Intra-group outsourcing arrangements in the financial services industry

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Outsourcing has never been so popular in the financial services industry. The benefits from cost effectiveness to operational excellence are undeniable. It drives innovation in an increasingly competitive business environment. Benefits aside, outsourcing comes with inherent strategic, operational, financial, compliance and legal risks. European regulatory agencies have been publishing guidelines to frame outsourcing governance and ensure that risks are addressed adequately.

European Supervisory Authorities (ESAs) formed by the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) have each published extensive guidance on the subject. The European Central Bank and national authorities, including the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg, are also monitoring the sound governance of the outsourcing framework of the regulated entities through on-site inspections.

CSSF Circular 22/806 on outsourcing arrangements

The latest pertinent development in Luxembourg is the CSSF Outsourcing Circular (22/806), issued in April 2022, which implements the EBA Guidelines on Outsourcing (EBA/GL/2019/02) and ESMA Guidelines on outsourcing to cloud service providers.

In a nutshell, the Outsourcing Circular frames the governance requirements throughout the lifecycle of outsourcing arrangements. The circular applies to large group of entities which vary from credit institutions to investment fund managers. For investment fund managers, the Outsourcing Circular only applies to information and communication technology outsourcing arrangements.

The main regulatory requirements in the Outsourcing Circular are related to adequately defining management body, roles and responsibilities and the three lines of defense. These are regularly assessing the risks related to outsourcing arrangements, implementing a solid and comprehensive contract to continuously monitor the service provider, and having an exit strategy to activate the service termination phase. The regulated entities must maintain an appropriate level of documentation to establish the governance and management of their outsourcing arrangements.

The requirements in Circular 22/806 also apply to intra-group outsourcing. Intra-group outsourcing is an arrangement where the regulated institutions use the services of one of their own group entities. This group outsourcing operating model is expected to be encountered more frequently in the near future thanks to the operational benefits and opportunities it presents.

With the aim of aligning with the group's strategy, accessing network expertise and human capital, creating synergies, fostering innovation and efficiently managing costs, many financial institutions in Luxembourg have already started leveraging the services offered by their group or entities of the group (e.g., a group technology firm). In recent years, among frequently observed intra-group outsourcing, some examples are information and communication technology (ICT) services, back-office operations, and human resources services.

Specific considerations for intra-group outsourcing

From a risk management point of view, the regulators do not interpret intra-group outsourcing as risk-free in comparison to other third-party service providers. In fact, the Outsourcing Circular clearly states that intra-group outsourcing *"is subject to the*

same regulatory framework and conditions as outsourcing to service providers outside the group," as this is not less risky than outsourcing to an entity outside the group. As such, regulated institutions are still expected to manage risks related to their intra-group outsourcing.

The reasons for selecting the group entity should be based on objective reasons and subject to appropriate decision-making processes. The outsourcing arrangement may not expose the financial institution to an undue conflict of interest. The outsourcing entity should design a control framework to appropriately perform the monitoring and oversight of the group entity providing the services. When outsourcing to a group entity, regulated entities should pay attention to business continuity and exit strategy. Nevertheless, financial institutions can explore and exploit opportunities with their group entities under these requirements and also due consideration of applicable transfer pricing (TP) rules and principles.

Transfer Pricing considerations

As previously mentioned, principles and requirements enshrined in the Outsourcing Circular equally apply to arrangements entered into between related parties. Chapter 3 *"General principles governing outsourcing arrangements and intra-group outsourcing,"* explicitly references the arm's length principle, i.e., *"when functions are provided by a service provider that is part of a group or that is owned by the In-Scope Entity or its group, the conditions, including financial conditions, for the outsourced service shall be set at arm's length."* Hence, when outsourcing activities to related parties, TP implications must be carefully considered to ensure that respective arrangements comply with the arm's length principle.

The OECD Transfer Pricing Guidelines (OECD Guidelines) are an authoritative source of interpretation of the arm's length principle stated in Article 9 of the OECD Model Tax Convention. Luxembourg is a member of the OECD and its TP regulations incorporate key concepts of the OECD Guidelines. The general principles therein should be carefully considered. In particular, before setting an "arm's length price" on services, an In-Scope Entity must first accurately delineate the transaction and analyze the need for that service and if the service gave the recipient a benefit that a third party would be willing to pay for.

Depending on facts and circumstances, different TP methods can be applied to set the price of outsourced services. The selection of the most appropriate methodology would largely depend on the outcome of a dedicated comparability and functional analysis to be performed under the accurate delineation of the services. Generally, in cases where it is possible to identify independent comparable outsourcing transactions, the Comparable Uncontrolled Price (CUP) Method may be used to determine an arm's length remuneration.

However, in the absence of comparable uncontrolled transactions, the "Cost Plus" Method may be an appropriate alternative. Further, the Outsourcing Circular suggests to factor in synergies resulting from providing the same or similar services to several In-Scope Entities within a group. Group synergies are also a key concept in the OECD Guidelines, since the benefits of intra-group services include reduced costs from economies of scale and efficient use of resources which could affect the overall transfer price.

Regarding the contractual terms at arm's length, special consideration should be given to the "parties' financial obligations." While applicable TP method and arm's length remuneration can be explicitly disclosed, this is not expressly required by the Outsourcing Circular. It is common practice to include a broader reference to the applicable TP policy in the relevant intra-group agreement (to the extent, of course, that parties can duly substantiate that applicable transfer prices are at arm's length).

The sufficient level of substance to be retained by the entity outsourcing the services should also be carefully analyzed as it also triggers tax and TP considerations. Based on the Outsourcing Circular, In-Scope Entities must "maintain at all times sufficient substance and not become 'empty shells' or 'letter-box entities.'"

To this end, In-Scope Entities must meet certain criteria like exercising appropriate oversight over the outsourced functions, having sufficient skilled resources and capacities, meeting all authorization conditions at all times (including the management body effectively carrying out its supervisory function by overseeing and monitoring management decision-making). This clearly shows common points in the substance requirements (e.g., the presence of qualified personnel performing risk control/management functions) from a tax and regulatory perspective that - however - should be considered in detail on a case-by-case basis.

Above are only some of the Tax/TP related implications stemming from the Outsourcing Circular. For instance, In-Scope Entities must also design an appropriate TP policy to assess what level of TP documentation is necessary to support the arm's length nature of the services based on local requirements and standards plus secondary documentation to support the benefit test in relation to the outsourced services. Further, whenever branches are In-Scope-Entities (i.e., they are covered by the Outsourcing Circular), the Authorized OECD Approach should be applied in parallel to the OECD Guidelines in case the outsourcing occurs between a branch and its head office.

Here again, a thorough analysis is important to identify all tax/TP implications based on specific outsourced service at stake and to have proper documentation in place to ensure their compliance with the arm's length principle in order to minimize the potential risk of challenges from both a tax and regulatory perspective.

Concluding remarks

In the eyes of the regulator, intra-group outsourcing is not less risky than outsourcing to third-party providers, and there are specific challenges for this type of outsourcing given the unique relationship between the parties and the applicable regulations. Further, when thinking of outsourcing intra-group services, it is important to consider not only the regulatory implications stemming from the

Outsourcing Circular, but also the related tax and TP angles to ensure In-Scope Entities are compliant with the regulatory framework and relevant tax principles and standards.