'Outsourcing – Findings & Issues for Discussion'
Supervisory Risk Division
Central Bank of Ireland
North Wall Quay
Dublin D01 F7X3
By email to: outsourcingfeedback@centralbank.ie

31 January 2019

Re: 'Outsourcing – Findings & Issues for Discussion' – Central Bank publication 18 November 2018

Dear Sir / Madam

Thank you for the opportunity to engage with you on the topic of outsourcing in the financial services sector under the Central Bank's recent Discussion Paper ('the DP').

It is imperative that risks associated with outsourcing, in particular new technologies and an increased variety, scope and geographic spread of service providers ('OSPs') are well understood by firms and regulator alike. Discussion of these topics is a necessary and positive step towards ensuring that guidance and governance keep pace with market changes.

The supervisory findings of the Central Bank set out in the DP form an important part of this dialogue. The findings are of considerable assistance to firms in reviewing risk management frameworks and enriching Board discussions on the evolving operational risks associated with outsourcing.

FSI fully supports the principles of good governance, risk management and business continuity espoused in the DP. Having consulted with our members, we are pleased to share our views on some of the cross-industry risks and trends identified for discussion in Part B.

General context

As noted by the Central Bank,[1] outsourcing is an inherently valuable practice for industry and for the end-investor. When outsourcing risks are identified, monitored and managed appropriately, it can be a very effective way of:

- reducing operational risk;
- allowing small companies to access specialist skills that may not otherwise be available to them;
- providing access to deeper pools of expertise and resources to help manage capacity/resource shortages etc; and
- turning fixed costs into variable costs.

Without access to outsourcing, some firms would undoubtedly be exposed to higher levels of aggregate risk and be less viable. Therefore, it is imperative that risks and benefits are taken together

[1] Central Bank 'Outsourcing: Findings & Issues for Discussion', November 2018, p. 47.

and that the supervisory/regulatory approach to outsourcing does not render the practice impracticable.

Reputation & International Rules

FSI supports robust governance, compliance and risk management processes that underpin a positive reputation of Ireland as a global financial services centre. The implications of governance or risk management failures for the industry, regulator and 'Ireland Inc' are considerable. The manner in which these risks are identified and communicated by the Central Bank are critical to our reputation.

We are mindful of Ireland's position as the fourth largest exporter of international financial services in Europe, supporting 42,000 local jobs.[2] This position also gives us a proportionate interest in applying rules consistent with international standards. To that end, we request the Central Bank to take into account current activities by other key stakeholders in outsourcing supervision. For example, the following international consultations are *anticipated* or awaiting finalisation at the time of writing:

- European Banking Authority (EBA) draft guidelines on outsourcing[3];
- IOSCO guidelines on outsourcing;
- EIOPA guideline 14 on the system of governance (outsourcing)[4];
- European Securities & Markets Authority (ESMA) supervisory project on cloud computing & cyber risks[5]; and
- EBA draft guidelines on ICT & security risk management.[6]

Concentration risk

Firms may choose to outsource activities that are highly specialised, with a limited number of providers, and the questions within the DP at times suggest that associated concentration risk must be altogether avoided. Concentration risk associated with outsourcing certain activities should be considered against the risks associated with the firm performing that service itself. Taking cloud service providers (CSPs) as an example, these provide a range of services and best available capabilities at a standard and scale which is not easily replicated. The rise in volume may increase concentration risk, but materially reduces a number of other IT infrastructure and IT security risks. The benefit of risk reduction in these areas needs to be considered. Further, with their increasing use, many services become standardised, which allows for more transparency and predictability. As similar (security, regulatory, reputational) considerations dominate the customer agenda, solutions offered by OSPs such as data portability and interoperability, will also increase as standard.

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2 Department of Finance, IFS Messaging pack 2018, at https://www.finance.gov.ie/wp-content/uploads/2018/11/IFS-Messaging-Pack-Nov-2018.pdf

3 https://eba.europa.eu/regulation-and-policy/internal-governance/guidelines-on-outsourcing-arrangements

4 EIOPA, 'Peer Review of Key Functions: Supervisory Practices & Application in Assessing Key Functions'.

5 As noted by the European Supervisory Authorities Joint Committee Risk Report, April 2018, "the main objective of [ESMA's] project is to explore the compliance risk of cloud computing outsourcing, with a view to formulating a clearer supervisory response and strategy." P. 14.

6 https://eba.europa.eu/documents/10180/2522896/EBA+BS+2018+431+%28Draft+CP+on+Guidelines+on+ICT+and+security+risk+management%29.pdf

In December 2017, the European Banking Authority (EBA) issued guidance for the use of cloud service providers by financial institutions, noting that cloud computing is an important enabling technology leveraged by financial institutions to deliver innovative financial products and services. The EBA recommendations clarify the EU-wide supervisory expectations, so as to allow firms to leverage the benefits of using cloud services while ensuring that any related risks are adequately identified and managed.

<u>Offshoring & Chain Outsourcing</u>

The practice of outsourcing has evolved over the past number of years, as firms have engaged a wider range of service providers across different geographic locations providing an ever-increasing range of services. All of this is done in pursuit of cost and investment efficiencies, with direct benefits to the end investor.

Sub-contracting and chain outsourcing can present risks to 'visibility' of outsourcing arrangements, as noted in the DP. Per the EBA's Recommendations[7], firms can address this risk by requiring prior notice of any subcontracting, and the delineation in the Service Level Agreement of any services that are excluded from potential subcontracting. Awareness of the sub-contracting arrangement will allow firms to incorporate same into their risk appetite framework.

As regards Brexit-related risks, these will be specific to individual firms, and many will have detailed examples of their approaches in response to the Central Bank's earlier questionnaires on Brexit preparedness.

<u>Proportionality</u>

We do not agree that intragroup and external outsourcing risks are "predominantly the same"[8] at *industry* level. To conflate the two is a blunt response to legitimate concerns that may arise in specific cases; these should be addressed as such. Examples of similar risks between intragroup and third-party outsourcing, and/or poor management of same, are important to highlight and helpful to firms in approaching their governance and risk management policies. They should not be used as a driver of new regulatory requirements for wider industry (to which the DP is addressed).

Any debate must also be framed in the context of existing requirements/guidance that can give additional levels of assurance on the distinctions between both types of risks (e.g. CP86, Solvency II). A proportionate response will acknowledge that intragroup arrangements will not require the same level of resources as third-party arrangements in situations where there is an enterprise-wide/group risk management framework, with the level of control and reporting lines guaranteed. It would also recognise practices within groups that leverage specialist skills and expertise, e.g. in insurance companies where a Pre-Approval Controlled Function (PCF) is an employee of the undertaking, but uses wider group functions for solvency calculations. Or large global banks that utilise an intra-group servicing model that requires cross-border and intra-entity servicing; restrictions on access to such services could have a direct, detrimental effect on overall cost efficiencies and client pricing. This general principle is acknowledged by the EBA in its draft guidelines on outsourcing, and by EIOPA,

[7] EBA Recommendations on outsourcing to cloud service providers, S. 4.7, para 22.
[8] EIOPA, 'Peer Review of Key Functions: Supervisory Practices & Application in Assessing Key Functions', p. 15.

which has said it "will consider … a revision of its Guideline 14 on system of governance, in which a distinction between intra- and extra-group outsourcing taking into account the proportionality principle could be made."[9]

Applicability

The Central Bank defines outsourcing as a written arrangement of any kind between a regulated financial service provider and a service provider (whether regulated or unregulated) whereby the service provider performs an activity which would otherwise be performed by the regulated firm itself. Important questions remain about the extent to which 'outsourcing' can be said to apply to procurement of services that are not otherwise done by the regulated entity.

Issues that are specific to one sector will also not apply to another, and so rules must be sensitive to these. Onsite accessibility for example, will present security risks for financial institutions that exchange trade data for regulatory reporting requirements; 'delegation' in the fund and asset management industry, as distinct from outsourcing, is already subject to special rules under EU (UCITS and AIFM) Directives and Regulations.

The EBA draft guidelines on outsourcing acknowledge[10] that a tiered approach to the criticality or importance of outsourcing arrangements should be taken, and it will be important for any Central Bank approach to be consistent with this.

As regards substitutability and exit strategies; at issue is the ability of firms to switch smoothly and efficiently relative to their business needs. It would not practicable to expect for example, that firms could enter into 'standby'-type arrangements with OSPs.

Conclusion

FSI supports the updated consideration of risks associated with outsourcing, to assist firms and the Central Bank in identifying and managing/supervising risks, and to keep pace with policy developments at European and international level.

Outsourcing presents many industry-wide, common risks. The sharing of information about both poor and best practices is helpful to firms in tailoring their risk management and governance frameworks to their operational risks. Isolated findings should not be used as a benchmark against which new rules are designed and applicable to all sectors and activities.

We look forward to the industry event planned for later in Quarter One, and in the meantime, remain at the Central Bank's disposal on this issue, and to discuss any of the above in greater detail.

Yours faithfully

Paul Sweetman
Director, FSI

[9] *Ibid*, p. 10.
[10] EBA 'draft Guidelines on Outsourcing Arrangements' 2018, p. 10.