

December 8, 2017

## NKF Banking, Finance & Regulatory Team – Update 7/2017: Publication of the revised FINMA-Circular 2018/3 "Outsourcing – banks and insurance companies"

The Swiss Financial Market Supervisory Authority revised the Circular 2008/7 "Outsourcing banks" ("**Cir 2008/7**") and published the final draft on 5 December 2017. The revised Circular FINMA-Cir 2018/3 "Outsourcing – banks and insurance companies" ("**Circular**") applies to banks, securities traders and now also applies to insurance companies. Various suggestions from the consultation procedure were included into the final version. The revised version of the Circular will enter into force on 1 April 2018.

### I. KEY ISSUES

The most important changes in comparison to the Circular 2008/7 are:

- **insurance companies** are also included in its **scope**;
- the revised Circular aims in particular to **limit the risks** relating to delegation of functions;
- the term "**significant**" is defined as an **institution specific term** and will be determined by the individual institutions;
- the institutions will be required to maintain an **inventory** on the outsourced functions, which must be kept up to date;
- the institutions will be required to create a **risk analysis** on the outsourced functions prior to entering into an outsourcing agreement;
- the institutions are required to ensure that itself, its audit company and FINMA are **contractually granted** a constant, complete and unobstructed right to inspection and audit by the service provider;
- **outsourcing to service providers abroad** is only permissible, if the service provider can explicitly ensure that the institution, the audit company of the institution and FINMA will be able to **exercise and assert their rights to inspection and audit**. In this context, **the ability to rehabilitation and restructure a company in Switzerland** must be ensured and the required documents relating thereto must be accessible in Switzerland at all times;
- **The Circular no longer contains any data protection provisions.**

### II. SUBSTANTIAL CHANGES OF THE REVISION

#### 1. Purpose

The purpose article of the revised Circular was amended to read that compliance with the requirements on adequate organisation and now the **limitation of the risks relating to delegation of functions** will be central (note 1 Circular). By deleting the reference to the requirements on data protection and banking secrecy, a clear distinction between the requirements of supervisory law and other requirements according to criminal, private and data protection law shall be ensured.

In consequence, e.g. the form of the client consent to an outsourcing is no longer regulated in the Circular.

## 2. Terms

A function is only considered to be "outsourced" within the meaning of the Circular if it is a "significant" function. "Significant" means all functions on which compliance with the objectives and rules of financial market supervision legislation depend to a substantial extent (note 4 Circular). With this new terminology of "significant", the principle-based approach and aspect of individual responsibility of the institutions shall be better accounted for: the specification of the term "significant" must be determined on an institutional basis and defined by the institution itself. For this reason, the appendix of the Circular with practice examples to demonstrate which functions are considered to be significant within the meaning of the Circular, was deleted: the institution has now to determine itself, which functions shall be considered significant.

When customer data ("Customer Identifying Data", "CIDs") is outsourced, such an outsourcing is only regarded as significant if the service provider is granted access to mass CIDs (and not just individual CIDs) (page 15 Hearing Report of 21 September 2017).

## 3. Permissibility

Subject to the provisions of the Circular, the outsourcing of all essential functions is per se permissible.

The outsourcing of **operational** risk management and compliance functions of banks and securities traders is possible in all supervisory categories. For companies in supervisory categories 1 to 3, the **non-operational functions** of risk control and compliance cannot be outsourced. For companies in supervisory categories 4 and 5, it is sufficient for a member of the executive management to be appointed for non-operational functions (note 9 Circular), who must ensure that the relevant risks are adequately assessed from the company's perspective.

## 4. Financial groups / conglomerates

In principle, the Circular also applies to outsourcing within a financial group or financial conglomerate. However, the fact that a **function is outsourced within the group can be taken into account** with regard to the **duties** of selection, instruction and control of the service provider and in the content of the contract. For example, the selection procedure of an internal service provider could be less extensive than that of an external service provider (page 28 Consultation Report of 21 September 2017). However, such consideration is **only possible if risks typically associated with outsourcing do not exist** as far as it can be ascertained or certain requirements are not relevant or otherwise regulated.

## 5. Inventory of the outsourced functions

The institution has to maintain an inventory of the outsourced functions, which must be kept up to date. The **inventory** contains at least the **description of the outsourced functions**, **identifies the service provider** and the **recipient** of the function and **names the in-house designated body** for the supervision and control of the outsourced function (note 14 Circular). Whether a sub-concordant is to be included in the inventory depends on whether its contribution is to be qualified as significant within the meaning of the Circular (page 24 Consultation Report of 21 September 2017).

## 6. Selection, instruction and control of the service provider

Institutions are obliged to define and document the objectives and requirements of the service providers pursued by the outsourcing **prior to entering into an outsourcing agreement**. This also includes the creation of a **risk analysis**, which includes the essential economic and operational considerations and the associated risks and opportunities (note 16 Circular).

The duties of the institutions and the service provider **must be defined and differentiated** in the contract, in particular with regard to interfaces and responsibilities. In addition, the material risks

associated with outsourcing must be **systematically identified, monitored, qualified and managed** (note 19 et seq. Circular).

When outsourcing **several functions to the same service provider**, particular attention must be paid to the **concentration risk** (note 17 Circular). This is not intended to imply any limitation on the choice of the service provider per se; however, any risks must be taken into account in the evaluation (page 28 Consultation Report of 21 September 2017).

## 7. Security

As in the previous Circular, institutions are required to enter into contractual security agreements with the service provider for security-relevant outsourcing (in particular in the area of IT) (note 24 et seq. Circular) and to issue a **security disposition**, which now must cover the **continuation of the outsourced functions in case of emergencies**. The **concrete implementation of the security requirements for security-relevant outsourcing is to be carried out institution-specific** and in dependence on the outsourced functions, the specific risks and the systems used (page 30 Consultation Report of 21 September 2017).

## 8. Audit and supervision

Previously, the institution, its internal auditing department and external auditors, as well as FINMA, had to have full and unrestricted access and audit power over the outsourced divisions at all times (note 40 et seq. Cir 2008/7). Now, the institutions and their audit firms, as well as FINMA, must be in a position to ensure compliance with the supervisory provisions of the service provider, and for this purpose, a contractually **agreed full and unhindered right to inspection and to audit in relation to the outsourced function, which is guaranteed at all times, must be granted by the service provider**.

Those **terms, however, shall be interpreted in a proportionate manner** (pages 34-42 of the Consultation Report of 21 September 2017). The term "**at all times**" is met if test procedures were possible with an **adequate lead time**. The term "**full**" relates merely to **only supervisory matters**. "**Unhindered**" shall be understood as free access to the documents in connection with the outsourced function by the institution, **while preserving the trade secrets of third parties**. Similarly, local presence - especially in the IT area - is not absolutely necessary. The **rights of inspection can also be exercised remotely**.

As before, it is possible to delegate the audit activities to the auditors of the service provider, provided that they have the necessary professional skills. In such a case, the audit company of the institution is now allowed to **rely on the results of the audit company of the service provider** (note 27 Circular).

## 9. Delegation to service providers abroad

Outsourcing to foreign countries has previously required explicit proof of audit possibilities. According to the revised Circular, outsourcing to **service providers abroad is only permitted if the institution can expressly warrant** for the fact that it, its auditing company and FINMA can **exercise and enforce their rights of inspection and audit**. In addition, the **ability to rehabilitation and restructure of a company in Switzerland must be ensured** and the **required documents** relating thereto must be **accessible in Switzerland at all times**.

## 10. Transitional provisions

The Circular **applies** to outsourcing relationships of banks and securities dealers **that are completed or altered after 1 April 2018**. For outsourcing relationships of banks and securities dealers which already exist on the entry into force of the Circular, a **transitional period of five year** applies.

## 11. Specific provision for insurance companies

### a. Permissibility of delegation

In principle, it is **possible for insurance companies to outsource every function**, both within the group and externally, provided that the business plan requirements according to art. 4 letter j in conjunction with art. 5 section 2 of the Insurance Supervision Act "VAG" and the other statutory provisions are met and the interests of the insured persons are safeguarded (Art. 6 para. 1 VAG).

Outsourcing of **direct and reinsurance captives** is permissible **to a larger extent** than for other insurance companies. In particular, the following outsourcing activities are permissible:

1. Outsourcing the management of direct and reinsurance captives based in Switzerland (including central management functions of the management) to suitably specialised captive management companies;
2. Outsourcing the management of branch companies of foreign direct insurance captives within the group or to specialised captive management companies. The supervisory function of the Chief Representative must however not be restricted by the outsourcing of such functions.

This regulation for insurance captives corresponds to the **previous practice of FINMA**.

### b. Inventory of delegation

For insurance companies, the **business plan form J** should be adjusted in accordance with the inventory requirement. The business plan form J itself is not the subject of a reporting or licensing obligation (page 24 Consultation Report of 21 September 2017). On the contrary, the elements expressly designated in the business plan form J (highlighted in dark color) are subject to approval.

### c. Transitional provisions

There is **no actual transitional period** for insurance companies, as they were not subject to the Circular so far and, according to FINMA, the Circular largely corresponds to the already **established practice for insurance companies**. For insurance companies with initial authorisations, the Circular is valid from 1 April 2018; for change authorisations, the Circular is valid from the date on which a business plan amendment is submitted to FINMA for approval.

## Contacts: NKF Banking, Finance & Regulatory Team Partners



**François M. Bianchi, Partner**

Dr. iur., Attorney-at-law, LL.M.  
Telephone: +41 58 800 8352 (direct dial)  
E-mail: francois.m.bianchi@nkf.ch



**Thomas Frick, Partner**

Dr. iur., Attorney-at-law, LL.M.  
Telephone: +41 58 800 8349 (direct dial)  
E-mail: thomas.a.frick@nkf.ch



**Sandro Abegglen, Partner**

PD Dr. iur., Attorney-at-law, LL.M.  
Telephone: +41 58 800 8310 (direct dial)  
E-mail: sandro.abegglen@nkf.ch



**Adrian W. Kammerer, Partner**

Dr. iur., Attorney-at-law, LL.M.  
Telephone: +41 58 800 8328 (direct dial)  
E-mail: adrian.w.kammerer@nkf.ch



**Marco Häusermann, Partner**

lic. iur., Attorney-at-law, LL.M., C.B.A.  
Telephone: +41 58 800 8453 (direct dial)  
E-mail: marco.haeusermann@nkf.ch



**Bertrand G. Schott, Partner**

Dr. iur., Attorney-at-law, LL.M.  
Telephone: +41 58 800 8345 (direct dial)  
E-mail: bertrand.schott@nkf.ch

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.