

UPDATED GERMAN OUTSOURCING REQUIREMENTS

Following Wirecard AG's fraudulent activities and subsequent insolvency, with its adverse economic impact on institutional investors as well as small investors, Germany devised an action plan for combating financial reporting fraud and strengthening controls over financial markets. The action plan¹ is legislatively transposed in the governmental draft law² on "the strengthening of the integrity of the financial market" (*Finanzmarktintegritätsstärkungsgesetz – FISG*).³ One aspect of the multifaceted Draft relates to outsourcing, inadequacies of which also became apparent in the Wirecard AG case. The Draft introduces new rules to the German Banking Act (*Kreditwesengesetz, "KWG"*) for outsourcing, substantially enhancing how outsourcing is to be conducted and managed. Importantly, the new rules are targeted not only at German credit and financial services institutions but also explicitly at the outsourcing service providers themselves (including their sub-contractors), irrespective of where they are geographically located. The new rules timely reflect (and partly go beyond) the approach thereon under the EBA's guidelines on outsourcing arrangements. This briefing gives an overview of the new outsourcing rules for banking and financial services in Germany.

Key aspects of the outsourcing reform:

- Outsourcing service providers (including sub-contractors and those located in non-EEA countries) subject to direct supervision by BaFin's
- Obligation to establish outsourcing infrastructure (outsourcing register, outsourcing officer)
- Extension of BaFin's powers towards outsourcing service providers located in non-EEA countries

THE LARGER LEGAL OUTSOURCING FRAMEWORK

The revised outsourcing regime in the KWG fits into the larger picture of the outsourcing reforms in Europe. Within EBA's mandate in the Capital Requirements Directive⁴ to develop guidelines for institutions' governance arrangements, EBA released revised guidelines⁵ on outsourcing arrangements on 25 February 2019. The German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht, "BaFin"*) will implement the guidelines by

¹ Link to summary of the action plan in English by the German Federal Ministry of Finance of 9 October 2020: https://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Financial_markets/Articles/2020-10-09-combating-financial-reporting-fraud-strengthening-controls-financial-markets.html

² Referred to in this Briefing as the "Draft".

³ Published on 16 December 2020 by the German Federal Government.

⁴ Article 74 para 3 Directive 2013/36/EU.

⁵ <https://www.eba.europa.eu/documents/10180/2551996/EBA+revised+Guidelines+on+outsourcing+arrangements.pdf/38c80601-f5d7-4855-8ba3-702423665479>

amending section AT 9 (*Outsourcing*) of its Minimum Requirements for Risk Management ("**MaRisk**"). BaFin published the amended version of its MaRisk on 26 October 2020 for consultation.

The outsourcing rules in the KWG pursuant to the Draft will come into force on 1 July 2021, except for the appointment of a process agent (see 2.1), set-up of the outsourcing register (see 2.4) and the notification of outsourcings (see 3.1) which will come into force on 1 January 2022, allowing for sufficient implementation time. The revised MaRisk is set for publication at the end of Q1 2021. The Draft has been introduced to parliamentary proceedings by being delivered in a first step to the German Federal Council (*Bundesrat*) for discussion on 12 February 2021. It is not yet clear when parliamentary proceedings will be finalised.

Going forward, supervision of third-party service providers will be further regulated with a direct focus on third-party services providers of information and communication technologies (including cloud computing) in the context of financial services outsourcing through the European Commission's proposed Digital Operational Resilience Act (DORA)⁶ which aims to establish an oversight framework for critical third-party service providers with far reaching powers for one of the ESAs as lead supervisor.

THE AMENDMENTS

1. Concepts

1.1 Expanded understanding of outsourcing service provider

There is a significant uplift for BaFin's supervisory powers in the new outsourcing regime by directly targeting outsourcing service providers. To that end, the definition of what constitutes an outsourcing service provider is expanded and moved to section 1 KWG⁷, pursuant to which the outsourcing service providers become direct addressees of the obligations under the KWG and are in BaFin's range of supervision. The definition of outsourcing service provider (*Auslagerungsunternehmen*) refers to undertakings to which an institution or a parent company outsources activities and processes relating to the execution of banking transactions, financial services or other services typically provided by the institution itself. This undertaking may be a supervised or non-supervised entity. A new limb is added to the definition, explicitly including sub-contractors of outsourcing service providers with respect to sub-outsourcing that relates to activities and processes which are material for the execution of banking transactions, financial services or other services of the institution. Essentially, sub-contractors of outsourcing service providers are considered outsourcing service providers themselves under the KWG (and are thus subject to instructions by BaFin) in case of material outsourcing (see 1.2 below for details). Finally, outsourcing service providers located in non-EEA countries are explicitly in scope of the new expanded understanding.

1.2. Material outsourcing

The Draft makes many new rules contingent on outsourcing being "material", however, without defining the term. In this respect, as under the current applicable MaRisk, the materiality of an outsourcing arrangement must be determined on an individual risk analysis basis regarding each outsourced activity conducted by the institution itself.

2. Outsourcing risk management

Another part of the new outsourcing rules relates to enhancing institution's outsourcing risk management and infrastructure.

2.1. Outsourcing agreements

Outsourcing agreements must be in writing and must include certain new provisions (mainly for material outsourcing and in addition to those already listed in AT9.7 MaRisk previously):

- start and end date of the outsourcing;
- governing law;
- location where service will be provided/where data will be stored;

⁶ [European Commission Proposal](#) of a Regulation of the European Parliament and of the Council on digital operational resilience for the financial sector and amending Regulations (EC) No 1060/2009, (EU) No 648/2012, (EU) No 600/2014 and (EU) No 909/2014 COM/2020/595 final of 24 September 2020.

⁷ Section 1 para 10 KWG (as amended).

- agreed service level with quantitative/qualitative performance targets;
- insurance coverage;
- implementation and testing of business contingency plans;
- adherence to institution's code of conduct;
- service delivery reports by the outsourcing service provider⁸;

and with relevance for non-EEA outsourcing service providers,

- the appointment of a process agent (*Zustellungsbevollmächtigter*) located in Germany⁹.

2.2 Outsourcing supervisory conditions

Institutions have to ensure that an outsourcing service provider located in a non-EEA country is appropriately authorised/registered and supervised in its home country for the outsourced service. It is additionally required for non-EEA outsourcing service providers which perform a service that requires authorisation in the EEA, that these are supervised by an authority with which BaFin has a supervision cooperation agreement, e.g. in the form of a memorandum of understanding.¹⁰

2.3 Outsourcing monitoring

Institutions must conduct ongoing monitoring of compliance with the provisions set out in 2.1 and 2.2 above by the outsourcing service provider. Further, institutions need to establish performance and quality standards tailored to their business through tools such as key performance indicators, key risk indicators and service delivery reports by the outsourcing service provider (see 2.1 above as part of the outsourcing agreement) in order to be able to assess on a continuous basis the quality of the services rendered by the outsourcing service provider.¹¹

2.4 Outsourcing register

Institutions must set-up and maintain an up to date outsourcing register (*Auslagerungsregister*)¹² showing all outsourcing arrangements (irrespective of whether the outsourcing is material or not). Further, AT9.15 MaRisk expressly clarifies that this includes intra-group outsourcing arrangements and sub-outsourcing agreements should these relate to material outsourcing.

2.5 Outsourcing officer

Institutions must appoint an outsourcing officer (*Auslagerungsbeauftragter*)¹³ responsible to oversee and manage the internal outsourcing risk management, reporting directly to the management board.

2.6. Group specifics

AT9.14 MaRisk allows for outsourcing risk management to be centrally organised as well as the outsourcing register established and maintained centrally for institutions within a group.

3. Outsourcing supervision by BaFin

3.1 Notifications

The Draft introduces a new outsourcing notification requirement¹⁴ (for transparency not approval purposes), which according to the reasoning of the Draft, is to give BaFin a complete overview of each institution's outsourcing but also institutions' outsourcings under its reign seen collectively. Consequently, this also gives BaFin the information of any outsourcing concentration at the level of an outsourcing service provider. Based on this knowledge, BaFin would be put in a position to better assess if and how it should intervene on a case-by-case basis by applying its supervisory powers. Institutions have to notify to BaFin and Deutsche Bundesbank:

⁸ AT9.9 MaRisk.

⁹ Section 25b para 3 KWG (as amended).

¹⁰ AT9.4 MaRisk.

¹¹ AT9.9 MaRisk.

¹² Section 25b para 1 KWG (as amended).

¹³ AT9.12 MaRisk.

¹⁴ Section 24 para 1 no. 18 KWG (as amended).

- the intention of a material outsourcing;
- the execution of any outsourcing arrangement (not limited to material outsourcing);
- any change to the assessment of the materiality of the outsourcing;
- any material changes and/or severe events regarding existing outsourcing arrangements that could have a material impact on the continuing provision of the institution's business activities.

3.2 Information and inspection rights

Next to existing information and inspection rights of BaFin towards institutions with respect to all business matters, the Draft introduces explicit information and inspection rights towards outsourcing service providers.¹⁵ Outsourcing services providers are thus obliged to provide BaFin upon request with information on all business matters (including documentation and copies thereof) relating to any outsourcing arrangement (not limited to material outsourcing). Moreover, BaFin may conduct (on-site) inspections of outsourcing service providers which are entrusted with material outsourcing.

3.3 BaFin powers

According to the Draft, BaFin is granted supervisory powers to issue orders (*Anordnungen*)¹⁶ to the institutions as well as directly to the outsourcing service providers (located in or outside Germany) that are appropriate and necessary to prevent or stop violations of German supervisory requirements or mismanagement on the level of the institution, affecting either the security of the assets entrusted to the institution or the functioning of the outsourced banking or financial service. Being able to target an outsourcing service provider directly is particularly important (as per the reasoning of the Draft) in relation to complex chain outsourcings.

Examples of such orders set forth in the reasoning of the Draft are: an order for the observation of German supervisory requirements stipulated in the outsourcing agreement; anti-money laundering training of the staff of the outsourcing service provider; establishment of sufficient expertise of the management of the outsourcing service provider as regards the rendered services; or submitting the outsourcing service provider to regular reporting vis-à-vis BaFin.

3.4 Administrative offence

Non-compliance with the requirements and measures outlined above is sanctioned and constitutes an administrative offence which is subject to a monetary fine of up to 100,000 Euro.

FURTHER READING

- Full text of Draft in German:
https://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetze_Gesetzesvorhaben/Abteilungen/Abteilung_VII/19_Legislaturperiode/2020-10-26-Finanzmarktintegritaetsstaerkungsgesetz/2-Regierungsentwurf.pdf?__blob=publicationFile&v=2
- Full text of MaRisk in German:
https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Konsultation/2020/kon_14_20_Konsultation_MaRisk.html

¹⁵ Section 44 para 1 KWG (as amended).

¹⁶ Section 25b para 4a KWG (as amended).

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