Switzerland

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FINMA publishes new rules on outsourcings of Swiss banks and insurance companies

On 5 December 2017, the Swiss Financial Market Supervisory Authority published the new circular 2018/3 "Outsourcing – Banks and Insurance Companies". The circular will replace circular 2008/7 and enters into force on 1 April 2018. The new circular defines the regulatory requirements to be met by Swiss banks, securities dealers and insurance companies when outsourcing material business functions to outside service providers. It follows a principle-based approach and aims to be technology-neutral in order for in-scope financial institutions to be able to implement the outsourcing requirements in a way that takes into account their specific business models and risks.

CONTENT OF THE NEW CIRCULAR

Purpose

The new outsourcing circular stipulates the supervisory requirements which apply to the organisation of outsourcing arrangements of Swiss banks, securities dealers and insurance companies. Its purpose is to reduce the risks related to outsourcing arrangements. The circular no longer addresses aspects relating to data protection as well as customer and banking secrecy in order to avoid any inconsistencies with applicable data protection, criminal and private laws governing these topics. Data protection and banking secrecy legislation will, however, still have to be taken into account when outsourcing a business function to a third-party service provider.

Terms

An *outsourcing* as defined in the new circular occurs where an in-scope financial institution mandates a service provider to independently and permanently perform a function, either wholly or in part, that is material for the relevant company's business activities. For the applicability of the circular, it is decisive whether the outsourcing has to be considered *material* or not. Under the new regime, a function is deemed to be material where the function significantly depends on compliance with the objectives and provisions of financial market supervision legislation . It is the responsibility of each in-scope financial institution to determine whether this is the case. With regard to insurance companies, all functions that are inseparably linked to its operation have to be qualified as being material. These functions include production, inventory/contract administration, the settlement of claims, accounting, asset management and investment as well as IT. FINMA also takes the view that the risk management and compliance functions are material. For banks, an outsourcing will in any case be deemed to be material where the outsourcing provider obtains access to mass client-identifying data.

Scope

The new circular applies to banks and securities dealers having their legal domicile in Switzerland as well as to Swiss branches of foreign banks and securities dealers. In addition, Swiss insurance companies and branches of foreign insurers who are subject to approval by FINMA are in scope of the circular.[1] Financial groups and conglomerates are not in scope of the circular as they (as an economic group) cannot be a party to an outsourcing arrangement. However, they have to evaluate the risks associated with an outsourcing on a consolidated basis. Furthermore, the circular does not apply to (original) outsourcings of foreign subsidiaries or foreign branches of financial institutions domiciled in Switzerland. In this case, the outsourcing arrangement is subject to the supervision of the competent foreign supervisory authority. The circular does not contain any exceptions for outsourcings to specific service providers. This has the effect that the regulatory requirements also apply to the outsourcing of functions to financial market infrastructures such as SIX Group.

Authorisation requirements and permissibility

- **Authorisation requirements:** Banks and securities dealers are permitted to outsource material functions without the prior approval of FINMA. The outsourcing of material business functions of insurance companies is considered to be relevant for the business plan of the insurer[2] and therefore subject to FINMA approval.
- **Permissibility:** Generally, all material functions of a bank, a securities dealer or an insurance company may be subject to an outsourcing arrangement. There are, however, a number of exceptions. First of all, it is impermissible to outsource the overall management, supervision and control by the supreme management body of the company, key management tasks of the management board as well as decisions relating to the commencement and discontinuation of business relationships. In addition, functions relating to strategic decisions may not be outsourced. The restriction regarding decisions relating to the commencement and discontinuation of business relationships should be construed in a way that the business relationship in question must be of a certain importance for the company. In addition, it is not permitted to outsource risk management and compliance tasks other than those which are operational in nature. These functions must stay within the financial institution and must be designed in a way that the latter is able to control and supervise any business area which is subject to an outsourcing arrangement. If the risk management and compliance tasks are performed at a group level, it is possible to explore synergies on a lower (entity) level, it being understood that the supreme management body and the senior management of each legal entity will still be responsible for an adequate risk control at the relevant entity level. The new regime enhances the outsourcing capabilities of insurance companies who have only been able to outsource two out of three of their core functions so far. Further facilitations apply to the outsourcing of management/control functions of insurance captives.

Requirements for outsourcing companies

- **Inventory of outsourced functions**: As a new element, the outsourcing circular provides for the duty to establish an inventory of the outsourced

functions; in-scope entities have to keep an up-to-date inventory of all outsourced functions which meet the materiality threshold. The inventory must include a description of the outsourced business area, specify the service provider(s) (including any subcontractors) and recipient(s) of the outsourcing services, and indicate which unit is responsible for the outsourcing within the company. To determine whether a subcontractor has to be included in the inventory, one has to assess whether the tasks performed by the subcontractor are material in the context of the circular. The materiality threshold may also be met if the subcontractor is only responsible for tasks which are repetitive in nature or which can be replaced easily. According to FINMA, the description of the outsourced function or the service provider has to include information regarding the outsourcing of mass client-identifying data to a foreign service provider, if applicable. To fulfil their obligation to keep an up-to-date inventory, in-scope entities have to make sure that their service providers provide them with the necessary data. This is particularly relevant with regard to the identity of the deployed subcontractors. Insurance companies have to maintain the inventory in their business plan form J.[3]

- **Selection, instruction and monitoring of the service provider:** The standards for the provision of the outsourcing services have to be defined prior to entering into the outsourcing agreement. This includes a risk analysis that takes into account the main economic and operational considerations and deals with the risks and opportunities associated with the outsourcing in question. When selecting the service provider, the financial institution must carefully consider and assess the provider's professional capabilities as well as its financial and human resources. Furthermore, if several functions are outsourced to the same provider, potential concentration risks must be considered. This was criticised by market participants as the selection of one single source may also have several advantages and may not only reduce the costs of the outsourcing but also the complexity for the outsourcing company. Even though this aspect has not been included in the circular, there are valid reasons to take into account the advantages of receiving a service package from a single source when evaluating an outsourcing arrangement. One further aspect which has to be taken into account in the selection process is the potential impact of changing the service provider. It has to be ensured that the outsourced function can be reintegrated in an organised way. Finally, the service provider must ensure that it will be able to offer the offered services permanently. As is already the case under the current regime, the outsourced function must be integrated into the outsourcing company's internal control system. Material risks in connection with the outsourcing have to be systemically identified, monitored, quantified and managed. The outsourcing entity has to define an internal unit in charge of monitoring and evaluating the service provider on an ongoing basis in order to ensure that the necessary measures can be taken in a timely manner.
- **Intragroup outsourcings:** The new outsourcing regime also applies to outsourcings within a group of companies. However, intragroup affiliations may be considered when determining the requirements regarding the selection, instruction and monitoring of the service provider as well as the establishment of the contractual arrangements, in each case provided that in the intragroup context the risks typically associated with an outsourcing demonstrably do not exist, some of these requirements are not relevant or some of these requirements are otherwise regulated. For example, less strict requirements may apply in an intragroup situation to the selection of the service provider, particularly if the intragroup service provider has a proven track record of a high-quality service. Furthermore, it can be considered that it may be easier for the outsourcing entity to exercise its monitoring rights in an intragroup context, particularly if the service provider is a subsidiary. Furthermore, the risk analysis to be performed before the outsourcing may be different and the documentary requirements may be lower if the service provider is a group company. Finally, the concentration risk as well as the change risk should not be relevant in an intragroup context.
- **Responsibility:** The outsourcing entity is not released from its responsibility with regard to the outsourced function. Furthermore, the circular requires the outsourcer to ensure the proper conduct of its business at all times.
- **Security:** In the case of security-relevant outsourcing arrangements (especially in the IT area), the outsourcing company and the service provider have to contractually define the security requirements applying to the outsourcing. Furthermore, the parties must establish a contingency plan which ensures that the outsourced function may be continued in the case of an emergency. When establishing this contingency plan, the outsourcing entity has to apply the same level of care that it would apply if it were performing the outsourced services itself. In line with the new principle-based and technology-neutral approach, the circular leaves room for the determination of the security requirements and does not set specific standards in this regard. According to FINMA, the security requirements must be implemented on an institution-specific basis taking into account the outsourced function, the specific risks as well as the systems and technologies used in the relevant case.[4] The scope of the contingency plan has to be defined by the outsourcing entity in the course of its risk analysis. At a minimum, an in-scope entity must comply with the self-regulation standards issued by the Swiss Insurance Association or, in the case of banks, the Swiss Bankers Association.
- **Audit and supervision:** As is already the case under the current regime, the company, its auditors as well as FINMA must be in a position to review and assess the service provider's compliance with applicable supervisory regulations. For this reason, the contractual arrangement must include specific audit and inspection rights which can be freely exercised in full at any time. The audit activities may be delegated to the service provider's external auditors, provided that they possess the necessary professional expertise to perform this task. In response to criticism expressed by market participants with respect to the requirement that the audit and inspection rights can be exercised "freely", "in full" and "at any time", FINMA clarified that these terms have to be interpreted based on the principle of proportionality. According to FINMA, it is acceptable if the audit rights can be exercised with adequate advance notice only. Furthermore, it was clarified that the audit and supervision rights

only relate to facts which are relevant from a supervisory perspective. Also, FINMA clarified that the requirement to freely exercise the audit and supervision rights is also fulfilled if these rights can only be exercised while respecting the business secrets of third parties. Finally, FINMA indicated that, particularly with regard to outsourcings in the IT area (eg in connection with the use of cloud infrastructure), on-site presence will not be necessary in any case.

- **Outsourcings to foreign service providers:** Outsourcings to foreign service providers are generally permitted, provided that the outsourcing entity can explicitly guarantee that itself, its auditors and FINMA are able to exercise and enforce their audit and supervision rights. The current requirement to provide evidence of the possibility of exercising the relevant audit and supervision rights by way of a legal opinion or a confirmation from the competent foreign supervisory authority no longer exists. This is attributable to the fact that there were many cases where it was not possible to produce a legal opinion or where the opinion was heavily qualified. Confirmations from foreign supervisory authorities were not relevant at all in practice. Despite the fact that the former evidence requirements no longer apply, in-scope entities are still required to "adequately verify" whether the audit and supervision rights may be exercised in the case of an outsourcing to a foreign service provider. This requirement should be fulfilled if the possibility of exercising the audit rights is confirmed by an in-house counsel who is familiar with the legal system in question. The new circular requires that the restructuring and/or winding-up of the outsourcing entity in Switzerland must be ensured. The information necessary for this purpose must be accessible in Switzerland at all times. With regard to banks, this requirement is deemed to be fulfilled if it is possible to access the required data *from* Switzerland. For digital data, this will usually be the case.
- **Agreement:** The new circular requires that the outsourcing arrangement be governed by a written agreement, which must include a description of the outsourced function. Among other things, the agreement must also stipulate that the engagement of subcontractors exercising material functions requires the prior consent of the outsourcing company. Furthermore, such subcontractors have to comply with all obligations and warranties of the third-party service provider which are necessary to ensure compliance with the circular. Furthermore, a number of other contractual arrangements have to be made to comply with the requirements of the circular. These include the stipulation of contractual audit, supervision and inspection rights for the benefit of the outsourcing entity, its auditors and FINMA, as the case may be, the stipulation of security requirements in the case of security-relevant outsourcings as well as the stipulation of specific rules relating to the provision of information and data relating to the outsourced function. No exceptions from the documentation requirements exist for intragroup outsourcings. However, intragroup affiliations may be taken into account when establishing the contractual arrangements, provided that in the intragroup context the risks typically associated with an outsourcing demonstrably do not exist, some requirements are not relevant or some requirements are otherwise regulated. Depending on the intragroup situation, the contractual requirements may therefore be lower than the requirements which have to be met between unrelated parties. For example, it should be sufficient to implement internal guidelines and directives which govern the outsourcing arrangement.

Conditions and exemptions

As under the current regime, FINMA may completely or partially exempt certain institutions from the requirements under the circular or impose additional or other conditions on a company.

Entry into force and transitional rules

The new circular will enter into force on 1 April 2018 and directly applies to outsourcing arrangements of banks and securities dealers *entered into* or *amended* after this date. Existing outsourcing arrangements of such entities will be grandfathered during a transition period of five years ending on 1 April 2023. By then, all arrangements must be amended in a way that they comply with the requirements of the circular. Accordingly, banks and securities dealers must be aware that each amendment of existing outsourcing agreements has the effect that the requirements of the new circular become immediately applicable to such agreement. However, even if the circular does not explicitly state so, minor amendments of existing agreements as for example a change of prices or quantities or a change of contact details should not trigger the obligation to implement the requirements of the new circular. For insurance companies, a different regime applies. While new insurance companies will immediately be subject to the circular, the regime will only apply to existing insurance companies once they apply for a change of their business plan.

CONCLUSION

The new outsourcing circular follows a principle-based approach and leaves room for in-scope financial institutions to implement the outsourcing requirements in a way that considers their specific business model and risks. Under the new regime, the individual responsibility of in-scope financial institutions is strengthened – a change which will likely be welcomed by the industry. However, due to this conceptual change, it will be necessary for financial institutions to evaluate at an early stage which changes have to be made to existing outsourcing agreements and internal processes in order for them to comply with the new regulatory regime. ■

1 To date, the outsourcing of functions by insurance companies was subject to circular 2017/8 "Business Plans Insurance Companies" and further explanatory notes published by FINMA.

2 See Art 4, s 2(j) and Art 5, s 2 of the Federal Insurance Supervision Act.

3 Accessible under https://www.finma.ch/de/bewilligung/versicherungen/geschaeftsplan/

4 If client-identifying data is subject to the outsourcing arrangement, the outsourcing entity is bound by applicable data protection laws and is obliged to take adequate technical and organisational measures to protect the outsourced data and to make sure that the relevant security requirements are also implemented by the service provider. Furthermore, the outsourcing entity must monitor whether the service provider applies relevant security measures.