



To: Committee of European Banking Supervisors

Re: Consultation Paper CP02: high level principles on outsourcing

Dear Sir

The purpose of this letter is to provide you with feedback regarding the CEBS consultation paper on high level principles on outsourcing.

In general, BNP Paribas welcomes the CEBS's intention to converge supervisory approaches to outsourcing practices and finds many of the principles contained in this consultation paper quite sound. However, we recognise that the current paper is still a work in progress and we would like to make some suggestions.

Our general comment is that outsourcing is and should remain a bank's decision based on economic grounds after a careful risk analysis. We consider that barring a bank from outsourcing some of its activities should be a very rare occasion, which can only be justified when the soundness of the bank itself is placed in jeopardy by the decision. The bank must retain the responsibility for the final quality of the services it outsources. This is normally achieved by managing the contractual and commercial relationship with the outsourcing service provider. We recognise that the regulator has a legitimate right and regulatory duty to review such contracts and commercial relationships.

BNP Paribas, like other larger banks, provide important financial services to other companies (banks and non-banks) which a few years ago would have been considered "core" to those other companies. For example, BNP Paribas is an outsourcing service provider for securities services. Therefore, banks have different strategies and therefore different "core activities". So the proposal not to allow outsourcing of "strategic or core" activities turns out to be problematic. It might be helpful in this situation to introduce segmentation between outsourcing to authorised and unauthorised financial institutions or other entities. As long as the banking or other supervisors regulate the entity acting as the outsourcing service provider, processes that could fall into another bank's view of "strategic or core" activities could be outsourced.

Only outsourcing to non regulated entities should fall under the regulators' scrutiny and we rely on their judgment to assess the strategic nature of such outsourcing, which is a relative and changing notion.

We would like CEBS to be clearer about the practical application of the materiality test. The materiality test should be designed in such a way to be easy to understand and apply and should be directly related to activities "that can affect the ability to meet the regulatory responsibilities or to continue the business".

CEBS needs to develop their ideas about how supervisors break down their analysis of the outsourcing arrangements. For example, a distinction could be made between:

- criteria supporting the business decision to outsource
- specific risk factors linked to the outsourced processes themselves
- generic risks applying to all outsourced processes: responsibilities, business continuity arrangements, chaining, monitoring, auditability etc.

The approval process should not be mechanistic. The importance attached to the criteria and risks should be balanced by the supervisors in a flexible way to ensure that banks have transparency about any issues they may need to address during the approval process to obtain the requested authorisation.

We encourage CEBS to develop their ideas on “concentration” risk: where all banks outsource all processes of a particular type to one or two outsourcing service providers. Individual regulator’s validation and review of single outsourcing contracts will not cover this. Indeed, concentration risk already exists following successive groupings and mergers of outsourcing service providers. Perhaps CEBS should investigate the feasibility of a “global assessment” of deals to be made across regulatory jurisdictions. And this could result in some regulators disallowing deals with certain outsourcing service providers when the number of banks globally serviced reaches a certain level. Alternatively, a regulator could insist on extra risk management controls or investment in disaster recovery or “partnering” arrangements with other outsourcing service providers to cover their deals in the event of major disruption in their services.

BNP Paribas are also concerned that regulators review carefully the risk transfers from outsourcing service providers to their own sub-contractors which can sometimes increase the operational risk to a level bigger than if the processes had remained within the bank in the first place. Ensuring that the chaining of responsibility and accountability works in times of stress within a string of different suppliers, one contracted to the other, is a particular concern of ours and demands strong controls to be in place. We believe that the risks of “chaining” should be reviewed and validated by the bank before a second supplier is sub-contracted to do the work.

BNP Paribas also encourage CEBS to investigate criteria the banks could track regarding existing outsourcing deals. Such criteria could be used to alert banks and regulators alike that a deal is not performing as originally contracted and/or the service provider is not delivering the service to the standards or on time with the inevitable negative consequences on the bank and its customers. CEBS should explain how banks should alert supervisors when an outsourcing contract starts to deteriorate.

CEBS should also be clearer about whether supervisors will apply these principles “retro-actively” to historical deals. We propose that any authorisation process explicitly referring to these principles should only apply to new outsourcing deals and previous contracts are only subject to the “ongoing monitoring” principles. Therefore, no “back-valued” authorisations using these principles by supervisors should take place.

BNP Paribas supports the position that an institution retains the prerogative and power to decide whether to outsource or not, on the basis of risk analysis prior to outsourcing. In addition, ongoing monitoring by the bank post outsourcing is required to ensure associated risks are managed effectively. BNP Paribas recommend that no further risk analysis guidance is required other than that contained in the international regulatory regime from the Basel Committee on Banking Supervision. Therefore, we would appreciate some form of reference to such documents as sources of guidance for banks to perform their risk analysis and for supervisors to evaluate the adequacy of the risk analysis. Documents BNP Paribas use as sources of guidance on risk analysis include “Sound Practices for the Management and Supervision of Operational Risk”, February 2003, “Framework for Internal Control Systems in Banking Organisations”, October 1998 and “Framework for the Evaluation of Internal Control Systems”, January 1998, published by the Basel Committee.

BNP Paribas recommend more work is performed in relation to the risk transfer mechanisms and clarification, through examples, of when operational risk is and is not, outsourced/outsourceable. CEBS should also clarify if outsourced processes are subject to the operational risk regulatory capital adequacy framework being introduced by the Basel Committee. This includes consideration of whether the operational risk management processes (i.e. monitoring of incidents), organisation, tools and methodologies have to be implemented within the outsourcing service provider for the processes outsourced.

BNP Paribas recommend that CEBS clarifies under what circumstances a supervisor would refuse to authorise an outsourcing contract. Examples could be given such as the outsourcing of a very large set of processes to a very small unauthorised or inexperienced company because they offered the lowest price. Decisions motivated purely by cost without proper and satisfactory due diligence of the delivery capability of the outsourcing service provider should be discouraged.

We hope that these comments add some value to the start of a fruitful dialogue between the banking industry and CEBS.

If you have any questions in relation to the letter or any other related matter please get in touch.

Yours sincerely

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