SUPPLY MANAGEMENT INSIDER

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INTRODUCTION

UK banks, financial institutions and PRA-designated investment firms – as well as UK insurance and reinsurance firms and groups in scope of the Solvency II regime – are currently battling to implement new guidelines set by the European Banking Authority (EBA) around reviewing and updating outsourcing contracts.

The EBA outsourcing guidelines have been in place for all new outsourcing arrangements since 30 September 2019, but a hard deadline from the EBA for firms to comply with the guidelines for legacy arrangements is set at 31 December 2021.

The guidelines mean institutions must review and update any documentation for legacy outsourcing arrangements of critical or important functions – other than those made with cloud service providers – that they had entered into prior to the new rules coming into force.

In the UK, however, the Prudential Regulation Authority (PRA) has confirmed that it does not expect banks and investment firms subject to its regulation to meet the EBA deadline. Instead, it has applied its own supervisory statement, which states new outsourcing arrangements should now comply (since 31 March 2021). It expects legacy contracts to do so "at the first appropriate contractual renewal or revision point" on or after 31 March 2022.

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INTRODUCTION cont'd

"For new contracts that are in negotiation at the moment, we would expect that financial institutions will be complying with the supervisory statement," says Yvonne Dunn, a partner at law firm Pinsent Masons. "But for existing arrangements, the PRA hasn't stipulated a long stop-date but is saying you should bring them into line at the next possible opportunity. That is likely to be a renewal or a change in process, and that might be the time when a company would be expected to identify where the gaps might be, and address them."

In May, the Financial Conduct Authority (FCA) complicated matters further. It stated that it no longer expected firms to inform it if they have failed to remediate critical or important outsourcing arrangements by the EBA's deadline, but has said they must do so by 31 March 2022.

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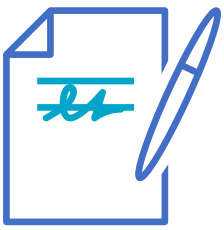
In a statement which differed from its initial position of sticking to the requirement to meet the EBA's deadline, the FCA said: "Firms are not expected to report to us on their progress towards meeting the timeline of 31 December 2021 in the EBA guidelines regarding legacy outsourcing arrangements.

"Firms should aim to review any outstanding critical or important outsourcing arrangement at the first appropriate contract renewal following the first renewal date of each existing outsourcing arrangement or revision point. Where arrangements of critical or important outsourcing arrangements have not been finalised by 31 March 2022, firms should inform us."



There is a difference here, though, between the stance of the two UK regulatory bodies, says Dunn, and dual-registered organisations are unlikely to want to have to inform the FCA that they have not met the guidelines. "We imagine that firms would prefer not to have do this, which will drive remediation of legacy critical or important outsourcing arrangements to be complete by 31 March 2022," she says. Yet, she adds, many clients have been working to the EBA's original deadline of 31 December 2021, and it makes sense to continue to ensure existing contracts comply.

EBA GUIDELINES

While there has been some divergence from the UK as a result of its post-Brexit freedom from EU supervisory authorities, the underlying essence of the guidelines remains. The fundamental concept is to ensure that outsourcing does not inject additional risk to financial services companies.

It introduces two guiding principles: that outsourcing agreements should not remove the responsibility of senior management for core management functions, and that arrangements must not detract from either the supervisory body's control of the agreements or its risk management obligations.

The EBA guidelines impose both governance and process requirements on financial institutions and investment firms. On the governance side, organisations must have written outsourcing policies and maintain a written register of arrangements, which must be made available to the regulator when required. On the process side, institutions need to conduct a pre-outsourcing analysis for new services, including undertaking relevant due diligence and assessing any risk. It must also assess whether the arrangement can be viewed as an outsourcing agreement, and whether the content of this is for functions that can be deemed critical or important.

Most institutions should by now be up to speed with their obligations for new suppliers, with the regulations having been in force for almost two years. For those looking to review or amend an existing service, though, institutions must undertake similar checks, including assessing whether the contract is an outsourcing agreement and ensuring proper analysis is carried out.

IMPORTANT DIFFERENCES

The PRA has made it clear that its supervisory statement should be the main source of reference for UK firms. It includes measures around governance and record keeping, the oversight of sub-outsourcing arrangements, cybersecurity and rights of access, audit and information, as well as business continuity. Organisations are also now required to have an exit strategy for both stressed and non-stressed situations that is designed to ensure minimal disruption for customers.

The statement also includes some amendments to previous provisions following feedback from the sector through a consultation. One of these, says Dunn, is that it does not expect institutions to directly monitor fourth parties in all circumstances, and it has also removed the assumption that all arrangements in a prudential context are automatically outsourcing.

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"While it will not accept that intragroup arrangements should automatically be treated differently to external third-party contracts, it does acknowledge areas where a proportionate approach can be taken, including in relation to contracting," she says. The PRA also makes reference to "material" outsourcing, rather than the "critical or important" used by the EBA.

Significantly, there are also some differences between the PRA's statement and the EBA guidelines. The PRA, for instance, has imposed additional obligations around the advance notification of material outsourcings to it, even suggesting in some cases it may be appropriate to notify the regulator of a planned material arrangement before a final service provider has been selected.

There are also differences around the flowdown of obligations to sub-outsourcers. Here, the EBA guidelines require flowdown of audit rights and obligations to comply with applicable law to any sub-outsourcer of a critical or important function. The PRA supervisory statement only requires this where the sub-outsourcing itself is deemed a material arrangement, introducing an additional criterion which institutions will need to evaluate.

IMPORTANT DIFFERENCES cont'd

Luke Scanlon, head of fintech propositions at Pinsent Masons, also highlights two clarifications in the area of cybersecurity. One relates to the issue of encryption keys, after the PRA had initially suggested it may require firms to make any keys used to access encrypted data accessible to it. "The PRA has now confirmed, however, that while institutions will need to ensure that the regulator has access to the encrypted data, they will not need to ensure it can access the encryption keys themselves," he says.

The second issue relates to access, audit and information rights, which the PRA has confirmed extend in the case of material outsourcings to requiring institutions to ensure that third parties agree to share the results of security penetration testing they carry out or which are carried out on their behalf. "In its draft guidelines, it had required that firms ensure they have a right, where relevant, to carry out such penetration testing themselves," says Scanlon.

The PRA statement is also significant because, for the first time, it also makes mention of non-outsourcing third-party contracts coming into scope. "That's got a little bit lost in all of the discussion about outsourcing but it potentially now includes a bundle of contracts that previously would have been discounted," says Dunn. "That uncertainty is just beginning but some financial institutions are having to revisit their third-party contracts, and look again at some of the things they have previously done to be compliant with the rules."

HELPING HAND

Procurement teams should be working closely with legal departments and suppliers to help ensure contracts are correctly assessed and reviewed or amended appropriately. “If you’re a procurement professional in a financial services regulated business, then you need to be sure that your contract is compliant and meets the requirements of the PRA supervisory statement in the timetable it sets out,” says Dunn.

“In practice, that means that you need to ensure you’ve carried out a mapping exercise to map the contract to the rules and identify if there are any gaps.” In time, suppliers will also come to understand the rules, she adds, and ensure they are only offering contracting positions that are compliant with the regulations.

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But organisations will also need to put in place a system to ensure all aspects of the contracting process – the purchase, the contract and the supplier – are aligned and comply with the regulations, which will be particularly challenging in organisations where processes are often owned by individual, siloed business units and based on multiple disparate IT platforms.

Many organisations are currently relying on outdated contract management systems, tailored in-house packages or even spreadsheets which do not give full visibility across the supplier and contracting process, and are unable to track the vast number of documents that form part of this process.

The new EBA guidelines and PRA supervisory statement has thrust procurement firmly into the spotlight as the function responsible for ensuring overall compliance. With this comes the opportunity to shape a solution to keep track of everything.

HELPING HAND cont'd

Some financial institutions including Credit Agricole, BNP Paribas and Groupe BPCE are already using technology to help overcome this complexity, providing a full source-to-pay platform to deliver cost savings, reducing supplier risk and delivering efficiency in the procurement process, while meeting the compliance requirements associated with the EBA guidelines. The platform covers four core components, including the request for service, sourcing, contracting and the supplier itself, as well as providing a repository to demonstrate compliance around outsourcing agreements to auditors or regulators.

Crucially, the system, provided by Ivalua, is fully configurable, meaning it can be adapted to cope with any future changes in the regulatory requirements or tailored by financial institutions to meet their own needs or interpretation of the regulations. "A lot of financial institutions haven't understood yet that software is a possible solution because the landscape at the moment in the banks is that they have disparate systems that aren't connected up," says Stephen Cleminson, alliances director EMEA at Ivalua.

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Stephen Cleminson, alliances director EMEA, Ivalua

One other factor to consider here is the potential for the UK to adapt its interpretation of the guidelines in future, using its post-Brexit flexibility. "We might see UK regulators looking to do their own thing around the EBA guidelines," says Dunn. "People will have different views on that but there is the risk of creating another exercise, and also of creating different rulebooks for entities that are both in the UK and Europe. But we haven't seen any particular suggestion from the regulators that that's a route they're looking to go down in the short term."

The one thing that is certain is the new guidelines are here to stay, and are likely to evolve in the future as regulators, financial institutions themselves and suppliers adapt their processes. "The key for financial institutions is to look at the process and the systems that they have in place, but also to anticipate that there are probably going to be further changes in those regulations, such as the definition of material outsourcing," adds Cleminson. "It's essential that financial institutions are able to adapt to those."

To find out more about how Ivalua could help your organisation meet the requirements of the new guidelines and manage the process effectively, go to **ivalua.com**

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