

ZENTRALER KREDITAUSSCHUSS

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Committee of European Banking Supervisors
(CEBS)

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2. CEBS Consultation Paper “Standards on Outsourcing“ CP02 revised¹

Dear Sir or Madam,

We appreciate the opportunity to submit our comments on the Consultation Paper “Standards on Outsourcing” (CP02 revised) which you published on April, 6th 2006.

Executive Summary

- In the definition of outsourcing, along with purchase agreements, further procurement agreements (e.g. rental agreements or leasehold agreements etc.) should be exempted (cf. Standard 1).
- Because the corresponding risk situation is more favourable during outsourcing of areas to supervised companies within the EU, less stringent requirements should apply. Outsourcing of activities within groups and financial networks (e.g. financial networks such as the FinanzVerbund der Deutschen Volksbanken und Raiffeisenbanken and the Sparkassen Finanzgruppe) should not qualify for treatment as outsourcing activities (cf. Standard 4).
- In order to avoid red tape, the information obligation concerning all outsourcing activities should be dropped (cf. Standard 4).
- In order to cater to the multiple differences in business models as well as the idiosyncracies of sub-markets in an adequate manner, further exemptions from the application of the basic principles should be explicitly allowed (cf.

¹ This position paper is subject to approval by the committees of the Association of German Banks.

Standard 5). Furthermore, there needs to be a clarification that the supervisory authorities are granted the leeway necessary to take account of the peculiarities of the highly heterogenous business models.

As already mentioned in our comments on the first draft, we welcome the fact that the establishment of European-wide standards will create a level playing field for credit institutions within the EU thus facilitating cross-border outsourcing solutions. Furthermore, we support the approach chosen by CEBS to use the standards in order to provide national supervisory authorities with a framework allowing them to take adequate account of the manifold differences of the business models from institutions with their respective specific risk situation as well as the idiosyncrasies of local submarkets.

Furthermore, we welcome the fact that CEBS and CESR have explicitly endorsed a forthcoming harmonisation of their outsourcing provisions to the greatest extent possible. Yet, given these plans, it remains surprising that CEBS and CESR continue to stick to their own language and that they have also abstained from creating linguistic convergence in those areas where the content is deemed to be congruent. In practice, this would inevitably lead to inconsistent implementation policies. We would only like to mention such key concepts as “outsourcing service provider”, “senior management” or “chain outsourcing”. All of these are concepts which have been defined by CEBS, but for which there is absolutely no concept clarification by CESR.

Last but not least, in order to create a level playing field for banks and investment firms, whenever the content is identical, the “Standards on Outsourcing” issued by CEBS and under MiFID should strive for terminological convergence. To achieve this CEBS and CESR should draw up a common regulatory framework in order. A general part – which would largely prevail – should contain all identical provisions. This could then be complemented by a special part including specific regimes for credit institutions or investment firms.

In order to justify any deviations from CESR's provisions that CEBS considers unavoidable, there should be a review of all points which CEBS itself highlights. On pages 2 and 3 of the Consultation Paper, CEBS has prepared a corresponding list. Partly the rationale behind some items/issues on this is difficult to comprehend and appears unjustified. Particularly the reference to the different scopes of application by CEBS and CESR remains essentially unclear. It also fails to deliver an explanation of the deviations

right down to the very basic outsourcing concepts. We would like to illustrate this point by means of a few examples:

- Definition outsourcing (lit. a): Here, any deviations would work as a gateway into two completely different regulatory systems. This should absolutely be avoided. CEBS points out that, although CESR fails to incorporate the term continuity in the concept clarification, CESR then allegedly incorporates this term by reference in various sections. This allegation is incorrect. In the subsequent sections the term 'continuity' does not relate to the duration of the outsourcing activity. Instead, it is used for example for the definition of critical or important operational functions (§13(1) of the Directive on MiFID implementation).
- Materiality (lit. b): There are different specifications regarding the risk based rating of different outsourcing activities. During practical implementation, this leads to considerable uncertainties. At the same time, compliance with the divergent requirements becomes far more complex and onerous. At this juncture - along with the definition of outsourcing - CEBS and CESR require uniform standards as the smallest common denominator for their liaison process. In this context, potential catalogues of non-material activities need to be closely coordinated and do not allow any fragmentation (cf. Standard 5.2.b and Section 13(2), CESR implementing directive).
- Activities which must not be outsourced (lit. d): Another unrealistic implementation hurdle for the regime results from the divergent definition of business areas or business activities which must not be outsourced to an unauthorised entity. This would lead to disproportionately high burdens for the institutions. In turn, this would translate into grievous competitive disadvantages at universal banks.
- Outsourcing of non-material activities (lit. f): The difference between the regulatory approaches of CEBS and CESR or, moreover, the intended practical consequence of the different approaches remains unclear. Activities which are non-material should undoubtedly be exempt from all requirements or obligations. This is already required by the conceptual clarity. After all, also as far as risks are concerned, activities which are non-material do not give rise to any need for regulatory action.

In addition to the foregoing discrepancies with CESR's provisions, CEBS's Consultation Paper contains further deviations from CESR's provisions. By way of example, we should like to mention the following issues:

- Direct accesses by supervisor: Standards 8.2.h and 11 digress from CESR's provisions in that the contract should include an obligation on the outsourcing service provider to allow direct access by the outsourcing institution's supervisory authority to relevant data and its premises as required. Hence it is not clear why the information obligations envisaged by CESR in section 14(4), implementing the directive should not be sufficient.
- Requirements with regard to outsourcing contracts: In Standard 8, CEBS stipulates quite detailed requirements with regard to the content of outsourcing contracts. This limits the contractual freedom of the companies which are affected by the outsourcing exercise in a disproportionate manner. Given the clearly less detailed requirements under Section 14(2) of CESR's Implementing Directive, there is no objective need for this.

Again, this is an area where a harmonisation of the various provisions by CEBS and CESR is called for. Otherwise and in the absence of any objective reason, both regimes might drift apart even further.

Market requirements change. The business arena keeps changing. This change is constantly accelerating. Hence, institutions are increasingly held to focus on their core competencies meaning they may have to outsource to specialised service companies certain functions which do not form part of their core business or which due to the required economies of scale cannot be rendered in house at economically viable costs. It is therefore of paramount importance for the banking industry that supervisory provisions merely establish corner points, i.e. confine itself to creating a favourable climate which will allow institutions to respond with the necessary flexibility required by the markets and that they do so in a way in which they remain fully responsible for their actions. On principle, regulatory provisions on outsourcing should not prejudice entrepreneurial freedom. Mandatory regulatory provisions should strictly be geared to those risks that are actually relevant. They should remain limited to the degree necessary in order to guarantee an efficient implementation and management for the sake of both parties, i.e. supervisory authorities on the one hand and supervised institutions on the other hand.

Especially in view of the foregoing remarks, we strongly regret that the revised draft has not incorporated our comments on the first draft to a greater degree. We therefore feel compelled to revisit once more these points in all candour. The reason for this reiteration is that we are firmly convinced that these points are vital for a forthcoming, risk sensitive standard that is fit for practical application on the ground.

Based on what has been said above, we would like to submit the following comments on the individual regulatory proposals:

1. Standard 1

We see a need for a clarification that an activity will only be deemed for outsourcing if such activity specifically relates to the implementation of a banking or financial services transaction.

Standard 1 b contains a definition of the term “purchasing”. However, there is no reference to this definition in the further document. In our preliminary understanding purchasing contracts, i.e. purchase or service agreements, by means of which the institution procures standardised products, shall be exempt from the definition of outsourcing; this had already been envisaged under the first consultation paper. We therefore kindly request that a corresponding provision be reincorporated.

Furthermore, the definition of purchasing should be expanded. There should be a clarification that any other procurement agreements, such as rental or leasehold agreements, do not fall under the regulatory scope of the standards on outsourcing. Furthermore it is irrelevant whether an institution purchases standardised or bespoke goods or services. This becomes evident by looking at the example of software development. Software development does not form part of banks original business areas. Instead, due to efficiency reasons, it is regularly delegated to third parties. We therefore feel it should similarly not be considered as part of outsourcing. Along with the purchase of standard software, institutions regularly commission bespoke applications which, however do not increase the risk profile. What is decisive for the security of a banking operation is not whether a software is standardised or bespoke, but that the institute carefully tests the functioning and the security before the software is deployed in the banking organisation.

Furthermore, it should be clarified that also the deployment of temporary workers does not constitute an instance of outsourcing, because for the duration of their activity they are comprehensively integrated into institutions' operational structure and its workflow organisation. Their complete integration into the organisation means that the situation is not different from the deployment of staff which works directly for the institution.

Finally the definition of the term “outsourcing service provider” in Standard 1 c is too far-reaching. The component “supplier of goods” refers to the purchase of goods by the credit institution. The purchase of goods, however, should not be regarded as outsourcing at all, because outsourcing’s general requirement of continuity as set out in Standard 1 a is not met in these cases. Moreover, from risk management’s point of view it is not convincing to monitor and control specific risks in connection with the purchase of goods by a special outsourcing unit as suggested in Standard 6 note 5. This is because the purchasing department itself is in a much better position to evaluate and control the risks in associated with the corresponding purchases rather than an extra monitoring unit that is not familiar with the individual purchase. In conclusion, the purchase of goods does not only lack the requirement of continuity but it can - from the risk side - be dealt with much more effectively by the respective unit within the company. Therefore “supplier of goods” should be excluded from the outsourcing definition in Standard 1 c.

The component “supplier of facilities” should also be deleted. The term in this context mainly refers to the lease of infrastructure. With respect to the risks involved there is no significant difference between the lease and the purchase of goods. In other words, the lease of infrastructure is just an alternative to the purchase of equipment. Therefore purchase and lease should be dealt with similarly, and with respect to the arguments brought forward above both components should not be considered outsourcing. The definitions should be altered accordingly.

2. Standard 2

The provision under note 3 of the explanation is worded in an ambiguous language. It could be construed to mean that the institutions are being requested to maintain certain core competencies with a view to all outsourced areas in order to potentially reengage themselves in the outsourced activities again at a later point. This would be excessively far-reaching. Personal and technical preconditions for a direct takeover are not permanently available in the institutions; hence it would not be possible to entirely

reassume the outsourced activities as captive business within a few days only. For this it would rather be necessary to have an adequate period of lead time. For institutions which are part of a financial network structure, the problem is further compounded by the fact that due to the division of labour within the financial network, certain activities, such as securities trading or international payment transaction have always been executed by central service providers. Hence, in these cases it would regularly be impossible for the institution to assume these activities itself. However, in practice, the points raised above have not led to any problems, either. The reason is that upon termination of the outsourcing agreement with the previous service provider, the activity is transferred mostly to a new service provider. We therefore kindly request a clarification that the provision under note 3 of the explanation means that an institution needs to adopt safeguards so that, in a worst case scenario, it will be able to assume the outsourced activities itself after an adequate period of time or, alternatively, commission another service provider to perform these activities.

3. Standard 4

Pursuant to Standard 4.1, services and activities relating to the acceptance of deposits or to lending may only be outsourced to such service providers who have a licence or an authorisation to carry out such activities. This provision is too far-reaching. Pursuant to this, any auxiliary activities in the framework of the deposit taking or lending business could only be legitimately outsourced to the service providers in possession of an authorisation or a license. However, this would contravene today's standard market practices: today, numerous services in the context of deposit and lending transactions are already being transferred to service providers who are not subject to banking supervision. This includes, for instance, call centres which take down customer orders or IT centres which keep and process the data for past transactions. Standard 4.1 should therefore be limited to core activities in the context of deposit taking and lending operations.

Pursuant to Standard 4.3, institutions should inform their supervisory authority in an adequate manner about this type of outsourcing. This general clause provides both supervisory authorities and also the institutions with sufficient leeway as regards the most diverse outsourcing solutions. However, this leeway is being excessively restricted by note 2 of the explanation. Pursuant to this, information on each and any outsourcing should be made available to the supervisory authority in a timely manner. We strongly object to this. The corresponding explanation should be dropped or it should at least be

clarified that this does not signify a general disclosure obligation. Sub-note e) on the explanations – alignment with securities regulation – already makes it clear that the term "prior notification" has been replaced by "adequately inform" so as to safeguard sufficient leeway for national authorities and in order to avoid the obligation of having to stipulate a general notification obligation.

Germany has known such a kind of disclosure obligation for several years now. During this period, it became evident that this disclosure obligation led to a plethora of mandatory notifications which, in turn, created a major burden, both for institutions and also for regulators. There was no obvious supervisory benefit. Given our past experience, we feel it would make sense to renounce to a general information obligation. Instead, we feel it would be wiser to leave it to the discretion of national supervisory authorities to decide which information they wish to receive on which types of outsourcing activities; e.g. outsourcing towards service providers located outside of the EU.

Furthermore it should be clarified that the supervisor's entitlement – under Standard 4 note 2 - to "impose specific conditions" does not mean that the supervisory authority has the right to determine specific conditions for each outsourcing activity. This would inevitably result in legal uncertainty as it cannot be ensured that those "specific conditions" would not alter from time to time.

Under note 3 of the explanation, institutions are requested to disclose any material changes to the supervisor. We strongly object to this provision since it would only create a significant additional burden for the institutions. Given that there are no obligations to disclose material changes for any other area of banking business, there is no objective need for this.

Contrary to the provisions under note 5 of the explanation, from the point of view of the risk involved, we feel that outsourcing to other companies within the same group or the same financial network as well as similar constellations (e.g. joint-ventures) should not be viewed as outsourcing and should therefore be exempt from the regulatory scope.

The outsourced companies are regularly dutybound to follow the directions of the senior company or the instructions of the network bodies. Hence, there is no danger that the control and management options of the outsourcing company's executive management will be impaired or that the latter might lose the control over the due and proper execution of banking transactions or financial services. Furthermore, when it comes to

these outsourcing companies, the supervisor's auditing rights and control possibilities are invariably guaranteed. Intra-group and intra-network outsourcing activities are gaining in importance. Hence, as far as risk management is concerned, the inclusion of such internal outsourcing activities under the scope of the outsourcing provisions would create little value added. Quite on the contrary: more often than not it would merely burden the institutions with considerable and costly red tape.

Such a kind of exemption would furthermore be in line with the recognition of special risk situations faced by groups which the European legislator accepted in the framework of the new capital adequacy provisions. With regard to solvency and large exposure regulations, for fully consolidated groups, group level supervision has already been permitted with the introduction of the right to choose under Article 69 of the amended Banking Directive 2006/48/EC to recast 2000/12/EC. A similar rationale is also underpinning Article 80(7) and Article 80(7a) of Directive 2006/48/EC to recast 2000/12/EC which allows the choice to waive capital backing for intra-group exposures between institutions that are embedded in a group or network structure. The transition to group level supervision should therefore not be limited to the aforementioned areas only. Instead it should also cover other areas of banking supervision, e.g. especially outsourcing.

Contrary to this, in its feedback on the first consultation round (cf. note 8) CEBS emphasises that supervisory authorities do not endorse any waivers for outsourcing activities within groups and network structures, yet, it fails to provide a rational reason for this. As already mentioned above, this fails to recognise an important aspect which is relevant for the assessment of outsourcing, i.e. the exposure situation prevailing within groups and financial network structures. This becomes especially clear in cases where the internal outsourcing is made to a company which itself is subject to banking supervision. Given the harmonisation of the European supervisory structures it is irrelevant whether this involves a domestic or an international - notably EU-domestic – outsourcing activity.

One further argument which speaks in favour of the described facilitations for group or financial network level outsourcing activities is the fact that frequently the general provisions are not applicable or completely run into a vacuum. This particularly applies to outsourcing which takes place from one or several subordinate companies to a senior company. Here, given the company law link between the respective stakeholder companies, the responsibility for the group – and thus also for the outsourcing company – anyway lies with the senior company which is why the outsourcing company will generally not require any control powers and direction rights *vis à vis* the controlling

company. There are anyway legal reasons (pertaining to the field of company law) why it is hardly possible that subordinate companies obtain comprehensive rights of direction *vis-à-vis* the controlling company.

4. Standard 5

Along with the outsourcing of non-material activities mentioned in Standard 5 there are also certain other areas which should not be covered by the scope of the “Standards on Outsourcing”. Certain transaction types, for instance, presuppose a corporation of several companies based on the division of labour. In cases where - due to the workflow structure underlying the respective transaction for the complete economic implementation of the transaction or due to the group’s or financial network’s special structure necessary for its division of labour - the involvement of third parties is indispensable, the formalistic application of the outsourcing principles would lead to considerably higher complexity. It would drive up costs and create unnecessary red tape. In the worst case it might even lead to a disruption of closely intermeshed processes. All of these repercussions would not be offset by any tangible value added. We therefore advocate that particularly the following transaction types be explicitly exempted from the scope of application of the “Standards on Outsourcing”: Function of the clearing and settlement mechanisms within the framework of payment transactions and securities settlement, the use of securities trading systems through other institutions, the authorisation centres for electronic cash transactions as well as the central bank’s functions within a financial network, the involvement of lead managers or agents for syndicated loans and comparable scenarios.

In order to adequately take account of the institutions' many business models within the EU, there should be an explicit regulation that the national supervisory authorities may determine further exemptions for certain areas in their jurisdiction. The respective risk situation can only be taken adequately into account if there is a sufficient degree of flexibility in the provisions. This should also allow waivers. In Germany it has proven a successful policy that BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht) and the banking industry agree on specific individual cases or, moreover, case groups, where the risks associated with an outsourcing activity are deemed as negligible from the point of view of banking supervision.

5. Standard 6

In order to avoid superfluous regulations we suggest that Standard 6.2 should be deleted, because its content seems to be self-evident.

Furthermore under note 5 of the explanation it is being requested that the outsourcing institution establishes an internal unit that is responsible for monitoring and management of each outsourcing arrangement. Yet, a central unit would generally not be in possession of the necessary expertise for simultaneous efficient management and supervision of each and every service provider. Hence, the provision should merely require that a central unit shall be obligated to maintain a holistic overview over all outsourcing activities whilst the ongoing coordination and monitoring shall be implemented by those units that are in possession of the necessary technical expertise to do so.

6. Standard 7

Note 1 of the explanation requests that the outsourcing institution shall inform its supervisory authority of any material development. In practice, this would lead to a completely excessive and unnecessary bureaucratic extra effort without any supervisory surplus. In Germany, it has proven a successful policy that potential shortcomings shall be contained in the auditor's report which accompanies the annual financial statement of the outsourced unit. This will then be brought to the attention of the supervisory authority. Furthermore, in Germany, every auditor is obligated (§29(3) KWG/German Banking Act) to immediately inform the supervisory authority if and when there any circumstances which may materially impair an institution's performance. Also, note 1 is not in line with note 3 of Standard 4 as it requires much stronger disclosure obligations. We therefore suggest deleting the second sentence of note 1 of Standard 7.

7. Standard 8

Note 2(j) of the explanation requests that a provision shall be entered into the outsourcing contract pursuant to which the outsourcing institution may cancel the agreement if so required by the supervisory authority. For agreements with unsupervised service providers which not only have institutions but also other business corporations as clients such a provision will hardly be feasible or might create considerably higher costs for the

outsourcing activities because the service provider cannot assess when such a case will become manifest. This requirement is furthermore redundant because note 2.d of the explanation already stipulates that the contract has to contain a termination clause which allows a reasonable termination of the agreement. Hence, the requirement in note 2 j. of the explanation should be dropped. This would also render note 6 of the explanation on Standard 11 obsolete.

Under certain circumstances, an individual right to give instructions as well as the granting of independent audit competencies for the purposes of an internal revision of every outsourcing institution may lead to very problematic implications for service companies which have assumed an identical service for a large number of institutions. Such individual rights would massively impair the cost efficient shifting of functions to units capable of achieving major economies of scale. Hence, a waiver should be introduced for service providers with multiple clients so as to rule out unlimited and inappropriately far-reaching individual auditing and direction rights for every single institution.

8. Standard 9

Standard 9 stipulates the need to draw up a service level agreement (SLA). Such an SLA is being drawn up separately to the agreement when it comes to outsourcing activities which require a comprehensive service specification. For other activities which require a considerably less sophisticated service level specification, however, a service specification in the outsourcing agreement will be sufficient. We understand this provision to mean that an SLA does not necessarily have to be drawn up separately in addition to the outsourcing agreement and would very much appreciate a corresponding clarification. After all, the question of a separate SLA, in the final analysis, depends on the individual circumstances and on the respective jurisdiction. What is decisive is that the service is being rendered on the basis of a written agreement.

9. Standard 11

We consider Standard 11 note 7 self-evident and therefore think that the stipulation should be deleted.

10. Standard 12

Standard 12 stipulates that the supervisory authorities are held to identify and monitor concentration risks at the level of the individual institution and at the sectoral level. We take it that the standard is supposed to leave the activity of so-called multiple client service providers unaffected. These multiple client service providers regularly dispose of a far greater know-how than individual providers and may carry out adjustments in the event of changed supervisory requirements at far lower costs.

We should like to thank you in advance for a careful deliberation of our foregoing remarks.

Yours sincerely,

For and on behalf of the

ZENTRALER KREDITAUSSCHUSS

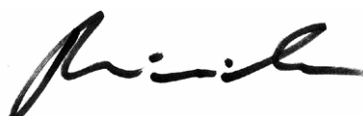
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