

# TECC Conference 2018

## Warsaw

# OUTSOURCING



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# Disclaimer

The subsequently expressed opinions  
and presentation correspond  
to the presenter's point of view and  
not necessarily to that of EY



1. [*Definitions*]
2. The ultimate responsibility for the proper management of the risks associated with outsourcing or the outsourced activities lies with an outsourcing institution's senior management.
3. Outsourcing arrangements can never result in the delegation of senior management's responsibility.
4. Summary: *Regulated Core business and material activities are restricted from outsourcing.*
5. There should be no restrictions on the outsourcing of nonmaterial activities of an outsourcing institution.
- 6.1 The outsourcing institution should have a policy on its approach to outsourcing, including contingency plans and exit strategies.
- 6.2 An outsourcing institution should conduct its business in a controlled and sound manner at all times.





7. An outsourcing institution should manage the risks associated with its outsourcing arrangements.
8. All outsourcing arrangements should be subject to a formal and comprehensive contract. The outsourcing contract should oblige the outsourcing service provider to protect confidential information.
9. In managing its relationship with an outsourcing service provider an outsourcing institution should ensure that a written agreement on the responsibilities of both parties and a quality description is put in place.
10. *Summery: Chain-outsourcing and subcontracting should be subject to prior agreement by the outsourcer and closely monitored.*
11. Supervisory authorities should require that the outsourcing institution has established supervisory authority access to relevant data held by the outsourcing service provider and, where provided for by the national law, the right for the supervisory authority to conduct onsite inspections at an outsourcing service provider's premises.
12. Supervisory authorities should take account of concentration risk.



### Section 25b para 1 KWG

### Outsourcing of activities and processes

(1) <sup>1</sup>An institution shall, depending on the nature, scope, complexity and riskiness of outsourcing to another undertaking activities and processes that are material to the execution of banking business, financial services or any of an institution's other usual services, make appropriate arrangements in order to avoid incurring excessive additional risks. <sup>2</sup>Outsourcing shall impair neither the proper execution of such business and services nor the business organization within the meaning of section 25a (1). <sup>3</sup>**In particular, the institution shall ensure ongoing appropriate and effective risk management that includes the outsourced activities and processes.**

# Example of transition of CEBS Guidelines into local law

## German Banking Act 2/2

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**Section 25a**  
**Para 1 KWG**

<sup>1</sup>An institution shall have in place a proper business organization which ensures compliance with the legal provisions to be observed by the institution as well as business requirements. ....

<sup>3</sup>A proper business organization shall comprise, in particular appropriate and effective risk management .....

## Example of transition of CEBS Guidelines into local law Minimum Requirements for Risk Management (**new rules**) 1/2



„Outsourcing is,

**AT 9 TZ 1 MaRisk**

the commissioning of another enterprise to provide activities and processes relating to the execution of banking business, financial services or any of an institution's other usual services that would otherwise be provided by the institution itself“. **Contractual agreements between the parties involved shall not exclude the fact of outsourcing and the applicability of the correspondent rules and requirements.** *[e.g. by splitting up certain services]*

# Example of transition of CEBS Guidelines into local law

## Minimum Requirements for Risk Management (**new rules**) 2/2

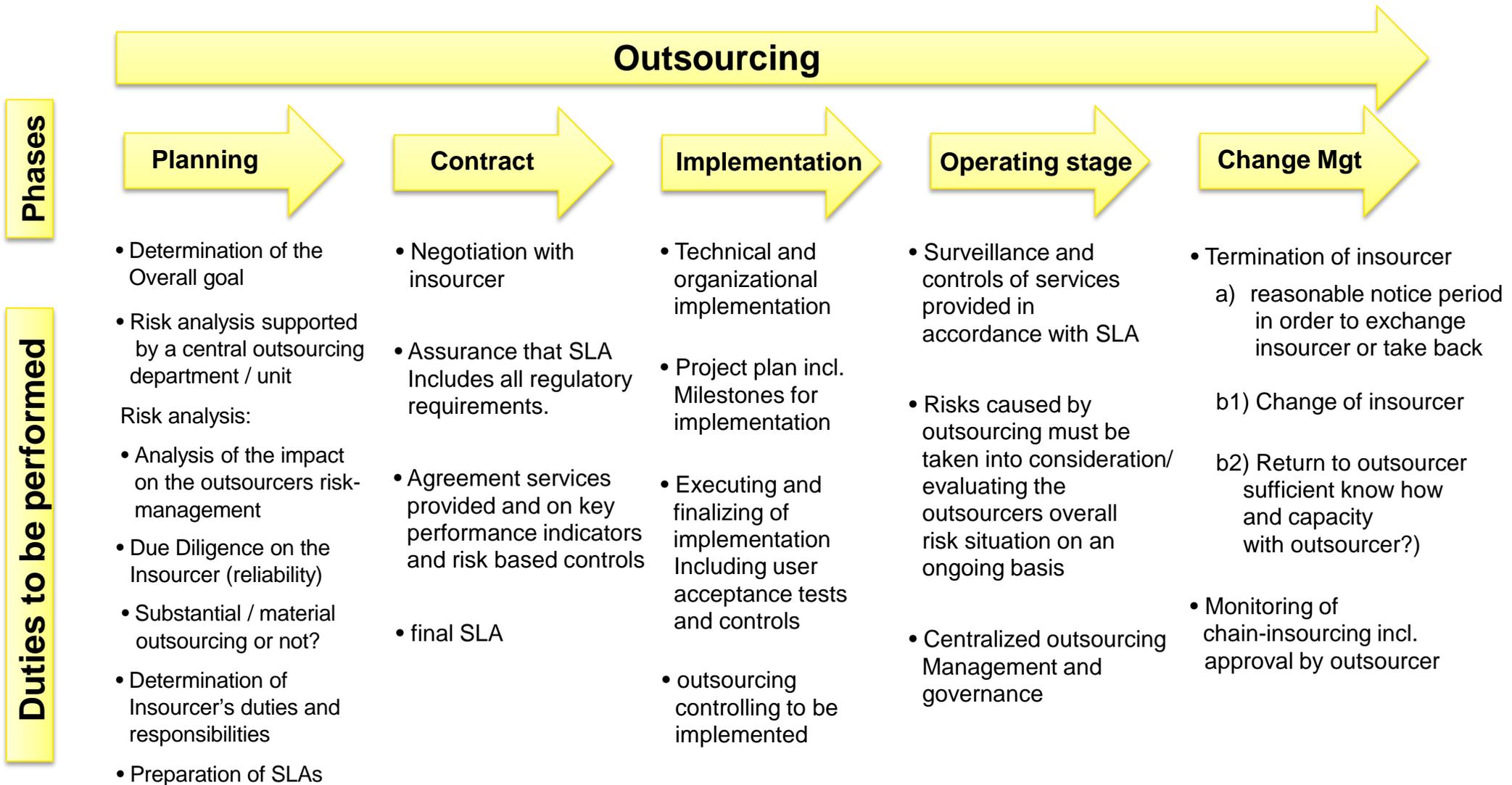


### Outsourcing,

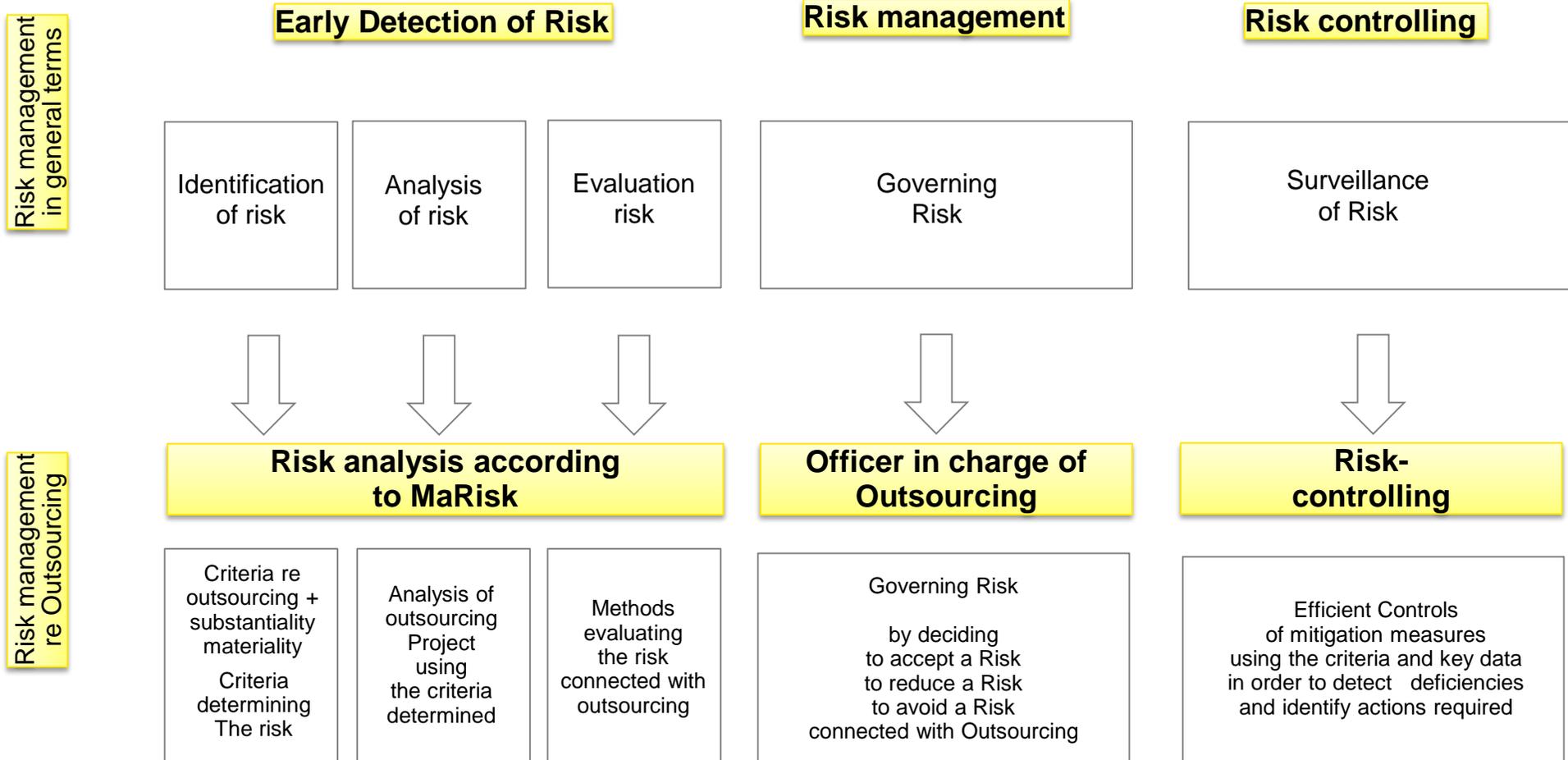
**AT 9 TZ 1 MaRisk  
Interpretive Notes**

Other external procurement of services is not to be qualified as outsourcing within the scope of this Circular. **This does not hold true for software used for identification, evaluation, governing, controlling and communication of risks or software used for activities, which are of substantial and material importance for the bank; support services in connection with such a software is considered to be outsourcing. The same holds true, if the software is being run by an external third party.**

# Summary: The five phases of Outsourcing



**The overall responsibility remains with Management of the outsourcer, the day to day duties stay with an outsourcing officer who should be supported by a central outsourcing department / unit.**



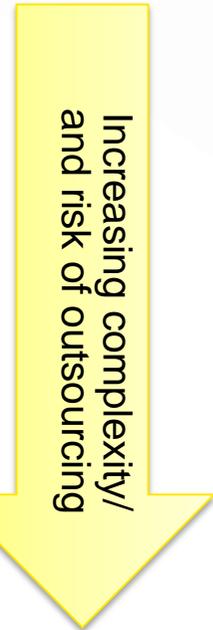
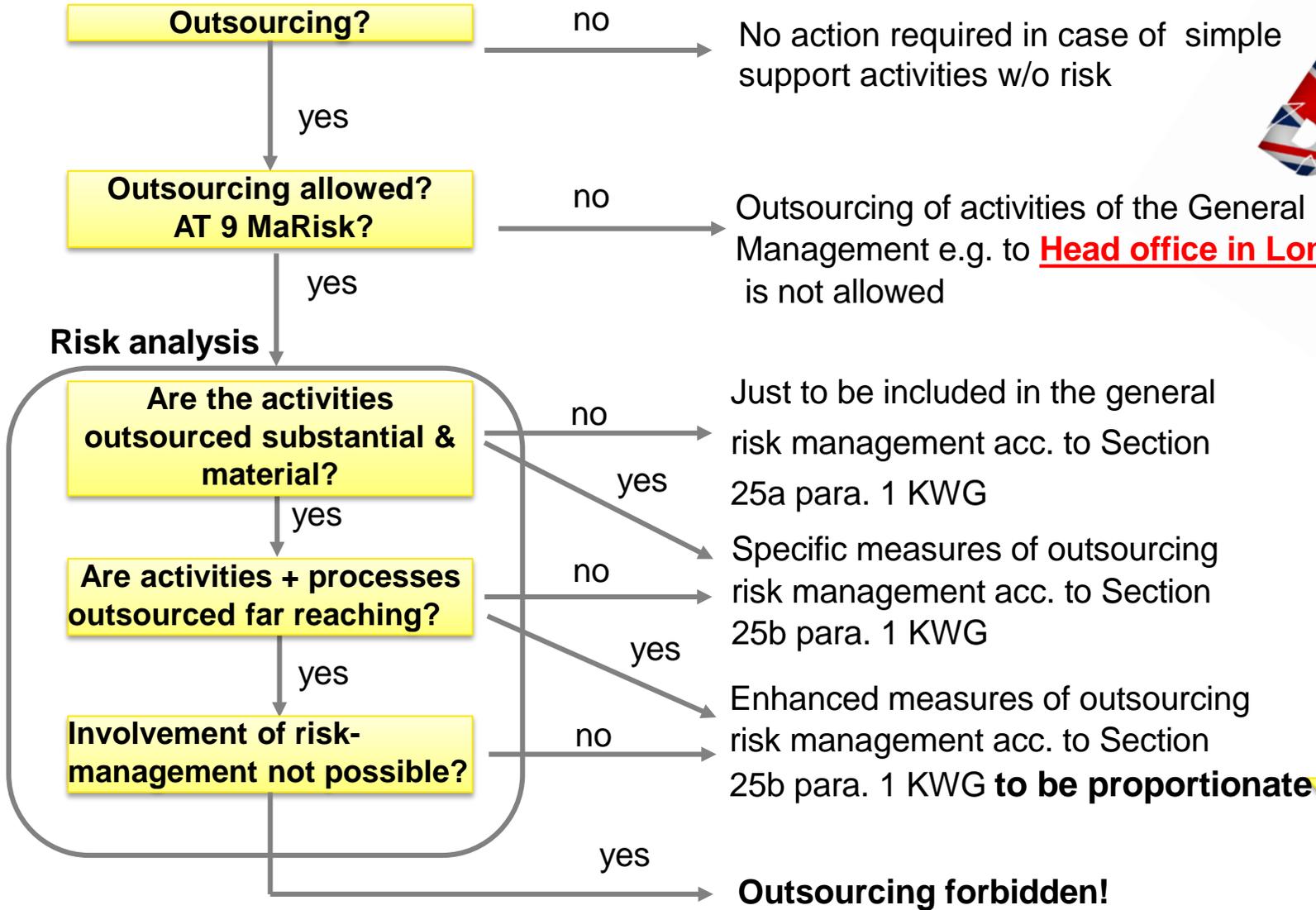
# Requirements of a Risk Analysis of Risk (stemming from Outsourcing)

Likelihood ↑	Very likely	Acceptable risk Medium 2	Unacceptable risk High 3	Unacceptable risk Extreme 5
	Likely	Acceptable risk Low 1	Acceptable risk Medium 2	Unacceptable risk High 3
	Unlikely	Acceptable risk Low 1	Acceptable risk Low 1	Acceptable risk Medium 2
What is the chance it will happen?	Minor	Moderate	Major	
	Impact → How serious is the risk?			

- **Risk analysis:** should be structured in a consistent way and performed systematically and well documented. Responsibilities of the parties involved have to be determined. A rulebook describing such an approach may be helpful.
- The **content, complexity, extent of the Risk** of the outsource activities and processes have to be evaluated. The **substantiality and materiality of the outsource activities** and processes have to be determined.
- It has to be determined, whether the insourcing enterprise is **suitable, fit and proper** to provide the services expected. An independent certification may be used.
- **Proportionate Analysis:** The extensiveness of the Risk analysis depends on the kind, the content and the complexity of the outsourced activities.
- **All units of the bank affected** by the outsourcing must be involved preparing a risk analysis
- The preparation of a Risk analysis re outsourcing **is obligatory** in most EU jurisdictions (e.g. Germany MaRisk AT 9 Nr. 2)
- The Risk analysis has to be up-dated on a regular basis and in case of changes of the circumstances connected with outsourcing (e.g. insourcer, rules & regulation, market environment)

# Risk analysis

Likelihood	Very likely	Acceptable risk Medium 2	Unacceptable risk High 3	Unacceptable risk Extreme 5
	Likely	Acceptable risk Low 1	Acceptable risk Medium 2	Unacceptable risk High 3
	Unlikely	Acceptable risk Low 1	Acceptable risk Low 1	Acceptable risk Medium 2
What is the chance it will happen?	Minor	Moderate	Major	
		Impact How serious is the risk?		



# Risk analysis: Substantial and material Risk of outsourcing(1/3)

Likelihood	Very likely	Acceptable risk Medium 2	Unacceptable risk High 3	Unacceptable risk Extreme 5
	Likely	Acceptable risk Low 1	Acceptable risk Medium 2	Unacceptable risk High 3
	Unlikely	Acceptable risk Low 1	Acceptable risk Low 1	Acceptable risk Medium 2
What is the chance it will happen?	Minor	Moderate	Major	
		Impact How serious is the risk?		

Outsourcing can provide an added value for the Bank. Each outsourced activity however may cause additional risks for the bank, which have to be taken into consideration evaluating the pros & cons, which may have an impact determining the materiality of the outsourcing.

## Strategic Risk

The Insourcer could use the information and know how gathered from the outsourcer as a potential competitor.

## Reputational Risk

Substandard performance by the insourcer could damage the outsourcer's reputation.

## Compliance Risk

The insourcer does not follow the applicable compliance requirements and does not apply the necessary controls.

# Risk analysis: Substantial and material Risk of outsourcing(2/3)

Likelihood	Very likely	Acceptable risk Medium 2	Unacceptable risk High 3	Unacceptable risk Extreme 5
	Likely	Acceptable risk Low 1	Acceptable risk Medium 2	Unacceptable risk High 3
	Unlikely	Acceptable risk Low 1	Acceptable risk Low 1	Acceptable risk Medium 2
What is the chance it will happen?	Minor	Moderate	Major	
		Impact How serious is the risk?		

## Operational Risk

Additional operational risks (e.g. **IT and digitalization problems** of insourcer, insufficient **data protection**.)



## „Exit Strategy Risk“

Outsourcer is would not be able to “re-integrate” outsourced activities due to lack of know-how and manpower.

## Counter party Risk

Insufficient Service Level agreements w/o proper description of duties to be performed by insourcer and controls by outsourcer may lead to a poor quality of services provided.

## Country Risk

Political, legal or sanctions related issues in the country of the insourcer may limit accessibility for the outsourcer. Even a business continuity plan may be at risk.

## Contractual Risk

Services may not be delivered as agreed upon and it may legally or factually impossible to obtain the services especially in cross border situations

# Risk analysis: Substantial and material Risk of outsourcing(3/3)

Likelihood	Very likely	Acceptable risk Medium 2	Unacceptable risk High 3	Unacceptable risk Extreme 5
	Likely	Acceptable risk Low 1	Acceptable risk Medium 2	Unacceptable risk High 3
	Unlikely	Acceptable risk Low 1	Acceptable risk Low 1	Acceptable risk Medium 2
What is the chance it will happen?	Minor	Moderate	Major	
		Impact How serious is the risk?		

## Risk of limited access for Supervisory Authority as well as External and Internal Auditor

It may be legally or factually impossible to obtain information or even gain access to the premises of the insourcer.

## Cluster Risk

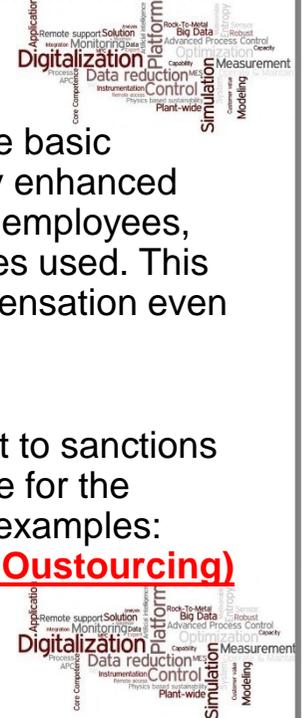
In case a whole industry outsources certain e.g. **IT activities** to one or a few insourcer in one country (e.g. India), technical or labour problems in this one country may cause substantial problems for the whole system.

## Ethical Risk

The insourcer in a third country may not be subject to the same basic standards like in the US or Europe and may therefore not apply enhanced European or US standards like health and safety measures for employees, limited working hours or fire protection measures in the premises used. This may lead to a reputational damage or monetary claim for compensation even w/o guiltiness. (India?)

## Sanctions Risk

The insourcer or the country or certain products may be subject to sanctions by the EU or the US. Even if US sanction may not be applicable for the outsourcer may be affected by secondary sanction by the US (examples: ABLV from Riga/Latvia or the accusations against Pakistan **(IT Oustourcing)** supporting Taliban, Russian **software** from Kaspersky)



# Risk analysis: Goals and problems of the evaluation of the risk involved

A risk matrix diagram with 'Likelihood' on the vertical axis and 'Impact' on the horizontal axis. The vertical axis has three levels: 'Very likely', 'Likely', and 'Unlikely'. The horizontal axis has three levels: 'Minor', 'Moderate', and 'Major'. The matrix cells are color-coded: green for 'Acceptable risk', yellow for 'Unacceptable risk', and red for 'Unacceptable risk Extreme'. Each cell contains a risk level and a numerical score.

	Minor	Moderate	Major
Very likely	Acceptable risk Medium 2	Unacceptable risk High 3	Unacceptable risk Extreme 5
Likely	Acceptable risk Low 1	Acceptable risk Medium 2	Unacceptable risk High 3
Unlikely	Acceptable risk Low 1	Acceptable risk Low 1	Acceptable risk Medium 2

What is the chance it will happen? (Vertical axis)  
Impact: How serious is the risk? (Horizontal axis)

## Goal: Quantification of risks should be archived by evaluating the risk in order to compare identified risks

- with other outsourcings (Outsourcing-Governance and -Controlling)
- with alternative solutions (decisions to be made)
- With other risks categories (integrated Risk-Management-System required for the bank's overall risk management)

## Problems:

- Subjective evaluation vs. objective subsumption
- Definition of comparable and uniform criteria
- Limited number of data and information in order to archive an objective evaluation
- Proper classification of characteristic features in the risk-matrix

# Governing the Risk: Issues to be addressed in an outsourcing agreement



- Based on the risk-analysis a decision will be mad whether to outsource or not.
- Following the decision to outsource mitigation measures have to be considered.
- Outsourcing agreements must include the following:
  - Specific description of the services to be provided by the insourcer.
  - Definition of the Criteria/ key performance index/ benchmarks to be used for risk based control measures and obligation to provide information required.
- Contractual obligation to **tolerate audits** by the Supervisory Authority and provide them with the information requested.
- Contractual obligation to **tolerate audits** by the Bank's Internal Audit and External Auditor and provide them with the information requested.
- Granting the **authority to give direction** to the outsourcer.
- Ensure proper **data protection compliance** by the insourcer, especially regarding servicers servicing multiple clients
- Mutually appropriate period of notice to terminate the outsourcing agreement.
- Clear regulation (e.g. approval requirement) for **further chain outsourcing by the insourcer**.
- Obligation of the insourcer to inform the outsourcer on any events, which may hamper the fulfilment of the insourcer's obligations.





- **Internal Auditor has to audit all substantial and material outsourcings**

Alternatives:

- Internal Audit runs the audits themselves.
- Internal Audit may abstain from its own audit and may depend
  - on audits of performed by the insourcer's internal audit or
  - on a certification by an external audit form (ISO 9000)
- Outsourced activities must be included in the overall corporate management and controlling (**Unternehmenssteuerung**)
- Services provided by the insourcer and the performance and functionality of the insourcer's Internal Audit must be subject either to the audit of the outsourcer's Internal Audit or of the audit by the independent External Auditor, who delivers a certification according to common standards (e.g. ISO 9000)
- The Risk Analysis must be subject to a regular check and update.

# Risk Analysis: Integration in the risk management system

Likelihood	Very likely	Acceptable risk Medium 2	Unacceptable risk High 3	Unacceptable risk Extreme 5
	Likely	Acceptable risk Low 1	Acceptable risk Medium 2	Unacceptable risk High 3
	Unlikely	Acceptable risk Low 1	Acceptable risk Low 1	Acceptable risk Medium 2
What is the chance it will happen?		Minor	Moderate	Major
				Impact How serious is the risk?

Outsourcing Officer allocated in the outsourcing area/department

**Outsourcing 1  
-Risk Analysis  
-Controlling &  
Reporting**

Likelihood	Very likely	Acceptable risk Medium 2	Unacceptable risk High 3	Unacceptable risk Extreme 5
	Likely	Acceptable risk Low 1	Acceptable risk Medium 2	Unacceptable risk High 3
	Unlikely	Acceptable risk Low 1	Acceptable risk Low 1	Acceptable risk Medium 2
What is the chance it will happen?		Minor	Moderate	Major
				Impact How serious is the risk?

**Outsourcing 2  
-Risk Analysis  
-Controlling &  
Reporting**

Likelihood	Very likely	Acceptable risk Medium 2	Unacceptable risk High 3	Unacceptable risk Extreme 5
	Likely	Acceptable risk Low 1	Acceptable risk Medium 2	Unacceptable risk High 3
	Unlikely	Acceptable risk Low 1	Acceptable risk Low 1	Acceptable risk Medium 2
What is the chance it will happen?		Minor	Moderate	Major
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**Outsourcing n  
-Risk Analysis  
-Controlling &  
Reporting**

Likelihood	Very likely	Acceptable risk Medium 2	Unacceptable risk High 3	Unacceptable risk Extreme 5
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What is the chance it will happen?		Minor	Moderate	Major
				Impact How serious is the risk?

Risk-analysis-Reports

**Outsourcing-Officer**

**Risk Management**

consolidated information

Report on outsourcing

Governing overall risk

**Board of managing directors**

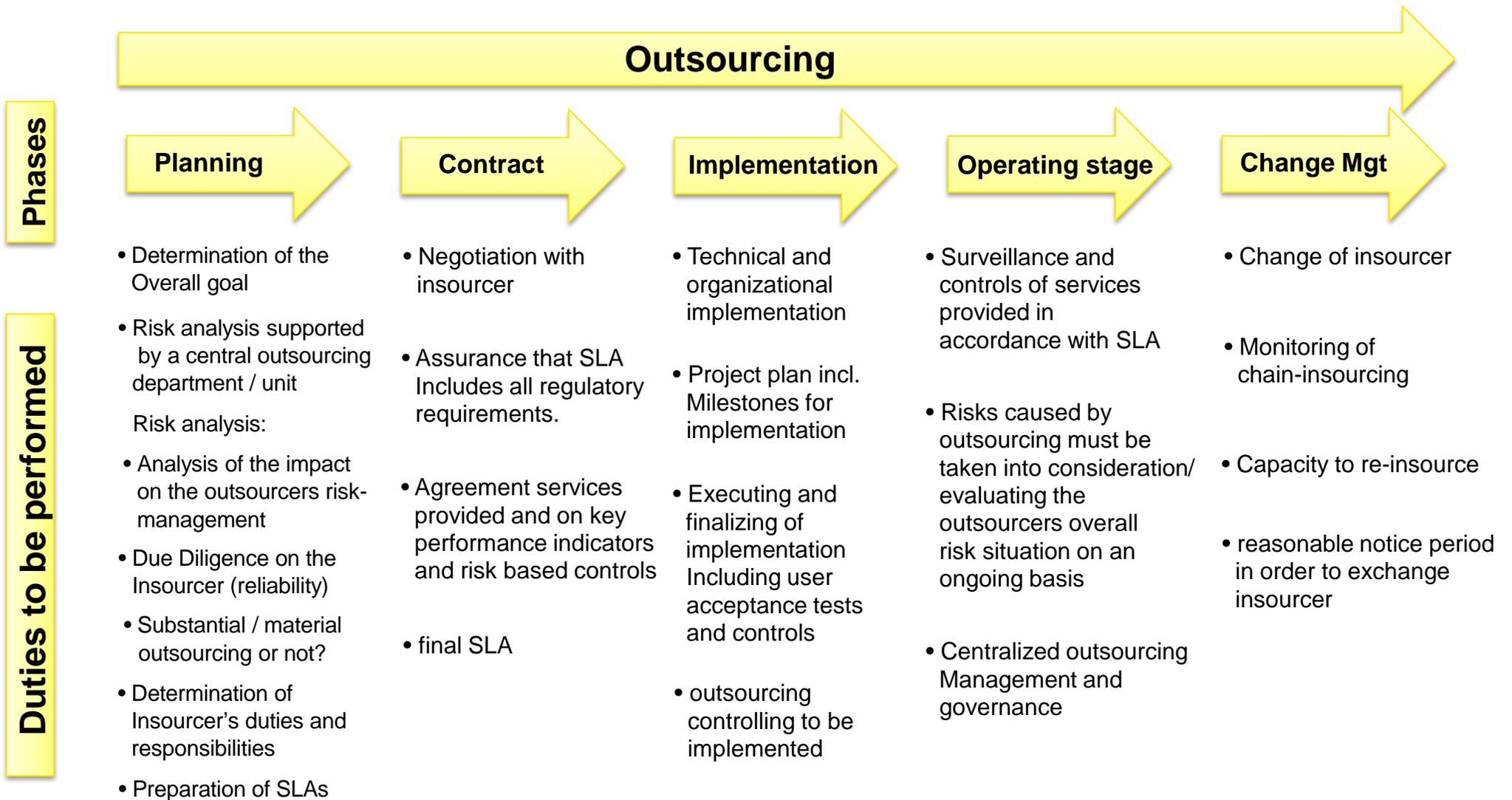
Consolidated information

Risk report  
(incl. Outsourcing-Risks)

- SLAs
- Performance
- Volume
- Period of outsourcing

- Indicators
- Evaluation of risk
- incidents
- mitigation measures

# Summary: The five phases of Outsourcing



**The overall responsibility remains with Management of the outsourcer, the day to day duties stay with an outsourcing officer who should be supported by a central outsourcing department / unit.**



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