Deutsche Börse Group

Response

to

FSB Discussion Paper
“Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships”

published on November 9, 2020

Eschborn, 08 January 2021

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A. Introduction

Deutsche Börse Group (DBG) welcomes the opportunity to comment on the Financial Stability Board (FSB)´s Discussion Paper 'Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships' published in November 2020 (in the following, 'discussion paper').

DBG operates in the area of financial markets along the complete chain of trading, clearing, settlement and custody for securities, derivatives and other financial instruments and acts as such as a provider of highly regulated financial market infrastructures.

Among others, DBG comprises (International) Central Securities Depositories ([I]CSDs) and Central Counterparties (CCPs), some of which are also authorised as credit institutions within the meaning of point 1 of Article 4 (1) of the Capital Requirements Regulation (CRR), as well as operators of multilateral trading facilities (MTFs).

Due to the nature of the group's business along the chain of financial market activities but operating via different legal entities – which is to a substantial extent driven by financial services legislation –, a high degree of inter-connectedness of activities exist and certain activities for central functions as well as IT are concentrated within dedicated legal entities of the group. In line with the aim to set-up and maintain business continuity and to operate under the "follow the sun" principle, some activities are in addition performed by dedicated service companies of the group in different locations and countries. Moreover, DBG is also outsourcing selected activities to third party service providers to make use of service providers' specific knowledge as well as access to selected new financial technologies, including the use of cloud solutions. Consequently, outsourcing is an important topic within DBG and for its regulated undertakings.

The importance of outsourcing is constantly increasing, so does the need for a proper regulatory treatment. We welcome FSB's intention to encourage dialogue among financial institutions (FIs), supervisory authorities and third parties on challenges in identifying and managing the risks relating to outsourcing and third-party dependencies. The ever-growing complexity of regulatory requirements related to outsourcing posed a challenge to regulated entities as outsourcing of selected activities became a widely used tool to handle pressure to reduce costs and enhance efficiency. Moreover, outsourcing allows entities to benefit from new technologies without large one-off investments.

The document at hand contains dedicated responses to the questions raised in the discussion paper (Part B).

B. Responses to the questions raised in the discussion paper

Q.1 What do you consider the key challenges in identifying, managing and mitigating the risks relating to outsourcing and third-party relationships, including risks in sub-contractors and the broader supply chain?

The importance of outsourcing is constantly increasing, so does the need for a proper regulatory treatment. While we generally support a proper regulatory treatment of outsourcings and agree that the ultimate responsibility remains with the outsourcing entity, we would like to point to key challenged particularly related to the increasing regulatory requirements related to outsourcing and use of third-party services.

The **ever-growing complexity of regulatory requirements** related to outsourcing poses a challenge to regulated entities as outsourcing of selected activities became a widely used tool to handle pressure to reduce costs and enhance efficiency. By constantly broadening the scope and complexity of regulatory requirements related to outsourcing or even the use of third-party services, potential benefits, including access to expert knowledge and new technologies, are being put at risk.

The challenge to comply with all necessary regulatory requirements is even further increasing as i) the **definition of outsourcing** is regularly being extended by national regulators and ii) regulatory requirements apply increasingly also to **third party services**, not classifying as outsourcings thereby blurring the principle of proportionality. As we will outline in our answer to question No 2, we believe that a clear and consistently applied definition of outsourcing would decrease the regulatory burden for financial institutions without posting additional risks.

As correctly outlined in the discussion paper, the **management of outsourcing risks along the outsourcing chain** is another key challenge as outsourcing chains are increasing in length and complexity while financial institutions typically enter into a contractual relationship only with their direct service provider. Despite potential contractually specified information and audit right or notification obligation along the outsourcing chain, the possible influence decreases along the outsourcing chain.

In practice FIs have no direct reach to sub-contractors or further parties along the outsourcing chain. Even under respectively specified contractual obligations regarding sub-outsourcing, it is difficult to bind sub-contractors directly to those obligations as they are typically no party in the contract. Subjecting financial institutions to extensive regulatory requirements along the outsourcing or supply chain, will lower potential benefits for the financial institution due to the disproportionate operational costs related to management along the whole outsourcing chain.

Notwithstanding the aspiration of several national, supranational and international regulatory bodies to directly supervise material or critical third-party service providers, we do see challenges arising through direct supervision of sub-contractors since (national) competent authorities might interfere with the rights of other competent authorities. For that reason, we see it as essential to foster cross-border and cross-sectoral cooperation between competent authorities thus producing a more globally coordinated and consistent approach.

In this context, we would moreover like to add that **negotiating contracts with service providers** including the ever-growing list of mandatory minimum content is becoming increasingly difficult. Legally binding written contract between a regulated entity and a service provider is essential to ensuring an appropriate and reliable provision of services as well as access, audit and information rights. Notwithstanding this, many service provider offer a “one-to-many” service model, meaning service is provided in the same way too many different customers. As a result, service providers generally offer the same or substantially similar contract terms to those different customers without the flexibility to have bespoke arrangements. Therefore, we actively support the EU´s work designing “Voluntary Standard Contract Clauses” to facilitate future negotiations and encourage collaboration between regulatory bodies on this.

Finally, we question the **management of concentration risk** (in the sense of macroprudential or system risk) on single entity level. We agree that the identification of concentration risk (i.e. concentration towards a single service provider) faced by a specific entity should be in the responsibility of the particular entity. However, market wide or systemic concentration risk, i.e. the risk of many regulated entities outsourcing to a single or only few service providers, we believe, exceeds the responsibility of single entities and should rather be addressed by competent and supervisory authorities. Moreover, single entities lack information to comprehensively assess potential market wide concentration risks.

Q.2 What are possible ways to address these challenges and mitigate related risks? Are there any concerns with potential approaches that might increase risks, complexity or costs?

As already outlined above, we consider i) the growing complexity of regulatory requirements ii) contract negotiation, iii) the identification and management of outsourcing risks along the outsourcing chain as well as iv) the management of market wide concentration risk as key challenges in managing outsourcing risk.

We agree that outsourcing may pose challenges to regulated frameworks and supervisory authorities and that appropriate limitations in conjunction with appropriate requirements are necessary to limit and manage potentially related risk. However, we would like to encourage regulatory bodies to stronger acknowledge the benefits related to outsourcing including security related aspects associated with the use of cloud infrastructures. Ensuring information security, business continuity or disaster recovery often involve outsourcing of specific elements, which can improve overall security (e.g. red teaming or cloud services as a fall-back solution for disaster recovery).

Growing complexity of regulatory requirements

The extensive minimum requirements and criteria required by supervisory authorities already as of today could risk any benefits associated with outsourcing including (but not limited to) the use of specialist knowledge, the access to new technology and the pooling of knowledge within a group. We are of the opinion that an appropriate handling of outsourcing requires a more focussed approach and should allow for enough flexibility to account for institutions' particularities and even more on the particularities of the concerned services, activities and processes as well as the legal framework of operations. We are of the opinion that the growing complexity of regulatory requirements, which is increasingly constituting an operational challenge for financial institutions, could be adequately reduced through consequently applying the principle of proportionality and a targeted definition of outsourcing.

In order to apply the principle of proportionality in a risk-based manner, national and international regulatory bodies should abstain from broadening the scope of regulatory requirements to all third-party services, including such not constituting outsourcings. A proper definition of outsourcing should capture the provision of such third-party providers that, if not properly provided, might risk the continuation of the financial institution's critical services or the institutions' compliance with legal and regulatory requirements. Moreover, services performed by entities subject to a dedicated authorisation to provide this service, should be excluded. Through a clear definition of outsourcing the operational burden would be lowered, enabling institutions to focus on those outsourcing potentially posting severe risks while it would also support harmonization of outsourcing requirements and mitigate potential regulatory arbitrage.

The wording of the IOSCO's proposed definition of "outsourcing" includes any *tasks*, functions, processes, services or activities (collectively, "tasks"), which a regulated entity *would, or could in principle, otherwise be undertaken by the regulated entity itself*.[1] While we generally agree with focusing on functions, processes, services or activities within the definition of outsourcing, we consider *tasks* as being rather one-time actions that should not be covered be the term outsourcing, although performed by a service provider. The performance of single tasks is generally not related to a transfer of responsibilities to a service provider and should therefore be regarded in line with purchasing and excluded from the definition of outsourcing.

Moreover, multiple processes, services or activities can be performed by service providers for the benefit of a regulated entity, which are neither specific to the regulated service nor particularly needed in order to perform the regulated services. In case these processes, services or activities are not performed by a service provider, they naturally would be ("otherwise") performed by the regulated entity itself. This is e.g. true for catering, cleaning services, any advisory services or other one-time services. As the term "otherwise be undertaken by the regulated entity" is too broad, we would propose to limit the outsourcing definition to functions, services activities and processes related to the respective regulated entity's core services /

[1] IOSCO (2020) Principles on Outsourcing: Consultation Report, Page 6

services subject to banking license and the related IT Services. We also support the explicit exclusion of purchasing from the scope of outsourcing.

When it comes to the definition of outsourcing and the related regulatory scope, we deem the approach of Korea, Singapore, Switzerland and Russia as quite interesting and worth examining in greater detail. The application of a targeted definition of outsourcing focusing on continuous and recurring activities directly related to the provision of the institution's core financial services is risk-based, well-balanced and it seems to create an environment where risk management measures are manageable and proportionate. Considering the broad interpretation and occasional extension of IOSCO's definition by national regulators, we are of the opinion that the definition lacks clarity and could be perceived as misleading and should therefore be amended as outlined above. Third party services not classifying as outsourcings, should in general not be subject to comparable requirements as outsourcings as this would contradict the principle of proportionality.

Further, we believe that using a service provider, which is a dedicatedly authorised service providers in the respective jurisdiction for the services used (e.g. a trade repository, a data reporting service provider, an index provider or a CSD), should not fall within the scope of outsourcing, irrespective of whether the provision of that specific activity requires explicit authorisation or could also be performed by the financial institution itself. Dedicatedly authorised service providers are subject to supervision by regulators and therefore do not pose comparable risks to outsourcing entities as other unregulated service providers.

Finally, we believe that the operational challenge of applying the full scope of regulatory requirements related to outsourcing could be lowered further in a risk-based manner by distinguishing between outsourcing among entities of a group (intra-group outsourcings) with existing control and enforcement mechanisms and outsourcings to external third parties. The enforcement of outsourcing rules and regulations along the outsourcing chain can be much more powerful and effectively executed within a group than in the case of a third-party service provider outside such groups. Effectiveness of those intra-group structures can be ensured irrespective of the country of service performance and irrespective of whether the service provider falls within the scope of the same consolidated supervision. In general, under due consideration of specifics of single group entities, the same standards and policies apply and there is a high likelihood of a common control framework. Further, a reasonable degree of management integration exists, and common committees may be often in place to steer the business and control activities. In this sense we would support the opinion of the Bank of Italy as outlined in the discussion paper that a group can be deemed as a single economic entity. We believe that the specifics of intra-group outsourcings need to be reflected more appropriately especially regarding the requirements on due diligence, concentration risk, business continuity plans and exit strategies, where we would welcome special arrangements for intra-group outsourcings, irrespective of a potential consolidated supervision.

Contract negotiations

Already as of today, financial institutions are obliged to include specific minimum requirements into the contract governing the outsourcing of (material or critical) activities. In recent year, this list of minimum contractual requirements has grown for material as well as non-material outsourcings.

Negotiating specific contractual requirements is particularly difficult with service providers providing standardised services. Extensive or far-reaching contractual minimum requirements bear the risk of reducing the attractiveness of customers from the financial industry which in turn might risk the access to new technologies and expert knowledge as well as limit potential benefits as cost reduction and use of synergies. In addition, we have observed that diverging interpretation of the definition of outsourcing as well as related requirements weaken the negotiating power of single financial institutions as - particularly international - service providers refer to comparable regulated customers not obliged to include specific contractual specifications.

As possible solution, voluntarily standard contract clauses could facilitate the negotiations with regulated entities and allow them the use of innovative technology offered by one-to-many service providers. Therefore, we actively support the EU´s work designing "Voluntary Standard Contract Clauses" to facilitate future negotiations and encourage collaboration between regulatory bodies on this.

Management of outsourcing risk along the outsourcing chain

Regulators all over the world have increased their focus on potential risks arising along the outsourcing chain. Although regulatory requirements related to outsourcing usually apply to the whole outsourcing chain, requirements have been increasingly adjusted to specify supervisory expectations on the management of risks along the outsourcing chain. Among others, financial institutions shall consider adherence to human rights and environmental aspects when assessing risks along the outsourcing chain and request notifications on sub-contracting, both along the whole outsourcing chain.

We fear that subjecting financial institutions to extensive regulatory requirements along the outsourcing or even supply chain, will lower potential benefits from outsourcing due to the excessive operational burden related to the management along the whole outsourcing chain. Such excessive burden is likely to exceed any potential risk reducing benefits and might lead to excessive back-sourcing. This in turn might exclude in particular smaller institutions from access to new technologies and the realisation of synergies.

While we agree that a functioning outsourcing chain can be crucial to the provision of critical services to financial institutions, we encourage regulators to consider the practical limitations faced by financial institutions as well as supervisory bodies and rather focus on strengthening risk mitigating measures implemented by financial institutions. We believe that financial institutions having a thorough understanding of effects of a potential failure in service provision, including an understanding of the direct service providers capacities and resilience under stresses conditions, as well as having effective business continuity plans and feasible exit plans in place, are well prepared to manage potential risks arising from the outsourcing chain.

Management of market wide concentration risk

We agree, that financial institutions should manage concentration risk on single entity and group level, i.e. should assess and manage the risk of potential losses arising from a lack of diversification in service providers used by the specific financial institution. In contrast to this, market wide or systemic concentration risk, i.e. the risk arising from a concentration in the provision of services to financial institutions by single or only few service providers, we believe, exceed the responsibility of single entities and should rather be addressed by competent and supervisory authorities.

Financial institutions are already as of today subject to notification or authorisation obligations in case of (material) outsourcings. Competent authorities should use this information to assess potential concentration risks. Single entity's contribution to managing market-wide concentration risk should focus on risk mitigating measures as maintaining reliable exit plans to ensure appropriate transfer of services, either through transfer to on-premise structures or an alternative service provider. Single regulated entities should not be responsible for managing risks created by others by e.g. amending their choice of service providers or underlying contracts (duration), particularly as a change in service provider might be related to a decrease in quality.

The danger of a strong market concentration with a few service providers (e.g. "lock-in"), must be actively countered not only on the side of the regulated entity, but primarily on the regulatory one. Risks arising from concentration within the sector need to be evaluated by competent authorities as this is not possible for individual entities. Additionally, the regulatory environment must be supportive for new actors to offer new services and to bring more competition to highly concentrated markets. Also, entities do not know and cannot influence the behaviour of other entities to choose a specific service provider in the sector or in other industries. Furthermore, the consequence of identified concentration risks above a certain threshold by regulators seem unclear. Would an entity be prohibited to outsource services at some point, while others would be allowed ("first come first serve")? This might contradict competition laws and could harm innovation and damage level playing fields. Therefore, clarity must be provided in advance on how the identification of market wide concentration risk might affect single entities.

As one possible solution regulatory authorities should consider subjecting third parties posting a high level of concentration risk to the financial industry under direct supervision and control or request authorisation, proving compliance to certain criteria applicable in their jurisdiction. This should however be done on a risk-based principle by applying the criteria of materiality or criticality of the outsourced function as well as concentration of material / critical outsourcings to a single service provider. In this regard we would like to point out to regulation in Luxembourg where certain service providers are required to be authorised and specialised service providers to the financial industry and supervised by CSSF[2]. In case of outsourcings to such an authorised service provider, the outsourcing financial institution can benefit from simplified regulatory requirements. We consider this as a viable way in which the FIs would still manage their own risks (such that no delegation of responsibilities would occur), while the management of market wide concentration risk would be complemented by competent authorities. That would on the one hand reduce costs and complexity for FIs while on the other hand it would lower the operational burden in the outsourcing process which in turn could ensure benefits related to outsourcing, including improve resilience, reduce risks or foster innovation.

In case of direct supervision or mandatory authorisation of service providers posting a concentration risk to the financial industry, financial institutions should be released from selected regulatory requirements covered through direct supervision or mandatory authorisation. This should at least include requirements related to the performance of due diligence or performance of audits.

Q.3 What are possible ways in which financial institutions, third-party service providers and supervisory authorities could collaborate to address these challenges on a cross-border basis?

A lack of harmonization as well as "gold-plating" regarding the regulatory framework especially regarding the use of new technologies (see for example the developments in the area of Distributed Ledger Technology/Blockchain) makes cross-border activities quite difficult today. One solution would be targeted legislative changes in existing national regulations to allow for a harmonized use of new technologies, based on common standards.

From our point of view, not only the cooperation between market participants and authorities at different levels is important, but also greater alignment and cooperation of authorities in different jurisdictions and at different levels as well as sectors would be beneficial (horizontal and vertical cooperation). This is especially relevant regarding the uptake of new technologies, which are getting more and more relevant for industries of different sectors. For example, so called "smart contracts" will be relevant not only for the

[2] CSSF: Law of 5 April 1993 on the financial sector

financial sector, but also for the real-world economy. Therefore, multi-disciplinary cooperation of authorities and the usage of common standards are essential to create a coherent approach.

Often, service providers are already as of today subject to dedicated requirements or even subject to oversight in their home jurisdiction. With an increased cooperation across sectors and jurisdictions might ease the enforcement of burdensome requirements.

Q.4 What lessons have been learned from the COVID-19 pandemic regarding managing and mitigating risks relating to outsourcing and third-party relationships, including risks arising in sub-contractors and the broader supply chain?

While we have experienced scarcity of selected hardware items easing the work from home during the initial phase of the pandemic (e.g. Headset) we did not experience disruption in outsourced services. Moreover, the COVID-19 pandemic showed us that clear lines of communication are even more important in such unexpected working conditions.