



## New FINMA Outsourcing Circular Key Content and Impact on Banks, Securities Dealers and Insurance Companies

**On December 5, 2017 the Swiss Financial Market Supervisory Authority FINMA published the new Circular 2018|3 "Outsourcing – Banks and Insurers". It sets out the regulatory requirements that have to be met by banks, securities dealers and insurance companies when outsourcing material functions to third party providers. This Bulletin discusses the circular's key points and the actions required as a result.**

### I. Key Points

The new circular will enter into force on April 1, 2018. In contrast to the previous circular, it applies not only to banks and securities dealers, but extends also to insurance companies. The purpose of the circular is to stipulate the regulatory requirements applicable to the outsourcing of material functions to service providers. *Banks and securities dealers* must amend existing outsourcing agreements by no later than April 1, 2023 in order to bring them in line with the requirements of the new circular. Existing

agreements that are amended prior to this date have to be brought in line with the new circular when such amendments are implemented. For *insurance companies*, on the other hand, no transitional provisions are foreseen; the new circular applies as of April 1, 2018 to any amendments to their business plans.

In substance, the new circular implements the following changes:

- **Materiality**, which is the criterion used to determine whether or not an outsourcing falls within the scope of the circular, is now described in a very broad manner and is, therefore, open to interpretation. This will raise questions, in particular for *banks and securities dealers*, who could, until now, rely on the appendix to the current circular, which lists examples of outsourcings that are in scope of the circular. This annex will no longer be included in the new circular, and therefore, banks and securities dealers will have to determine whether or not an outsourcing is

material using only the broad and abstract definition of materiality in the new circular. Nevertheless, in practice, the examples and differentiations contained in the previous annex will likely continue to be relevant. For *insurance companies*, the materiality of functions was already to a large extent determined by supervisory practice. According to FINMA, this will continue to apply.

- For the engagement of foreign outsourcing providers, the new circular will provide for more lenient rules. In particular, for audit purposes, companies will be entitled to rely on the audit reports of the service provider's foreign audit firm. This will in all likelihood facilitate outsourcings to foreign cloud providers. Furthermore, the former requirement to inform clients by way of a specific information letter about outsourcings to a foreign provider has been eliminated.
- The revised circular no longer addresses data protection and customer secrecy, but the applicable requirements under the relevant laws will continue to apply in substance.
- The new duty to maintain an inventory of outsourcings and to amend outsourcing agreements will impose an additional burden on banks, securities dealers and insurance companies.

The new circular is substantially different from the draft circular of December 2016, largely because many provisions that were criticized during public consultation were removed. As a result, the new circular looks more like the previous circular than the draft. In particular, with respect to group internal outsourcings, the fact that no external provider is involved may continue to be taken into account, which in practice will likely simplify group internal outsourcings. Further, the additional requirements for systemically relevant banks that had been introduced in the draft circular have been retracted.

## II. Key Content of the New Circular

### 1. Purpose

According to FINMA the purpose of the new circular is to continue the principle-based supervisory practice and to harmonize the requirements for banks and insurance companies to the extent feasible and permissible. The new circular specifies that it only stipulates the requirements applicable to outsourcings under supervisory law. Customer secrecy and data protection will no longer be addressed in the new circular in order to avoid inconsistencies with the relevant laws governing these subject matters.

### 2. Terms

A **Company** is a bank or securities dealer as well as now also an insurance company. **Outsourcing** occurs where a Company mandates a service provider to perform a function, either wholly or partially, that is material to its business activity on an independent and permanent basis. In contrast to the prior circular, the new circular refers to the outsourcing of a "function", rather than a "service". According to FINMA, this is merely a matter of terminology without any substantive impact. In addition, the current practice of what constitutes an "independent and permanent basis" also remains unchanged. On the other hand, the term **materiality** is defined in the new circular in an abstract manner, with a function being considered material where "compliance with the goals and provisions of financial market supervisory legislation significantly depends" on it. Since this description is open to interpretation, whether or not a given function is to be considered material in the sense of the circular, will have to be determined on a case by case basis, taking the relevant institution into account. The shift to an abstract definition was a deliberate choice by FINMA aimed at delegating the responsibility for determining materiality to a large extent to the Companies outsourcing functions to third parties. According to FINMA, the

practice currently in place for *banks* will continue, although the circular will no longer contain the previous list of examples of material functions. For *insurance companies*, the determination of material functions will remain essentially unchanged based on the existing supervisory practice, except for the fact that also risk management and compliance will be considered as material functions.

For *banks* in particular, outsourcings are deemed to be "material" where a service provider obtains access to mass client identifying data (**CID**). Granting access only to limited CID will, as such, not exceed the materiality threshold. For *insurance companies* the term mass-CID is used differently. Here, the assessment of materiality will depend on the extent to which the interests of the insured persons are affected.

### 3. Scope

The circular applies to *banks and securities dealers* domiciled in Switzerland as well as Swiss branches of foreign banks and securities dealers. Furthermore, it does now also apply to *insurance companies* domiciled in Switzerland and Swiss branches of foreign insurance companies.

The circular does not apply to original outsourcings of material functions by foreign subsidiaries or foreign branches of Companies domiciled in Switzerland since such outsourcings are already supervised by the competent foreign authorities.

### 4. Permissibility

Generally, *banks and securities dealers* are permitted to outsource material functions without FINMA's approval. For *insurance companies*, such outsourcings are relevant for the business plan and hence subject to approval.

As under the current circular, it is impermissible to outsource (i) the overall management, supervision

and control by the board of directors; (ii) key management tasks of the executive board; and (iii) decisions concerning the commencement and discontinuation of business relationships. Additionally, the new circular sets out that "functions encompassing the taking of strategic decisions" are non-outsourcable as well.

The new circular contains rules regarding the outsourcing of risk management and compliance. These rules differentiate between the supervisory categories as follows:

- For Companies falling into supervisory categories 1 to 3, risk management and compliance functions as independent control bodies are non-outsourcable. However, according to FINMA "synergies at the legal entity level may be leveraged", if risk management and compliance are handled at group level.
- For Companies in the supervisory categories 4 and 5, it is sufficient if one member of the executive board is designated as responsible for the outsourced function.

Companies of all supervisory categories are furthermore allowed to outsource "operational" tasks related to risk management and compliance. In concrete terms, this means that risk management and compliance may be performed by service providers if the responsibility, supervision and control remain with the outsourcing Company.

Facilitations apply with regard to *insurance captives*, for which outsourcing of management and control functions is less restricted. Direct and reinsurance captives domiciled in Switzerland are allowed to outsource their management to specialized captives management entities. And branches of foreign direct insurance captives may outsource their management either within the group or to specialized captive management entities (however, by doing so they must not limit

the supervisory function of their general representative).

## 5. Requirements for Outsourcing Companies

### 5.1. Inventory

The new circular imposes a duty to maintain an up-to-date inventory of outsourced functions. This inventory must contain not only a description of the outsourced function (including information on whether it is an outsourcing to a foreign provider), but it must also identify the provider and involved subcontractors, if any, as well as the recipient and the responsible unit within the Company. According to FINMA, the duty to include information on subcontractors only applies if such subcontractors fulfill material functions. *Insurance companies* are to maintain the inventory in their business plan form J, although the inventory itself and changes to the inventory are not *per se* subject to a reporting or approval obligation (unlike those elements that are expressly designated as such in the business plan form J).

It is important that Companies who outsource functions contractually require their service providers to provide them any information required to maintain the inventory that is known only to the service provider. This is in particular relevant in order to keep the list of subcontractors up-to-date, to the extent such subcontractors perform material functions. It should be noted that a part of the information that is required for the inventory will, in any event, have to be available under European data protection legislation. In particular, the EU General Data Protection Regulation will require an inventory of processing activities to be maintained, and similar rules are expected to be included in the new Swiss Data Protection Act, which is currently in parliamentary deliberations.

### 5.2. Selection | Instruction | Monitoring

As under the current circular, the contractual requirements regarding the provision of the outsourced function must be established prior to the conclusion of the corresponding agreement. Additionally, the new circular requires that a risk analysis be performed and that both the contractual requirements and the risk analysis be documented. Furthermore, the new circular mentions a series of criteria to be taken into account when selecting a service provider, such as the service provider's capabilities and resources; the mechanics and potential impact of changing the service provider; and, if several functions are outsourced to the same provider, potential concentration risks. Furthermore, the service provider must ensure durable service and the handover of the outsourced service upon termination. In addition to reflecting this in the relevant provisions of the agreement, practical measures might need to be implemented in order to ensure that the handover of the outsourced function upon termination of the agreement will not create frictions. Finally, the new circular also requires that the responsibilities of the Company and the service provider are laid down and delineated in the agreement. Unlike the current circular, the new circular no longer sets out supervisory requirements regarding the measurability and assessability of the service provider's performance.

With regard to the monitoring of the service provider, the new circular continues the approach in place under the current circular. The outsourced function must still be incorporated in the internal control system. Material risks associated with the outsourcing need to be systemically identified, monitored, quantified and managed. The service provider has to be monitored and evaluated on an ongoing basis and the outsourcing Company has to designate a responsible unit for this task. The outsourcing Company needs to ensure that the

agreement contains the required instruction and control rights.

### 5.3 Intragroup Outsourcings

According to the new circular, intragroup affiliations can be taken into account when determining the scope of the new circular's requirements regarding selection, instruction and monitoring of service providers (see above 5.2) as well as those regarding the agreement to be entered into with the service provider (see below 5.8). This may be of relevance where (i) the risks typically associated with an outsourcing demonstrably do not exist; (ii) certain requirements are not relevant; or (iii) certain requirements are organized otherwise in the intragroup context. With this provision, the new circular sets out in a principle-based manner that the group perspective can be taken into account in cases of so-called "internal outsourcings". For example, with regard to the selection process, less strict requirements might apply to intragroup service providers than for group-external service providers if it is known that the relevant group-internal service provider can deliver high-quality services. Also, less strict requirements may, for example, apply to the monitoring requirements if the outsourcing Company has control over the service provider as a subsidiary.

### 5.4. Responsibility

The new circular states that the outsourcing Company is not released from its responsibility with regard to the outsourced functions. *Vis-à-vis* FINMA, the Company who outsources functions continues to bear the same responsibility as if it were performing the outsourced service itself.

### 5.5. Security

The new circular requires that in the case of security-relevant outsourcings, such as IT outsourcings, the security requirements be contractually defined and that compliance with

these requirements be monitored during the term of the outsourcing. Furthermore, appropriate business continuity plans and measures need to be established and implemented. In so doing, the same level of care applies as if the Company was performing the outsourced function itself.

According to FINMA, the requirements need to be implemented adequately and on an institution-specific basis, taking into account the outsourced function, the specific risks involved and the systems affected. At a minimum, the Company needs to comply with the applicable self-regulation standards set by the Swiss Insurance Association and the Swiss Bankers Association. Furthermore, where the processing of personal data is outsourced, the applicable data protection regulation, including also its requirement that technical and organizational measures to guarantee data security be implemented, have to be taken into account too.

### 5.6. Audit and Supervision

The regulations regarding audit and supervision correspond in substance to those of the current circular. The company and its auditor as well as FINMA must be in a position to review and assess the service provider's compliance with supervisory regulations. The contract with the service provider must provide for audit and inspection rights on the part of the Company. It will still be permitted to delegate audits to the service provider's auditor, provided that such auditor is capable of doing so. Unlike under the current circular, however, the auditor of the service provider, upon whose audit the Company relies, no longer needs to be domiciled in Switzerland. This is an important and welcome change, in particular with respect to outsourcings to foreign service providers, for example to foreign cloud providers. However, outsourcings must still not impair oversight by FINMA. If the service provider is not subject to FINMA's supervision, it must contractually be obligated by the Company to provide FINMA with

all necessary information and documents concerning the outsourced function.

## 5.7. Outsourcings to Foreign Service Providers

The provisions addressing outsourcings to foreign service providers have been simplified. Going forward, the Company only needs to be able to guarantee that the Company, its auditor and FINMA can exercise their audit rights. The verification by way of expert opinion or confirmation from the relevant supervisory authority is no longer required. The obligation to inform FINMA in advance if mass-CID are outsourced to foreign service providers, which was foreseen in the draft circular, has been removed. However, the inventory must mention the fact that functions are outsourced to foreign service providers. In addition, the restructuring and/or winding up of a Company in Switzerland must be ensured and the information relevant for such purposes must be accessible in Switzerland at any time.

Given that the new circular does not contain any provisions regarding data protection and customer secrecy, it also no longer provides for the "particular information letter" currently required in case of an outsourcing to a foreign service provider. However, in substance, this is not a material change as applicable requirements under data protection and customer secrecy continue to apply.

## 5.8. Agreement

Like the current circular, the new circular requires that a written agreement be entered into with the service provider that implements the requirements of the circular. In addition to the description of the outsourced function and the delimitation of the responsibilities, the agreement thus also has to include provisions regarding the control, instruction, review and audit rights as well as the security requirements. Furthermore, the agreement

has to stipulate that subcontractors exercising material functions may only be appointed with the consent of the Company and that such subcontractors undertake the obligations and warranties required under supervisory law. By limiting the Company's obligation to consent to only those subcontractors that exercise "material" functions, the new circular provides some relief as compared to the current circular. However, in practice it may not be easy to impose the obligations and warranties required by supervisory law upon subcontractors. Finally, the agreement also has to ensure that the service provider provides the Company with all information needed to maintain the inventory of the outsourced functions (see above 5.1).

As under the current circular, the Company has to establish an internal process for authorizing outsourcing projects and the relevant agreements.

Although the new circular does not contain provisions regarding data protection, it has to be noted that data protection legislation sets out various provisions that have to be implemented in data processing agreements with a third party processor. Given that outsourcing service providers typically qualify as data processors, outsourcing agreements will usually have to comply with the relevant requirements under applicable data protection law.

## 6. Additional Requirements and Exemptions

As under the current circular, FINMA retains the right to impose additional requirements on a Company or to exempt a Company, in full or in part, from requirements under the circular.

## 7. Entry Into Force and Transitory Provisions

The circular enters into force on April 1, 2018.

Existing outsourcing agreements of *banks and securities dealers* have to be amended as needed

so that they comply with the circular within five years, *i.e.*, by April 1, 2023 at the latest. The circular is immediately applicable to outsourcing agreements entered into or amended after April 1, 2018. Although the circular does not explicitly say so, minor and non-material amendments of existing outsourcing agreements (*e.g.*, amendments to prices, notice provisions etc.) should not lead to the new circular becoming immediately applicable to such agreements as this would be contrary to the purpose of the transitory provisions.

The circular is applicable to first authorizations of *insurance companies* as from April 1, 2018. For amendment authorizations, the circular is applicable from the date such amendment to the business plan is communicated to FINMA for approval.

### III. Need for Action

The following actions are required prior to April 1, 2018, as a result of the new circular:

- Companies have to examine whether their internal procedures comply with the requirements of the new circular, in particular with regards to the selection of service providers. Necessary amendments have to be implemented in due course.
- The necessary inventories of outsourced functions have to be established, including the required information regarding subcontractors that may need to be obtained from the service provider.

From April 1, 2018, onwards, Companies need to ensure that the requirements of the new circular are complied with when concluding new or amending existing outsourcing agreements. If the amendments are only of subordinated nature, Companies have to examine whether, in the particular case and following consultation with FINMA, a forgoing of the renegotiation of such

agreement is permissible, in particular if such agreement would expire during the transitional period.

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