

# OUTSOURCING IN THE ASSET SERVICING INDUSTRY:

## CUSTODIAN AND DEPOSITARY BANKS

Evolving regulatory requirements and industry practices in the Eurozone and the UK

Working Paper



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It is my pleasure to welcome you to Avantage Reply's latest report: **Outsourcing in the Asset Servicing Industry.**

This report takes stock of the evolving regulatory requirements and industry practices in the Eurozone and the UK, focusing on outsourcing by custodian banks, depository banks and asset servicing companies (referred to collectively in this report as 'custodian banks' for the sake of readability).

The intention is to provide an overview of outsourcing in the current environment and to convey an understanding of the trajectory of outsourcing practices, regulation and supervision. We are available to provide further detail in this area, if desired.

Outsourcing is being carried out against a backdrop of increased regulatory and supervisory scrutiny, not just in custodian banks but also in the asset management industry<sup>1</sup>, the insurance industry<sup>2</sup> and banking more generally.

The authors, Marc Labat and Rohan Wilson, have drawn on years of outsourcing experience in writing this paper, both as practitioners and consultants.

## About Avantage Reply

Established in 2004, Avantage Reply (a member firm of Reply) is a pan-European specialised management consultancy delivering change initiatives in the areas of Compliance, Finance, Risk and Treasury.

Website: [www.avantagereply.com](http://www.avantagereply.com)

<sup>1</sup> <http://www.fca.org.uk/static/documents/thematic-reviews/tr13-10.pdf>.

<sup>2</sup> <https://www.fca.org.uk/static/fca/documents/thematic-reviews/tr15-07.pdf>.

## INTRODUCING THE AUTHORS



### **Marc Labat**

Marc Labat is a Senior Manager with over 20 years of experience in Financial Services, spanning senior roles in Consulting, Regulation and Audit. He has worked in the Eurozone, the US, the UK and Switzerland. He holds a Masters in Finance, is a CFA charterholder and a Certified Internal Auditor (CIA), among other qualifications.



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Rohan Wilson is a Senior Consultant with over eight years of experience in Banking, Risk and Financial Markets. He has worked in the UK, Germany, and the Benelux, including with several custodian banks. He is completing a Masters in Finance.

While the first, second and third lines of defence buzz with activity, and are protected by a complex array of cyber walls, moats and ramparts reminiscent of an elaborate French castle or a hacker's Guantanamo Bay, a lonely figure toils in a dusty back room offshore, harvesting your client's details on an industrial scale.

This is the stuff of nightmares in the custodian business, and it represents one of the most common and grave dangers facing custodian banks today. While outsourcing has brought cost savings, expertise and operational efficiencies, the inherent complexity of an international banking business means that managing these activities becomes increasingly difficult.

In the information age, when a vulnerability (every bank has them) is exploited, the efficiency and scale of the system becomes its own undoing. As thousands of hours of clerical work can be done with the push of a button, so can tens of millions of pages of client data be shared with criminals. Ultimately, custodian banking profits are built on trust, volume and margins. In the face of margin headwinds and relentless customer pressure to settle faster for less, there is a danger of eroding precious trust by taking unnecessary and avoidable outsourcing risks.



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# Executive Summary

Outsourcing is conceptually straightforward – it is in its execution that challenges begin to arise. Like a high school sports coach encouraging students to ‘do the basic things well’, regulatory authorities are pushing for financial institutions to outsource in a way that covers the key risks. These fundamental tasks include being able to oversee who is doing the work, having a contractual relationship in place, and having options prepared should the service provider fail.



With recent changes in the regulatory landscape, there is greater pressure than ever for custodians to have their outsourcing affairs in order. The amount of capital that a firm has to hold is now influenced by the degree of outsourcing risk, as well as the robustness of the outsourcing oversight and outsourcing risk management within the firm. Other supervisory measures are now being applied (e.g. supervisory remediation programs, bans on further outsourcing and/or bans on offshoring initiatives) when supervisors note weaknesses in outsourcing and/or risk management. Last but not least, the goalposts continue to move regarding operational continuity in resolution and the consequent implications for outsourcing arrangements.

By providing an overview of outsourcing requirements and best practice, as well as the direction of travel, we hope to impart some of the lessons learnt. We are more than happy to discuss the content at a greater level of detail if required.

The root causes of outsourcing weakness are limited. Despite this, the challenges of establishing and maintaining communication, control and flexibility over what can be incredibly complex institutional models mean that audit points continue to be found, and remediation continues to be imposed by new and established supervisors.

As cybersecurity budgets grow and data protection concerns receive greater attention, there is a danger that an Achilles heel of outsourced activities involving inadequately protected end client data is overlooked.

Moves to push for greater individual liability in the financial sector mean that board members and senior management can face personal repercussions should there be inadequate management of outsourcing arrangements. The string of outsourcing disasters over recent years highlights how easily the management of outsourcing can fall short.

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**“Overhauling the culture of the City requires a generational shift in attitudes akin to that seen for drink-driving in recent years....”**

Tracy McDermott, FCA

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To take the drink-driving analogy further, those responsible for outsourcing oversight and governance must ensure that drivers in far-flung destinations are wearing seatbelts, are licenced and are obeying European standards from the start of the engagement to the end. For those who have experienced the roads in Mumbai, Bangkok or Dar-es-Salaam, personal accountability for these activities, compounded by the obligation to provide evidence of supervision, control and reporting of these ‘drivers’, is no mean feat.



## OUTSOURCING

What is outsourcing?



# What is outsourcing?

## Background

As the rush to outsource to India took off in the 1980s, the country's high educational standards and low wages allowed costs to plunge. As Indian wages have risen over the decades, outsourcing has moved further afield, seeking similar wage savings in other Asian countries, Eastern Europe and Africa. Economic efficiencies attained by centralising services mean that information and work are constantly criss-crossing the Earth's surface.

Custodian and depositary banking lends itself to an outsourcing business model. There is a vast amount of operational processing for areas including fund accounting such as Net Asset Value (NAV) calculations and periodic accounting, for some of the transfer agency business dealing with investor redemptions and subscriptions, for financial reporting, etc.

In many ways, custodian banks can be considered as the outsourcing link between asset managers, funds, banks and other clients, who outsource middle and back office functions to custodians who then further outsource this work. Custodian banks have traditionally outsourced high-volume operational tasks. While these still form the bulk of outsourcing, activities that contribute to the running of banks themselves are now also being routinely outsourced, including significant chunks of Customer Services, Human Resources, Risk and Finance.

## Definition of outsourcing

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**Outsourcing is “an authorised entity’s use of a third party [...] to perform activities that would normally be undertaken by the authorised entity.”**

EBA Guidelines<sup>3</sup>

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A number of jurisdictions have issued supervisory rules or outlined expectations related to outsourcing to manage the associated operational risk. While there is no universally accepted definition of outsourcing (originally derived from “outside resourcing”), a useful reference – at least as far as banking is concerned – is provided by the 2006 CEBS<sup>4</sup> Guidelines on Outsourcing.

The regulatory definition of outsourcing is where another firm or legal entity performs work on a bank’s behalf that would otherwise be carried out by the outsourcing bank. There are discrepancies in the exact scope of this – cleaning services count as outsourcing in some countries and not others, as do telephone voice-recording services. Outsourcing can involve another legal entity of the same bank (offshoring), a relationship with a third party or a joint venture. From a regulatory standpoint, while the two types of outsourcing are distinct, the requirements for both across the European Union (EU) are converging.

For the purposes of this report, the ‘outsourcer’ is the company outsourcing the work, and the ‘service provider’ is the company performing the work for the outsourcer.

## Why is everyone doing it?

The key drivers of outsourcing are price, efficiency, headcount reduction, innovation and client service (e.g. for time-zone or language-specific service). When peer firms are achieving significant cost savings and stealing market share, it is challenging not to follow suit. Custodian banking is, in most products, a high-volume, low-fee business, and so operational efficiency is vital to remaining competitive.

For example, take Ireland, a fund industry hub, and India, the most popular destination for outsourcing work – Irish Fund Accountant starting salaries are four times higher than the average salaries in India<sup>5</sup>. When comparing Luxembourg to more ‘frontier’ outsourcing destinations in Asia or Africa, the wage arbitrage opportunities become even greater. The cost savings of properly managed outsourcing can be enormous – provided nothing goes wrong. Outsourcing allows for economies of scale, as a single provider can serve many locations. This allows for expertise to be developed as the outsourcing location develops institutional memory.

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<sup>3</sup> <https://www.eba.europa.eu/documents/10180/104404/GL02OutsourcingGuidelines.pdf>

<sup>4</sup> The Committee of European Banking Supervisors – predecessor to the European Banking Authority.

<sup>5</sup> Source: Fund Accounting vacancies advertised on Glassdoor, September 2015.

## OUTSOURCING

### What is outsourcing?

Headcount reduction is at the core of banking efficiency drives. Despite the hype and hysteria regarding the profession, banking is still a people industry – the five largest global institutions directly employ over two million people<sup>6</sup>, and the largest custodian banks spend a third of their revenue on staff<sup>7</sup>. Similarly to the banking industry as a whole, banking employment and recruitment are highly cyclical. Necessary periodic culls can result in an association between headcount reduction and increasing efficiency.

#### What is the trajectory?

An anecdotal observation in the marketplace is the increasing use of third party (as opposed to intra-group) outsourcing, often in concert with intra-group service providers. This gives banks access to pools of expertise, but equally introduces vulnerabilities into the system when inappropriately supervised. Regulators have cottoned on to the trend and are beefing up their analysis of this form of outsourcing.

It is important to remember that outsourcing frameworks differ from bank to bank. The models were developed in different ways, with different priorities and risk tolerances. The multiplicity of parameters and choices has allowed for wide diversity in custodian banking outsourcing arrangements.

Custodian banks are managing the pressures of regulation, low interest rates (and hence low net interest margins), and relentlessly lowered fees. All are looking at sources of operational efficiencies. The outsourcing momentum in custodian banking shows no sign of abating.

While the short-term effects of recent regulation are visible, it is challenging to predict what the structural changes will be in the longer term. For example, the fiduciary function will continue to grow due to increased workloads related to AIFMD and UCITS V, but is unlikely to be completely outsourced – whereas custody will continue to be outsourced. This will alter the balance of custodian banks in the future.

#### Custodian banks: a historical perspective

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“Plus ça change, plus c’est la même chose.”

Jean-Baptiste Alphonse Karr

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The term ‘global custody’ has been in existence now for over 40 years<sup>8</sup>. The financial services industry may feel like it has changed out of all recognition in the last decades, but there are surprisingly many parallels over time. The hot topics of the day have changed – dematerialisation of securities has now been replaced by a ‘tsunami’ of regulation. However, costs are being driven down, now as they were then. Consolidation has happened; this is a seismic change. All the numbers (volumes, assets under custody) have increased, apart from errors

<sup>6</sup> <http://www.statista.com/statistics/264671/top-20-companies-based-on-number-of-employees/>

<sup>7</sup> Source: 2014 annual reports of the four largest custodian banks. Employee compensation divided by total net revenue is 32.5% when weighted by USD amount and 35% for the simple mean of the four banks.

<sup>8</sup> As extrapolated from Greensted, R., 1994, The Custody Atlas.

and turnaround time of service, which are smaller – this is a continuation of the trends noted over 20 years ago. Technology is again struggling to meet the demands of new products and services, despite there now being modernised core activities and software providers servicing custodian banking functions. There has been the addition of different types of asset classes, with real estate being a potential new frontier for growth, as well as successes in absorbing project finance and hedge funds into the realm of products held under custody. That said, as the iPhone approaches its ninth birthday and in the era of the driverless car, faxes continue to be sent in the custodian industry.

The settlements nightmare following the Lehman disaster in 2008 is reminiscent of the time spent dealing with the aftermath of the 1987 crash (settling trades, resolving ownership disputes, etc.). While Moore's Law (that computer power doubles every 18 months) was certainly upheld during this span, the complexity, volume and frequency of client activity has ensured that technology now, as then, continues to be a limiting factor in custodian banking.

It remains to be seen how technologies such as the block chain and other distributed ledgers will disrupt, be integrated with, or fail to influence the traditional custodian business model. A total of 25 major banks<sup>9</sup> have joined a consortium (formed by product-development firm R3 CEV) looking to apply block chain technologies to financial services<sup>10</sup>. These include global custodians BNY Mellon, Citibank, HSBC, JP Morgan, RBC, Société Générale and State Street. NASDAQ is also testing the use of the block chain in share trading<sup>11</sup>.

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<sup>9</sup> As of October 2015.

<sup>10</sup> The Economist, (2015), 'The Trust Machine', 31 October.

<sup>11</sup> [http://www.wsj.com/article\\_email/a-bitcoin-technology-gets-nasdaq-test-1431296886-lMyQjAxMTE1MzEyMDQxNzAwWj](http://www.wsj.com/article_email/a-bitcoin-technology-gets-nasdaq-test-1431296886-lMyQjAxMTE1MzEyMDQxNzAwWj)

## OUTSOURCING

### What goes wrong?

# What goes wrong?

When an institution outsources custodian business, there are a number of areas in which it can become vulnerable, including but not restricted to:

- Loss of expertise;
- Loss of capacity;
- Lack of an adequate back up plan;
- Inadequate Management Information (MI) over outsourced activities, leading to inadequate board of director and firm oversight;
- Inadequate contracts for the outsourced activity;
- An inadequate legal framework with the outsourcing counterparty; and
- Inadequate communication with the relevant National Competent Authorities (NCAs).

As staff leave or are reassigned, institutional memory is lost, as is system access and expertise. Many problems found 'in the field' stem from a loss of experienced staff, either from the outsourcer or the service provider. While computer systems change, processes become modernised and new services are offered, there is no substitute for having 20 years of specialised experience on standby to manage any issues that may arise. It is easier, quicker and cheaper to outsource a department than it is to rebuild one from scratch. It is possible to push the envelope too far.

Outsourcing necessarily involves a degree of capacity loss from the outsourcer. However, it is important to be mindful of the loss of flexibility that arises from losing the ability to perform the relevant activity. With a lower headcount 'on site', there is less available bandwidth to take up work if necessary, and there is a danger of losing the specialists qualified to oversee and govern the outsourced activity. In many cases, the extent of the outsourcing is such that the work can never be regained without a total rebuild of the department. Where there is not an adequate back-up plan, as below, this results in overdependence on the service provider.

In this era of modern banking, most key departments have a back-up plan, business continuity arrangements or similar provisions. While this is admirable, it is relatively easy to end up with pro forma procedures that would not cover a genuine emergency. If there is no fall-back plan, adequately researched and practised, that considers the 'portfolio' of outsourced services and anticipates what will happen with other outsourcers at the same time, then there is a vulnerability to external shocks.

Relevant parties frequently 'get the nod' before testing, much of which is not live. It takes a brave banker to risk business-as-usual activity by forcing a genuine, unexpected 'fall-back' test on employees. In cases where real world events put these carefully laid plans to the test, a common theme in the feedback is that it was very difficult, a great deal was learnt, and the new resiliency plans are quite different.

An aspect often overlooked is the portfolio nature of the outsourcing risk in terms of business resiliency. Whether the business continuity plan involves employees working from a secondary location or dialling in from home, or the use of another team entirely, it is important to ask:

- Who else will be trying to avoid failure in a real disaster?
- What will be the priority for the people picking up the work – will they care? Are you their biggest customer? If an intra-group arrangement, do your managers have the hierarchical firepower required to ensure that your business is taken care of first?
- How many customers could the destination location cope with at once?

Best practice involves sending relevant MI on a regular basis. This must walk the line between being informative and being brief enough to be readable. Supervisors are looking for the ‘so what?’ factor. They want to see the logical, evidenced chain of a problem or risk occurring, followed by:

- MI covering the relevant issue;
- Management decisions based on this information (even if the decision is that the issue is within the Risk Appetite of the bank and that no action is to be taken);
- Action plans being drawn up; and then
- Follow-up action and management until the problem is rectified.

Experienced supervisors are tired of seeing MI that does not contain relevant information, negative MI that is not followed up on, and action plans that are not seen through. Where there is a legal entity/affiliate and mother company situation, supervisors are interested in who has made the call on what action to take.

The most common issue with legal arrangements is being out of date, especially regarding activities performed, and occasionally in terms of the location in which the work is performed. It can be challenging to get the service provider to help with completing these activities. Where end client consent has to be obtained through a network of investment managers and related parties, it can be like pulling teeth.

There must be a document outlining the legal framework between the outsourcing legal entity and the service provider. This can be missing in intra-group arrangements, and is necessary in order to have legally enforceable contractual relationships.

Depending on location, the communication with the local NCA can be light or onerous. As this involves many business lines, a centralised storage location for these communications is useful. It is also advisable to minute meetings with the NCA.

# OUTSOURCING

## What goes wrong?

### Continuity and Exit Planning

Banks deemed 'too big to fail' have cost taxpayers billions. Hence there has been a regulatory push to prepare banks for times of distress. This includes ensuring that there are mechanisms in place to allow banks to recover or enter orderly resolution without the need for public funds. In order to do this, the interdependencies of legal entities and individual firms must be possible to untangle. Two ways of achieving this are continuity and exit planning, both of which are inextricably linked to a financial institution's outsourcing arrangements, including the use of intra-group shared services.

Continuity involves ensuring a service continues to be provided to a bank being wound-down and can be achieved through the use of resolution-proof service agreements and bankruptcy remote software ownership.

Supervisory expectations regarding exit planning are increasing and custodian banks must be prepared to demonstrate how they have prepared for situations where outsourcing arrangements must be terminated. Firms are now moving beyond exit clauses in contracts and are performing exit management exercises, which sometimes include joint workshops with suppliers. There is an expectation in some quarters that in the near future, Exit Plans will have to be both written and tested in the same way as Business Continuity Plans are now.

### IT: the cornerstone of outsourcing arrangements

Technology cannot be separated from custodian outsourcing. Every outsourcing decision is an IT decision, the ramifications of which are ignored at the outsourcer's peril. The earlier IT specialists are involved in an outsourcing decision, the more easily they can offer choices to guide the solution toward something likely to be compliant, effective and safe.

For information on clients to be kept confidential, the data must be encrypted when it is at-rest, in-motion, and in-use. The unspoken secret of the data destruction industry is that, in many cases, the data never dies. While public destruction of old hard drives, degaussing (the use of a powerful magnet to destroy the data storage on hard drives), and responsible data management are both admirable and effective, how can you ever be sure that the outsourced server back-up drives have been selectively wiped of client data? There are many vectors by which data can end up in the wrong hands, and, despite the maturity of the IT industry, there remains a lack of standardisation for these processes. This is one area where third party outsourcing is more risky than its intra-group equivalent, although this can be mitigated with effective Information Security governance and risk management with effective information security controls.

Data privacy is ignored at a bank's peril. This can be a bone of contention for cross-Atlantic management of European legal entities, in particular due to what are predominantly more restrictive European requirements for the privacy and protection of individual investor data.

The invalidation of the US Safe Harbour Decision<sup>12</sup> further complicates and restricts movement of data from the EU to the US. The Safe Harbour Decision allowed movement of data from the EU to the US under the Data Protection Directive as the US was deemed to ensure an adequate level of data protection. As a consequence of the Edward Snowden revelations, the European Court of Justice deemed these protections inadequate. Currently, there is uncertainty regarding the management of outsourcing agreements that involve the movement of Personally Identifiable Information (PII) and other confidential data from the EU to the US.

<sup>12</sup> [http://ec.europa.eu/justice/data-protection/international-transfers/adequacy/files/eu-us\\_data\\_flows\\_communication\\_final.pdf](http://ec.europa.eu/justice/data-protection/international-transfers/adequacy/files/eu-us_data_flows_communication_final.pdf)

# Regulation

## Regulation naturally follows from the above issues

Where does all this regulation come from? Experience, mostly. One sees the same themes again and again across regulation from every continent and country. Regulators want to make sure that custodian banks are managing their business properly – they have learnt from the mistakes of the past in writing regulation to prevent their recurrence. They also conduct thematic reviews to assess where current and future weaknesses may lie. Regulators are keen to assess the overall impact of outsourcing on bank risk profiles.

Many people carry the concept of accepting some regulatory risk being non-optional. Regulatory risk is a risk like any other, but, ultimately, it is the regulator that has the power to pull the plug and take away a banking license. In the past, Machiavellian game theorists would have considered the bare minimum to be the optimal approach to regulatory requirements that present a pass/fail outcome. The Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA) in the UK and the Single Supervisory Mechanism (SSM) Joint Supervisory Teams (JSTs) are now taking a more nuanced approach, changing incentives by grading banks on a more granular scale, and considering both quantitative and qualitative factors. These factors are used to produce an assessment that has a direct impact on a bank's competitiveness, by influencing the amount of capital that it needs to hold or intervening in the bank's ability to distribute dividends or to outsource.

## What are the rules?

While the specific rules vary from country to country and from region to region, the central themes remain the same, as outlined above. In order to prevent negative outcomes, and based on experience, regulation tends to be concentrated on the following themes:

- **Business continuity:** the outsourced work must be able to be performed, even where issues with the service provider arise;
- **Information from the service provider:** the outsourcer must have enough information to be able to manage the relationship;
- **Information to the board:** the managing authorities of the outsourcer must have sufficient information to manage the outsourcing arrangement;
- **Chain outsourcing:** responsible persons must be able to oversee the links in the chain through to the end;
- **Protection of customer data** (where relevant) for material outsourcing;
- **Authorisation from the NCA** (where relevant);
- Getting **client consent** and enhancing **client reporting**; and
- **Restrictions** on the final check and release of Net Asset Values (NAVs), for example.



# Luxembourg: Spotlight on Outsourcing Regulation

The 'Bible': CSSF Circular 12/552

Themes:

- Control of end investor client data, including restrictions on taking data out of the Grand Duchy and/or Europe;
- A challenge for legal entities in negotiating Luxembourg-specific regulation with their global groups;
- More stringent requirements for material or critical outsourcing;
- Contains provisions for Professionals of the Financial Sector (PFS), specially authorised outsourcing contractors;
- A number of key elements must be covered, including the legal framework, business continuity, management information and **Commission de Surveillance du Secteur Financier (CSSF)** notification or, in certain instances, approval.

## Outsourcing to the group and outsourcing to third parties

While there is a clear risk distinction between outsourcing to another entity in a banking group and outsourcing to a third party service provider, this is an area of contention in the regulatory space, with the lower risk of outsourcing within the group sometimes outweighed by complacency and a lack of adequate controls.

Custodian banks have historically provided more oversight and control to arrangements with third parties than to those with the rest of their banking group. This has been treated sympathetically in the past, although there is now an expectation from regulators that these banks close the gap. There is also a deliberate use of the word 'outsourcing' (rather than 'offshoring') from regulators and supervisors, to encompass both intra-group and third party outsourcing.

## 'Offshoring' is Outsourcing

- The CEBS (precursor to the EBA) defines an outsourcing service provider as:  
"The supplier of goods, services or facilities, which may or may not be an authorised entity, and which may be an affiliated entity within a corporate group or an entity that is external to the group."
- The CSSF defines outsourcing as:  
"The complete or partial transfer of the operational functions, activities or provisions of services of the institution to an external service provider, whether or not s/he is part of the group to which the institution belongs."

A notable point is where there is a ‘chain’ or ‘cascade’ of outsourcing, where an outsourcer outsources work to a service provider who further outsources this work, and so on. In this situation the division of responsibility becomes problematic. While many feel that their responsibility ends once the work has been handed over to another firm, this is not the case, and an ability to oversee what is being done is necessary. The implications of cascade outsourcing are a key component in the supervisory assessment of bank’s operational risk profile (e.g. by the UK FCA, the UK PRA or the SSM JSTs).

## The UK: Spotlight on Outsourcing Regulation

The ‘Bible’: Chapter 8 of the Senior Management Arrangements, Systems and Controls sourcebook (SYSC 8):

- This contains FCA and Prudential Regulation Authority (PRA) rules on outsourcing;
- More stringent requirements exist for material or critical outsourcing;
- Due skill, care and diligence must be exercised at all stages of a Material Outsourcing arrangement;
- Expertise must be retained by the outsourcer; and
- Contingency plans must be established by both the outsourcer and the service provider.

### Legal entities and the wider group

Since Lehman Brothers collapsed, regulators have been very conscious of the danger to their home jurisdictions from the collapse of an international banking group. The operational mindset in most firms has traditionally been to consider a bank as a single unit, which is subdivided into functional lines of business. However, this will no longer cut any ice with the regulators. With great difficulty and at great expense, some major international banking groups have divided themselves into separate, connected pieces. These are now split into geographical regions, containing parallel systems, technology and personnel.

The trend is for regulators in Europe, and to some extent the UK, to place a much larger focus on the concept of legal entities as opposed to banking groups. As a consequence, being ‘balance sheet agnostic’ is no longer permissible – where assets are held and by whom is now of vital importance. Global operating models and business line driven decisions made by global custodians must be reconciled with constituent legal entities and the statutory objectives of regulatory and supervisory authorities. How group balance sheets and businesses are carved up among legal entities now matters in both life and death – this has significant consequences for outsourcing, even where the outsourcing is intragroup.

## OUTSOURCING

### Regulation

The push for independent entities within a structure of consolidated ownership naturally fosters conflict as legal entities are 'encouraged' to behave independently while being governed under a corporate structure. This centrally administered corporate structure may implement policies that are at odds with the local requirements of specific legal entities.

A sore point for many custodian bankers is being forced to prove that they are managing their businesses correctly, when they know or believe that this is the case. The expectation is that the outsourcer is able to demonstrate the ability to operate effectively in both business-as-usual and stressed conditions, without being excessively reliant on outsourcing service providers.

#### Systematic risk and custodian banks

While custodian banks do not tend to meddle too much in credit derivatives or other 'weapons of mass destruction', they warrant special regulatory attention due to their systematic importance to the global economy. Custodian banks can be considered as having a 'quasi-market infrastructure' status. They are crucial for smooth economic functioning. It is not a concern about trading losses, but a danger of losing the proper functioning of the marketplace as the failure of a global custodian could mean that trillions of dollars of assets would be made inaccessible at least temporarily. If this scenario were to occur, it would most likely happen during a period of severe financial strain, freezing financial markets at a critical moment.

## Three Lines of Defence

- **First line** of defence: risk management performed by front line staff at the outsourcer and the service providers;
- **Second line** of defence: performs oversight, sets and implements policies, governs the life cycle of specific outsourcing arrangements and carries out due diligence visits to service providers (together with the first line of defence);
- **Third line** of defence: the internal audit function, which monitors and assesses the first two lines of defence on an ongoing basis, including regular reviews into specific outsourcing topics to ensure that they are in line with bank policy and regulatory requirements.

## Remediation

As the regulatory spotlight passes over the custodian banking industry, the majority of custodian banks are engaged in or have recently completed outsourcing oversight and risk management enhancement projects, either on their own initiative or imposed from outside. This has made the standard of outsourcing a moving target. For those banks that have remediation imposed for outsourcing weaknesses, the consequences are severe. Banks may be restricted from further outsourcing arrangements, may have to insource certain activities, and/or hold additional capital. For example, the Single Supervisory Mechanism (SSM) has been in existence for a year now, and has been encouraging banks to review their outsourcing oversight and governance arrangements. The UK FCA and PRA have also been focusing on this issue with increasing scrutiny. The 'path to green' following a remediation or a negative audit does not have to be excessively onerous, providing one knows how to get out of the situation.

## Inside the mind of a banking supervisor

When preparing for a supervisory inspection (or, for that matter, for an internal audit), it is important to look at the situation with fresh eyes. Consider what is described in the policies and procedures, and compare this to what is happening on the ground.

By mapping out the logic of the outsourcing oversight and governance framework in a way that is consistent and clear, supervisors will be able to understand your framework and assess it accurately. Most importantly, the bank must live and breathe its outsourcing framework in a way that can be communicated to a supervisor. Compare policies and procedures directly against the applicable regulation and available guidance, in order to ascertain to what extent they are covering regulatory requirements and supervisory expectations.

It is important to see how the above policies and procedures are followed. Consider that supervisors will be interviewing a wider range of personnel than may have been the case in the past. There will be direct comparisons being made between the bank being inspected and the range of peer banks. The bar is being raised for all players.

# Personal liability for outsourcing practitioners

### What are the consequences for those involved?

The resurgence in regulatory confidence and reach is arguably unparalleled in history. It is commonly accepted that a regulation cycle exists, involving a banking boom in which regulation is gradually peeled away, followed by a banking sector collapse and recession, after which there is tightening of the banking rules.

In the eyes of the public, 'bankers' must take responsibility. Hence, in the same vein as the Senior Manager's Regime (SMR)<sup>13</sup> in the United Kingdom, senior managers and board members must be held responsible for their actions, and regulators must be seen to hold them accountable.

### Spotlight on Luxembourg: Personal Liability of the Board of Directors' Powers of the Commission de Surveillance du Secteur Financier (CSSF)

The board of directors shall mainly ensure:

- The execution of activities, as well as the preservation of business continuity; and
- The monitoring and assessment of the effectiveness of the institution's internal governance framework.

Considering the personal liability of a bank's directors in the instance where weak controls lead to regulatory non-compliance, a board member who was found to have:

- Failed to comply with the applicable regulations;
- Provided incorrect or incomplete information; or
- Jeopardised the sound management of their bank

is liable to a:

- Warning;
- Fine of 250 to 250,000 Euros; and/or
- Suspension or ban from professional activities.

As clarified this year by the Court of Cassation, an individual may bring a civil liability claim against a board member where there has been a violation of the board member's professional obligation.

<sup>13</sup> For more detail, see the practice note <http://www.reply.eu/en/topics/risk-regulation-and-reporting/Shared%20Documents/Senior-Managers-Regime-SMR.pdf>.



## OUTSOURCING

### Why Avantage Reply?

# Why Avantage Reply?

#### High cost of doing too little too late

A number of firms are either in remediation or have recently come out of a remediation program, whether imposed internally or from outside. This is often a painful process, but it has allowed many peer firms to improve their oversight and governance of outsourcing arrangements. European and UK regulators will be judging banks based on comparisons with peer firms and will be asking far more searching questions than those asked last year.

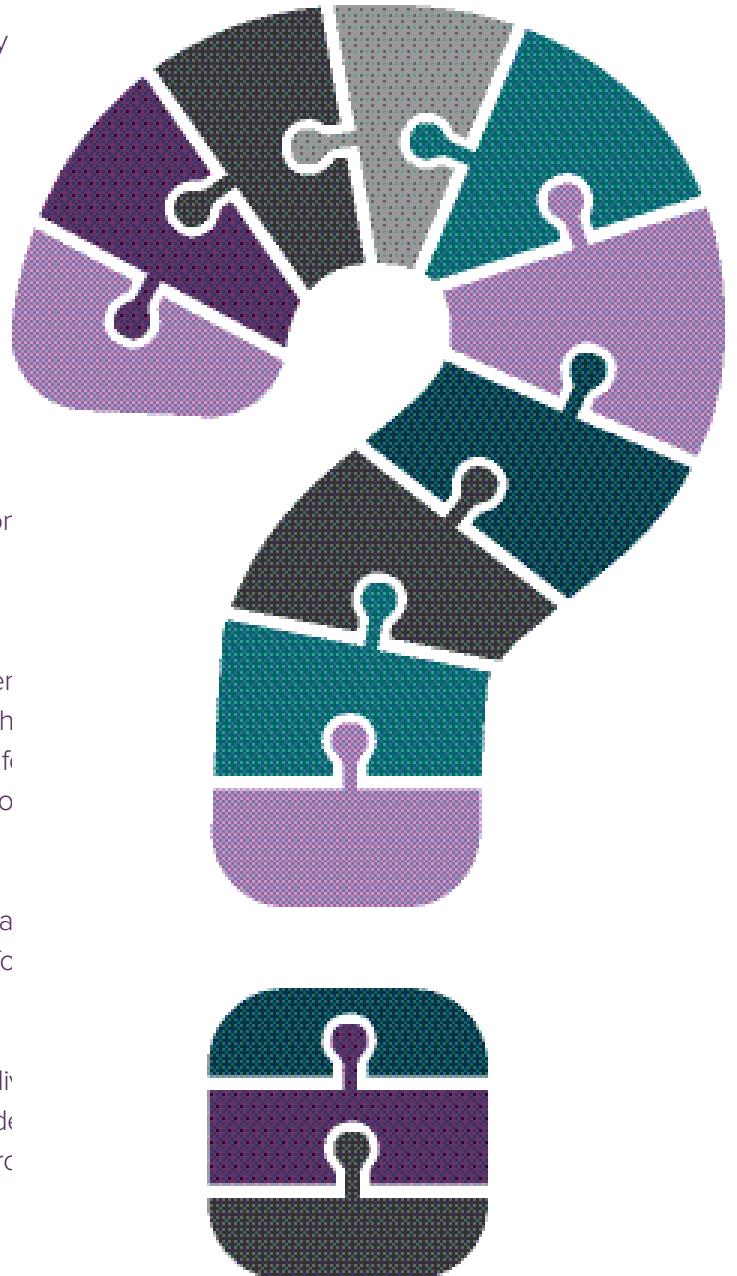
Under these circumstances it is imperative to fix gaps in the outsourcing oversight and governance framework and to ensure that this framework actually governs what is done

#### What can be done about it?

Assess the situation – find a framework by which the different parts of business can be compared with each other to see where the relative risks are. Understand also where the key risks exist for clients. This allows a more efficient allocation of resources to areas of higher risk.

On-site visits to service providers allow for deeper understanding, knowledge sharing and the opportunity to catch issues before they arise. This is highly recommended.

Consider the staffing of oversight roles – are the individuals overseeing outsourcing arrangements suitably senior with adequate support? Discuss and assess roles and responsibilities across three lines of defence.



Have a look at the:

- Contractual arrangements;
- Legal framework between the outsourcer and the other entities;
- Regulatory pre-approval or notification obligations (if applicable);
- MI arrangements and the extent to which they can/could be evidenced to a supervisor – these should be reviewed periodically;
- Internal framework for managing outsourcing;
- Extent to which this internal framework is followed in practice;
- Business continuity arrangements – be able to move between suppliers where possible, understand the contingency plans of the supplier and assess how their risk appetite and business model are compatible. Consider whether procurement processes would hinder a fail-over to a new service provider;
- Full life cycle of outsourcing relationships, from onboarding to business-as-usual through to exit strategies;
- Degree to which effective oversight can be evidenced.

### **Avantage Reply**

We have a deep understanding of outsourcing in the custodian bank sector gained through working on outsourcing projects since the early 1990s. Our clients hold the majority of the planet's assets under custody, and we are able to highlight areas of comparative strength and weakness.

We have a practical, efficient approach, and our consultants have the right mix of practitioner, regulatory, supervisory and academic experience.



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