

# Luxembourg Regulated Outsourcing





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# The Luxembourg financial centre

Luxembourg is the second largest investment fund centre in the world after the United States, the premier captive reinsurance market in the European Union and the premier private banking centre in the Eurozone. The financial sector is the largest contributor to the Luxembourg economy.

From its origins as a Euroloan centre, the financial centre subsequently developed as a private banking centre and then, from the 1980s, also as a leading domicile for investment funds. The success of the financial centre is grounded in the social and political stability of the Grand Duchy and in a modern legal and regulatory framework that

is continuously updated, inspired by regular consultation between the government, the legislator and the private sector. Thus, over the years, specific regulatory frameworks have been created for alternative investment funds, private equity and venture capital investment funds, international pension funds, specialised investment funds, captive reinsurance companies, covered bond issuing banks, securitisation vehicles and family wealth management companies.

This legal framework, combined with Luxembourg's openness to the world, has attracted banks, insurance companies, investment fund promoters and specialised service providers from all over the world.

The Luxembourg financial centre is characterised by a strong culture of investor protection and rigorous anti money-laundering policies. Its specialist teams are multilingual and multicultural, with a long tradition of financial expertise and extensive knowledge of the needs of an international clientele.

# Outsourcing in the financial industry

## Background

Financial institutions are increasingly outsourcing operations relating to their business activities. Since the quantity of critical operations outsourced is constantly on the rise, the outsourcing arrangements themselves are becoming increasingly complex.

While financial institutions outsource activities in order to reduce costs and achieve strategic goals, the over-reliance on outsourced activities that are critical to the viability of a regulated entity and its obligations to customers potentially raises issues that are related to risk transfer and management. Outsourcing may have an impact on their ability to manage risks and monitor compliance with regulatory requirements.

In order to help financial services firms to remain in charge of their business and in control of their business risks,

the Joint Forum<sup>1</sup> published, in February 2005, a set of high-level principles on outsourcing that can serve as benchmarks and apply across the banking, insurance and securities sectors.

## The Luxembourg approach

In Luxembourg, the development of outsourcing is actively supported by the Government which has established a specific legislation applying to service providers that enter into outsourcing arrangements with financial institutions. This ensures that service providers are regulated and supervised to the same extent as financial institutions themselves, in order to reduce operational risks and confidentiality breaches.

The financial institutions can thus concentrate on their core business and entrust specialised service providers with auxiliary yet business critical activities.

Today some 100 regulated service providers offer a wide range of highly specialised business processes to credit institutions, professionals of the financial sector (PSFs), Undertakings for Collective Investment (UCIs), pension funds, insurance and reinsurance companies established under Luxembourg or foreign law. The legal framework requires that service providers fulfil strict auditing requirements and fulfil best practices for safeguarding the confidentiality of the data and records received from their clients.

<sup>1</sup> The Joint Forum comprises the Basel Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).

# The statute of “Support PSF”

The financial sector is regulated by the Law of 5 April 1993 on the financial sector, as amended. A special statutory authority, the “Commission de Surveillance du Secteur Financier” (CSSF), is responsible for the prudential supervision of credit institutions, other professionals of the financial sector, undertakings for collective investment (UCIs), pension funds, SICARs, securitisation vehicles issuing securities to the public on a continuous basis, stock exchanges, payment and securities settlement systems and operators of payment or securities settlement systems. It also supervises the securities markets. The CSSF regularly complements the regulatory framework by issuing Circulars. Through these Circulars, the CSSF clarifies the implementation of legal provisions, publishes prudential rules

relating to specific activities and gives recommendations regarding financial activities.

In 2003<sup>2</sup>, Luxembourg extended the supervisory powers of the CSSF by granting the statute of Professional of the Financial Sector to service providers that deliver operational services including accessing confidential data on behalf of a financial institution.

To obtain this statute, service providers need to demonstrate expertise in providing support services and fulfil prudential and reporting requirements as defined by the CSSF.

The four categories of PSF service providers described below have recently been regrouped under the term “Support PSF” to functionally distinguish the PFS providing

exclusively operational services from other professionals of the financial sector providing financial services such as asset managers.

The risks related to the activities of Support PSFs are primarily of operational nature, which implies reallocation of the focus of the ongoing monitoring function.

## Client communication agents

Client communication agents are entitled to provide a range of communication services to customers on behalf of credit institutions, professionals of the financial sector (PSFs), UCIs, pension funds and insurance or reinsurance companies established under Luxembourg or foreign law.

<sup>2</sup> Law of 2 August 2003 amending, amongst others, the Law of 5 April 1993 on the financial sector



## Administrative agents

Administrative agents act as sub contractors and supply administrative services that can be part of the core business of credit institutions, PSFs, UCIs, pension funds and insurance or reinsurance companies established under Luxembourg or foreign law.

## Primary IT systems operators

Primary IT systems operators are entitled to run, install and maintain IT systems that enable the establishment of accounts and financial statements, and are an integral part of the core IT system of a credit institution, PSF, UCI, pension fund, insurance or reinsurance company established under Luxembourg law or foreign law.

Primary IT systems operators may also automatically perform the activities of a secondary IT systems and network operator.

## Secondary IT systems and network operators

Secondary IT systems and network operators are entitled to run, install and maintain IT systems<sup>3</sup> other than those enabling the establishment of accounts and financial statements, being part of the core IT system of a credit institution, PSF, UCI, pension fund, insurance or reinsurance company established under Luxembourg law or foreign law. Such systems and networks may either belong to the client or be made available by the operator.

<sup>3</sup> Including the electronic processing or transfer of data stored in the IT system

# Services

The benefit of Luxembourg's regulated Support PSF approach is best described as offering a safety guarantee to financial sector customers when they outsource operational services selectively. Such a warranty constitutes a unique advantage for any customer who contracts services from Luxembourg Support PSF companies. This is not just relevant to Luxembourg domiciled customers, but also to any financial institution, no matter under which regulations it is established and where it executes its core business.

The following examples provide a summary of services that can be contracted from Support PSFs.

## Management of customer and investor communications

Customer and investor communication is a highly visible process whereby financial institutions communicate with their clients and shareholders through the distribution of statements, deal confirmations or other documents related to corporate actions. Over the years, this client reporting process has gained in complexity as it seeks to support the distribution of financial products globally.

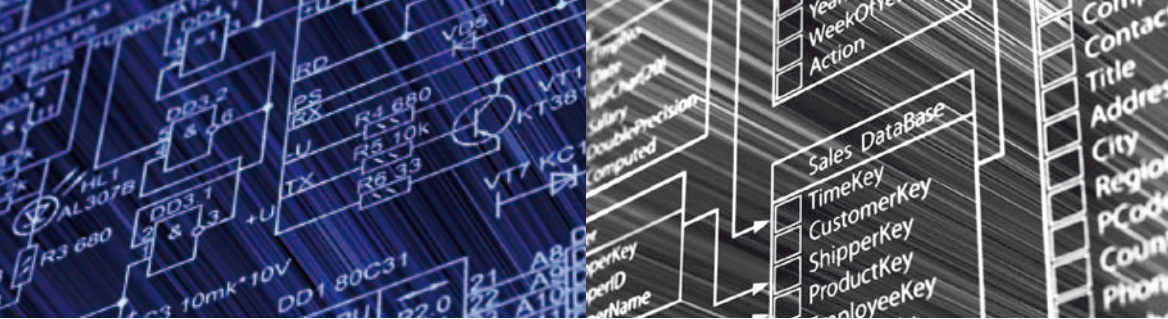
Hence the wide variety of language requirements, time zone differences and complex data elements have caused the emergence of specialist client communication agents who can perform these functions on behalf of financial institutions in Luxembourg. The distribution of this information is

managed through a variety of different channels: print and mail, e-mail, fax or data to data link using customised templates. Client information is handled with the highest possible level of care to ensure the necessary confidentiality.

Luxembourg based communication agents are increasingly leveraging their expertise to support their clients in other financial centres in Europe and Asia.

## Document and records management

Some Support PSFs have, under the communication agent agreement, developed a new range of business data protection solutions to provide digital document management and data protection services including off-site document transfer, storage, disposal, and long term preservation.



Traceability rules and recognised standards apply to all document and records management processes to ensure compliance with governance requirements. Information is managed to the highest standards of data confidentiality, security and integrity.

## Market price data management

Support PSFs offer core administrative and back office services to banks and investment funds. Services such as the input, consolidation and follow-up of market price data in core banking systems are provided by the specialised administrative agents. This complex activity requires in-depth knowledge and expertise of the highest order. It combines extensive experience and sound judgement with the use of state of the art technology.

Because of the highly technical nature of this service, the regulator ensures that the administrative agent has the required level of expertise before the statute of PSF is awarded.

Luxembourg Support PSFs service offerings provide timely data processing and automation based on clearly established service level agreements and attractive pricing.

## Operating IT systems

IT operations involve the running, servicing and monitoring of IT infrastructure such as servers and networks. Financial institutions may entrust the responsibility of operating and/or hosting the infrastructure and application software entirely to a Support PSF. Clear and precise service level agreements are crucial to ensure that the financial institution maintains

full control over its outsourced information systems.

Whether their clients need onsite or remote operations management or want to offload all or part of their IT environment, the Luxembourg PSF community has built a managed solution that meets all business requirements. The outsourcing principles of regulated Support PSFs ensure compliance with the standards applying to internal organisations and operations necessary for the protection of client interests and risk management, and under which the management of the PSFs accepts primary responsibility. The ability to deliver highly available systems is the key to success as it is based on effective and efficient Service Level Management (SLM).

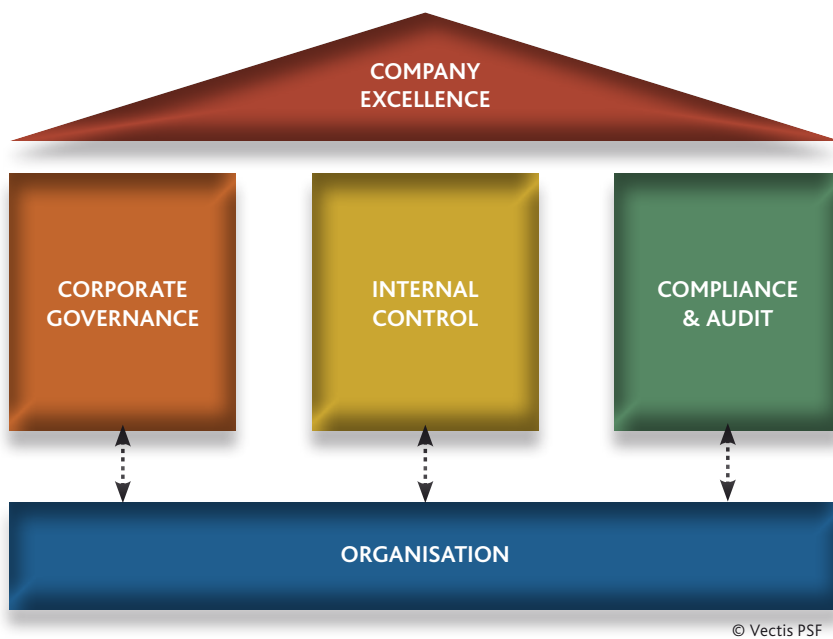
## Application service provisioning

A recent development in the PSF area is the concept of partnerships among professionals. Some Support PSFs have designed consolidated service packages that are made up of the following activities:

- Running of IT systems operations in two separate data centres;
- development and ongoing support of banking software and applications;
- integration with the existing infrastructure of the bank;
- input of market prices into the core banking system.

The observance of regulatory audit requirements and other legal obligations by the service provider is fully integrated in the service package in order to provide the customer with the highest level of confidence. Thanks to its sophisticated quality and reliability, the Luxembourg model has earned recognition throughout the world by investment firms in major financial centres that have business relations with Luxembourg Support PSFs.

# Benefits of working with a Support PSF



The prudential reporting guidelines defined by Luxembourg laws and regulations provide the foundation for the level of excellence achieved by Support PSF companies.

## Organisation

The foundations of organisational excellence are a clearly defined and well described framework of processes, customs and policies that are implemented and regularly measured across the enterprise.

Support PSFs have analysed and closely aligned their business processes with the statutory requirements and business needs of their customers. In so doing, Support PSF service providers have gained the expertise and knowledge that makes them today an integral part of the financial community.

Luxembourg Support PSFs are optimising their process management and quality control with internationally recognised standards and best practice models such as ISO 27001, ITIL, COBIT, SAS70 and others. Service level management is the cornerstone of the added value offered by a Support PSF.

Three pillars underpin the concept of organisational excellence: sound internal control mechanisms, good corporate governance principles as well as compliance and audit.

## Internal control

With policies and processes clearly defined and optimised, the management and board of directors of the organisation effectively oversee the execution of internal control mechanisms in relation to:

- management oversight
- risk assessment
- accountability measures
- information and communication
- monitoring of activities.

The Support PSF puts in place sound and efficient risk evaluation processes as well as processes for managing the risk of those operational activities which are closely associated with the financial sector.

The observance of legal and regulatory requirements ensures the long term viability of the Support PSF. Strictly conducted internal and external audits, as well as direct reporting lines, guarantee ongoing control by the supervisory authority.

## Corporate governance

The tight supervision rules prescribed by Luxembourg's financial supervisory authorities lead to an effective application of corporate governance principles. These principles provide guidance, foster the balanced exercise of power and control within the organisation, and encourage dialogue and transparency in the best interest of all stakeholders.

Support PSFs are committed to good corporate governance and their execution of appropriate measures is supervised by the CSSF. These strict governance rules apply to definition of mission scope and service levels. They ensure a high level of quality of the outsourcing relationship and commitment to clear service level agreements.

Luxembourg Support PSF regulation provides a solid framework for compliance with the requirements of the Basel Committee, the Committee of European Banking Supervisors (CEBS), the MiFID Directive and the corresponding Level 2 measures<sup>4</sup>, in the case where a financial institution relies on third party providers for managing critical operational functions.

<sup>4</sup> The Level 2 measures of the MiFID directive provide information and guidance on how to implement Article 13(5) in great detail, including:

- non-delegation of compliance: if a supervised company delegates an activity to a service provider, the responsibility of the activity remains with the management of the investment firm;
- service level agreements: written agreements between the supervised company and the service provider are mandatory and must clearly define the functions of each party as well as provide measures for continuous monitoring and mechanisms for managing services and adjusting the agreement;
- general requirements of the supervised company in relation to supervising services and risk management: monitoring quality, maintaining internal supervisory expertise and providing appropriate termination rights.



## Compliance and audit

Supervised companies must comply with the law and with the circulars published by the Luxembourg prudential supervisory authority. Compliance is assessed by conducting evidence based internal audits.

The obligatory auditing helps customers to improve control of their outsourced activities, and guarantees that formal agreements are translated into a tangible reality.

The Support PSF applies the same code of conduct as its financial industry customers. Each person involved at any level of the organisation shares knowledge and understanding of the rules applicable to deposit-taking institutions such as banking secrecy, confidentiality of customer

information and anti-money laundering measures. Continuous training of relevant staff ensures that Support PSFs are up to date with the latest developments of the financial sector as they apply to the services they provide.

## A final word

Luxembourg's unique approach has contributed to building a centre of excellence for regulated outsourcing. In addition to other attractive factors, this may prompt financial institutions to consolidate certain global services for their organisations in Luxembourg.

Companies that go this way will achieve economies of scale and reap benefits from outsourcing to well trained Support PSF teams who have aligned their business processes with the statutory environment of their customers.

# Luxembourg for Finance

Agency for the Development of the Financial Centre

Luxembourg for Finance is a public-private partnership between the Luxembourg Government and the Luxembourg Financial Industry Federation (PROFIL). It consolidates the efforts made by the public authorities and principal actors of the financial sector to ensure the development of an innovative and professional financial centre through a coherent and structured communications policy.

Thus Luxembourg for Finance will enhance the external presentation of the financial centre, communicating the advantages of its products and services to a wider public and highlighting the numerous opportunities available to investors and clients, whether institutional or private, from around the world.

Luxembourg for Finance organises seminars in international financial centres and takes part in selected world class trade fairs and congresses.

The agency also develops its contacts with opinion leaders from international media and is the first port of call for foreign journalists.



## Luxembourg for Finance

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