

Communication of the Association of Global Custodians
European Focus Committee
Subject to Supplemental Commentary

26th July 2021

By Email – outsourcingfeedback@centralbank.ie

Central Bank of Ireland
Supervisory Risk Division
PO Box 556
Dublin 1

Re: Consultation Paper 138

Dear Sir/Madam,

INTRODUCTION

The European Focus Committee of the Association of Global Custodians (AGC-EFC) welcomes the opportunity to respond to the Central Bank's above-referenced Consultation Paper (the "CP").

Established in 1996, the Association of Global Custodians (the "AGC") is a group of 12 global financial institutions¹ that each provides securities custody and asset-servicing functions primarily to institutional cross-border investors worldwide. As a non-partisan advocacy organization, the Association represents members' common interests on regulatory matters and market structure. The member banks are competitors, and the Association does not involve itself in member commercial activities or take positions concerning how members should conduct their custody and related businesses.

Background on Securities Custodians and the AGC

Securities custodians play a critical role in the global financial system by providing to investors (1) access to entitlements in securities issued by Irish and other companies throughout the world as well as (2) services necessary to give effect to investors' rights in these securities, including facilitating settlement of their sale and purchase and the exercise of voting rights, rights offerings, payment of dividends and income, processing of reclaims for withheld taxes. Securities custodians also facilitate availability of collateral arrangements which have become increasingly critical for capital markets in view of the increasing need for financial collateral taking the form of investment securities.

Customers range from retail and private client investors to large highly regulated investment funds, institutional investors (such as pensions) and supranational entities (such as sovereign funds) throughout the world.

A very large portion of the services that securities custodians typically provide are performed for investors on a cross-border basis, requiring a chain of trusted custodians providing the necessary linkages to enable investors in one jurisdiction to purchase, own and exercise rights with respect to securities in another jurisdiction.

The AGC has long engaged extensively with government and regulatory authorities to support their work to better understand our industry and ensure the safe and efficient provision of securities custody services for the benefit of investors and the financial system as a whole. The Association continues to support these efforts and stands ready to provide assistance and information – within the boundaries of competition and

¹ The members of the Association of Global Custodians are: BNP Paribas; BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company.

antitrust constraints - as authorities require. The AGC-EFC for many years has encouraged international, European and other national authorities to harmonise laws and practices relating to the holding, disposition and other exercise of rights relating to intermediated securities.

In addition, the AGC has participated in and contributed extensively to EU and Member State efforts to apply the requirements of the Alternative Investment Funds Directive (the “AIFMD”) and the Directive on Undertakings for Collective Investment Schemes (the “UCITS” Directive) to AIF and UCITS depositaries. Since the 2008-09 financial crisis, we have actively engaged with co-legislators at the EU level, ESMA and Member State national competent authorities across a wide range of depositary-related issues, including the interpretation and treatment of “delegation” by depositaries under the Directives.

Our extensive engagement both on global securities custody issues and UCITS and AIF depositary issues has led to the formation of developed views in these areas which we believe are important for the Central Bank to consider. In particular, we believe that cross-border elements in the areas mentioned above require a consistent and harmonised approach across Member States as well as with countries outside the EU. We fear that inconsistency and fragmentation of approaches will lead to increased costs, inefficiencies and risks both for investors and the financial system as a whole.

AGC-EFC RESPONSE TO THE CENTRAL BANK’S CONSULTATION

First, the AGC-EFC acknowledges and supports the submission of Irish Funds to the Central Bank’s Consultation. As a result, we will strive not to repeat Irish Funds’ points and views and will focus mainly on elements of the Consultation that the AGC-EFC believe warrant further explanation.

Second, we believe it is warranted to review briefly other similar, relevant initiatives that have been undertaken at the national, supranational and global levels. The AGC-EFC has engaged with and responded to these other initiatives other initiatives with a view to ensuring cross-border consistency and harmonisation, which we believe advance the interests of customers and fund investors as well as of the financial system as a whole.

Other similar initiatives

On 25th February 2019, following a public consultation to which the AGC-EFC responded, the European Banking Authority (“EBA”) published its Guidelines² that defined outsourcing as:

“... an arrangement of any form between an institution, a payment institution or an electronic money institution and a service provider by which that service provider performs a process, a service or an activity that would otherwise be undertaken by the institution, the payment institution or the electronic money institution itself.”

The EBA Guidelines affirm a view that, as a matter of principle, global network infrastructures, clearing and settlement arrangements between clearing houses, central counterparties and settlement institutions and their members and correspondent banking services should not be considered as outsourcing. We note Irish Funds’ submission to the Central Bank referring to these conclusions and agree with them.

Other EU competent authorities by and large have followed the EBA Guidelines in not extending them to securities custody – including use of sub-custodians – and correspondent banking

In May 2020, the International Organization of Securities Commissions IOSCO published a consultation on its Outsourcing Principles to ensure operational resilience, and in August 2020, the Basel Committee on Banking Supervision (BCBS) published two consultation papers: one on Principles for Operational Resilience and one on Principles for the Sound Management of Operational Risk (PSMOR). AGC-EFC welcomed these consultations and agreed with the stated need for consistent global regulatory standards for appropriate operational resilience across cross border banking groups.

² EBA/GL/2019/02.

More recently, in March 2021, the UK's Prudential Regulation Authority ("PRA") published its Supervisory Statement SS2/21 on "Outsourcing and Third-Party Risk Management" following a public consultation to which the AGC-EFC also responded. The PRA concluded that arrangements such as those for custody services provided among regulated financial institutions, including between firms that are not part of the same group and between firms and financial market infrastructures, do not fall within the definition of outsourcing. The PRA added however:

While these arrangements do not fall under the definition of outsourcing, they are third party arrangements that can give rise to significant risks to the PRA's objectives and should be subject to appropriate monitoring and risk-based controls. The PRA therefore expects firms that are parties to these arrangements, either as service providers or service recipients, to leverage applicable, existing regulatory requirements to manage relevant risks and promote an appropriate level of resilience.³

Meanwhile, on 9 November 2020, the Financial Stability Board (FSB) published a discussion paper for public consultation on Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships (the "FSB Consultation").⁴ The discussion paper drew on findings from a survey conducted among FSB members, and identified a number of issues and challenges.

To facilitate and inform discussions among authorities (including supervisory and resolution authorities), financial institutions and third parties on how to address the issues identified, the discussion paper invited comments from external stakeholders on:

1. the key challenges in identifying, managing and mitigating the risks relating to outsourcing and third-party relationships (including risks in sub-contractors and the broader supply chain);
2. possible ways to address these challenges and mitigate related risks, including in a cross-border context; and
3. lessons learnt from COVID-19 relating to outsourcing and third-party relationships.⁵

The public consultation period for the discussion paper ended on 8 January 2021. The FSB received 39 responses from a wide range of stakeholders including banks, insurers, asset managers, financial market infrastructures (FMIs), third-party service providers, industry associations, individuals and public authorities, which included the AGC-EFC.⁶ The FSB also held a virtual outreach meeting in late February 2021 to discuss evolving industry practices, practical challenges associated with outsourcing and third-party risk management and potential ways to improve coordination among the relevant stakeholders (i.e. supervisory and resolution authorities, financial institutions and third-party service providers) with a view to enhancing the resilience of financial institutions and the financial system: the AGC-EFC participated in this meeting as an observer.

On 14th June 2021, following review of the responses as well as interventions in the virtual meeting, the FSB published an "Overview of Responses". The FSB noted that respondents generally welcomed the discussion paper, which they viewed as a timely and balanced overview of the benefits and challenges relating to the evolving nature of financial institutions' outsourcing and third-party dependencies. Respondents agreed with the challenges and issues identified in the discussion paper, such as: constraints on the rights to access, audit and obtain information from third parties; and concentration risks in the

³ Paragraph 2.12, PRA Supervisory Statement.

⁴ FSB (2020), Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships, 9 November.

⁵ Most respondents did not mention significant issues with regard to financial institutions' outsourcing or third-party relationships during the COVID-19 crisis, although the FSB noted that hardware scarcity was an issue for some respondents during the height of the COVID-19 crisis.

⁶ The consultation responses – including the AGC-EFC's response – are publicly available on the FSB's website at: <https://www.fsb.org/2021/01/public-responses-to-the-regulatory-and-supervisory-issues-relating-to-outsourcing-and-third-party-relationships-discussion-paper/>

provision of certain critical services that are very difficult to substitute. In addition, treatment of intra-group outsourcing, fragmentation of regulatory, supervisory and industry practices across sectors and borders, restrictive data localisation requirements, cyber and data security, and resource constraints at financial institutions as well as supervisory authorities were highlighted as potential challenges or issues that deserve attention.

To address these challenges or issues, the FSB identified five main categories of measures that were suggested by respondents: (i) the development of global standards on outsourcing and third-party risk management; (ii) the adoption of consistent definitions and terminology; (iii) pooled audits, certificates and reports; (iv) dependency mapping and enhanced supervisory oversight; as well as (v) enhanced cross-border cooperation and dialogue with stakeholders.

The FSB noted that suggestions by respondents – including public authority respondents - to address key challenges and associated risks, including cross-border challenges included:

- (1) global standards on outsourcing and third-party risk management;
- (2) consistent definitions and terminology, including terms such as “outsourcing” and “third-party relationships”, and criteria for “criticality/essentiality/materiality” so as to clearly understand what activities are in scope of regulation;
- (3) the use of “pooled audits”, i.e., collaborative assessments of common third-parties carried out by groups of financial institutions or experts appointed on their behalf;
- (4) establishment of an inventory of services and technologies provided by third-parties (including key entities involved in their supply chains) to map financial institutions’ dependency on third-parties; periodically evaluate the information they receive from third-party service providers; regularly update the skills and training of employees responsible for monitoring their third-party dependencies; and share their experiences with supervisory authorities; and
- (5) organisation by the FSB of a regular international forum (or a public-private global working group) comprising relevant stakeholders (i.e. supervisory authorities, financial institutions, third-party service providers) to exchange views and best practices with a focus on cross-border issues associated with outsourcing and third-party relationships.

The AGC-EFC’s contribution was mentioned mainly in relation to number “(2)” above, with the FSB observing that “some respondents argued that custody services or services provided by FMIs fall outside the definition of ‘outsourcing’”.⁷

The Central Bank’s approach to outsourcing in its Consultation

We note that the Central Bank proposes to define outsourcing as:

Outsourcing - means an arrangement of any form between a regulated firm and an outsourced service provider (OSP) by which that service provider performs a process, a service or an activity that would otherwise be undertaken by the regulated firm itself, even if the regulated firm has not performed that function itself in the past.⁸

While we believe this is generally consistent with the approaches taken by the EBA and the UK PRA described above, we note that the FSB’s approach is yet to crystallise. Under the circumstances, we believe the Central Bank’s definition is sensible in principle.

Securities custody broadly has not been viewed as outsourcing in recognition of this principle. Custody involves the engagement by a firm of a third party (a custodian) to hold or safekeep investment assets which ultimately belong to the firm’s clients. In the context of a global custodian, it is not possible for a single

⁷ Although one respondent noted that some jurisdictions apparently do consider the provision of services by FMIs as “outsourcing”.

⁸ Schedule 1 – Draft Cross-Industry Guidance on Outsourcing, p. 62 (February 2021).

custodian to be in every market itself: it needs to be able to appoint third-party sub-custodians in order to provide access to rights and entitlements to securities located in those markets for its customers.

Securities custody is a specialised business which requires a local presence in foreign markets with the functional capabilities to connect to local market infrastructure and to provide services – such as engagement with local tax authorities – that can only be provided locally. Although global custodians can choose to develop their own sub-custody offering, this is a choice and not an inherent ability in a global custodian. No global custodian is in a position to offer its own sub-custody network in all markets. Moreover, investing in securities on a cross-border basis necessarily involves recognising the applicability of foreign bodies of law to property rights in those securities (i.e., in the local market), meaning that only a sub-custodian in that market may be considered to “hold” such securities under its national law (usually law governing rights in “intangible” property). Global custodians without a presence in such markets therefore would not be able to provide access to relevant securities unless they can themselves become direct cross-border participants in the local markets. Taking all this together, it is clear that appointment of a sub-custodian cannot be seen as an “outsourcing” arrangement in the same way that other vended services are.

We believe the Central Bank’s proposed approach supports this view but we agree with Irish Funds about how its proposed definition may be applied in practice if elements of it are inconsistent with the EBA Guidelines in particular.

Additional concerns emerge in terms of the way in which the Central Bank proposes to address “outsourcing” in the context of “delegation” under the AIFMD and UCITS Directive.

Delegation under the AIFMD and the UCITS Directive

The Central Bank in Part B, Section 3, of the Consultation clarifies its view that outsourcing and delegation “are not different concepts”. The Central Bank goes on to explain that while the specificities of requirements for delegation arrangements are addressed in the relevant sectoral legislation, regulations and guidance (e.g., under the AIFMD and the UCITS Directive), “it is emphasized that the Cross-Industry Guidance on Outsourcing herein, is directly relevant to these regulated firms.”

We agree with Irish Funds that delegation arrangements which are explicitly provided for in EU legislation should be the subject of discrete consideration, with deference to rules governing the outsourcing of activities covered in relevant sectoral legislation, regulations and guidance. We believe that to the extent sectoral legislation addresses outsourcing arrangements specifically, it does so for a reason. This reason derives from considerations that may be unique to that sector, which a “one-size-fits-all” approach may undermine.

We support and agree with the examples that Irish Funds provides in its submission to the Central Bank, however, we would go further in pointing out that “delegation” and “outsourcing” are not – and cannot be – “the same concept”, as the Central Bank writes in its CP. The reason for this derives from the peculiar treatment of “delegation” that is unique the AIFMD and UCITS Directives, originating with the de Larosière Report to the European Parliament of 25 February 2009,⁹ which concluded:

The depositary institutions, as custodians, should remain responsible for safe-keeping duties of all the fund's assets at all times, in order to be able to perform effectively its compliance-control functions. Delegation of depositary functions to a third party should therefore be forbidden. Nevertheless, the depositary institution may have to use sub-custodians to safe-keep foreign assets.

Logically, this suggested that “delegation” meant abdication of “compliance-control functions”. The AIFMD and UCITS V of course both impose strict “compliance-control” functions on depositaries in

⁹ See, The High Level Group on Financial Supervision in the EU, Report (25 Feb. 2009), http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

respect of safe-keeping duties, but it was recognised from the beginning that some elements of “compliance control functions” could only be performed locally: i.e., by a sub-custodian who must comply with local law and market practice in a way that no depositary would be able to do. These “delegation” arrangements, therefore, took on unique, highly contextualised attributes. The European Commission and co-legislators recognised these attributes as elements that could be taken into account in establishing the requirement for an “objective reason” for appointing a delegate¹⁰: in other words, depositaries could not simply appoint a delegate whenever it was convenient to do so: the requirement for an “objective reason” bespoke an element of necessity in making the appointment, the most obvious objective reason being that the depositary could not provide sub-custody services in a local market itself since it lacks a local subsidiary or branch (for reasons that are described further above). Depositaries would remain strictly liable in restitution for any “held-in-custody” financial instruments that were lost by these “delegates” and would be required to satisfy specific, targeted conditions in order to appoint and continue to use these delegates providing “safekeeping” of fund assets locally.

All of this is a far cry from typical “outsourcing” arrangements involving activities other than the safekeeping of fund assets.

In this context, the Directives’ prohibition of “delegation” of depositary duties other than “safekeeping” makes sense, since no other activities performed by an outsource provider would have the attributes that are unique to the safekeeping of assets that are described above. Moreover, the development and legislative history of the AIFMD and UCITS V make it clear there was never any intent to prohibit depositaries from utilising outsourcing providers like any other financial services firm could. “Delegation”, truly, was a special case borne of particular concerns around the safekeeping of fund assets.

This understanding – which reflects as it does the unique and contextualised application of “delegation” to safekeeping of assets under the AIFMD and UCITS Directive – is also consistent with broad regulatory acknowledgment described further above that the appointment of a sub-custodian is not considered an outsourcing arrangement. If, on the other hand, delegation and outsourcing were to be treated as “not different concepts”, it is difficult to see how the definition of outsourcing proposed by Central Bank – and adopted by other public authorities – could be reconciled with “delegation” to sub-custodians as addressed by the AIFMD and UCITS Directive.

Our views on separate treatment of “delegation” and “outsourcing” are consistent with our above-stated reservations about fragmentation and inconsistency because we believe it is clear that, in fact, the two concepts are not the same.

We hope you find the views have expressed in this letter helpful. Please do not hesitate to contact the undersigned with any queries. The AGC-EFC would welcome further dialogue with the Central Bank on this very important topic.

Very truly yours,



John Siena

**Chair, European Focus Committee
Association of Global Custodians**

¹⁰ AIFMD, Level 1, Art. 21.11(b), UCITSD V, Level 1, Article 22a.2.