, payment services institutions and e-money institutions. Although these types of firms are already subject to a number of outsourcing provisions implemented under MiFID II,³ CRD IV, PSD2,⁴ and the BRRD⁵, the EBA Guidelines are comprehensive in their coverage and will inevitably require firms to both modify their approach to outsourcing and to review both existing and new outsourcing arrangements.

This development will be of interest to in-scope firms that are currently putting in place outsourcing agreements as part of their Brexit contingency plans. This client briefing explores some of the aspects of the EBA Guidelines most relevant to firms in this context. Please also see our client briefing 'Final EBA Outsourcing Guidelines: A Review' of March 2019 for our analysis of the main changes to be introduced by the EBA Guidelines in a broader context.

'Letter-box' entities

When assessing firms' Brexit contingency plans, national competent authorities (**NCA**s) have been particularly vigilant in ensuring authorised entities that have extensive outsourcing and delegation arrangements do not function as mere 'letter-box' entities. In our experience, the expectation is that the EU outsourcing entity should in practice perform more investment functions and services internally than it outsources. This will necessitate the EU outsourcing entity having appropriate technical and human resources, both at operational and management levels, with the skills, knowledge and experience necessary to deliver services to clients and to select and oversee the performance of service providers. In particular, EU regulatory authorities are likely to mandate that certain key functions and roles that are crucial for the EU outsourcing entity's operations and decision making be performed in the EEA rather than be outsourced to a third country such as, post-Brexit, the UK.

¹ EBA Guidelines on Outsourcing (EBA/GL/2019) of 25 February 2019

² CEBS Guidelines on Outsourcing (GL02) of 14 December 2006

³ Recast Markets in Financial Instruments Directive 2014/65/EU

⁴ Revised Payment Services Directive 2015/2366/EU

⁵ Bank Recovery and Resolution Directive 2014/59/EU

Consistent with this messaging, the EBA Guidelines 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. Furthermore, firms are required to retain the ability to control their activities and the services they provide to their clients – this is achieved by exercising sufficient oversight of service providers and maintaining the ability to transfer, re-integrate or exit the arrangement where needed.

Outsourcing of banking and/or payment services activities

The EBA Guidelines acknowledge that outsourcing is relevant in the context of gaining or maintaining access to the EU’s financial market and that third country institutions may wish to set up subsidiaries or branches in the EU in order to get or maintain access to EU markets and infrastructure. The Background section to the EBA’s Final Report accompanying the EBA Guidelines goes on to state that third country institutions may seek to minimise the transfer of the effective performance of business activities to the EU by, for example, outsourcing processes, services or activities to the third country parent institution or other third country group entity. This acknowledgement is helpful in the context of firms’ Brexit contingency plans.

The EBA Guidelines state that institutions should ensure that banking activities or payment services that require authorisation or registration by a competent authority in the Member State where the institution is authorised can only be outsourced to a service provider located in a third country if the following conditions are met:

- the service provider is authorised to provide that banking activity, or payment service in the third country and is effectively supervised by a relevant competent authority in that third country;
- there is an appropriate cooperation agreement in the form of a memorandum of understanding between the competent authorities responsible for the supervision of the institution and the supervisory authorities responsible for the supervision of the service provider; and
- the cooperation agreement shall ensure that regulatory authorities are able, at least, to: (a) obtain on request the information necessary to carry out their supervisory tasks; (b) obtain appropriate and prompt access to any data, documents, premises or personnel in the third country which are relevant for the performance of its supervisory powers; (c) receive as soon as possible information from the supervisory authority in the third country for the purpose of investigating apparent breaches of the requirements of applicable law; and (d) cooperate with the relevant supervisory authorities in the third country on enforcement in case of breach of applicable regulatory requirements and national law in the Member State (cooperation should include but not necessarily be limited to receiving information on potential breaches of applicable regulatory requirements from the supervisory authorities in the third country as soon as practicable).

The requirement for an appropriate cooperation agreement to be in place in such circumstances only applies from 31 December 2021. However, firms that have put in place such outsourcing arrangements in the context of Brexit should keep track of the status of such cooperation agreements prior to this implementation date.

In the context of banking and/or payment services, it is important to note that certain functions, such as correspondent banking services and participation in clearing and settlement arrangements, are expressly excluded from the scope of the EBA Guidelines.

APPLICATION OF THE EBA GUIDELINES IN THE UK POST-BREXIT

“In the context of firms’ Brexit contingency plans, the EBA Guidelines are likely to apply to the EU outsourcing entity – UK firms will be impacted in their capacity as third country outsourced services providers.”

Intra-group outsourcings

The EBA notes that intragroup outsourcing is not necessarily less risky than outsourcing to an entity outside the group, for example, intragroup outsourcings can entail conflicts of interest that might not otherwise be present. It is therefore unsurprising that the EBA Guidelines subject intra-group outsourcings to the same regulatory framework and oversight as outsourcing to services providers outside the group.

Where firms intend to outsource important or critical functions to entities within the same group, they are required to ensure that the selection of a group entity is based on objective reasons and that the conditions of the outsourcing arrangement are set at arm's length and explicitly deal with conflicts of interest that such an outsourcing arrangement may entail. Firms should clearly identify all relevant risks and detail the mitigation measures and controls put in place to ensure that the outsourcing arrangements with affiliated entities do not impair the firm's ability to comply with the relevant regulatory framework. However, firms should account for proportionality when applying the EBA Guidelines and due consideration should be given to any higher level of control a firm may have over the outsourced function in an intra-group arrangement, which they could take into account in their risk assessment.

Saying this, it may be difficult to justify attaching a lower risk assessment to intra-group outsourcing arrangements put in place between EU outsourcing entities and UK group entities in the context of Brexit on the basis of proportionality. In the context of Brexit, ESMA, in its Opinions⁶, went as far as to state that where investment firms intended to outsource functions/services to entities within the same corporate group, NCAs should assess the due diligence carried out by firms in more detail and be satisfied that the selection of a group entity is based on objective reasons despite the additional conflicts of interest such an outsourcing structure may entail. ESMA goes on to assert that outsourcing to non-EU entities could make oversight and supervision of the outsourced functions more difficult. Consequently, ESMA has advised NCAs give special consideration to such outsourcing arrangements and the additional risks arising from them and in particular whether NCAs should require (relocating) firms to submit a detailed plan of the phasing out of any such outsourcing arrangements – a trend we have seen in practice.

Branch 'outsourcings'

There has been much discussion in the context of Brexit on UK branches of EU financial institutions – especially so called 'fat' branches where the activity conducted out of the branch is proportionally greater than that undertaken by the EU head office. ESMA's view as set out in the ESMA Opinions is that the use of non-EU branches should be based on objective reasons linked to the services provided in the non-EU jurisdiction as should not result in a situation where such non-EU branches perform 'material functions' or provide services back into the EU. However, we have also seen a number of firms explore the option of leveraging a UK branch to in part provide services on behalf of its EU head office.

In this context, the EBA has issued a number of supervisory expectations in respect of Brexit planning, including with respect to the treatment of intra-group outsourcing arrangements clarifying that from a supervisory perspective outsourcing includes not only agreements between two legal entities but also service level agreements between parent companies and their branches.

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) and therefore services provided by a branch should not be considered an outsourcing. On the face of the EBA Guidelines then, service level agreements between parent companies and their branches should not be considered an outsourcing for the purposes of the EBA Guidelines. This may lead to a difference in approach of NCAs to firms' post-Brexit operating models depending on whether or not the EU entity is leveraging the resources of a UK branch or UK group company.

⁶ ESMA Opinion to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union 13 July 2017 ESMA35-43-762
https://www.bankingsupervision.europa.eu/banking/relocating/shared/pdf/ssm.supervisoryexpectationsbookingmodels_201808.en.pdf

Next steps

In instances where firms are building out or establishing EU regulated vehicles as part of their Brexit contingency plans, firms will likely be considering the extent that they can implement outsourcing arrangements to leverage UK-based resources. Firms are encouraged to review both new and existing arrangements in light of the EBA Guidelines 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. 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.

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