

Association of Global Custodians
European Focus Committee

Financial Stability Board
Basel, Switzerland

RE: Financial Stability Board's Discussion Paper on Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships

The Association of Global Custodians European Focus Committee (the "AGC-EFC") appreciates the opportunity to provide comments on the Financial Stability Board ("FSB") Discussion Paper (the "Discussion Paper") on Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships published on 9 November 2020.¹ The Discussion Paper provides an overview of the regulatory and supervisory landscape on outsourcing and third-party risk management in FSB Standing Committee on Supervisory and Regulatory Cooperation ("SRC") member jurisdictions, and seeks comments on four specific questions to facilitate discussions among regulatory and supervisory authorities, financial institutions and third parties.

Executive Summary:

The AGC-EFC welcomes the Discussion Paper as policy makers and regulators globally are increasingly focusing on their respective regulatory frameworks on outsourcing, third party risk management and operational resilience; and the AGC-EFC members are supportive of globally consistent measures which can ultimately improve resilience across supply chains and the industry.

The AGC-EFC has focused this response on what it sees as the primary challenges for Global Custodians in identifying managing and mitigating the risks relating to outsourcing and third-party relationships, as well as the possible ways to address these challenges and mitigate risk. We have not commented on all the issues and challenges posed to Global Custodians as a result of the outsourcing and third-party risk management frameworks as a number of the issues and challenges are relevant to more than just Global Custodians, and we feel other industry associations are better placed to represent the views of the financial sector as a whole.

Key focus areas covered in this response include:

- Challenges which arise from global inconsistencies in definitions and key terms relating to outsourcing and third-party relationships, which may inadvertently layer additional "outsourcing" requirements on custodians on top of well-established regulations which already address custody related risks
- Challenges related to a one-size fits all approach to managing outsourcing and third-party relationships, and the need for a proportionate and outcomes-based approach to address risk
- Sector wide challenges of identifying systemic concentration risk, and custodian's inability to assess concentration risk beyond our own individual risk exposures to third-party service providers
- Challenges created by regional or country specific data localization rules which impose costs for custodians and our clients, jeopardize our outsourcing and third-party arrangements, and sometimes create increased operational risks for market participants; and,

¹The attached [appendix](#) provides further background on securities custodians and the AGC and its members.

- Challenges associated with custodians limited ability to manage 4th, 5th and nth parties along the supply chain, and the need for a proportionate risk-based approach to oversight of supply chains

As discussed below, a number of the proposed mitigants to the primary challenges for Global Custodians relate to improved collaboration and discussion across Global Custodians, our clients, third parties (including Financial Market Infrastructures), and regulatory authorities and policymakers.

We have focussed our response on Questions 1, 2 and 3 in the Discussion Paper and left other industry associations to provide more specific comments in relation to lessons learned from the COVID-19 pandemic. AGC-EFC members however demonstrated during the COVID-19 pandemic that their operating models, which to different degrees rely on outsourcing and third-party arrangements, are operationally resilient. This does not detract from the importance of this Discussion Paper and regulator's focus on the topic, but demonstrates the industry's focus on operational resilience, outsourcing and third-party risk management and the progress that has already been made in this area.

Some member firms may also respond directly to the Discussion Paper or contribute to the responses of other industry associations.

Questions AGC-EFC focussed on:

Q1. What do you consider the key challenges in identifying, managing and mitigating the risks relating to outsourcing and third-party relationships, including risks in sub-contractors and the broader supply chain?

Q2. What are possible ways to address these challenges and mitigate related risks? Are there any concerns with potential approaches that might increase risks, complexity or costs?

Q3. What are possible ways in which financial institutions, third-party service providers and supervisory authorities could collaborate to address these challenges on a cross-border basis?

Global inconsistency of definitions and key terms relating to outsourcing and third-party relationships

A key challenge for Global Custodians in identifying, managing and mitigating the risks relating to outsourcing and third-party relationships is understanding and interpreting policymakers' and regulators' inconsistent use and references to "outsourcing", "third-party relationships" and related terms globally. Although these terms are defined broadly, they are often used and interpreted differently across jurisdictions, creating increased complexity for Global Custodians and the wider industry.

The traditional definition of "outsourcing" is linked conceptually to the idea that a firm engages a third party to do something that the firm could have done itself. Firms may choose to outsource, for example, so that a firm can focus on its core competencies, and to benefit from efficiency savings generated by economies of scale and specific expertise that an outsourced service provider can deliver. Meanwhile, the definition of a "third-party", as defined in the G-7 Third Party Elements, the European Banking Authority (EBA) ICT Guidelines and the UK Prudential Regulation Authority (PRA)

(CP30/19), is ‘an organisation that has entered into a business relationship or contract with a firm to provide a product or service’.

We note that some policymakers and regulators are considering moving away from the traditional definition of “outsourcing” towards a more holistic concept of “third-party relationships”, and potentially merging definitions in parts. For example, the PRA in its recent consultation on outsourcing and third-party risk management (CP30/19), and accompanying draft Supervisory Statement, noted that it “expects firms to start from the assumption that all activities, functions and services performed or provided by third parties in a ‘prudential context’, as defined in the PRA Rulebook, should come under the definition of outsourcing”.

Although the AGC understands the general view that custodians and the wider industry should take a holistic approach to risk management of third party and outsourced arrangements, policymakers and regulators will need to carefully consider the potential unintended consequences of changes in their definitions and approach to outsourcing and third party relationships. For example, “Custody” – the appointment of a custodian - is not considered as outsourcing but instead typically involves the engagement by a firm of a third party (a custodian) to hold or safekeep investment assets which ultimately belong to the firm’s clients (assuming the firm – such as an asset manager or a broker - acts as agent for underlying clients). The custodian holds the assets for and on behalf of the firm’s clients. This is an important part of the post-trade landscape, driven by existing regulations, and is designed for the protection of clients.

Many other activities which apply to custodians or their services are not considered an ‘outsourcing’, either, as paragraph 28 of the EBA’s Outsourcing Guidelines indicates by establishing categories of exceptions which include, amongst other things, global network infrastructures; clearing and settlement arrangements between clearing houses, central counterparties and settlement institutions and their members; correspondent banking services; and the acquisition of services that would otherwise not be undertaken by the institution or payment institution²

As for a global custodian itself, it is not possible for a single custodian to be in every market itself – therefore it needs to be able to appoint sub-custodians. The appointment of sub-custodians also is not considered an outsourcing. Custody is a specialised business which requires presences in various local markets with the functional capabilities to connect to local market infrastructure. Although global custodians can choose to develop their own sub-custody offering, this is a choice and not an inherent ability in a global custodian. No global custodian is in a position to offer its own sub-custody network in all markets. Moreover, investing in securities on a cross-border basis necessarily involves recognising the applicability of foreign bodies of law to property rights in those securities (i.e., in the local market), meaning that only a sub-custodian in that market may be considered to “hold” such securities under its national law (usually law governing rights in “intangible” property). Global custodians without a presence in such markets therefore would not be able to provide access to relevant securities unless they can themselves become direct cross-border participants in local market infrastructure where the securities are immobilised and dematerialised (i.e., the “central securities depository”, or “CSD”).³

² EBA Guidelines on outsourcing arrangements – Final Report - (Feb 2019)

<https://eba.europa.eu/sites/default/documents/files/documents/10180/2551996/38c80601-f5d7-4855-8ba3-702423665479/EBA%20revised%20Guidelines%20on%20outsourcing%20arrangements.pdf>

³ Whilst this can happen in some cases (such as in the case of large international CSDs such as Euroclear and Clearstream), it is the exception rather than the rule.

We also emphasise that a sub-custodian is utilised in order to provide to the custodian (on behalf of its clients) access to rights in securities, which typically are immobilised and dematerialised at the relevant local central securities depository. The relevant rights and responsibilities that give effect to the realisation of investor rights in securities are mainly a function of relevant national laws governing property rights and shareholders' rights. Characterising a sub-custodian as somehow carrying out functions that the firm appointing it could conduct itself is a conceptual error that can have significant negative consequences for the post-trade industry and ultimately for investors⁴, which the AGC has long sought to prevent.⁵

We fear that if policymakers and regulators globally start to bring "custody" within their respective definitions of "outsourcing" this would inadvertently layer additional "outsourcing" requirements on custodians, on top of well-established regulations which already fully address relevant attributes of custody and associated risks; examples of such other regulations include the UK Client Asset Sourcebook (CASS) and MiFID II, UCITS, AIFMD and CSDR in the EU. This potential layering of "outsourcing" requirements will only serve to further confuse the situation for custodians and our clients. The AGC-EFC therefore proposes that regulators should ensure Custody is not included into the strict regulatory definition of "outsourcing".

Proportionality and a risk-based and outcome-focused approach to regulating outsourcing and third-party relationship arrangements

More generally, the AGC-EFC members acknowledge the benefit of regulated firms taking a more holistic approach to third-party and outsourced relationships. However, under such an approach, we believe it is important to take proportionate and outcomes-based approach to address risk stemming from these relationships, rather than a one-size fits all approach. We encourage regulators to adopt proportionate, risk-based and outcome-focused regulatory approaches to third party relationships as applying stringent requirements across all types of third-party relationships will significantly impact current and future oversight and due diligence capacities and increase costs and efforts of vendor contract negotiations. We would encourage regulators to outline the regulatory outcomes they are seeking to achieve and allow Global Custodians, and other financial institutions, to determine a principles-based approach to deliver on these outcomes.

For example, in respect of intra-group outsourcing, regulators should take into account the principle of proportionality, allowing for custodians to rely on existing group-wide policies and procedures to address outsourcing and due diligence requirements. Furthermore, we emphasise the risk and resiliency benefits that can be obtained through leveraging intra-group arrangements. Therefore, regulators should facilitate its use, rather than require the replication of systems data and processes in legal entities. The focus should be ensuring that the legal entity in region is able to show that it is complying with the regulations and standards of the region in which it operates regardless of where geographically the technology or risk management is coming from.

⁴ This conceptual framework has caused confusion in some critically important respects, including with respect to collateral management provided by third parties, the roles of CSDs, etc. This confusion has unnecessarily exacerbated operational risks and legal risks, as well as systemic risk.

⁵ See, e.g., AGC-EFC submission in response to the Segregation Consultation conducted by the European Securities and Markets Authority (ESMA), dated 15th July 2016. (found at <https://www.esma.europa.eu/file/19817/download?token=o7eGadGy>).

Likewise, relationships between regulated participants (e.g. banks or institutional investors) and regulated third parties (e.g. Global Custodians and Financial Market Infrastructures (“FMIs”), and unregulated third parties, should be subject to different regulatory treatment (e.g. the degree of oversight required) proportionate to the risks involved.

The AGC-EFC members see this is a key area for further industry dialogue and discussion as new regulatory approaches and frameworks emerge across outsourcing, third-party risk management and operational resilience. We are particularly supportive of industry dialogue amongst Global Custodians, FMIs, our institutional investor client base and regulators.

Additional areas for consideration

Further challenges for Global Custodians in identifying, managing and mitigating the risks relating to outsourcing and third-party relationships, amongst others, include:

- The identification of systemic concentration risk at a sector-wide level: custodians are only able to assess *individual* risk exposures to each third-party service provider and are not best positioned to assess sector-wide custody related concentration risks at third parties. We believe that the right path forward is not to seek the elimination, drastic reduction, or even equitable distribution of these risks; instead, the path forward should be focused on gaining visibility into concentration risk, building the right security and resiliency framework to manage these risks, and for the public and private sector to work together to create an environment which does not stifle the ability to utilise third parties. In specific reference to a custodian’s exposures to regulated CSDs, custodians are unable to consider substitute providers of settlement services in most cases. The AGC-EFC members believe that concentration risks at CSDs should be managed and mitigated through appropriate resiliency frameworks applied by CSDs and required by their regulators and supervisors.

- Regional or country specific data localization rules - i.e. rules which require data to be stored locally – which impose costs for custodians as well as their clients and jeopardize outsourcing and third-party arrangements, including intra-group arrangements. Further, such rules can result in global custodians and other financial institutions replicating the provision of systems, data and processes within a local entity, as opposed to relying on group wide systems, data and processes which are typically safer and more secure. As an example, through operating cyber defence capabilities on a global, firm-wide basis, global custodians and other financial institutions can have cybersecurity centres in several global locations, which enables them to follow a model that provides 24/7 firmwide coverage. This provides better cybersecurity capabilities and protection for clients, and for their local operations. If custodians are only able to make use of cyber operations within local entities, this would increase cybersecurity risks at the local entity level. The AGC-EFC members are therefore of the view that regulators should seek to fully harmonize data associated rules, e.g. data privacy and cross-border data flow rules across major geographies in order to avoid Custodians and other financial institutions being subject to costly, conflicting, divergent or duplicative data localization requirements. We note in this regard that the recent EU-UK Trade and Cooperation Agreement has a provision (Article DIGIT.6 Cross-border data flows) that prevents data localisation.

- The ability of global custodians (and their institutional investor clients where relevant) to manage 4th, 5th and nth parties along the supply chain. Although global custodians generally seek to hold their suppliers accountable in relation to supplier's subcontractors, they often have limited ability to contractually bind a subcontractor engaged by a third-party supplier. The AGC-EFC members are of the view that any regulatory expectations for global custodians should be realistic and proportionate to the risks involved. For instance, the focus should be on critical outsourced (i.e. where the portion subcontracted is critical) providers, and to obtain assurance that such providers have robust third-party risk and supply chain frameworks. We also believe further industry dialogue and discussion in this space is required as new regulatory approaches and frameworks emerge across outsourcing, third-party risk management and operational resilience. We are particularly supportive of industry dialogue amongst Global Custodians, FMIs, the institutional investor client base and regulators.
- Audits organised by groups of financial institutions sharing one or more service providers and performed by representatives of the participating firms or specialists appointed on their behalf ("pooled audits"). The AGC-EFC would welcome such "pooled audits" of suppliers, especially of suppliers being considered for concentration risks. There are clear benefits to both suppliers and the individual FIs to investigate this area further. As an example, it should be investigated if there is a risk of violation to market competition on the occurrence of collaboration between financial institutions in this area.

Conclusion

The AGC-EFC members appreciate the opportunity to respond to the Discussion Paper and stand ready to provide further assistance and information as the FSB requests.

Signed:

John Siena

Chair

**Association of Global Custodians
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Appendix: Background on Securities Custodians and the AGC

Established in 1996, the AGC is a group of 12 global financial institutions⁶ that each provides securities custody and asset-servicing functions primarily to institutional cross-border investors worldwide. As a non-partisan advocacy organization, the Association represents members' common interests on regulatory matters and market structure. The member banks are competitors, and the Association does not involve itself in member commercial activities or take positions concerning how members should conduct their custody and related businesses.

Securities custodians play a critical role in the global financial system by providing to investors (1) access to entitlements in securities issued by companies as well as (2) services necessary to give effect to investors' rights in these securities, including facilitating settlement of their sale and purchase and the exercise of voting rights, rights offerings, payment of dividends and income, processing of reclaims for withheld taxes. Securities custodians also facilitate availability of collateral arrangements which have become increasingly critical for capital markets since the financial crisis.

Customers range from retail and private client investors to large highly regulated investment funds, institutional investors (such as pensions) and supranational entities (such as sovereign funds) throughout the world. A very large portion of the services that securities custodians provide are performed for investors on a cross-border basis, requiring a chain of trusted custodians providing the necessary linkages to enable investors in one jurisdiction to purchase, own and exercise rights with respect to securities in another jurisdiction. Facilitation of safe and efficient cross-border holdings and associated rights are key elements in the development of markets to support companies' efforts to raise capital.

The AGC has long engaged with governments, policymakers and regulatory authorities throughout the world to support their work and ensure the safe and efficient provision of securities custody services for the benefit of investors and the financial system as a whole.⁷

⁶ The members of the Association of Global Custodians are: BNP Paribas; BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company.

⁷ The AGC-EFC's work recently in this arena include:

1. Presenting to the International Organization of Securities Commission ("IOSCO") in plenary and submitting a contribution in response to its *Principles regarding the Custody of Collective Investment Schemes' Asset Consultation Report* (CR07/2014);
2. Addressing the so-called Giovanni Barriers together with new identified barriers under the auspices of the European Post-Trade Forum ("EPTF");
3. Responding to the European Commission's 2017 Consultation on post-trade in a Capital Markets Union⁷ (the "2017 EC Consultation");
4. The UK FCA's continuing development of the Clients Assets Sourcebook (CASS); and
5. UK Prudential Regulation Authority (PRA) Consultation CP30/19 on outsourcing and third-party risk management
6. Extensive engagement with the European Commission, ESMA and EU national competent authorities on custodial account structures (*i.e.*, omnibus versus segregated and related issues) through the intermediated holding chain of custody for investment funds under the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD).