

Consultation Procedure

Proposal for Banking Rule BR/14

Explanatory Note

The documents circulated by the MFSA for the purpose of consultation are in draft form and consist of proposals. Accordingly these proposals are not binding and are subject to changes and revisions following representations received, inter alia, from licence-holders and other involved parties. It is important that persons involved in the consultation bear these considerations in mind.

Note for Consultation

(Banking Rule BR/14)

1. Purpose

1.1 Article 19A(2) of the Banking Act (Cap.371) grants the MFSA the power to issue a Banking Rule laying down the requirements for the recognition of outsourcing service providers and the provision of such outsourced services.

1.2 Following the above, a new Banking Rule on Outsourcing by Credit Institutions has been drafted by the MFSA in line with the Committee of European Banking Supervisors' (CEBS) publication dated 14 December 2006, entitled 'Guidelines on Outsourcing'. In this respect, we are attaching the draft for consultation prior to actual implementation. Comments are to be provided to the MFSA in writing by not later than the 30 November 2009.

2. The proposed draft Banking Rule (BR/14)

2.1 Given the increasing use of outsourcing by credit institutions, including on a cross-border basis, and its implications for effective prudential supervision, the MFSA has deemed it appropriate to implement the principles underlying the CEBS Guidelines through the draft BR/14 since such principles have been designed to promote an appropriate level of convergence in supervisory practices throughout the EU.

2.2 BR/14 applies the concept of proportionality to outsourcing which will be related to the size of the institutions as well as to the sophistication and diversification of the outsourced activities. Accordingly the draft Rule is based on a range of current practices and the common elements of policy that have been elaborated to date in various Member States but also takes into account various recent international and European initiatives in the field of outsourcing.

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We thank you for your cooperation.

Banking Unit
30 October 2009

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

BANKING UNIT

BANKING RULES

*OUTSOURCING BY CREDIT INSTITUTIONS
AUTHORISED UNDER THE BANKING ACT 1994*

Ref: BR/14/2009

OUTSOURCING BY CREDIT INSTITUTIONS AUTHORISED UNDER THE BANKING ACT 1994

INTRODUCTION

1. In terms of Article 4(2) of the Banking Act 1994 ('the Act'), the competent authority ('the authority') as appointed under Article 3(1) of the Act may make Banking Rules ('the Rules') as may be required for carrying into effect any of the provisions of the Act. The authority may amend or revoke such Rules. The Rules and any amendment or revocation thereof shall be officially communicated to credit institutions and the authority shall make copies thereof available to the public.
2. The Rule on the provision of outsourcing by credit institutions is being made pursuant to Article 19A(2) of the Act.

"The competent authority may issue a Banking and, or Electronic Money Rule as the case may be, laying down the requirements for the recognition of the outsourcing service provider and the provision of such outsourced services."

3. It should be emphasised, however, that Rules must not be construed to be solely a substitute for a reading of the Act itself. The responsibility for observing the law rests entirely with the applicant and the individual persons concerned. Potential applicants should therefore refer to the Act and may also wish to seek legal advice.

SCOPE AND APPLICATION

4. The Rule applies to all credit institutions licensed under the Act.
5. The scope of this Rule is to outline the general principles regulating the conduct of outsourcing undertaken by credit institutions that are licensed in terms of Article 5(1) of the Act.
6. In drafting the Rule the authority has been guided by the Committee of European Banking Supervisors (CEBS) Guidelines on Outsourcing issued on 14 December 2006.

OBJECTIVES

7. The objectives of this Rule are to establish:
 - (i) the activities that constitute outsourced services for the purposes of this Rule;
 - (ii) the form and the content of applications by credit institutions to the authority for the recognition of outsourcing service providers;
 - (iii) the obligation to supply documentation and other information to the authority as required;
 - (iv) the measures available to allow the authority to ensure compliance by recognised outsourcing service providers and outsourcing institutions with this Rule; and
 - (v) other matters ancillary to or connected with the above.

PROCEDURES FOR OBTAINING RECOGNITION

8. The procedure for obtaining recognition for outsourcing service providers is made pursuant to Article 19A(1) of the Act.

“No credit institution shall outsource its material services or activities unless the outsourcing service provider is granted recognition by the competent authority under this article.”

9. For the purposes of Article 19A(1) and the Rule, the applicant credit institution is to make a written request to the authority to obtain recognition for the outsourcing service provider in terms of the said sub-article. Such written request shall provide information on the following aspects:
- i) the name and address of the outsourcing service provider;
 - ii) the material services or activities to be outsourced;
 - iii) the reasons for outsourcing such services or activities; and
 - iv) information on the regulatory status, if any, if the outsourcing service provider is authorised or licensed in a foreign jurisdiction.

It should be emphasised that the recognition of the outsourcing service provider made in terms of Article 19A(1) does not for the purposes of this Rule imply that such recognition extends to subsequent utilisation of the same outsourcing service provider by another credit institution.

Notwithstanding the above the authority may at its discretion request other documents to be provided by the credit institution in support of its application, such as, draft service level agreement/s (SLA/s) with the outsourcing service provider, changes in contingency plans and exit strategies relating to such outsourced services or activities, changes in internal procedures (if any) following the outsourcing of such services or activities and the internal policy on the credit institution’s approach to outsourcing as drawn up in line with Principle 6 of this Rule.

10. Although the Rule specifically refers to licensed credit institutions, prospective applicants in terms of the Application Procedures and Requirements for Authorisation of Licences for Banking Activities Rule (BR/01) are also required to provide information relating to any material services intended to be outsourced. Accordingly, any SLAs as required to be provided to the authority, between outsourcing service providers and the applicant credit institution have to be in line with the Rule.
11. The concept of proportionality, as laid down in the provisions of the Directive 2006/48/EC and the Supervisory Review Process of Credit Institutions Rule (BR/12) applies also to outsourcing and its policy which will be expected to be related to the size of the credit institutions as well as to the sophistication and diversification of the outsourced activities. The authority will adapt its approach to outsourcing to ensure it is proportionate to the nature, scale and complexity of the outsourced activities of an institution.

PART 1: DEFINITIONS

Principle 1: For the purposes of this Rule, the following definitions shall apply:

- 12a. *outsourcing*:** an authorised entity's use of a third party (the "outsourcing service provider") to perform activities that would normally be undertaken by the authorised entity, now or in the future. The supplier may itself be an authorised or unauthorised entity;
- 12b. *purchasing*:** *inter alia*, the supply (i) of services, goods or facilities without information about, or belonging to, the purchasing institution coming within the control of the supplier; or (ii) of standardized products, such as market information or office inventory. (Authorised entities should ensure that what they are buying is fit for purpose.). The supply of (i) or (ii) is not outsourcing;
- 12c. *outsourcing service provider*:** 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;
- 12d. *outsourcing institution*:** the authorised entity which is the buyer of such goods, services or facilities;
- 12e. *authorised entity*:** a licensed credit institution. For the purposes of this Rule, the terms authorised entity, outsourcing institution and credit institution shall be used interchangeably.
- 12f. *material activities*:**
- (i) activities of such importance that any weakness or failure in the provision of these activities could have a significant effect on the authorised entity's ability to meet its regulatory responsibilities and/or to continue in business;
 - (ii) any other activities requiring a licence from the authority;
 - (iii) any activities having a significant impact on its risk management; and
 - (iv) the management of risks related to these activities.
- 12g. *senior management*:** persons who effectively direct the business of the authorised entity;
- 12h. *"chain" outsourcing*:** outsourcing where the outsourcing service provider subcontracts elements of the service to other providers.

PART 2: PRINCIPLES APPLICABLE TO OUTSOURCING INSTITUTIONS

Principle 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.

13. All outsourcing regimes should ensure that the outsourcing of functions to an outsourcing service provider does not impair the supervision of the outsourcing institution.
14. Responsibility for outsourced functions must always be retained by the outsourcing institution. The outsourcing of functions does not relieve an outsourcing institution of its regulatory responsibilities for its authorized activities or the function concerned.
15. Outsourcing institutions should be required to retain adequate core competence at a senior operational level in house to enable them to have the capability to resume direct control over an outsourced activity, in extremis.
16. Outsourcing shall not affect managers' full and unrestricted responsibilities under applicable legislation (e.g. under inter alia the Act).

Principle 3: Outsourcing arrangements can never result in the delegation of senior management's responsibility.

17. The outsourcing of core management functions is considered generally to be incompatible with the senior management's obligation to run the institution under their own responsibility. Core management functions include, inter alia, setting the risk strategy, the risk policy, and, accordingly, the risk-bearing capacity of the institution. Hence, management functions such as the setting of strategies and policies in respect of the authorised entity's risk profile and control, the oversight of the operation of the entity's processes, and the final responsibility towards customers and inter alia the authority should not be outsourced.

Principle 4.1: An authorised entity may not outsource services and activities requiring a licence from the authority under the Act concerning the acceptance of deposits or to lending unless the outsourcing service provider either (i) has an authorisation that is equivalent to the authorisation of the credit institution; or is (ii) otherwise authorised to carry out the activity of lending in accordance with the Financial Institutions Act.

Principle 4.2: Any area of activity of an outsourcing institution other than those identified in Principles 2 and 3 may be outsourced provided that such outsourcing does not impair:

- a. the orderliness of the conduct of the outsourcing institution's business or of the financial services provided;
- b. the senior management's ability to manage and monitor the authorised entity's business and its authorised activities;
- c. the ability of other internal governance bodies, such as the board of directors or the audit committee, to fulfil their oversight tasks in relation to the senior management; and
- d. the supervision of the outsourcing institution.

Principle 4.3: An outsourcing institution should take particular care when outsourcing material activities. To this effect, the outsourcing institution should seek due recognition in respect of the outsourcing service provider from the authority.

18. These requirements do not affect the principle of managers' sole responsibility (Principle 2) for all authorised activities. The managers of the outsourcing institution

shall be fully responsible to the authority for any outsourced activity. The managers should therefore take suitable measures to ensure that the outsourced activities continue to meet the performance and quality standards that would apply if their own institution were to perform the relevant activities in-house.

19. An outsourcing institution shall inform the authority on any material activity to be outsourced for recognition to be granted in terms of Article 19A of the Act. Such information should be made available in a timely manner in order for the authority to evaluate the proposal or to allow it to consider whether the proposal raises prudential concerns and to take appropriate action if required.
20. Outsourcing institutions should be aware that for the outsourcing of material activities the authority may impose specific conditions. In doing so, the authority will consider factors such as the size of the institution, the nature of the outsourced activity, the characteristics and market position of the service provider, the duration of the contract and the potential of the outsourcing to generate conflicts of interest.
21. An outsourcing institution shall inform the authority of any material development affecting the service provider and its ability to fulfil its obligations to customers.
22. Subject to the principles that apply to cross-border outsourcing expressed under Principle 4.1(i), no special rules are needed in relation to the geographical location of an outsourcing service provider. However, due to possible data protection risks and risks to effective supervision undertaken by the authority, institutions should take special care when entering into and managing outsourcing agreements that are undertaken outside the EEA.
23. Intra-group outsourcing and outsourcing according to Principle 4.1(i) can be material. Outsourcing institutions should be aware that the authority may take specific circumstances into consideration, such as the extent to which the outsourcing institution controls the service provider or has the ability to influence its actions, and the extent to which the service provider is included in the consolidated supervision of the group, when assessing the risks associated with an intra-group outsourcing arrangement and the treatment to apply to such arrangements.

Principle 5: Outsourcing institutions are not restricted from outsourcing their non-material activities.

24. In such cases, and in terms of Article 19A of the Act, the outsourcing institution is not required to inform the authority for recognition purposes. Nevertheless, outsourcing institutions should adequately manage the risks relating to such outsourcing arrangements at all times. In line with Principle 2, the senior management of the outsourcing institution should be fully responsible for any outsourced activity.
25. Areas which could be regarded as non-material are those not falling within the definition of “material activities” according to Principle 1(f), and may include:
 - a. areas which do not potentially constitute relevant risks and which, if outsourced, would not compromise the provisions set forth in Principle 4.2 above; and

b. purely advisory services used by the institution. For example, this applies to legal and tax consulting, even where this is not limited to individual aspects or projects.

Principle 6.1: The outsourcing institution should have a policy on its approach to outsourcing, including contingency plans and exit strategies.

Principle 6.2: An outsourcing institution should conduct its business in a controlled and sound manner at all times.

26. The outsourcing institution should have a general policy that covers all aspects of outsourcing, including non-material outsourcing, irrespective of whether the outsourcing takes place within a corporate group or not.
27. When drawing up the policy the outsourcing institution should recognise that no form of outsourcing is risk free. The policy should recognise that the management of non-material and intra-group outsourcing should be proportionate to the risks presented by these arrangements.
28. The policy should explicitly consider the potential effects of outsourcing on certain significant functions (e.g. the internal audit function and the compliance function) when conducting the risk analysis prior to outsourcing such functions.
29. The policy should ensure that the outsourcing service provider's financial performance and essential changes in the service provider's organisation structure and ownership structure are appropriately monitored and assessed by the outsourcing institution's management so that any necessary corrective measures can be taken promptly.
30. The outsourcing institution should specify the internal units or individuals that are responsible for monitoring and managing each outsourcing arrangement.
31. The policy should consider the main phases that make up the life cycle of an institution's outsourcing arrangements:
 - a. the decision to outsource or change an existing outsourcing arrangement (the decision making phase);
 - b. due diligence checks on the outsourcing service provider;
 - c. drafting a written outsourcing contract and SLA (the pre-contractual drafting phase);
 - d. the implementation, monitoring, and management of an outsourcing arrangement (the contractual phase). This may include also the following-up of changes affecting the outsourcing service provider (e.g. major change in ownership, strategies, profitability of operations);
 - e. dealing with the expected or unexpected termination of a contract and other service interruptions (the post-contractual phase). In particular, outsourcing institutions should plan and implement arrangements to maintain the continuity of their business in the event that the provision of services by an outsourcing service provider fails or deteriorates to an unacceptable degree, or the firm experiences other changes. This policy should include contingency planning and a clearly defined exit strategy.

Principle 7: An outsourcing institution should manage the risks associated with its outsourcing arrangements.

32. Compliance with this principle should include an on-going assessment by the outsourcing institution of the operational risks and any concentration risk, if any, associated with all its outsourcing arrangements. An outsourcing institution should inform the authority of any material development.

Principle 8: All outsourcing arrangements should be subject to a formal and comprehensive contract. The outsourcing contract shall oblige the outsourcing service provider to protect confidential information.

33. Any outsourcing arrangement should be based on a clear written contract.
34. An outsourcing institution should make sure that the written contract takes account of the following (bearing in mind other specific Rules and/or legislation):
- a. The operational activity that is to be outsourced shall be clearly defined.
 - b. The precise requirements concerning the performance of the service shall be specified and documented, taking account of the objective of the outsourcing solution. The outsourcing service provider's ability to meet performance requirements in both quantitative and qualitative terms should be assessable in advance, including compliance with this Rule.
 - c. The respective rights and obligations of the outsourcing institution and the outsourcing service provider should be precisely defined and specified. This should also serve to ensure compliance with relevant laws, supervisory rules and/or regulations and guidelines for the duration of the outsourcing arrangement.
 - d. In order to underpin an effective policy for managing and monitoring the outsourced activities, the contract should include a termination and exit management clause, where proportionate and if deemed necessary, which allows the activities being provided by the outsourcing service provider to be transferred to another outsourcing service provider or to be reincorporated into the outsourcing institution.
 - e. Notwithstanding the provisions of Article 34 of the Act, the contract shall cover the protection of confidential information, banking secrecy and any other specific provisions relating to the handling of confidential information. Whenever information is subject to confidentiality rules at the level of the outsourcing institution at least the same level of confidentiality should be ensured by the service provider.
 - f. The contract should ensure that the outsourcing service provider's performance is continuously monitored and assessed so that any necessary corrective measures can be taken promptly.
 - g. The contract should include an obligation on the outsourcing service provider to allow the outsourcing institution's compliance and internal audit departments complete access to its data and its external auditors full and unrestricted rights of inspection and auditing of that data.

- h. The contract should include an obligation on the outsourcing service provider to allow direct access by the authority to relevant data and its premises as required.
 - i. The contract should include an obligation on the outsourcing service provider to immediately inform the outsourcing institution and the authority of any material changes in circumstances which could have a material impact on the continuing provision of services. This may require obtaining consents from affected parties such as the parent company and relevant home supervisory authority.
 - j. The outsourcing contract shall contain provisions allowing the outsourcing institution to cancel the contract by contractual notice of dismissal or extraordinary notice of cancellation if so required by the authority.
35. When drafting the contract the outsourcing institution should bear in mind that the level of monitoring, assessment, inspection and auditing required by the contract should be proportionate to the risks involved and the size and complexity of the outsourced activity.

Principle 9: In managing its relationship with an outsourcing service provider an outsourcing institution should ensure that a SLA is put in place.

36. A SLA should normally contain a mixture of quantitative and qualitative performance targets, to enable an outsourcing institution to assess the adequacy of service provision.
37. An outsourcing institution should also consider the need to evaluate the performance of its outsourcing service provider using mechanisms such as service delivery reports, self-certification or independent review by the outsourcing institution's, or the outsourcing service provider's, internal and/or external auditors.
38. An outsourcing institution should be prepared to take remedial action if the outsourcing service provider's performance is inadequate.

Principle 10.1: The outsourcing institution should take account of the risks associated with "chain" outsourcing.

Principle 10.2: The outsourcing institution should agree to chain outsourcing only if the sub-contractor will also fully comply with the obligations existing between the outsourcing institution and the outsourcing service provider, including obligations incurred in favour of the authority.

Principle 10.3: The outsourcing institution should take appropriate steps to address the risk of any weakness or failure in the provision of the sub-contracted activities having a significant effect on the outsourcing service provider's ability to meet its responsibilities under the outsourcing agreement and/or SLA.

39. The sub-outsourcing of outsourced activities and functions to third parties (sub-contractors) should be treated by the outsourcing institution like a primary outsourcing measure. Compliance with these conditions should be ensured contractually, for example by a clause in the outsourcing contract requiring the prior

consent of the outsourcing institution to the possibility and the modalities of sub-outsourcing.

40. The outsourcing institution should ensure that the outsourcing service provider agrees that the contractual terms agreed with the sub-contractor will always conform, or at least not be contradictory, to the provisions of the agreement with the outsourcing institution.

PART 3: PRINCIPLES ON OUTSOURCING ADDRESSED TO THE AUTHORITY

The authority shall carry out supervision on outsourcing activities in line with Part 3 – Guidelines on Outsourcing addressed to supervisory authorities contained in the CEBS Guidelines on Outsourcing issued on 14 December 2006.

Whilst noting that the Rule is addressed to credit institutions, the authority still deems it appropriate to reproduce below the two principles specifically addressed to supervisory authorities. The disclosure of the authority's obligations in the Rule is aimed to provide licence holders and other stakeholders with a transparent viewpoint as to how the authority would carry out supervision on outsourcing activities.

Principle 11: The authority shall require that the outsourcing institution has established that it is granted full access to relevant data held by the outsourcing service provider and, where provided for by the Act and/or any Regulations made thereunder, Rules or the right to conduct on-site inspections at an outsourcing service provider's premises.

41. The authority should aim to be satisfied that outsourcing institutions ensure that their outsourcing contracts with outsourcing service providers grant it the rights to information and, in accordance with domestic legislation, to inspection, admittance and access (including access to databases), as well as the right to give directions or instructions, which it needs to exercise its supervisory functions.
42. The authority shall encourage outsourcing institutions to ensure that information may also be made available to it by the outsourcing service provider's external auditor.
43. The authority shall aim to ensure that its powers to issue orders or instructions to the outsourcing institution can be reliably enforced, without being compromised by instructions issued to the outsourcing service provider by other bodies, so as to ensure the orderly performance of the outsourced activities.
44. The authority shall aim to ensure that it can obtain detailed information about any outsourcing processes which might undermine the stability of the consolidated group whose overall supervision is, ultimately, its responsibility.
45. In the case of outsourcing to service providers abroad, the outsourcing institution should be responsible for ensuring that the authority can exercise its information gathering rights, including its right to demand documents and audits, and, compatibly with the overall legal framework, its inspection rights.
46. The requirement to cancel the outsourcing contract under paragraph 34 (j) of Principle 8 should be properly justified by the authority on the basis of non-compliance with the

provisions of these Principles, in particular of those with regard to the safeguarding of rights of supervision and enforcement.

47. The outsourcing institution may – prior to outsourcing – consider in consultation with the authority what alternative measures could adequately mitigate the risks involved.

Principle 12: The authority shall take account of concentration risk.

48. The authority shall seek to identify any concentration risk on a sectoral level and seek to monitor these risks at a systemic level.

OFFENCES AND PENALTIES

49. Any person who commits an offence in terms of this Rule as provided for under Article 35 of the Act is liable to such penalties as may be prescribed pursuant to the said article.