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THE NEW DANISH REQUIREMENTS FOR OUTSOURCING IN THE FINANCIAL SECTOR

- HOW TO BECOME COMPLIANT

The new executive order on outsourcing for credit institutions etc. – expected to become effective on 1 July 2020 – introduces stricter requirements to companies' governance and to new and existing outsourcing agreements.

Outsourcing Guide

This guide provides an overview of the requirements that companies subject to the Outsourcing Order will need to implement in relation to their governance setup and outsourcing agreements.

Background

On 17 February 2020, the Danish Financial Supervisory Authority (**Danish FSA**) published executive order on outsourcing for credit institutions etc. (**Outsourcing Order**) for consultation.

The Outsourcing Order is expected to become effective on 1 July 2020 and replace the current executive order on outsourcing of significant areas of activity no. 1304 of 25 November 2010. The Outsourcing Order implements the European Banking Authority's (**EBA**) Outsourcing Guidelines that became effective in September 2019.

The Outsourcing Order introduces revised and new requirements to credit institutions; mortgage-credit institutions; investments firms; investment management companies; savings undertakings; shared data centres; operators of regulated markets; e-money institutions; payment institutions and Danmarks Skibskredit A/S.

The Outsourcing Order is not finally adopted, however, as it is based on the EBA's Outsourcing Guidelines, we do not expect any material changes to be introduced to the main requirements as a result of the consultation.

As the new requirements will become effective on 1 July 2020 companies should – regardless that the Outsourcing Order has not become effective yet - initiate the implementation of the new requirements to ensure compliance by 1 July 2020.

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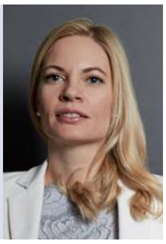

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What should companies be aware of?

The Outsourcing Order introduces stricter requirements to companies' governance setup and to new and existing outsourcing agreements.

Companies subject to the Outsourcing Order need to implement a revised and extended governance setup by 1 July 2020 and identify and renegotiate existing outsourcing agreements not fulfilling the new requirements by 31 December 2021.

The Outsourcing Order will – as described in more detail in the following – require companies to:

- Implement procedures for ***identifying outsourcing*** and ***critical/important outsourcing***
- Revise risk ***assessment models*** and ***due diligence checks***
- Revise ***outsourcing policies***
- Appoint ***outsourcing officers***
- Establish ***outsourcing registers***
- Revise procedures for entering into ***new outsourcing agreements***
- Identify, analyse and renegotiate ***existing outsourcing agreements***

What constitutes an outsourcing?

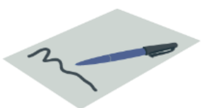
The Outsourcing Order applies to *all* outsourcings and not only to outsourcing of *significant areas of activities* which is the case for the current executive order on outsourcing.

Under the current executive order on outsourcing, the main focus for companies has been to identify significant or material outsourcing. With the Outsourcing Order, companies will need to take a step back and start by identifying if an activity constitutes an outsourcing and then identify whether such outsourcing constitutes a critical or important outsourcing (currently material outsourcing).

Companies will need to implement procedures – included in their outsourcing policies – for identifying whether an activity constitutes an outsourcing.

The outsourcing definition in the Outsourcing Order is broad and includes:

"any form between a company and a service provider by which that service provider performs a process, a service or an activity that would otherwise be undertaken by the outsourcing company itself"



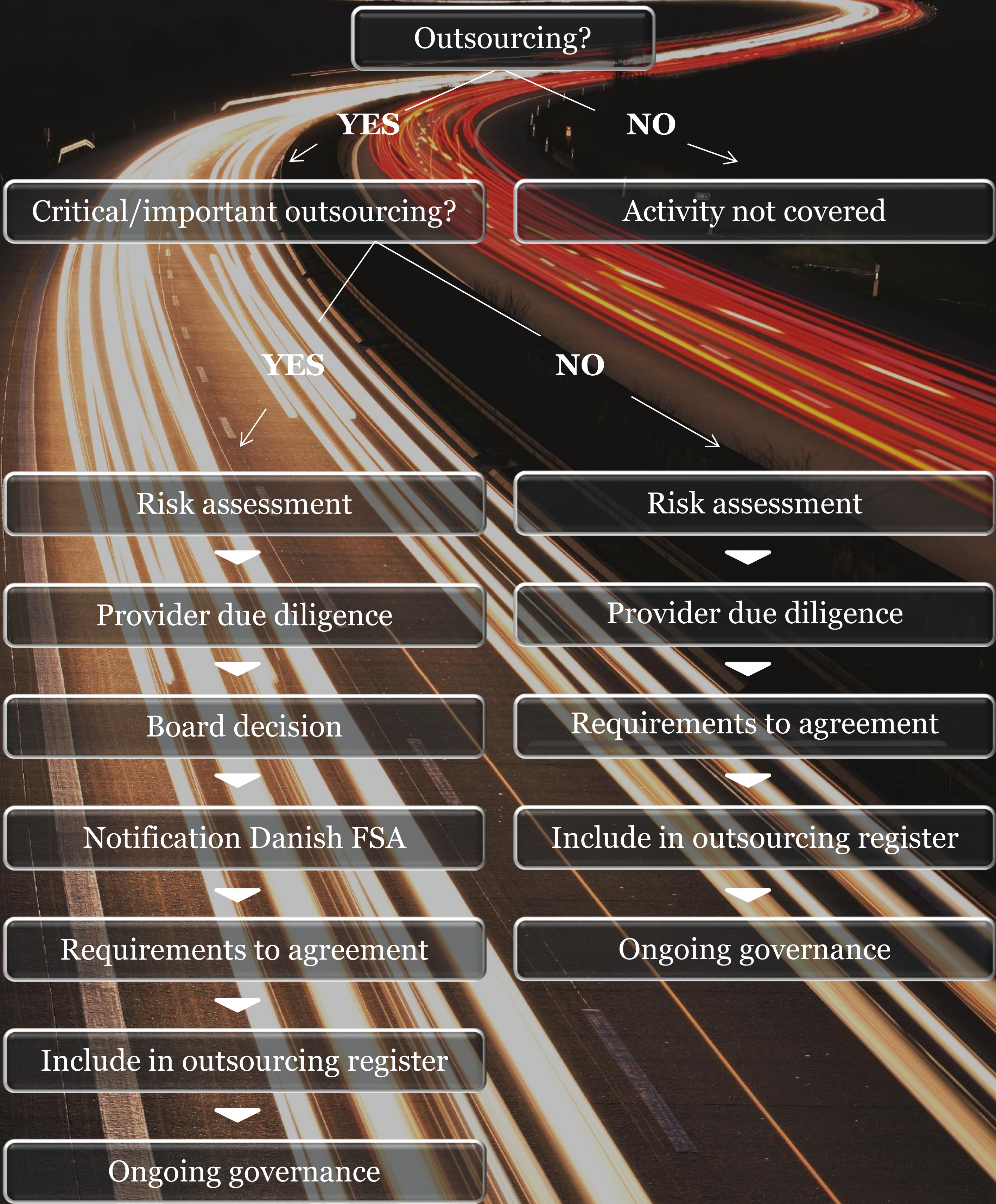
The definition does not only include large infrastructure outsourcings but also use of e.g. standard cloud solutions.

The Outsourcing Order lists a number of activities – and the EBA's Outsourcing Guidelines include additional activities – that do not constitute outsourcing including:

- A function that is legally required to be performed by a service provider, e.g. statutory audit.
- Market information services.
- Global network infrastructures.
- Clearing and settlement arrangements between clearing houses, central counterparties and settlement institutions and their members.
- Correspondent banking services.
- The acquisition of services that would otherwise not be undertaken by the institution or payment institution.

As examples on the latter the EBA's Outsourcing Guidelines mention the following examples on services (advice from an architect, providing legal opinion and representation in front of the court and administrative bodies, cleaning, gardening and maintenance of the institution's or payment institution's premises, medical services, servicing of company cars, catering, vending machine services, clerical services, travel services, post-room services, receptionists, secretaries and switchboard operators); the following examples on goods (e.g. plastic cards, card readers, office supplies, personal computers, furniture); and the following examples on utilities (e.g. electricity, gas, water, telephone line).

The governance process



Identification of critical or important outsourcing

The Outsourcing Order applies to all outsourcings, however, a number of the requirements only apply to critical or important outsourcing and companies therefore need to identify whether an outsourcing is critical or important. A company's outsourcing policy should include criteria and processes to identify an outsourcing as critical or important.

As part of the assessment, companies should consider:

- Whether the outsourcing is directly connected to the provision of activities for which the outsourcing company is authorised.

- The potential impact of any disruption to the outsourced function or failure of the service provider to provide the service at the agreed service levels on a continuous basis on the outsourcing company's:

  - short- and long-term financial resilience and viability;
  - business continuity and operational resilience;
  - operational risk;
  - reputational risks; or
  - where applicable, recovery and resolution planning, resolvability and operational continuity in an early intervention, recovery or resolution situation.

- The potential impact of the outsourcing arrangement on the outsourcing company's ability to:

  - identify, monitor and manage all risks;
  - comply with all legal and regulatory requirements; or
  - conduct appropriate audits regarding the outsourced function.

- The potential impact on the services provided to its customers.

- All outsourcing arrangements, the outsourcing company's aggregated exposure to the same service provider and the potential cumulative impact of outsourcing arrangements in the same business area.

- The size and complexity of any business area affected.

- The possibility that the proposed outsourcing arrangement might be scaled up without replacing or revising the underlying agreement.

- The ability to transfer the proposed outsourcing arrangement to another service provider.

- The ability to reintegrate the outsourced function into the outsourcing company.

- The protection of data and the potential impact of a confidentiality breach or failure to ensure data availability and integrity on the outsourcing company and its customers.

Stricter requirements to the risk assessment

One of the main focus areas of the Outsourcing Order is – in accordance with the EBA's Outsourcing Guidelines – risk management. Before companies subject to the Outsourcing Order decide to outsource they are required to assess the potential impact on the outsourcing company's operational risk and take appropriate steps to avoid undue additional operational risk.

Most companies subject to the Outsourcing Order will already have a risk assessment model in place, however, it will be necessary to revise the risk assessment model to make sure it includes:

- Identification and classification of the relevant functions, services or activities and related data and systems as regards their sensitivity and required security measures.
- Conduct a thorough risk-based analysis of the functions, services or activities and related data and systems that are being considered for outsourcing.
- Consideration of the consequences of where the service provider is located.
- Consideration of the political stability and security situation of the jurisdictions in question.
- Definition and determination of an appropriate level of protection of data confidentiality, of continuity of the activities outsourced and of the integrity and traceability of data and systems in the context of the intended outsourcing.
- Consideration of the level of protection measures for data transfer, data processing and data storing.
- Consideration of whether the service provider is a subsidiary or parent undertaking of the outsourcing company.

Additionally, the risk assessment model should consider the expected impact on the outsourcing including:

- Concentration risks.
- The aggregated risks resulting from outsourcing several functions across the outsourcing company or within a group.
- The risk that may result from the need to provide financial support to a service provider in distress or to take over its business operations.
- The measures implemented by the outsourcing company and by the service provider to manage and mitigate the risks.

If the service provider may sub-outsource critical or important to sub-contractors, the risk assessment model needs to consider:

- The risks associated with sub-outsourcing.
- The risk that long and complex chains of sub-outsourcing reduce the ability of the outsourcing company to oversee the outsourced critical or important function and the ability of competent authorities to effectively supervise critical or important outsourcing.

Finally, the risk assessment model needs to consider risks related to termination of the outsourcing, including risks of transferring the proposed outsourced process, service or activity to another service provider or of reintegrating the outsourced process, services or activity into the outsourcing company.

Requirement of provider due diligence check

As part of the increased risk management requirements, companies subject to the Outsourcing Order are required to perform due diligence checks on prospective outsourcing providers prior to any outsourcings.

Most companies subject to the Outsourcing Order will already as part of their risk assessment models consider the outsourcing provider, however, it will be necessary to revise the procedures for due diligence checks on the outsourcing provider to make sure it includes:

- The outsourcing provider's business model, nature, scale, complexity, financial situation, ownership and group structure.
- The long-term relationships with outsourcing providers that have already been assessed and perform services for the outsourcing company.
- Whether the outsourcing provider is a parent undertaking or subsidiary of the outsourcing company.
- Whether or not the outsourcing provider is supervised by the Danish FSA.
- Whether or not the outsourcing provider can implement appropriate technical and organisational measures to protect the data, including personal data.
- Whether or not the outsourcing provider and, if applicable, their sub-contractors, comply with the outsourcing company's values and code of conduct.

Stricter requirements to the outsourcing policy

The Outsourcing Order includes a requirement for the board of directors to approve and regularly revise and update a written outsourcing policy in accordance with appendix 1 to the Outsourcing Order.

Companies subject to the Outsourcing Order should already have an outsourcing policy in place, however, the outsourcing policy will in most cases not fulfil the requirements in appendix 1 to the Outsourcing Order and it will therefore be necessary to revise the outsourcing policy.

The outsourcing policy shall apply to all outsourcings and not just to critical or important outsourcing (currently material outsourcing).

The outsourcing policy shall include criteria and processes to identify critical or important outsourcing and the main phases of the life cycle of outsourcing arrangements and define the principles, responsibilities and processes in relation to outsourcing.

The requirements to the outsourcing policy are set out in appendix 1 to the Outsourcing Order and include in particular stricter requirements to:

- Risk identification, assessment and management.
- Due diligence checks on prospective outsourcing providers.
- Procedures for the identification, assessment, management and mitigation of potential conflicts of interest.
- Business continuity planning.
- Audits and control.
- Exit strategies and termination.

Appointment of an outsourcing officer

The Outsourcing Order includes a requirement for the management to appoint a person responsible for managing, monitoring and audit outsourcings and ensuring documentation related hereto.

Most companies subject to the Outsourcing Order will already to some extent have appointed one or several responsible persons in its outsourcing policy, however, this will usually be related to specific areas or tasks.

The Outsourcing Order includes a requirement of a formal appointed responsible person or "outsourcing officer" directly responsible to the management.

Establishment of an outsourcing register

The Outsourcing Order includes a requirement for companies subject to the Outsourcing Order to establish and maintain a register on outsourcings in accordance with the requirements in appendix 2 of the Outsourcing Order. The outsourcing register shall include all outsourcings and not only critical or important outsourcings (currently material outsourcings).

Most companies subject to the Outsourcing Order will already to some extent maintain a register of outsourcing agreements, however, in most cases such register will not fulfil the requirements in appendix 2 to the Outsourcing Order and it will be necessary to establish or revise the outsourcing register.

As part of the establishment or revision of the outsourcing register it will be necessary to map all outsourcing agreements.

New requirements to outsourcing agreements

New outsourcing agreements

The Outsourcing Order applies to all outsourcing arrangements entered into, reviewed or amended on or after 1 July 2020 and includes a requirement of a written outsourcing agreement with the outsourcing provider setting out the rights and obligations of the parties. The Outsourcing Order sets out a list of requirements to the outsourcing agreement, including in appendix 3 of the Outsourcing Order, most of which only apply to critical or important outsourcing.

The current executive order on outsourcing also includes a list of requirements to outsourcing agreements but only for material outsourcing. As the Outsourcing Order introduces a number of new requirements – as well as a few easements to existing requirements – companies need to revise their procedures and requirements for new outsourcing agreements.

Mapping and renegotiation of existing outsourcing agreements

Outsourcing agreements entered into prior to 1 July 2020 shall no later than 31 December 2021 be in line with the requirements of the Outsourcing Order.

Companies subject to the Outsourcing Order need to map all existing outsourcing agreements and identify 1) whether they cover outsourcing of critical or important functions and 2) whether they comply with the requirements – depending on whether the cover critical or important functions - in the Outsourcing Order.

Existing outsourcing agreements that do not comply with the requirements in the Outsourcing Order shall by 31 December 2021 be revised which in many cases may require a renegotiation with outsourcing providers. Large infrastructure outsourcing agreements typically include a right for the outsourcing company to require changes to the outsourcing agreement necessary due to legal requirements. Regardless, a renegotiation can be challenging and lengthy.

Prior notification to the Danish FSA

The Outsourcing Order includes a requirement for the outsourcing company to notify the Danish FSA *in a timely manner* of a planned critical or important outsourcing.

The current executive order on outsourcing already includes a notification requirement to the Danish FSA, however, contrary to the notification requirement in the Outsourcing Order, outsourcing companies are currently only required to notify the Danish FSA no later than 8 business days *after* an outsourcing agreement has been entered into.

Companies subject to the Outsourcing Order will from a more practical point of view need to take this change into consideration as it may result in planned outsourcings being delayed or blocked if the Danish FSA has questions or reservations to a notified outsourcing.

Bird & Bird's outsourcing compliance offering

- Training of management; outsourcing officers; and other employees
- Drafting of policies; procedures; and; risk management models
- Mapping and assessment of existing outsourcing agreements
- Renegotiation of existing and new outsourcing agreements
- Process management and process management tools related to the assessment of existing and new outsourcing agreements

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