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Central Bank Outsourcing – Findings and Issues for Discussion
Supervisory Risk Division
Central Bank of Ireland
PO Box 556
Dublin 1

28 January 2019

Re: Outsourcing - Findings and Issues for Discussion (the "Discussion Paper"/"DP8")

Dear Sir/Madam,

Irish Funds is the representative body of the international investment funds community in Ireland, representing fund managers, custodian banks, depositaries, administrators, transfer agents, professional advisory firms and other specialist firms involved in the international fund services industry in Ireland. Given Ireland's strong reputation as a leading centre for the domiciliation, management and administration of collective investment vehicles (with industry companies providing services to collective investment vehicles with assets totalling in excess of €4.4 trillion) we acknowledge the importance of an effective and well-reputed regulatory environment. As a proven part of Ireland's international financial services offering our industry has been a consistent and growing part of the internationally traded financial services landscape for over twenty-five years.

We welcome the publication of the Central Bank of Ireland's ("CBI") paper entitled Outsourcing – Findings and Issues for Discussion and appreciate the opportunity to provide comment and feedback on this paper. This is an important area for the industry and we acknowledge the approach whereby the CBI insights and observations, from their onsite inspections and thematic reviews, are being communicated in this Discussion Paper. We believe such an approach is appropriate particularly given the increasing focus on outsourcing at both a global level (with IOSCO) and at a European regulatory level (EBA and ESMA). We believe, the CBI should continue to actively contribute and engage with their international colleagues and institutions before concluding any new significant requirements that may apply at a local level. This would be important to support a consistent international outsourcing framework and avoid diverging regulatory requirements across jurisdictions (particularly European).

While acknowledging the cross sectoral scope of this paper, we have identified proportionality as a key aspect of the Outsourcing environment that we believe requires further discussion and consideration, particularly as it applies to the Funds Industry. We would welcome the opportunity to engage on this with the respective supervisors/regulators of our industry.

Furthermore, we believe that there are relationships and activities undertaken by firms that are the subject of delegation arrangements, recognised in EU Directives/Regulation, as opposed to outsourcing arrangements, which are subject to local regulatory requirements.

While the Discussion Paper uses the term outsourcing to include delegation, we believe delegation arrangements which are explicitly provided for in EU legislation should be the subject of discrete consideration. We have outlined below examples of instances where we believe it appropriate to consider an activity as delegated rather than outsourced. For the purposes of our response to this paper we have primarily focused our observations in the context of outsourced activities.

The Outsourcing Environment

Before providing comment on specific aspects of the paper we felt it appropriate to recap on some of the key drivers of outsourcing and the outsourcing environment. Often outsourcing is mistakenly viewed as a cost efficiency measure only. While cost issues may well be a consistent factor, as firms seek to outsource it is important to understand that it is not the only or most important factor. A global operating model, utilising firmwide inter-group companies and external providers, allows firms to (i) deliver the 24/7 servicing that clients and their investors demand, (ii) establish and continue to develop deep centres of operational expertise and specialist function (e.g. technology), and (iii) support investors with services in the appropriate language. Some of these benefits of outsourcing also mitigate the operational risk that regulated firms would otherwise have. As an example, trade input and data processing centres can allow for greater efficiency, STP and system controls. In many cases, the use of centralised functions or regional service centres, hereafter collectively referred to as Centres of Excellence (“CoE”) will reduce instances of ‘unique’ processes being developed in single locations (which increase error and continuity risks). Furthermore, the use of centralised locations and CoEs can allow for stronger resiliency across locations and greater breadth of operating model. While it is well understood that the risks of outsourcing need to be appropriately managed it is important that those risks are set against the benefits that outsourcing delivers, particularly Intergroup Outsourcing, to the ultimate investors.

The corporate infrastructure of global organisations is designed to service their global client base. The use of CoE by a global organisation allows it to leverage the timezone benefits whereby these CoE can perform activities and provide pertinent information to the local legal entities in advance of the start of their business day, and support delivery of services to clients at a preferred delivery point in their business day.

The local (Irish) legal entities have established governance and oversight frameworks which oversee the quality and consistency of service received from their CoEs. They ensure the CoE has the appropriate knowledge of the regulatory obligations of the local (Irish) jurisdiction and ensures engagement by the CoE as required (and as defined in inter-group Service Level Agreements) to meet those regulatory obligations.

This approach avoids the need to establish and maintain multiple replica teams at local legal entity level which may not have the comparable depth of expertise necessary to manage the risks appropriately. It should also be recognised that local legal entities can benefit, from the scale and buying power of the group. The draft EBA Guidelines recognise the ability to leverage centralised functions in the oversight of outsourcing arrangements and we would ask the CBI to incorporate this into any final requirements they may deem appropriate.

1. Regulatory environment – Delegation V’s Outsourcing

The CBI defines outsourcing as a “written arrangement of any kind between a regulated financial service provider and a service provider (whether regulated or unregulated) whereby the service provider performs an activity which would otherwise be performed by the regulated firm itself.”

For a Fund Administrator an example of this is the pricing of the underlying securities held by investment funds undertaken by a Pricing CoE within the same corporate group as the Fund Administrator and located in another jurisdiction. The CBI survey “Guidance Document for Cross Sector Survey of Regulated Firms on Outsourcing Activities – Market Firms” differentiates this from delegation on the basis that delegation involves the local regulated entity contracting with another entity to perform certain functions originally contracted to the local regulated entity in circumstances where that delegation is either expressly permitted by regulation or is not expressly prohibited by regulation. The regulatory responsibility retained by the local regulated entity with respect to such a delegation would typically be for the local regulated entity to use due care and diligence in the selection, appointment, ongoing monitoring and retention of their delegate. An example of such a delegation is where the local authorised Depository delegates safekeeping of assets under UCITS/AIFMD to a Global Sub-Custodian.

If local depositaries were required to comply with the CBI requirements on outsourcing in relation to such delegations the global sub-custody infrastructure which includes the ongoing monitoring and due diligence of global sub-custodians would be severely affected. Depositaries are allowed to delegate safekeeping functions and as such the delegation of these functions should not be considered outsourcing. The delegation of safekeeping functions is governed within the UCITS and AIFM Directives. This global sub-custody model complies with European requirements and allows for the global due diligence and oversight of each of sub-custody appointment, thereby leveraging a deeply experienced function within the global custody organisation. It has been developed in line with international and European regulatory requirements and best practice. The imposition of additional requirements locally would not be justified in the context of the European Regulatory requirements and would introduce an additional layer of cost in Irish authorised funds without justification.

Many Management Companies in Ireland (and elsewhere) operate on a model of delegating some operating functions (such as Administration and Investment Management) to other regulated entities. Many of these management companies have numerous delegation arrangements and apply the CBI’s Fund Management Companies – Guidance (published in December 2016) to these arrangements. Given the significant effort expended by the CBI on the development of this guidance in relation to Fund Management Company governance, including specific detailed requirements for delegate oversight, we believe that this guidance is appropriate for delegated activities, and any additional regulatory requirements i.e. CBI’s requirements on outsourcing, should only be relevant where the CBI Fund Management Companies – Guidance is not applicable. If management companies were to have to apply the CBI’s requirements on outsourcing, in addition to the existing CBI Fund Management Companies Guidance, it would have significant impact on management companies operating model.

The final Fund Management Companies – Guidance published in December 2016 with a transition period to July 2018 for existing Management Companies, Fund Management Companies have implemented these requirements and are embedding them within their governance models. The CBI has signalled its intention to review the effectiveness of these requirements and their implementation as part of its supervisory work for 2019. Until such time as this supervisory work is complete and international discussions more advanced, it would seem premature to revisit these requirements.

Under AIFMD and UCITS requirements depositaries are allowed to delegate safekeeping functions and so we believe that the supervisory requirements in relation to 'outsourcing' and 'delegation' must be kept separate. Imposing the same requirements locally in Ireland in relation to delegation as outsourcing would move Ireland out of line with other European jurisdictions from a UCITS/AIFMD perspective. Delegation by UCITS and AIFMs is expressly recognized within the UCITS Directive and AIFM Directive respectively. Both Directives and related Regulations set out requirements governing such delegations. It is important that there continues to be a clear distinction between delegation as recognised within the European framework for those European products/managers and outsourcing activity by Irish authorised Fund Service Providers which are not specifically subject to European regulation which expressly recognises delegation arrangements. If the CBI is of the view that there are additional requirements that should be imposed in relation to the delegation by European products/managers such as UCITS and AIFMs these should be addressed in further regulation by the European Commission or through the work of ESMA. Such an approach would be consistent with that adopted by the EBA in relation to outsourcing by credit institutions through their work on the development of Guidelines on Outsourcing arrangements. If the CBI seeks to unilaterally impose additional requirements on UCITS or AIFMs in relation to delegation by these products/managers without work first being undertaken at a European level, it would result in a supervisory divergent approach across Member States in an environment where one of the stated objectives of European Regulators is supervisory convergence. One of the risks attached to such a supervisory divergent approach is regulatory arbitrage whereby UCITS and AIFMs could seek to establish in jurisdictions where there is less onerous delegation requirements which could in turn result in the systemic risk European regulators are seeking to avoid. In the context of Irish authorised Funds, both UCITS and AIFs, the appointed Fund Administrator will be subject to the CBI requirements in relation to outsourcing.

2. Proportionality

The discussion paper does not consider the important concept of proportionality which is critical to the design and operation of any outsourcing model and oversight structure. We maintain that the concept of proportionality must be addressed in any regulations or regulatory guidance concerning outsourcing. Firms should be allowed to determine and expected to document how they manage their outsourced operations and consider it in conjunction with their risk appetite. We have set-out below an illustrative but not exhaustive list of principles that firms should consider in designing their outsourcing and oversight models, namely:

2.1 Criticality - The criticality of the activities being outsourced are amongst the most fundamental parts of outsourcing considerations for any firm. As part of its ongoing risk management framework, firms will identify those activities which are of critical importance to it and ensure their management is properly resourced and overseen.

Applying just an FTE measure to the monitoring of outsourcing in isolation is an incomplete process as it does not take into consideration the criticality of the services. There could for example be one FTE working on a critical outsourced service which may be more important than 10 FTEs working on a less critical service. The Draft EBA Outsourcing Guidelines at Section 9.1 “Assessment of the criticality or importance” provides useful direction when considering the criticality or importance of an activity.

2.2 Regulated versus Unregulated Activities - In relation to the outsourcing of unregulated or support activities e.g. technology, HR, finance, etc, it should be acknowledged that oversight of such activities will not necessarily mirror the oversight framework applied to the outsourcing of operations activities and that it is often more appropriate to apply oversight models on a case by case basis. The corporate infrastructure of global organisations is built to service the firm worldwide and across a global client and regulatory base. The leveraging of firmwide structures in the provision of unregulated activities allows firms to utilise global expertise in relation to functions such as technology, HR and finance, amongst others. This practice yields significant benefits for regulated firms in terms of efficiency, best practice, access to leading edge technologies and thinking in a given discipline all of which mitigates the risk arising within these areas. This is acknowledged within the Draft EBA Outsourcing Guidelines. As noted above both the Irish regulated firm & inter-affiliate providing the unregulated/support activity will comply with corporate standards.

2.3 Inter Group versus Third Party Outsourcing Arrangements - In addition to the benefits of outsourcing set out above, it is also pertinent to acknowledge the advantages gained from leveraging a global organisation. While we acknowledge that outsourcing to intragroup entities is outsourcing and requires appropriate governance, we would question the view set out in the discussion paper that intragroup and external vendor outsourcing hold the same risk.

We note that the Draft EBA Outsourcing Guidelines refer to intragroup outsourcing as “not necessarily less risky than outsourcing to an entity outside the group” specifically mentioning the conflicts of interests that may be caused by outsourcing arrangements between different entities within the group. This does not obviate the mitigants which are likely to reduce, potentially significantly, risk for the outsourcing firm. These include:

- The availability of CoE across the wider group providing deeper expertise and increased availability of service (most firms offer a follow the sun service from such CoE).
- The greater resources available to and within the wider group, the benefits of which are available to local regulated group entities.
- The economies of scale achievable due to the bargaining power of the wider group.
- Consistency in performance consequent upon enterprise wide policies and standards; providing assurance around implementation of changes in policy or process and also ensuring that relevant local variations in policy and process are able to align consistently and in a timely manner to enterprise policies and standards.

- Availability of group level expertise, resource and support for local entities.
- Firmwide and shared technology platforms ensure full access to data and records at all times, increasing oversight capability and reducing resiliency risk. Such shared platforms are also subject to corporate technology standards and controls.
- Business continuity arrangements are transparent to the service recipient and standards applied to test plans, risk factors and test results success criteria are set out in firmwide policies and procedures.
- Intergroup arrangements are subject to contractual arrangements and terms and conditions which allows for the service recipient to take appropriate steps in the event of service issues.

3. Technology (to include cloud service providers)

We recommend that the CBI consider the EBA Final Report on Recommendations on Cloud Outsourcing (EBA/REC/2017/3) with specific reference to Section 4. Recommendations on outsourcing to cloud service providers. Under Section 2, the report acknowledges that compared with more traditional forms of outsourcing offering tailor-made solutions to clients, cloud outsourcing services are much more standardised, which allows the services to be provided to a larger number of different customers in a much more automated manner and on a larger scale. Although cloud services can offer a number of advantages, such as economies of scale, flexibility, operational efficiencies and cost-effectiveness, they also raise challenges in terms of data protection and location, security issues and concentration risk, not only from the point of view of individual institutions but also at industry level, as large suppliers of cloud services can become a single point of failure when many institutions rely on them. The aims of these recommendations, which present as being aligned to CBI objectives, are to:

- (a) provide the necessary clarity for institutions should they wish to adopt and reap the benefits of cloud computing while ensuring that risks are appropriately identified and managed; and
- (b) foster supervisory convergence regarding the expectations and processes applicable in relation to the cloud.

In addition, we recommend that the CBI tracks the EBA Consultation Paper on guidelines on Information and Communication Technology (“ICT”) and Security Risk Management. Similarly, to points raised in the Discussion Paper, the EBA Consultation Paper recognises that the complexity of ICT risks is increasing and that the frequency of ICT related incidents (including cyber incidents) is rising together with their potential to have a significant adverse impact on financial institutions’ operational functioning. Moreover, due to the interconnectedness between financial institutions, ICT related incidents risk causing potential systemic impact.

Cloud Outsourcing provides the ability to scale the delivery of services over a shorter period as opposed to the traditional hardware/software acquisition model. This flexibility works in two ways to the benefit of firms and clients alike. The ability to scale up ensures client service is seamless and meets their needs. The ability to scale down ensures firms retain control of costs and remain competitive to the benefit of the market as a whole.

While concerns are expressed around risks relating to concentration (both by firms and within the market), data protection, and security, these are equally capable of being seen as strengths of using a cloud service provider in the same way as intragroup outsourcing outlined above. The largest Cloud Service Providers (“CSPs”) represent CoE on a scale which many firms, including some of the very largest, would find it hard to match. The consistency of service provision achieved by these CSPs ensures that as a whole the market is less exposed to resiliency issues. This does not detract from the need for firms to ensure effective oversight of outsourced services but it does simplify the process for firms and regulators alike.

4. Exit Strategies

The area of substitute providers, contingency planning and exit strategies is quite an intricate area and one we believe that needs to be discussed further to ensure that the Regulator is aware of the complexities in this area. Such considerations can include the need to differentiate between the service involved and the data being used to provide the service. The end result we believe would then lend itself towards one that achieves the Regulator's objectives whilst being practical and achievable.

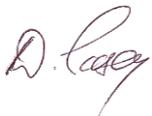
5. Adoption Period

The CBI should consider a transition period to allow for a full assessment of the impact of changes upon both the firm's governance and operational framework and to existing contracting arrangements, where firm's may be required to migrate existing arrangements using normal contract cycles and recognising that this involves negotiation between parties.

We have set out in Appendix I hereto our responses to the questions contained in the Discussion Paper.

We hope you find these comments constructive. We believe it would assist your consideration of our response if we were to meet and talk you through the issues raised in this response and we would be available to meet at your convenience.

Yours faithfully,



Declan Casey
Director Legal and Technical

Appendix I

Sensitive Data Risk

Question:

How are regulated firms ensuring that they have sufficient knowledge/expertise within their own organisation to effectively challenge and gain assurance that their data is being managed securely by OSPs, including CSPs (how and where it is being stored, processed, used, located etc.)?

Response:

- In intragroup outsourcing, firms will utilise group-wide technology platforms and connectivity, rather than transferring data to OSP. Specific controls are put in place (e.g. application and task specific user bands, segregation of duties and inability to use portable storage devices) to limit access to the relevant set of data only.
- Where firms utilise cloud services, investment in cloud certification for employees as a means of maintaining architectural and operational excellence when operating in these new environments.
- In intragroup outsourcing, firms use group-wide technology and connectivity - rather than transferring the data to the OSP, a secure gateway is provided to the OSP to access the data relevant to their responsibilities. Specific controls (e.g. application and task specific user bands, segregation of duties and inability to use portable data storage devices) are put in place to limit the access to the relevant set of data only.
- Engagement with industry cloud experts to design its technical and operational environment with focus on robust automation and security.
- The use of a common technology platform avoids the risk of data loss, alteration, corruption or unauthorised access to data while in transit.
- Ongoing investment in people with regard to technical proficiency and capability to effectively oversee and monitor relevant activities.

Question

What issues/challenges are regulated firms encountering in gaining assurance that their sensitive business and customer data is being managed securely in outsourcing scenarios?

Response:

- Technology is evolving at a rapid pace so firms have to increasingly invest more in keeping abreast of changes that might impact data management.
- The practical challenge of due diligence with OSPs which can impact timelines for changes.
- Designing effective testing plans for large CSPs to identify how and where relevant data is sourced.

Concentration Risk

Question:

How are regulated firms seeking to reduce their exposure to concentration risk both from the perspective of providers and geographical locations?

Response:

- Concentration Risk assessment is performed as part of pre-contractual due diligence before entering into a new outsourcing arrangement.
- The level of concentration risk should be justified on an on-going basis. There should be no bias to either reduce or indeed increase it. The level should be what is appropriate for the firm vis-à-vis its business model, its risk appetite and the profile and capabilities of its vendors.
- On-going review and monitoring of OSP BCP arrangements.
- Take Back-Resilience testing.
- Notwithstanding some of the challenges that arise with substitutability, exit strategy planning can help justify a certain level of concentration risk if measures such as alternate OSPs are in place.
- Effective oversight and challenge from the firms' boards.

Data:

- The firm ensures it has access to the data held/ used by OSP and can transfer it to an alternative OSP if required.
- Replication of data to secondary regions, chosen based on legal/governance considerations and latency concerns, to ensure data recovery in the event of infrastructure loss at the primary site.

Question

(a) How are regulated firms addressing concentration risk whereby they are outsourcing to OSPs who provide services for a large proportion of their sector?

Response:

- As part of due diligence and on-going monitoring, ascertain whether the OSP is providing services to other firms within the sector.
- On-going review and monitoring of OSP BCP arrangements.
- Take Back-Resilience testing.
- Outsourced Client Priority Lists.
- OSP responsibilities detailed in Outsourcing Contracts.

(b) Of particular interest is how regulated firms are dealing with concentration risk where there are limited numbers of providers of niche services such as CSPs?

- Perform due diligence on a number of competitors in the space as possible candidates during evaluation process.
- Data should be portable. Industries should adopt standards for data extracts such as mandatory field names, etc.
- Outsourcing vendor methodology framework should be open (e.g. TOGAT, ITIL, SAFe etc) and non-proprietary.

Question

Do regulated firms have views, as to how systemic concentration risk related to outsourcing, can be effectively monitored and managed by both regulated firms in all sectors and the Central Bank?

Response:

- Regulated firms should determine at the RFP stage and during on-going due diligence whether there is a concentration risk (i.e. OSP being utilised by a number of firms).
- Regulated firms should incorporate assessment of systemic concentration risk in their pre contractual due diligence and on-going risk assessment of OSPs and potential OSPs.
- The CBI could assist the regulated entities, by gathering appropriate data industry wide and highlighting where the potential for systemic risk exists.

Offshoring and Chain Outsourcing

Question

Given the significant volume of offshoring to the UK what preparations are regulated firms undertaking to prepare for Brexit and what related challenges are envisaged in terms of their outsourcing arrangements?

Response:

- Outsourcing to the UK is generally not prevalent among Fund Administrators in Ireland. However, for those that do outsource to the UK, the expectation is that, in the event that the UK leaves the EU, the UK would be treated as a third country. Existing governance, data privacy and oversight models may be updated to reflect the change of status. It is not anticipated at this point that any firms who currently outsource to the UK would change that arrangement due to Brexit.

Question

What steps are regulated firms taking to ensure they have full sight of any chain outsourcing which may be occurring within their outsourcing arrangements and how are they managing risks associated with this?

Response:

- Outsourcing contracts in place with all OSPs which include clauses detailing the OSPs responsibilities in regards to chain outsourcing including notification prior to entering into a chain outsourcing arrangement.
- Periodic outsourcing Due Diligence Questionnaire (“DDQ”) in which OSPs make a declaration regards chain outsourcing.
- Outsourcing arrangements reviewed and discussed during on-site due diligence visits.

Data:

- Security questionnaires to help assess the OSP's adherence to the firm's policies. These questionnaires specifically query the OSPs about their own outsource providers. This questionnaire is reviewed and if clarification is needed call(s) are organised with the OSP.

Question

How are firms ensuring that contractual rights of access are the same with all parties to a chain-outsourcing arrangement, as those granted by the primary third party OSP?

Response:

- Outsourcing contracts would be in place with all OSPs which include clauses detailing the OSPs responsibilities in regards to chain outsourcing including notification to the Fund Administrator prior to entering into a chain outsourcing arrangement. In the event of any sub-contracting by an OSP a requirement included in the contracts for the OSP to ensure any arrangements with a sub-contractor imposes upon them the same obligations regarding access and cooperation as are imposed on the primary third-party. Provisions also included confirming that the primary third-party OSP is, at all times responsible, for the act, omissions, and compliance with the terms of the Fund Administrators agreement with the primary OSP.

Substitutability

Question

What issues/ challenges are regulated firms encountering when assessing substitutability and exit strategies? How are these being addressed?

Response:

- Testing exit strategy given hypothetical nature of the circumstances where this may be required.
- Determining exit timeframe due to logistical, technical skillset and resourcing variables.
- Preparing scenario based cost impact analysis.
- Group considerations for intragroup outsourcing arrangements.
- Cost to the regulated firm to undertake the necessary on-going assessment and due-diligence on alternative OSPs in order to identify and maintain a list of suitable alternative providers.

Question

What are the risks / challenges where there is no substitutability or it is not possible to bring the service back in house? How are these being addressed?

Response:

Risks/Challenges:

- Over reliance on OSP.
- Weak negotiating position in performance and fee reviews.
- No backup in event of service disruption or service degradation or cessation – all associated risks e.g. strategic, reputational, etc. Where highly esoteric/specialized services/monopoly in the market, may be challenged in bringing this service back in house and to continue to provide these services.
- Less risky in intragroup outsourcing arrangements as unplanned termination is less likely.

Mitigates:

- Enhanced Due Diligence including assessment of OSP financial performance and organizational structure on an on-going basis including concentration risk.

- OSP responsibilities in regards to performance and business continuity detailed in Outsourcing Contracts.
- Use of intragroup outsourcing arrangements where these group entities are not providing servicing to non-group entities can help mitigate these risks.