OUTSOURCING UNDER BREXIT:
TARGETING MINIMUM REQUIREMENTS OR STRATEGIC LONG-TERM SOLUTIONS?

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What's the most effective, cost efficient way to operate after Brexit?

This is a serious concern for UK financial institutions that have significant business in the European Economic Area (EEA), but who will lose their EU passporting rights due to Brexit.

Transferring EEA business to new locations in Europe would require these banks to make major changes to their target operating models. However, in order to reduce operational costs and leverage existing infrastructure in the UK, Brexit impacted banks would prefer to outsource as many processes as possible back to the UK.

However, this approach is subject to challenge by the European Central Bank (ECB). The ECB has clearly stated they will not allow the creation of "Empty Shells" – entities that have no onshore business activities and that lack enough staffing, operational independence and adequate governance structures (such as risk management divisions).

Hence, the key question for most UK banks is: how do we find the right balance between fulfilling minimum outsourcing requirements, and establishing healthy, strategic long-term solutions to serve clients out of new European locations?

There are already numerous regulations that determine outsourcing requirements. Both the MiFIR and MiFID outsourcing regulations currently apply to both the UK and Germany, resulting in substantial overlap across these jurisdictions. In addition, MaRisk legislation in Germany, and SYSC 8 legislation in the UK, also provide guidance on outsourcing.

The European Banking Authority (EBA) has also issued Draft Guidelines on Outsourcing, which are still in the consultation phase. Although called "Guidelines", they are effectively requirements which can be used by banks to help them create and implement their outsourcing strategy.

When interpreting these regulatory requirements, the first step is to differentiate between critical and non-critical outsourcing. This is done by assessing the risk a firm is exposed to when outsourcing certain activities. Critical activities and processes, from control functions and core banking areas, can only be outsourced if the firms' operations quality is not materially impaired due to outsourcing.

In addition, the outsourcing of functions such as risk management, compliance, or internal audit is only permitted from parent institutions to subsidiaries under very strict requirements. In depth analysis is required when assessing the scope of activities that should be outsourced or located onshore. Problems may arise if the reconciliation of outsourced activities do not comprehensively cover the implications on process flows, organizational structure, and infrastructural intersections. Breaks in front-to-back processes across different jurisdictions can cause issues with meeting local regulatory compliance requirements.

Under Brexit, banks must also consider special outsourcing requirements for EEA countries, given that they are going to outsource processes from EU entities to the UK, which will be considered a third country post-Brexit. Activities that require authorization/registration with the regulator can only be outsourced if the service provider is authorized to perform such activities in the third country, and there exist memoranda of understanding between the regulators from both countries.

Also, one of the core requirements in the EBA Outsourcing Guideline is the proper supervision of the outsourced functions. Firms should be able to monitor the performance by service providers and any sub-contractors, and manage the corresponding risks associated with the outsourced processes.

Finally, another critical topic is the Retention of Responsibilities. In general, that means that management tasks and decisions cannot be outsourced and management responsibility for taken decisions should remain onshore.

Given these regulations and guidelines, it's clear that creating an appropriate, efficient and cost-effective outsourcing strategy, is not an easy task.

Internal politics and differing priorities within the affected functional groups within a bank will also make it difficult for banks to make decisions about their outsourcing model. UK banks will need to adopt a neutral point of view, as do extensive stakeholder management.

Although challenging at first, revising outsourcing models can be a big win for UK banks. It will allow them to identify processes outsourcing opportunities to make the organization more efficient, reduce costs in the long-term, and enable a lean and future-fit operating model.

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