German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on the FSB's Discussion paper on Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships

Register of Interest Representatives
Identification number in the register: 52646912360-95

Contact:
Dr Christoph Kunze
Telephone: +49 30 2021-2325
Telefax: +49 30 2021-192300
E-mail: c.kunze@bvr.de

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

Coordinator:
National Association of German
Cooperative Banks
Schellingstraße 4 | 10785 Berlin | Germany
Telephone: +49 30 2021-0
Telefax: +49 30 2021-1900
www.die-dk.de

General comments

Thank you for making available the FSB's Discussion paper (DP) on "Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships", on which we would like to comment as follows.

We are pleased that the FSB has taken up an increasingly important topic for the finance sector and is looking at not only the related risks but is also addressing the advantages that outsourcing could bring for the institutions.

In a footnote, this DP refers to a document[1] which among other things makes reference to data from 2015. The document mentions that only 1% of financial institutions (FIs) use core applications via the cloud. A reason for this is that the FIs lack the technological knowledge. It adds that there is only anecdotal evidence since only little data is available. We think that cross-references that are more than 5 years old have only limited significance and the FSB should not refer to them. In recent years, the institutions have in part grappled very intensively with the cloud technology and gained experience with practical implementation.

The FSB should, furthermore, not refer to anecdotal claims when presenting its views. Specifically, we would like to point out that FIs can tap into the necessary knowledge and further information with the aid of external sources too. One should not give the impression that either, out of ignorance, FIs do not use cloud services or take risks that they cannot evaluate. It is rather more the case that legal and FI-specific requirements make it ever more difficult to engage external contracting partners. In the myriad of already existing regulatory requirements facing outsourcing FIs we see a level reached that could create the risk that e.g., innovative technology providers that are not / not exclusively specialists for the financial sector would abandon FIs. Among other things, there is the danger that only very large providers with an international network of subsidiaries and cooperation partners are in a position to tackle the strong requirements. The FSB's focus should be to formulate reasonable requirements.

The analyses that the DP refers to go on to elaborate that four large cloud providers together have a market share of approx. 60%. This share has remained unchanged for the last 8 years and has not resulted in a clustering of financial stability risks.

In contrast, the FSB's DP itself expounds that systemic risks can arise, as FIs are dependent on a small number of service providers. There appears to be a contradiction here and/or the database has not been consistently evaluated.

Regarding the number of service providers, we think that with reference to the four providers the FSB has narrowed its view far too much. The Cloud Computing Market Ecosystem[2] can be broken down into three sub-systems: (i) system integrators (e.g., Infosys, Accenture, Oracle, NTT), (ii) cloud service providers for SaaS, PaaS, IaaS (numerous providers) and (iii) connectivity providers (Cisco, Verizon, Lenovo, IBM etc.). This means that from the number of external contract partners for banks there are many more combination possibilities for banks. At this point, the FSB should analyse more exactly from where operational risks could emerge. For with an increasing number of combination possibilities the network

[1] Title: FinTech and market structure in financial services: Market developments and potential financial stability implications, 14.2.2019. Chapter 3.3., page 20. https://www.fsb.org/wp-content/uploads/P140219.pdf; cf. Financial Stability Board, Third-party dependencies in cloud services – Considerations on financial stability implications, 19 December 2019, page 5.

[2] These are among others Microsoft, Salesforce, Amazon, NTT, IBM, SAP, vmware, Citrix, Oracel, 8x8, Dell, Fujitsu; https://www.marketsandmarkets.com/Market-Reports/cloud-computing-market-234.html

gets larger and thereby itself conduces to a stabilisation of the cloud ecosystem. At any rate, there are various additional providers that potentially play a role only in national bank markets.

We fear, moreover, that – based on stale analyses and studies – a welter of opinions will emerge that through regular repetition will become more entrenched but is in part no longer current. We would therefore welcome if the FSB worded its recommendations more consistently and called for a harmonisation of requirements and rules and a more strongly risk-oriented application. With regard to the use of definitions we advocate that the FSB not establish any new terms/concepts. We propose that clear and unambiguous meanings be derived from the numerous terms/concepts. As an example, the terms and definitions could follow the European Banking Authority's outsourcing guidelines (EBA/GL/2019/02).

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

From our point of view, there are major challenges in comprehensively assessing a third-party purchase or outsourcing from an operational point of view and reducing the risk contained on the one hand. This naturally becomes more difficult the more service providers there are involved in certain processes. On the other hand, it is a challenge to formally meet the diverse regulatory and legal requirements, which in many aspects embody comparable requirements, but can differ with regard to detail in some areas and thus require increased analysis and, if necessary, implementation effort, which with regard to further risk reduction we perceive as inefficient.

In multilevel sub-outsourcing, further challenges are seen in the decreasing transparency with each link in the supply chain along the various service procurements and the associated risks and the identification of concentration and default risks.

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

In our view, the possibilities to meet these challenges consist in carrying out a systematic assessment and estimation of the risks associated with outsourcing or significant external procurement and implementing appropriate control measures. There are concerns particularly in the light of the fact that, without simplifying existing regulations, new, additional approaches will increase the complexity and thus the costs of outsourcing management without significantly reducing the risks.

In addition, we believe that it makes sense to certify IT support tools for outsourcing management and hence to establish a best-practice standard. Also, a certification of outsourcing companies can be helpful. Taken together, this can ensure that control requirements for the provision of services are regulated and that on a case-by-case basis financial institutions can demand compliance from service providers. We see this as a suitable relief. It should be borne in mind also to ideally involve the organisations of the audit firms.

The centralisation of pre-auditing of providers by neutral bodies, particularly with multi-client providers such as cloud providers, would in our opinion result in enhanced efficiency in audit practice and increased transparency for regulators/supervisory authorities, institutions and service providers.

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

Cross-border cooperation would, in our opinion, be facilitated by establishing common standards for outsourcing management. Therefore, efforts should be made to harmonise regulatory approaches and content, definitions and categorisations; on the one hand, in relation to the different regulatory authorities and initiatives, on the other hand, with regard to the submarkets of the financial sector (loans, securities, money and capital markets etc.) in order to avoid complex, inefficient demarcation analyses and different interpretations. The principle of proportionality must be kept in mind, however, and not narrowed down by perhaps continually ratcheting up the demands and increasing the detail by means of a step-by-step process. Otherwise, there is the risk that FIs will back away from outsourcing due to the excessive regulatory requirements, and the associated benefits will no longer be reaped.

With regard to promotional banks, reasonable opt-out/exemption clauses should be included because of their special mandate and business model predicated on this and also their special requirements (especially public / EU-wide award/tender procedures) on the one hand and the special state protection on the other.

In addition, we refer to our answers to question 2.

4. What lessons have been learned from the COVID-19 pandemic regarding managing and mitigating risks relating to outsourcing and third-party service providers?

As expedient measures to reduce risk in the COVID-19 pandemic, the increase in the number of service providers' staff working from home (including amendment of contractual agreements regarding such remote work) as well as the updating of contingency plans and, if necessary, exit strategies for key service providers are being evaluated.

The pandemic has shown also that a fast and flexible engagement of new contractors or the expansion of existing contracts can be necessary and can cultivate a stabilising effect on the financial institutions. This applies particularly to non-risk-critical tasks and external information and communication technology (ICT) service providers and refers, for example, to solutions of web-based team communication opportunities. Any form of regulation should support and promote progress.

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