PwC Luxembourg Sourcing Strategies Survey:

The Age of Strategic Agility

Fourth edition

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Foreword

A radical paradigm shift is taking place within the financial sector.

With the global financial crisis of 2007-2009 now a somewhat distant memory, many had gotten used to the prolonged low-interest rate policies adopted by central banks across the board. But, for better or worse, those days are no more.

Our world is entering a new economic era defined by sticky inflation, high interest rates, and uncertain growth. Geopolitical instability and trade disruptions are the new normal, while the threat of climate change becomes more dire year after year. Moreover, new technologies – particularly artificial intelligence and its offshoots – appear poised to redefine virtually every sector and industry, in addition to the very way we work or handle matters as crucial as cybersecurity and data privacy.

Luxembourg is no stranger to such perilous economic times. In the 1970s, when the country was hit hard by the steep global decline in steel prices, the much-vaunted Tripartite Coordination Committee was formed, providing a forum for public and private stakeholders to collectively devise a way out. As a result, decades of sustained growth and prosperity ensued, with the Luxembourg financial centre now widely – and rightly – recognised as a global centre of excellence.

Today, Luxembourg is at a similar crossroads, and the financial centre's prominence makes it a key driver in the country's socioeconomic development. In this new context, financial institutions have no choice but to scrutinise their operational models, enhance their efficiency, and remain agile, all while navigating the intricate and perpetually evolving regulatory landscape.

At this juncture, the decision of whether to outsource crucial tasks has never been more consequential. We hope this report will help bring clarity to financial institutions in the Grand Duchy in these times of uncertainty.

Cécile Liégeois
Clients & Markets Leader
PwC Luxembourg

Executive summary

Outsourcing remains very high in Luxembourg's financial centre, as 90% of respondents outsource some kind of activity. The rate of outsourcing is high among all types of respondents, regardless of their sizes.

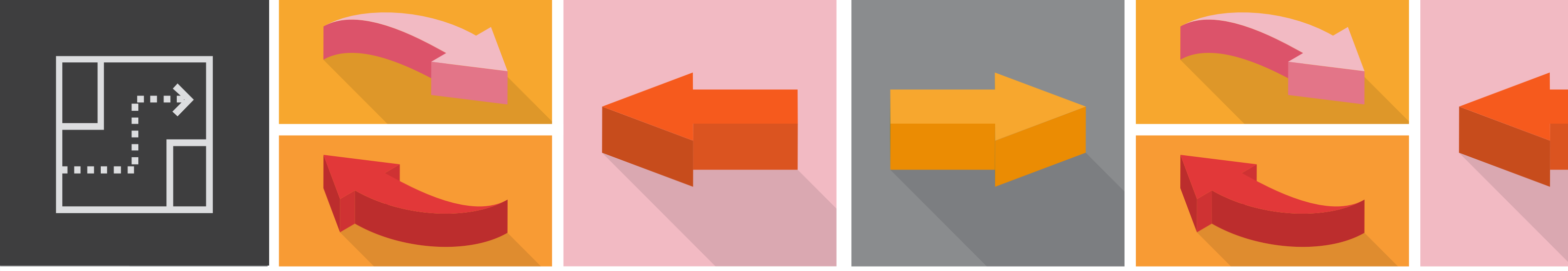
Financial institutions in Luxembourg are either **fully outsourcing** certain business functions **or not outsourcing** them **at all**. The partial outsourcing of functions has significantly fallen.

Respondents increasingly favour **quality and expertise over cost when it comes to outsourcing.**

The outsourcing landscape is undergoing **major changes** in anticipation of the EU's Digital Operational Resilience Act (DORA).

Use of AI is not as commonly outsourced as other functions, but this is likely because many firms have not implemented it yet.

The asset and wealth management industry outsources more than the insurance or banking sectors, while banks are the most concerned about DORA's implications.



Introduction

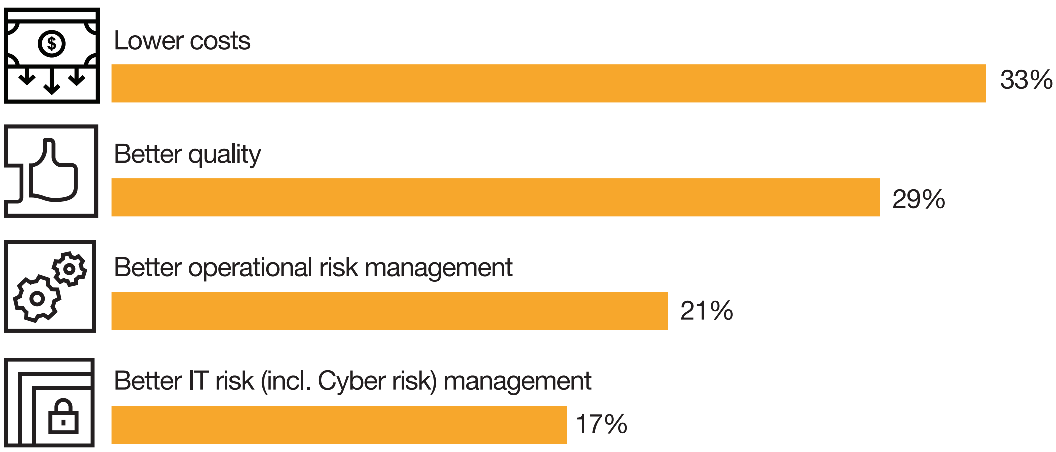
The financial sector is forward-thinking and preparing for a shifting world. Geopolitics, macroeconomic headwinds and the rapid development of technology have introduced new paradigms and evermore complex ways to deal with them. Meanwhile, regulations are constantly evolving to keep pace with this new world. Since financial actors need to be ready to switch gears at a moment's notice, their outsourcing strategy is of critical importance. The advent of the upcoming EU-wide Digital Operational Resilience Act (DORA), which will start applying from January 2025 onwards, is a tectonic shift that will specifically affect outsourcing activities across the EU as well as non-EU companies providing services to EU entities. Financial actors of all stripes must begin preparing themselves for it.

Financial players may need to turn to technologies such as cloud computing to maintain their profitability and expand their activities and client base, but many lack the in-house technical skills. According to the European Supervisory Authorities' (ESAs) report on ICT Third-Party Providers (TPPs), most outsourced ICT services support critical or important operations and cannot be substituted.[1] Luxembourg's *Commission de Surveillance du Secteur Financier* (CSSF) has stated that financial innovation and adapting to new technologies were some of the main challenges for 2023.[2]

Outsourcing has its benefits…

Lower costs are one of the many benefits of outsourcing. Indeed, when asked about the biggest benefit experienced with the current outsourcing arrangements, survey respondents ranked it as the top benefit, followed by better quality (cf. Exhibit 1).

Exhibit 1: Biggest benefits experienced with current outsourcing arrangements



Source: PwC AWM & ESG Research Centre

1. ESAs Report on the landscape of ICT third-party providers in the EU, September 2023
2. Financial Sector Supervisory Commission (CSSF) Annual Report 2022, August 2023

In the Asset and Wealth Management (AWM) industry, asset managers are under immense pressure to optimise their operations due to falling profit margins, which is pushing the industry towards outsourcing. Indeed, manager fees, especially for traditional asset managers who focus on active investment strategies, have been declining since the mid-2010s,[3] partially due to the rise of alternative and passive markets.[4] As reported by Bloomberg, 90% of revenues have been generated thanks to rising markets since 2006 – a strategy that can no longer be relied on in the current context.[5]

PwC's AWM Revolution series[6] has consistently foreseen the importance of outsourcing as a way to streamline operations, which could mark the difference between life and death for many industry players in the coming years. However, this new economic context has implications for all financial players, and outsourcing could be a viable option for financial stakeholders beyond the AWM industry.

… but regulatory changes have caused uncertainty

In 2019, the European Banking Authority (EBA)'s Outsourcing Guidelines[7] offered a comprehensive outline of the due diligence and oversight expected of firms towards their outsourcing contracts. In Luxembourg, the CSSF's Circular 22/806[8] on outsourcing arrangements then implemented these guidelines in 2022, slightly intensifying the regulatory requirements. Even though financial institutions are still adapting to these changes, they must simultaneously prepare for DORA.

DORA will undoubtedly be a game changer that will revolutionise outsourcing, requiring even more vigilance towards contracting parties, and it is set to make great strides towards enhancing technological and information security across the financial sector. However, stakeholders in the sector are finding themselves in a period of uncertainty, sandwiched between these two regulatory frameworks, while the European Fund and Asset Management Association (EFAMA) has already called some of DORA's approaches "excessive."[9]

Diverging strategies

Luxembourg's financial sector is being pulled in two directions when it comes to outsourcing. On the one hand, firms need to become more streamlined and access evermore complex paradigm-shifting technologies that are difficult to build in-house. However, businesses are also facing greater regulatory scrutiny than ever before, which is making outsourcing more difficult and costlier.

This survey reflects this new reality and reveals how the outsourcing landscape is drastically evolving, with firms either doubling down on outsourcing or increasingly moving away from it. Partial outsourcing is being abandoned in favour of these more extreme options, and outsourcing to a single, large contractor is gaining popularity over using multiple smaller vendors. This creates concentration risks, which DORA was created to oversee and monitor.

Indeed, the diverging strategies observed among survey respondents may be an anticipated response to DORA, which is set to drastically alter how services are contracted in the financial industry. Outsourcing strategies are likely to continuously evolve to meet the challenges that DORA represents as financial actors prepare for a new reality.

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3. PwC, *Asset and Wealth Management Revolution 2023: The New Context*, July 2023
4. Société Générale, *The Future of Asset Management: Reinventing the Wheel or Staying Still?*, June 2023
5. Bloomberg, Money Managers With $100 Trillion Confront End of the Bull Market, October 2023
6. PwC, *Asset and wealth management revolution: The power to shape the future*, 2020
7. European Banking Authority (EBA), *Guidelines on outsourcing arrangements,* February 2019
8. CSSF, Circular 22/806, April 2022
9. European Fund and Asset Management Association (EFAMA), *Proposed changes to DORA require more proportionality and simplicity*, September 2023

Respondents’ profile

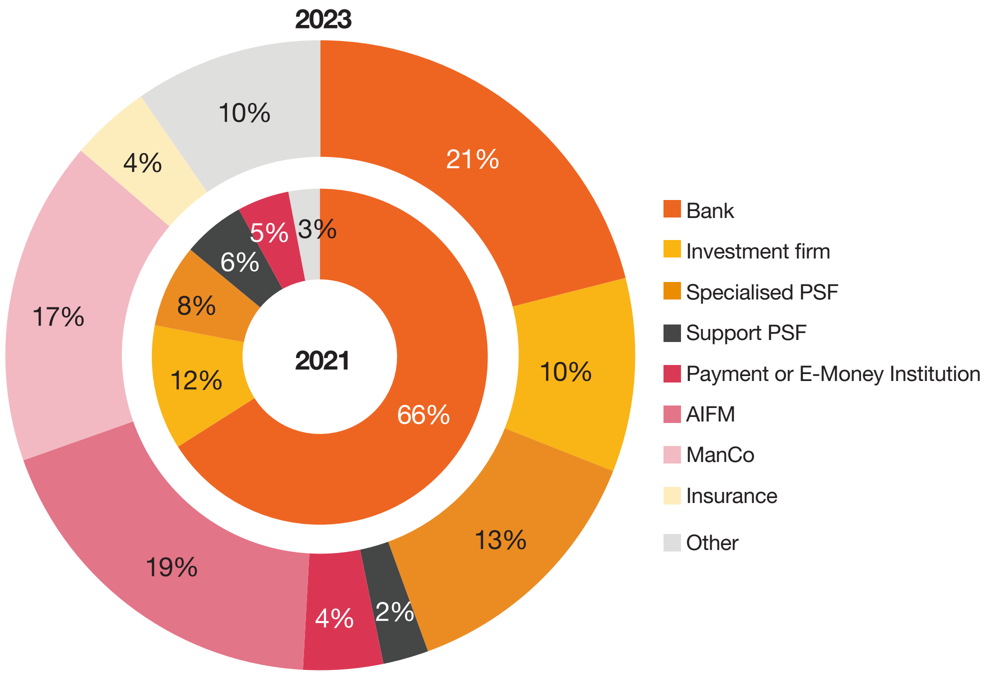
Our study is based on a comprehensive survey on outsourcing strategies addressed to the top executives and operational heads of prime financial establishments and service agencies in Luxembourg.

This year, the PwC Luxembourg Sourcing Strategies Survey was conducted using a much larger sample than in any previous edition. While the previous 2021 edition had 80 respondents, this report has a sample size of 342 drawn from a more diverse pool of financial entities. The significantly larger survey size has allowed us to conduct a more granular and in-depth analysis, with more robust findings about the state of outsourcing in the financial sector.

In addition to all the types of financial actors that were represented in the 2021 edition, survey respondents this year include Alternative Investment Fund Managers (AIFMs), Management Companies (ManCos), and Insurance Companies (including Life, and Non-Life insurance institutions).

Furthermore, as Exhibit 2 shows, this year, the sample offers a more balanced picture of the financial industry. Banks, i.e. the financial entities sample, only account for 21% of respondents, whereas they made up 66% in 2021.

Exhibit 2: Survey respondents by type of financial institution



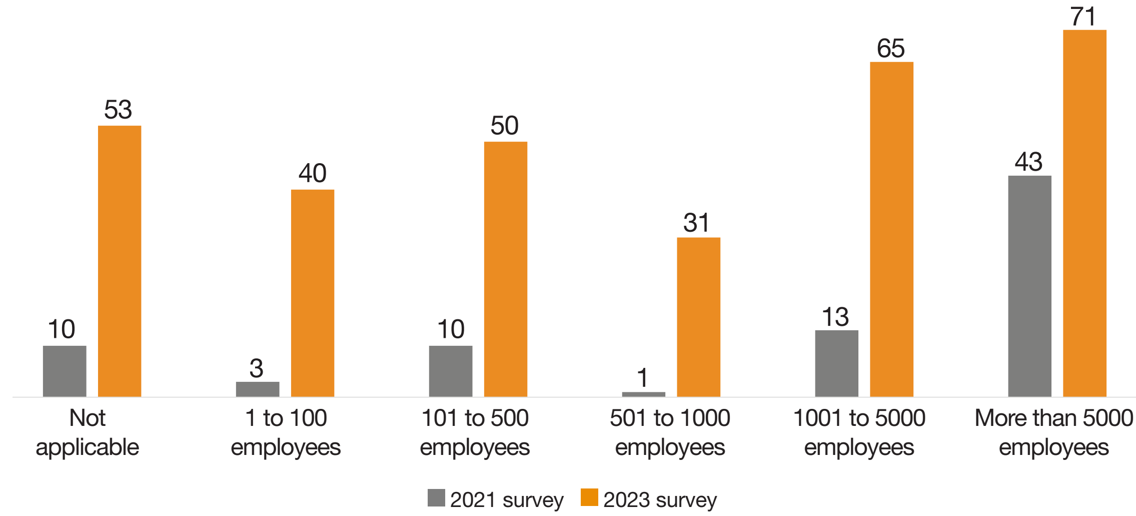
Note: The ‘Other’ category includes Advisory/Consulting firms, legal services, financial services, and accounting firms. For all subsequent graphs, respondents who answered ‘Other’ were excluded from the analysis as they are not in scope of outsourcing rules.

Source: PwC AWM & ESG Research Centre

Firms of all sizes are more evenly represented

In the 2021 edition, 43 out of the 80 firms (54%) represented had over 5,000 employees at the group level. In this edition, firms of all sizes are represented much more evenly. While this is a very important advancement that allows us to form conclusions about the industry with more certainty, it also means that last year's sample was skewed towards larger firms compared to this year's (cf. Exhibit 3). **Thus, it is important to consider this report's larger sample size and the fact that it is made up of a very different proportion of group sizes than the 2021 edition when drawing conclusions based on comparisons to data from the previous edition.**

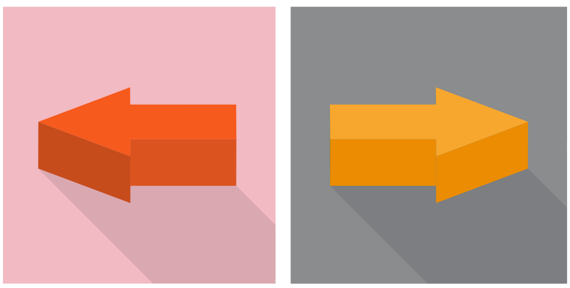
Exhibit 3: Number of survey respondents according to the number of employees at group level



Source: PwC AWM & ESG Research Centre

The vast majority (90%) of financial institutions in Luxembourg outsource at least some of their activities. This year's sample has allowed us to evaluate how a firm's size affects the extent to which it outsources. We have found that small firms tend to outsource at similar rates as large ones. Exhibit 4 shows how respondents answered the Yes/No question "Do you currently outsource parts of your activities?" and compares it to the size of the firm that those respondents belong to.

The results clearly show that the percentage of firms that outsource is similar for all firm sizes. Almost nine out of ten (89%) of the largest firms – those with more than 5,000 employees – outsource at least some of their activities. The number is almost identical (86%) among firms with 100 employees or less (cf. Exhibit 4).



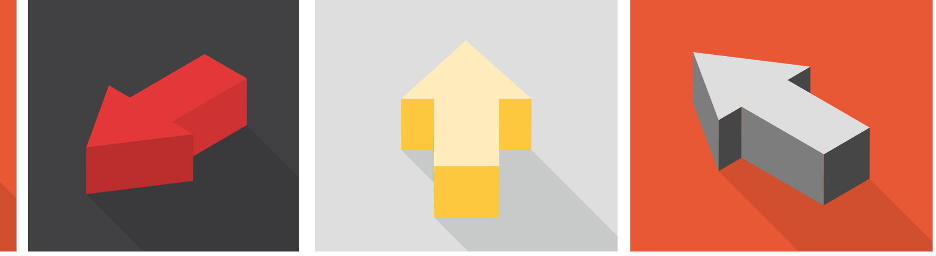
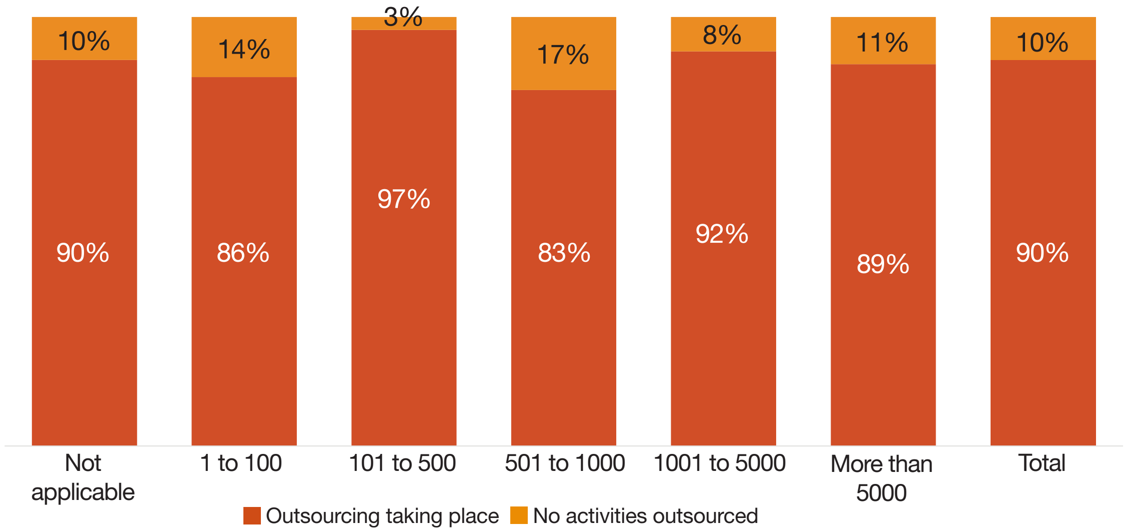


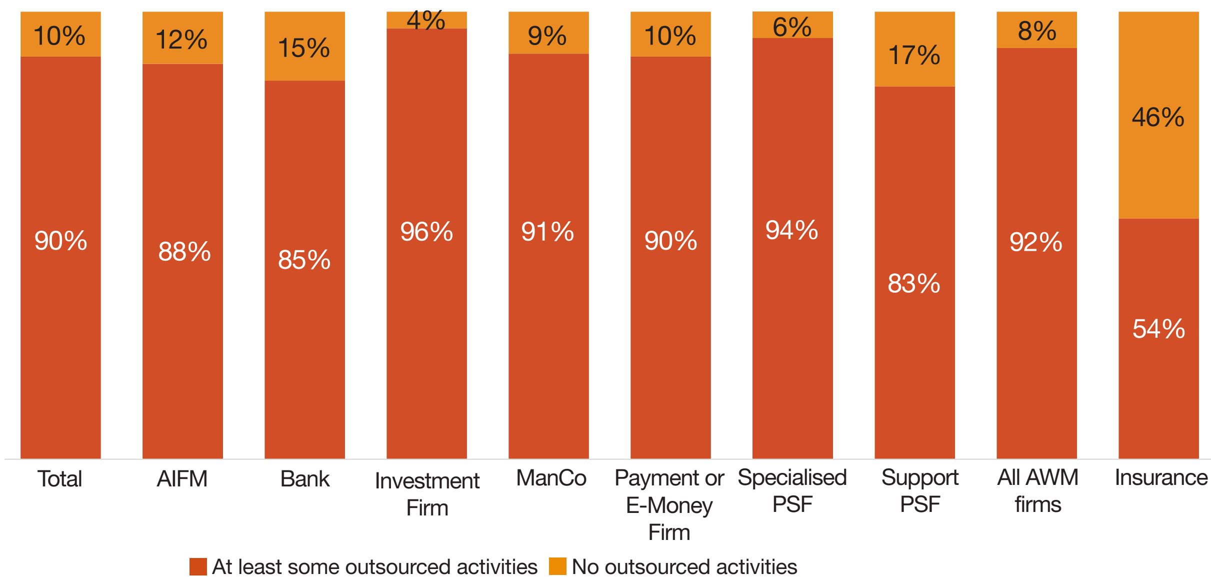
Exhibit 4: Outsourcing activities of Luxembourg-domiciled financial entities by group size



Source: PwC AWM & ESG Research Centre

When broken down by sector, the results show relatively little difference in outsourcing tendencies between most respondent categories – with the exception of the insurance companies. A whopping 85% and 92% of banks and AWM firms respectively outsource some of their functions, compared to just 54% of insurance companies. Among the AWM firms, just 4% and 9% of investment firms and ManCos do not outsource any activity (cf. Exhibit 5).

Exhibit 5: Outsourcing activities by type of financial institution



Note: The 'All AWM firms' category is an amalgamation of Investment firms, AIFMs, ManCos, Specialised PSFs, and Support PSFs that have been aggregated in order to provide an overview of the AWM Industry. The survey itself did not give participants the option to classify themselves as an 'AWM firm.'

Source: PwC AWM & ESG Research Centre

Regulatory overview

The financial sector is in a transitory phase between two regulatory eras.

New regulations are redefining the outsourcing landscape in both Luxembourg and the European Union. The financial industry is still adapting to the recent April 2022 CSSF regulations (Circular CSSF 22/806) on outsourcing, while anticipating the enforcement of the EU's DORA in January 2025. DORA is set to be a paradigm shift in terms of ICT outsourcing requirements, and ICT operations more broadly.

These regulations all require more oversight and due diligence by the financial sector vis-à-vis their outsourced activities, particularly their ICT operations when it comes to DORA. As a result, entities are limiting their outsourcing activities resorting to them only after careful consideration and only doing so when necessary.

May 2017
Circular CSSF 17/654 comes into effect.

Sep. 2019
EBA Guidelines on outsourcing arrangements 2019/02 enter into force.[10]

Feb. 2021
Publication of this survey's third edition.

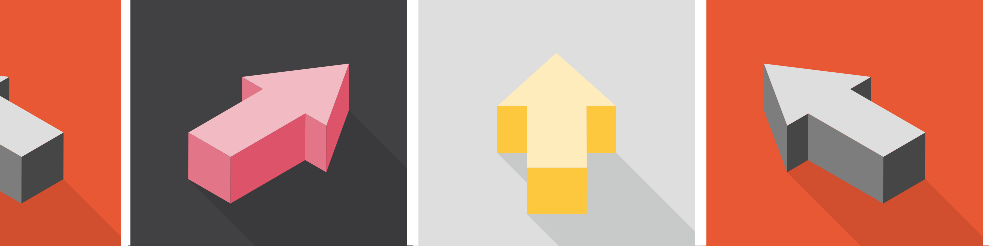
Apr. 2022
Circular CSSF 22/806 comes into effect.

Jan. 2023
DORA comes into effect but is not yet enforced.

Jan. 2024
DORA Regulatory Technical Standards published.[11]

Jan. 2025
Enforcement of DORA begins.[12]

10. European Banking Authority (EBA), *Guidelines on outsourcing arrangements*, February 2019
11. European Securities and Markets Authority (ESMA), *ESAs consult on the first batch of DORA policy products*, June 2023
12. PwC, *Digital Operational Resilience Act*, 2023



DORA overview

A game changer for the financial sector

The main objective of DORA is to strengthen the EU financial sector's operational resilience and manage its reliance on ICT Third party service providers. Among its provisions are the stricter outsourcing oversight requirements on ICT-related issues.

In June 2023, the ESAs launched a public consultation on four draft regulatory technical standards (RTS) and one draft Implementing Technical Standards (ITS) which seek "to ensure a consistent and harmonised legal framework in the areas of ICT risk management, major ICT-related incident reporting and ICT third-party risks management."[13] This was followed by another public consultation launched in December 2023, which will remain open until March 2024.[14]

Even though the consultation is ongoing, there is no denying that DORA's impact will be very significant on the European financial sector, particularly given that a wide array of ICT services are outsourced. DORA will demand constant attentiveness and detailed reporting from regulated entities once its provisions are applied starting in January 2025. Financial institutions will not only need to carry out due diligence on the partners they outsource to, but also on their partners' outsourcing partners (when there are any), ensuring that the entire outsourcing chain is secured. They must also carry out more comprehensive assessments and oversee operations on all of the ICT service providers in the entire outsourcing chain, and their ICT security strategies may be reviewed at any point by the regulators. DORA will thus affect financial institutions more intensely than any preceding ICT or outsourcing regulation.

Financial institutions will therefore have to thoroughly review their ICT outsourcing practices and incorporate new solutions if necessary in order to fully comply with DORA by 2025. By applying to ManCos and Insurance companies,[15] DORA also affects a much larger portion of the financial sector.

The new framework offers several benefits

DORA will make some processes simpler and enhance digital security. Firstly, it adopts a novel approach to regulating outsourcing by applying to IT contractors directly as long as they are considered "critical" to the financial sector. Rather than regulating ICT companies indirectly via their financial sector clients, tech companies with contracts in the financial sector will be required to submit themselves to the ESAs' oversight.[16] Additionally, DORA will help mitigate the high losses associated with ICT breaches.

According to IBM, the average global **cost of data breaches** in 2023 was **USD 4.45 million.**

In 2023 the **CSSF launched its first cyber-attack** in order to test entities' cybersecurity capabilities.[17]

The size of the International Business Processing Outsourcing market was estimated to be USD 292.3bn in 2023. By 2030 it is expected to reach USD 478bn.[18]

13. EIOPA (2023). *ESAs consult on the first batch of DORA policy products*, June 19, 2023. https://www.eiopa.europa.eu/esas-consult-first-batch-dora-policy-products-2023-06-19_en
14. ESMA, ESAs launch joint consultation on second batch of policy mandates under the Digital Operational Resilience Act, December 2023
15. EFAMA, *Proposed changes to DORA require more proportionality and simplicity,* September 2023
16. Bankinghub.eu, *Digital Operational Resilience Act (DORA) – new requirements and implications*, March 2023
17. Delano, *CSSF leads cyber attack on financial institution,* October 2022
18. Research and Markets, *Business Process Outsourcing (BPO) – Global Strategic Business Report*, December 2023

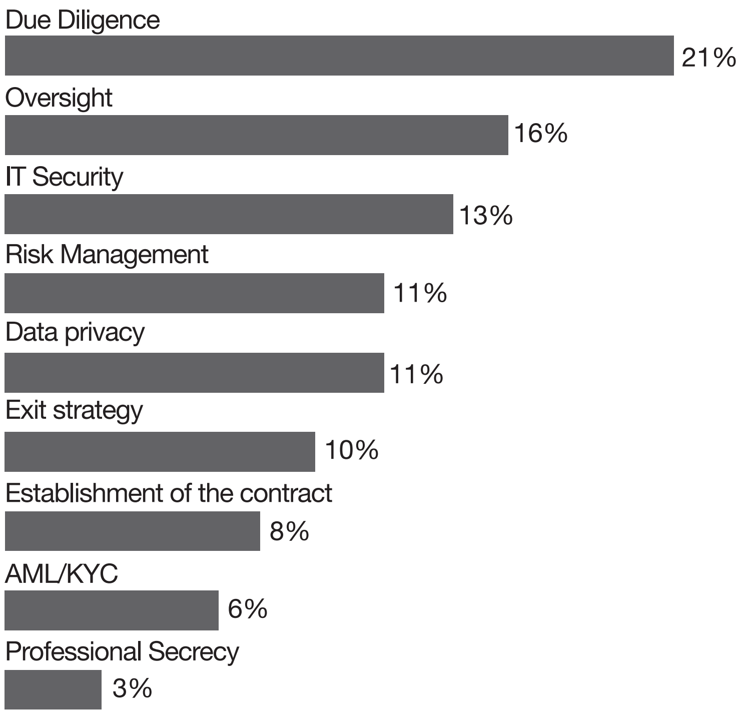
Impact of regulations

Due diligence and DORA trepidation

The main reaction from survey respondents to the regulatory waters in Luxembourg has been concern about due diligence. This is unsurprising given that this is the main requirement of all recent regulations that deal with outsourcing, including DORA. A little over one-fifth (21%) of respondents claim that due diligence is a main regulatory challenge to outsourcing, while a further 15% cite oversight as a challenge (cf. Exhibit 6).

Survey respondents are generally rightfully concerned over the extent to which DORA will affect their due diligence and overall operations. These challenges are two sides of the same coin, as they both refer to entities' responsibility to closely monitor their outsourcing activities. DORA will affect most businesses in unprecedented ways and require tectonic shifts in several day-to-day operations. It is therefore unsurprising that many respondents differ on how to react to DORA and the specific way in which it will affect them.

Exhibit 6: Regulatory challenges to outsourcing



Note: Numbers may not add up to 100% due to rounding.
Source: PwC AWM & ESG Research Centre

IT security is also a key concern for survey respondents, with 13% citing it as a top issue, and another 11% referencing risk management and data privacy. Failure to take ICT matters seriously – even before DORA becomes fully applicable – could lead to financial losses and legal missteps.

While one-third (34%) of our respondents are planning on further outsourcing activities in the coming two years, and another third (36%) are unsure whether they will do so (cf. Exhibit 7.a), it is interesting to note that, among those who intend to outsource, almost three-quarters (73%) are planning on outsourcing complex processes (cf. Exhibit 7.b), hinting at how DORA will significantly impact financial institutions and their ICT outsourcing processes in the very near future.

Exhibit 7a: Intention to further outsource in the coming two years

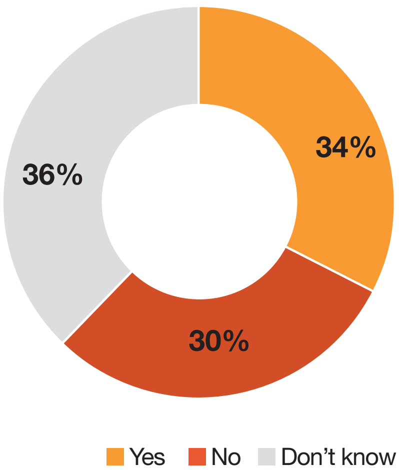
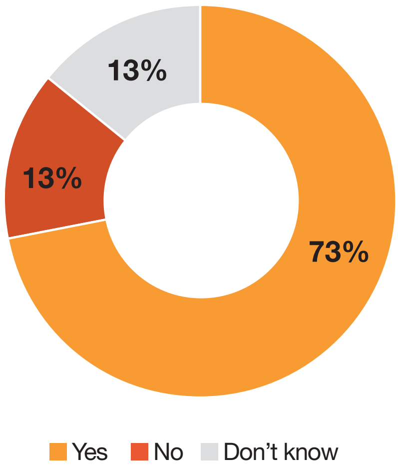


Exhibit 7b: Intention to outsource more complex processes in the coming two years

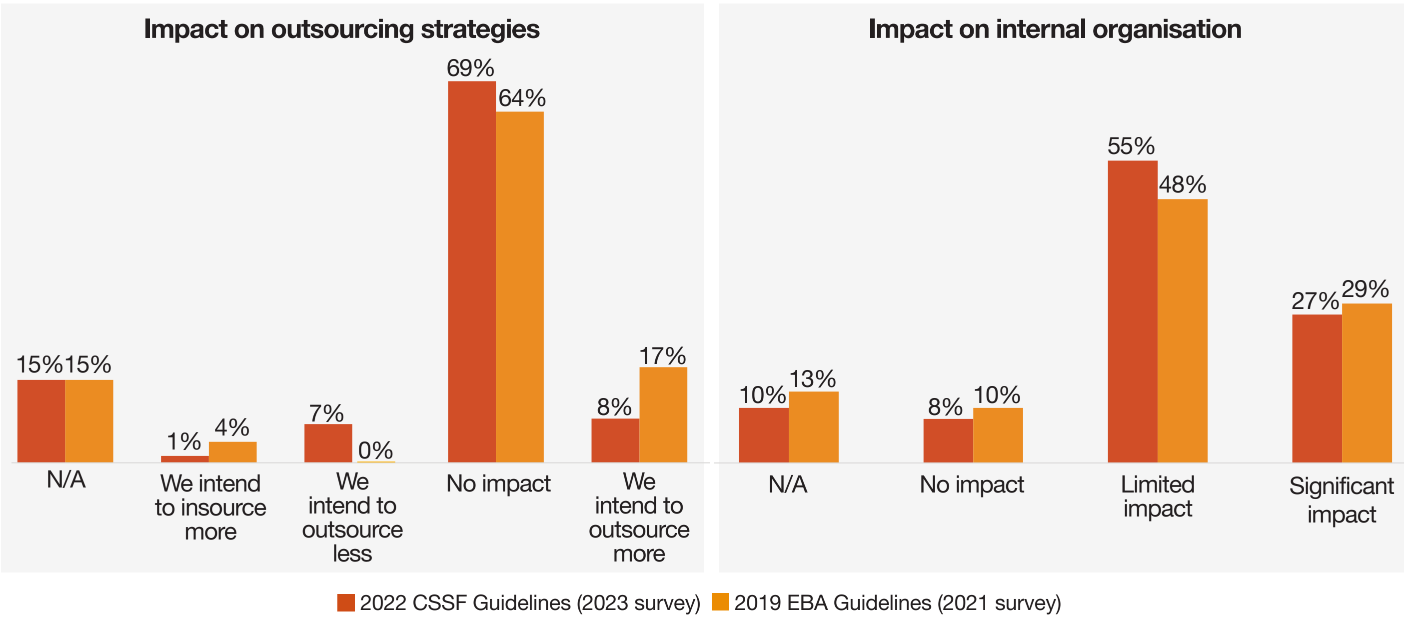


Source: PwC AWM & ESG Research Centre

CSSF Guidelines caused financial entities to outsource less

As Exhibit 8 shows, survey respondents from the current edition of the survey and the 2021 edition seem to find the impact of the 2019 EBA Outsourcing Guidelines and that of the 2022 CSSF Guidelines to be very similar. This makes sense, since the CSSF Circular is the Luxembourg implementation of the EBA Guidelines.

Exhibit 8: Impact of CSSF Guidelines and EBA Guidelines



Source: PwC AWM & ESG Research Centre

Nearly all responses to questions about the impact of these two regulations were very similar. However, there is one major discrepancy when it comes to the impact on outsourcing strategies. 17% of survey respondents in the 2021 survey stated they intended to outsource more because of the EBA Guidelines. When asked the same question about the CSSF Guidelines in 2023, only 9% stated they planned to outsource more. Conversely, none of the respondents stated in 2021 they would outsource less due to the EBA Guidelines, while 7% said they would do so in 2023 because of the CSSF rules.

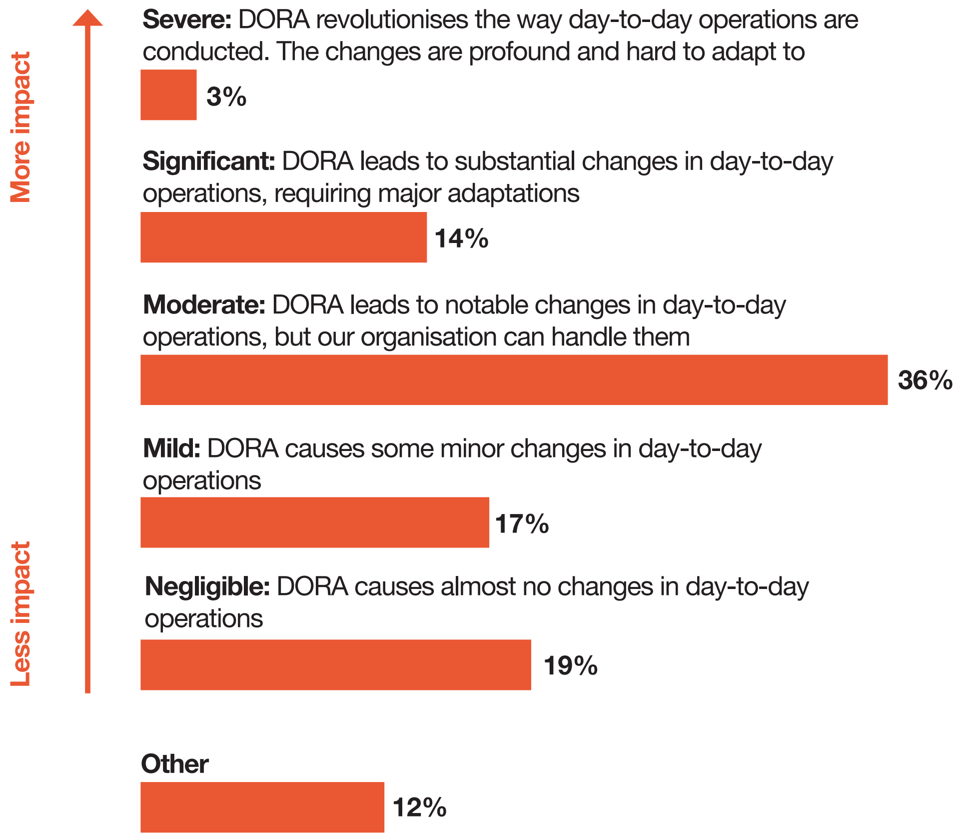
This is the only discrepancy in the responses to the two regulations, which indicates that the CSSF Guidelines caused some financial institutions that had been unphased by the EBA rules to begin limiting their outsourcing activities.

DORA is set to have a big impact on financial entities

Whereas most respondents (69%) reported that the CSSF Guidelines had no impact on their outsourcing strategies, financial institutions do seem to expect that DORA will have major ramifications for their operations. A little over half (53%) of respondents said that DORA would have moderate to severe impacts on either their outsourcing strategy or their internal organisation (cf. Exhibit 9).

Although only 3% of respondents claim DORA will have a severe impact on their organisation, it is worth noting that at the time the survey was conducted in September 2023, DORA's application was well over a year away. Concern over DORA is expected to intensify as 2025 approaches. Since this regulation will have widespread effects on the financial sector, underestimating it would be imprudent and it is expected that financial entities will increasingly view it as an impactful factor for their operations.

Exhibit 9: Impact on outsourcing strategy for internal organisation following the introduction of DORA



Source: PwC AWM & ESG Research Centre

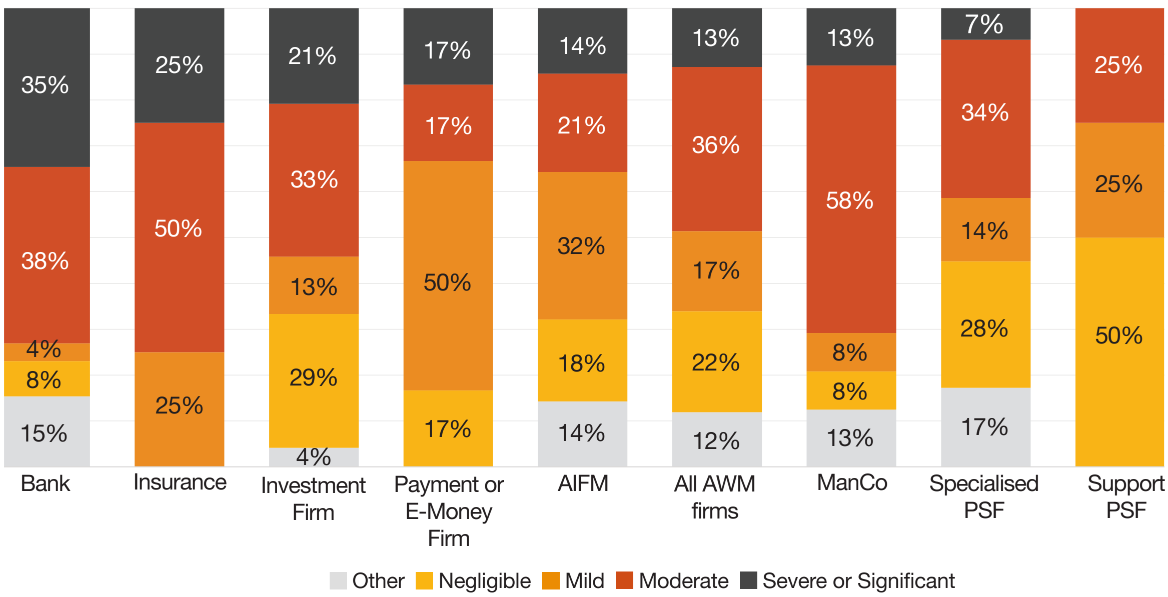
Banks anticipate the most severe impacts from DORA, but the AWM industry is not exempt

The anxiety surrounding the upcoming regulation is not evenly spread across the financial sector. Over one-third (35%) of surveyed banks expect DORA to have a severe or significant impact on their operations, and an additional 38% expect it will have a moderate impact.

On the other hand, respondents from the AWM industry – Investment firms, AIFMs, ManCos, and Specialised Financial Sector Professionals (PSFs) – might appear to expect slightly smoother sailing at first glance, with just 13% of them claiming DORA will have severe or significant effects, and 38% expecting DORA to have negligible or mild impacts (cf. Exhibit 9). However, when disaggregated by respondent categories, the picture becomes more complicated.

Over one in five (21%) investment firms expect DORA to have a severe or significant impact on them, and one-third (33%) expect moderate impact. Among ManCos, over half (58%) expect the impact to be moderate, while 13% expect it to be severe or significant. AIFMs are also not immune to DORA, as 14% are anticipating severe or significant impacts from DORA, while 21% expect moderate impacts.

Exhibit 10: Impact of DORA on different types of financial institutions



Note: the 'All AWM firms' category is an amalgamation of Investment firms, AIFMs, ManCos, Specialised PSFs and Support PSFs that has been aggregated in order to provide an overview of the AWM Industry. The survey itself did not give participants the option to classify themselves as 'AWM firm.' Numbers may not add up to 100% due to rounding.

Source: PwC AWM & ESG Research Centre

Outsourcing trends

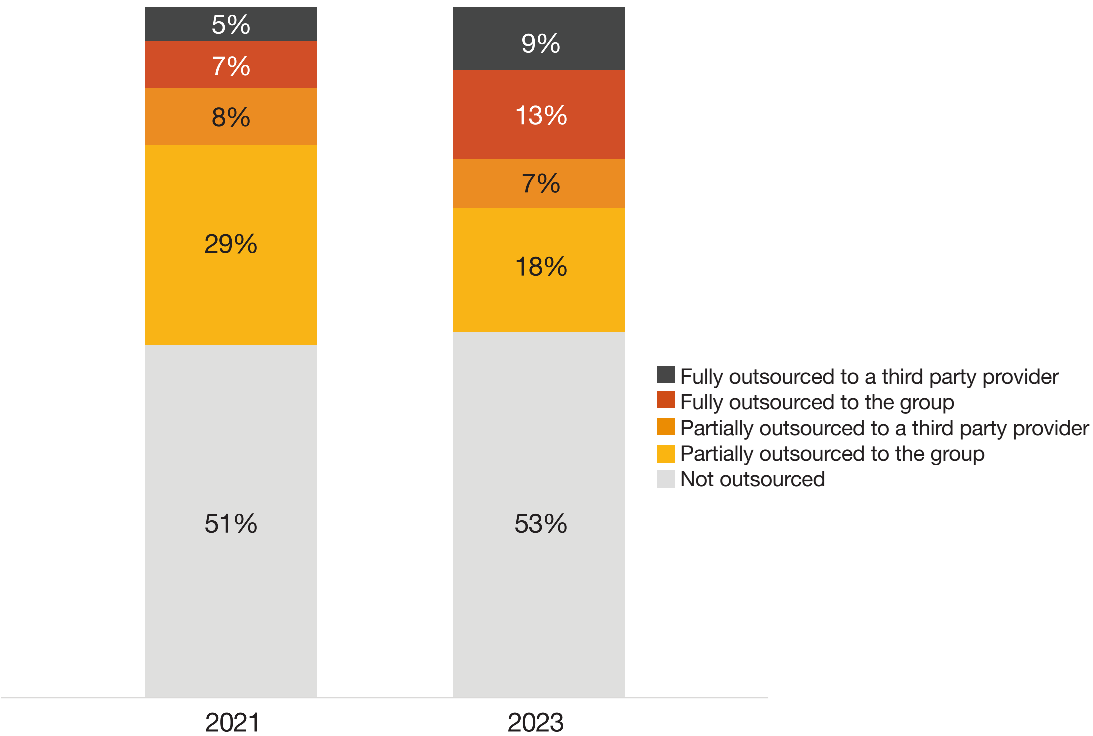
Half-measures abandoned

Overall outsourcing has become more polarised than in the last edition of this report. In the new sample there are slightly more entities with no outsourced operations compared to the 2021 survey. However, there are also more entities with fully outsourced functions. This suggests that companies might be favouring an all-or-nothing approach when it comes to outsourcing, preferring to either fully outsource or keep all their capabilities in-house.

This trend aligns with the uptick in regulatory requirements that has taken place since the 2021 edition, and which will continue in the coming years. Financial institutions are expecting more regulatory scrutiny and compliance requirements when it comes to their outsourcing activities and are thus opting for cut-and-dry solutions. Partially outsourced activities have seen a sharp decline since these grey zones are more likely to require overly complex monitoring by both companies and regulators.

In 2023, 22% of the business functions we questioned our survey's participants on were fully outsourced by Luxembourg financial institutions (either to a third party provider or to the entity's group), compared to just 12% in 2021. Conversely, partially outsourced operations contracted between 2021 and 2023 from 37% to 25% respectively. Non-outsourced functions increased from 51% to 53% (cf. Exhibit 11).

Exhibit 11: Average degree of outsourcing across business functions



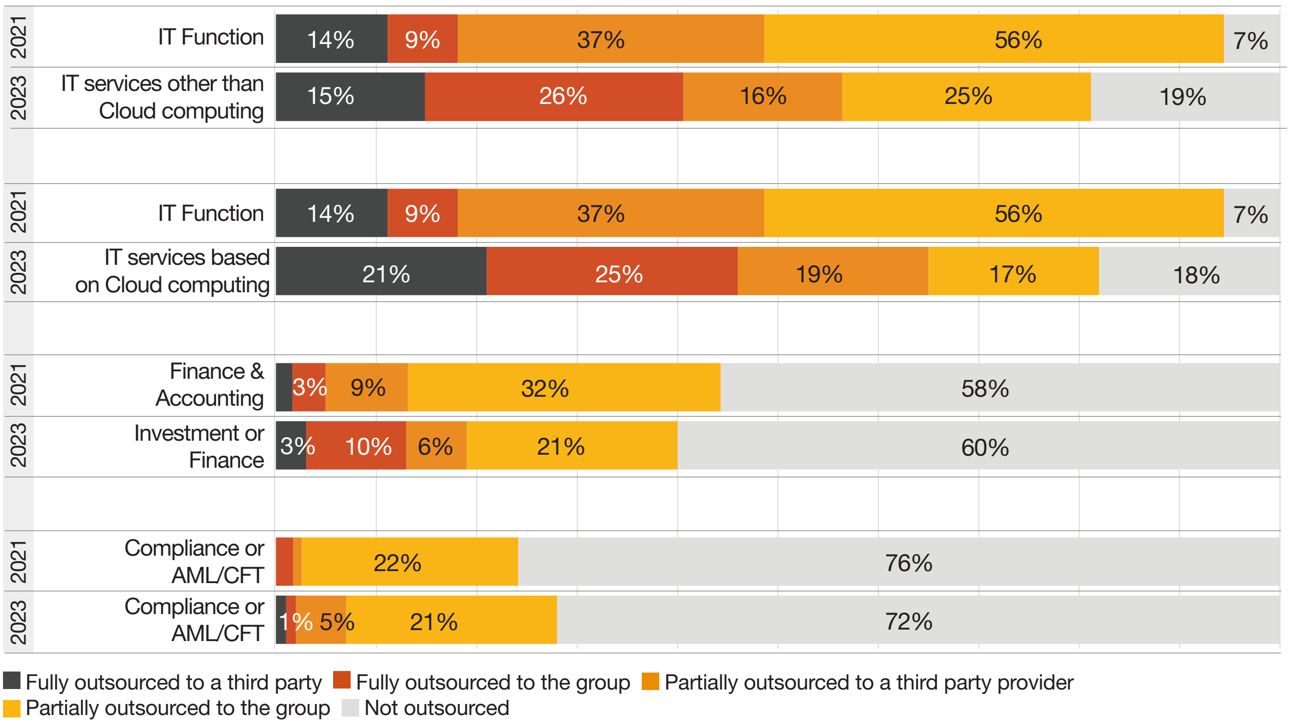
Note: The 2021 data is based on a sample size of 80, whereas the 2022 survey is based on a sample size of 342. The specific functions analysed for the 2021 data are different from those analysed for the 2023 data. Still, the aggregate average of outsourcing is a useful point of comparison between the two time periods.

Source: PwC AWM & ESG Market Research Centre

Outsourcing trends

This trend holds up when broken down by specific business functions. The functions in Exhibit 12 were highlighted because they appear in both the 2021 and 2023 reports and therefore offer a useful point of comparison. In nearly all cases, both fully outsourced and non-outsourced activities increased from 2021 to 2023, while partially outsourced activities declined. The only exception is with Compliance or AML/CFT, where non-outsourced activities decreased from 2021 to 2023 (cf. Exhibit 13).

Exhibit 12: Comparisons of selected functions between 2021 and 2023



Note: The 2021 data is based on a sample size of 80, whereas the 2022 survey is based on a sample size of 342. In the 2021 survey 'Compliance' and 'AML/CFT' were treated as distinct functions but were analysed as one in the 2023 survey. For the purposes of this graph, the Compliance and AML/CFT data from 2021 has been recalculated into one dataset.

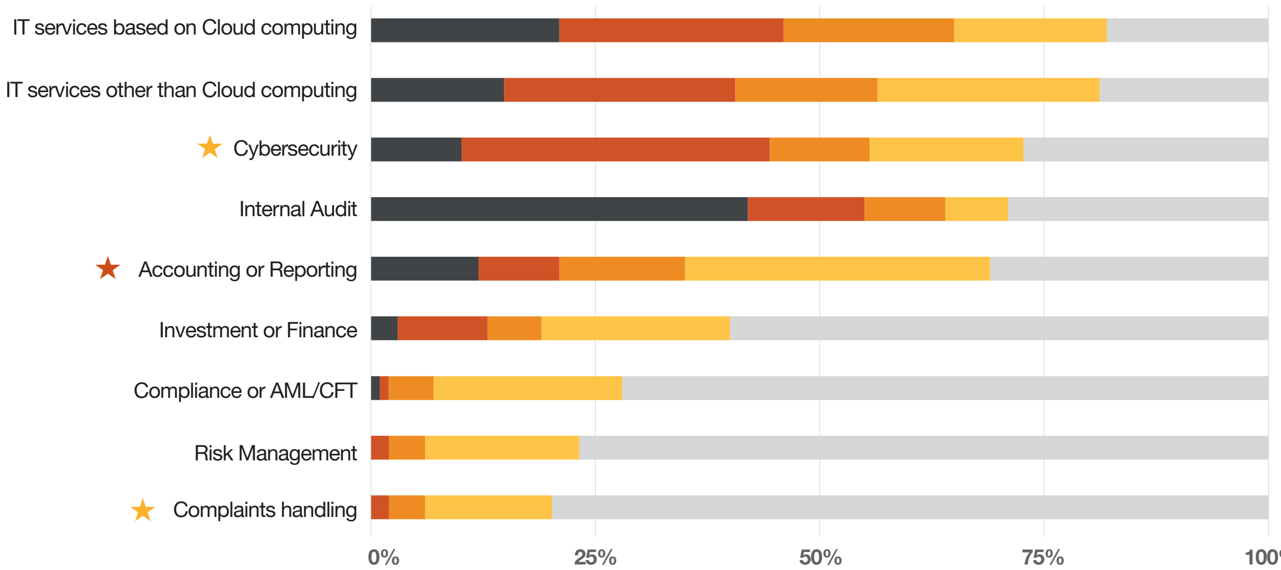
Source: PwC AWM & ESG Market Research Centre

Tech outsourcing in the lead

The following graph breaks down which activities are outsourced, and to which extent. It is generally the case that technology-related functions are more often outsourced. Indeed, ICT cloud computing and non-cloud computing services are the most frequently outsourced activities with 82% of them both outsourced to some degree (cf. Exhibit 14). This may also be a factor that helps explain why the financial sector is concerned about the advent of DORA.

It is noteworthy that AI and Data Analytics, despite their tech-heavy nature, are not as commonly outsourced as more traditional ICT functions. Only 26% of AI functions and 35% of Data Analytics functions are outsourced, either fully or partially, across respondents. However, this may be misleading. It is more likely that many AI activities are not outsourced because many firms do not use AI in the first place, rather than because the operations are carried out in-house. In fact, only 30% of financial firms in Luxembourg use AI technologies, according to the Central Bank of Luxembourg's (BCL) and CSSF's most recent survey on AI usage in the financial sector.[19]

Exhibit 13: "Traditional" outsourced functions

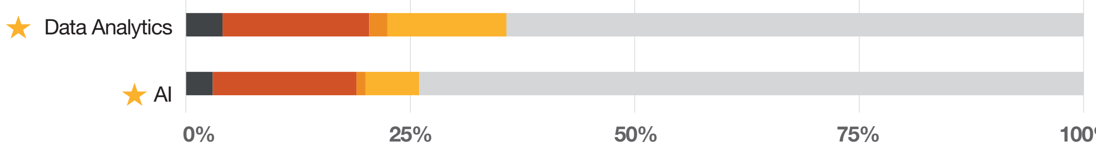


Fully outsourced to a third party Fully outsourced to the group Partially outsourced to a third party provider Partially outsourced to the group Not-outsourced

★ New topics since 2020 Survey ★ Significant increase in outsourcing since 2020

Source: PwC AWM & ESG Market Research Centre

Exhibit 14: "Emerging" outsourced functions



Fully outsourced to a third party Fully outsourced to the group Partially outsourced to a third party provider Partially outsourced to the group Not-outsourced

★ New topics since 2020 Survey ★ Significant increase in outsourcing since 2020

Source: PwC AWM & ESG Research Centre

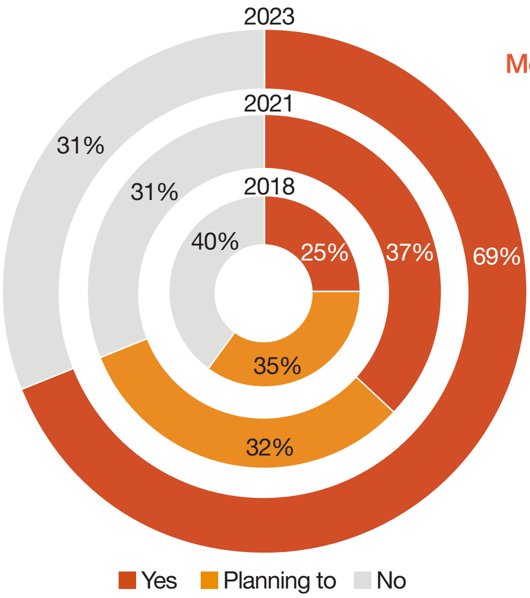
19. Banque Central du Luxembourg (BCL), CSSF, *Thematic review on the use of Artificial Intelligence in the Luxembourg Financial sector*, May 2023

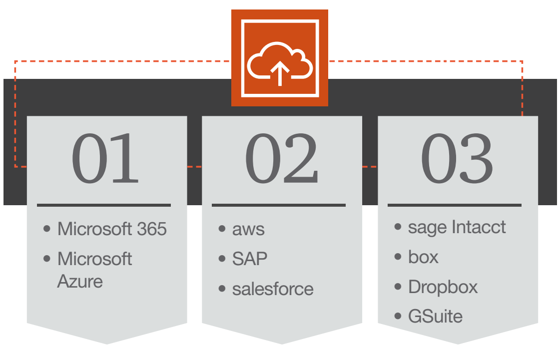
Cloud solutions

Financial firms are implementing more cloud solutions than in 2021 or 2018, when the second edition of this report was published.

This rise is consistent with the increase in IT outsourcing. Furthermore, survey respondents from 2021 seem to have followed through on their promises to increment their use of cloud technology. In the 2021 survey, 37% of respondents already used cloud solutions and 32% claimed they were planning to do so. As of the 2023 survey, 68% of respondents are cloud users. The most popular cloud solution among survey respondents is Microsoft, referring to either Office 365 or Azure (cf. Exhibit 15).

Exhibit 15: Implementation of cloud solutions





Source: PwC AWM & ESG Market Research Centre

Insurance Industry breakdown

This is the first ever edition of the survey to provide a specific analysis of the insurance industry. A total of 13 insurance firms answered the survey, and they were asked to answer additional industry-specific questions. Their responses are broken down in this section.

In Luxembourg, the insurance industry is regulated by the Commissariat aux Assurances (CAA) and is therefore not subject to CSSF regulations. However, the most recent CAA regulation on outsourcing, CAA Circular 22/16, is comparable to Circular CSSF 22/806 in terms of its general requirements and spirit. This regulation has been in effect since November 2022.

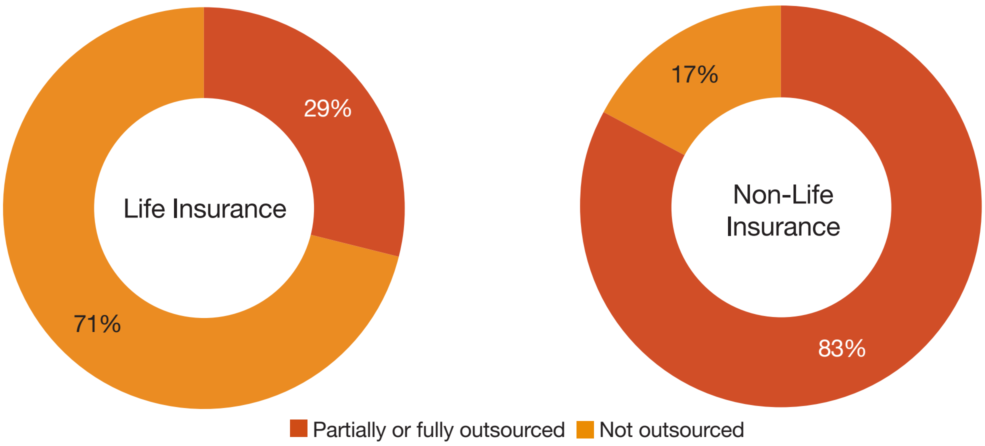
According to CAA Circular 22/16,[20] regulated entities are required to document all new outsourcing contracts in a register. Critical or important activities, key functions or activities leading to major business plan changes also need to be notified.[21]

20. Commissariat aux Assurance (CAA), *Circular Letter 22/16*, August 2022
21. PwC, *Luxembourg – Regulatory update – CAA released Circular 22/16 on outsourcing*, September 2022

Non-Life Insurance firms outsource much more

As Exhibit 16 clearly shows, 83% of Non-Life Insurance firms outsource some of their operations, compared to just 29% of Life Insurance firms.

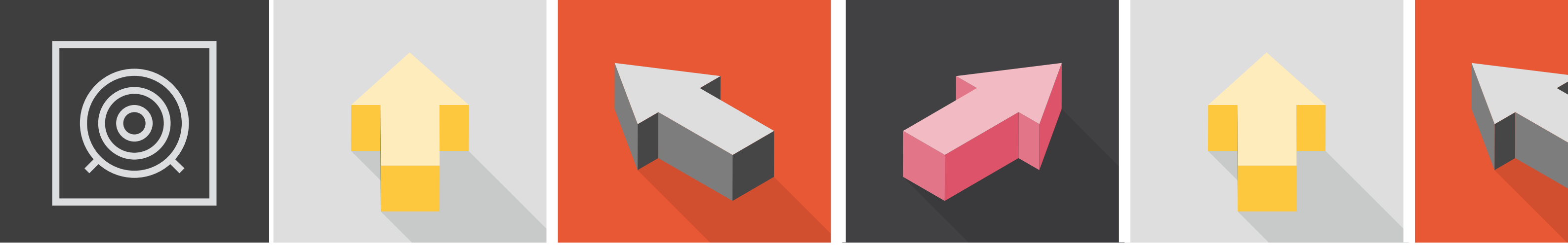
Exhibit 16: Insurance sector outsourcing breakdown



Note: This sample is made up of 7 Life Insurance firms and 6 Non-Life Insurance firms.
Source: PwC AWM & ESG Research Centre

Business activities that non-life insurance firms outsource according to the survey are Investment or finance, Cybersecurity, Product Distribution, and IT services (including those based on cloud computing). These operations were at least partially – if not fully – outsourced by three of the survey respondents.

However, changes under Article 300 of the Law of 7 December 2015 on the insurance sector could provide a new regulatory framework for entities and increase the amount of outsourcing within the industry. Outsourcing might also become a more attractive choice in the future, with insurance companies looking to enhance their services through more advanced technologies. It should be noted that outsourcing can also be a more attractive option for run-off portfolios rather than for businesses with active portfolios, where company involvement is more important. Further intra-group outsourcing should not be treated differently to external outsourcing.



Sourcing strategies

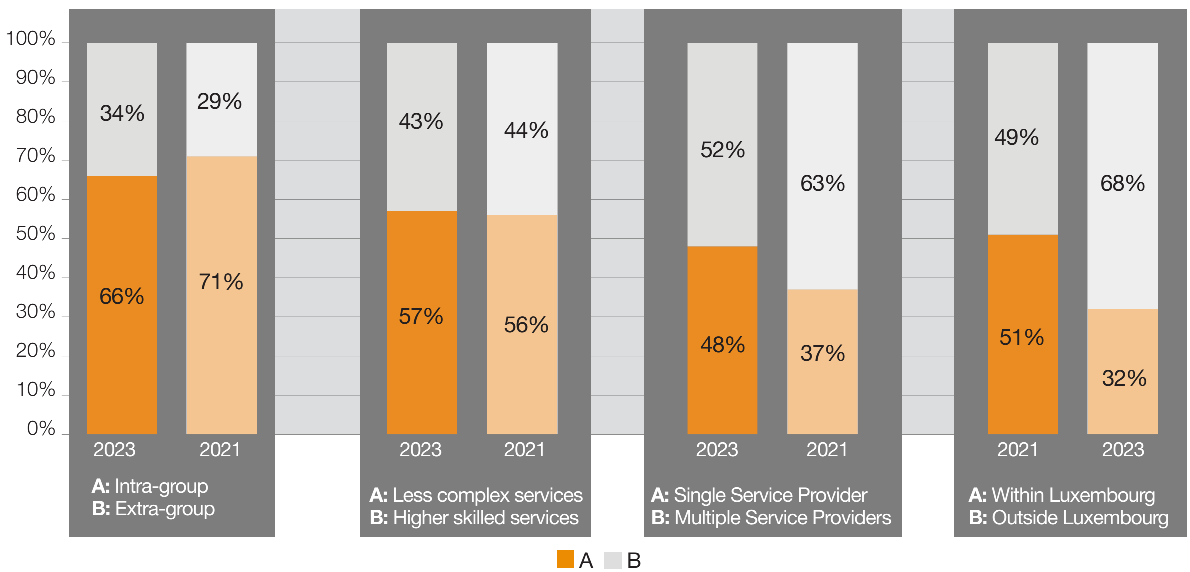
Comparing outsourcing models

The main outsourcing strategies used across the financial sector have changed in two significant ways since the 2021 survey. Firstly, there has been a marked rise in outsourcing to Luxembourg-based companies compared to those based outside the Grand Duchy. Secondly, single service providers have gained popularity over outsourcing to multiple contractors. This could be explained by the increased adoption of cloud technologies, which are often managed through one large service provider.

The shift towards Luxembourg-based providers is a sign that the Luxembourg government's strategy of developing national technological capabilities is paying off.[22] 51% of outsourcing companies now hire Luxembourg-based services, compared to just 32% in 2021.

The rise of single service providers, which has increased from 37% to 48% between 2021 and 2023 (cf. Exhibit 17), is a sign of the general consolidation observed within the industry, with firms pivoting from partial to full outsourcing. This change may also be taking place because firms are anticipating more oversight requirements from regulators. DORA will require thorough reporting and due diligence checks on all outsourcing contracts, meaning that hiring a single large provider will likely result in more streamlined internal processes for financial firms in comparison to having multiple small contracts, each requiring their own separate oversight process. However, firms will have to be mindful of concentration risks.

Exhibit 17: Implementation of outsourcing models



Note: The 2021 data is based on a sample size of 80, whereas the 2022 survey is based on a sample size of 342. Numbers may not add up to 100% due to rounding.

Source: PwC AWM & ESG Research Centre

22. Luxembourg Ministry of the Economy, *L'avenir de l'économie luxembourgeoise à l'horizon 2050*, 2023

Quality comes first

The largest group of respondents (28%) of the 2023 survey indicated that quality was the most important criterion when selecting a service provider to outsource to. This matches the findings from 2021, when quality also took the top spot. However, cost, which was previously in second place, is now the third-most important factor. Instead, expertise has taken second place. Data security which was previously in third place is in the fourth position in the 2023 ranking.

Exhibit 18: Selection criteria for a service provider

1	Quality	28%
2	Expertise	16%
3	Cost	15%

Source: PwC AWM & ESG Research Centre

The results are clear: knowledge and technical prowess are the most valued qualities for the financial sector when it comes to outsourcing. Quality and Expertise are thematically linked, and the fact that they have been given greater importance than in 2021 may be an anticipatory reaction to the greater scrutiny that will be placed on ICT service providers once DORA comes into effect. Firms will need to prove that their outsourcing partners do not pose any risks to their cybersecurity and, more important to the overall operational resilience that DORA prescribes. This will be easier with experienced providers.

This finding also makes sense given the context that full outsourcing is on the rise. With some in the financial industry increasing their reliance on external service providers, ensuring that those providers offer high-quality services is more important than ever.

It should be noted that Location, Ethics, and Social Responsibility were ranked as the least important criteria for selecting outsourcing partners, the same as in 2021.

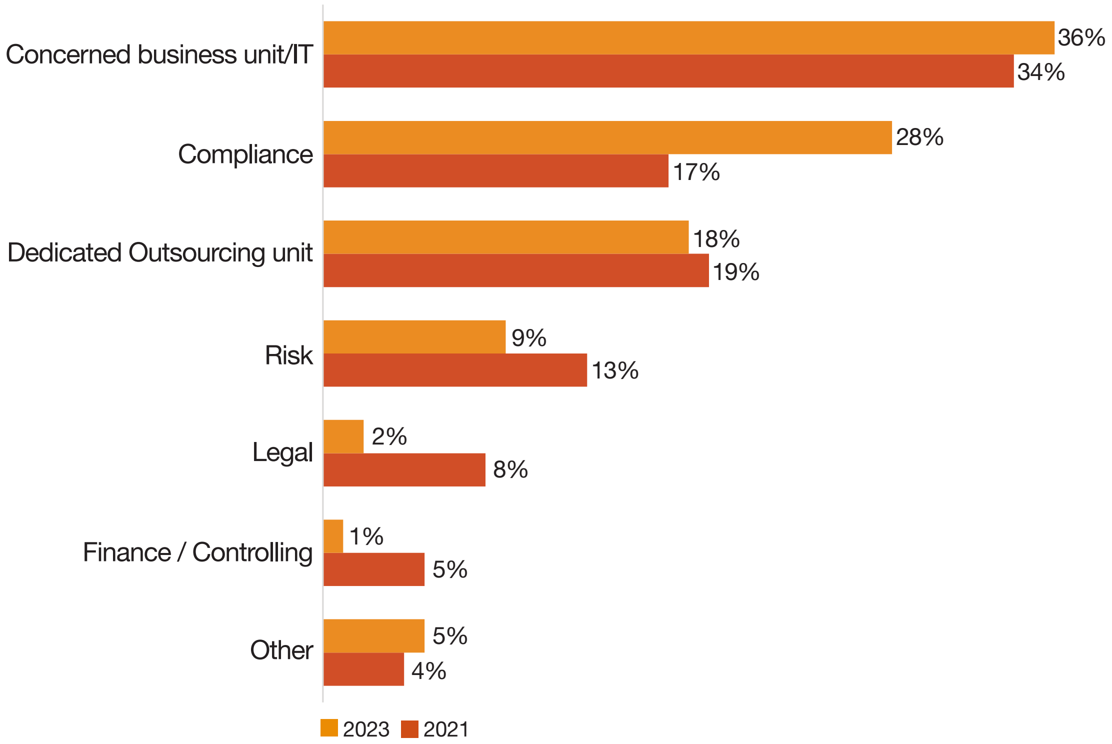
Oversight governance

New tendencies in internal firm procedures seem to reflect how important the oversight of outsourcing activities is. CSSF Circular 22/806, as well as DORA, require companies to formally appoint specific employees to oversee outsourcing operations with contracting parties. However, the department to which these employees and their team belong is up to firms' discretion.

In 28% of surveyed firms, the compliance department oversees outsourcing. This represents an increase of 11 percentage points compared to 2021 and is the most significant change compared to the previous study. This finding reflects the fact that outsourcing is increasingly being scrutinised by regulators. It is, however, generally considered a good practice to have the compliance department come in only after the respective outsourcing owner or a dedicated outsourcing unit have verified compliance with the relevant requirements.

Compared to 2021, responsibility for outsourcing has been moved away from the Legal, Risk, and Finance/Controlling departments (cf. Exhibit 19). Still, the most common arrangement within firms is for the business unit most related to the outsourced function to oversee it. However, in the survey this option was grouped together with IT. Given that IT functions make up a significant percentage of all outsourced functions in the financial sector, it is likely that a considerable portion of respondents who answered 'Concerned Business Unit' were referring to the IT department. IT outsourcing can often only be overseen by in-house IT departments due to the technical knowledge required to do so.

Exhibit 19: Business unit responsible for outsourcing oversight



Source: PwC AWM & ESG Research Centre

Knowledge retention

The most common solution for maintaining some in-house abilities after outsourcing is to have the employees or the team that was previously responsible for an outsourced function liaise with the new service provider. This effectively acts as a safety net for financial institutions, should they need to pivot back to using in-firm solutions.

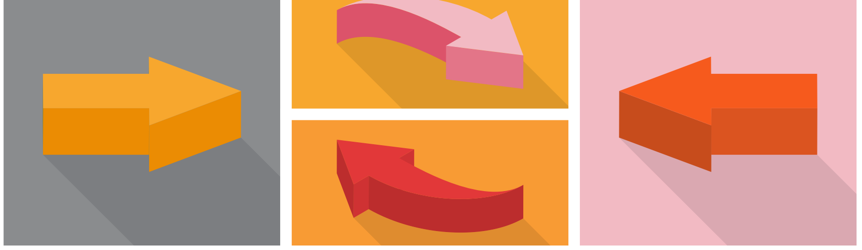
The second most popular option for retaining knowledge is to have third-party service providers carry out operations in the same way they were being carried out in-house. These results are the same as those from 2021. It should be noted that many entities use a combination of these two strategies, which makes for much more robust knowledge retention.

Exhibit 20: Retention of knowledge

1 Selected employees previously responsible for the outsourced activities are in charge of the ongoing oversight of the service provider

2 DOCX Detailed process descriptions to be followed are established and shared with the service provider

Source: PwC AWM & ESG Research Centre



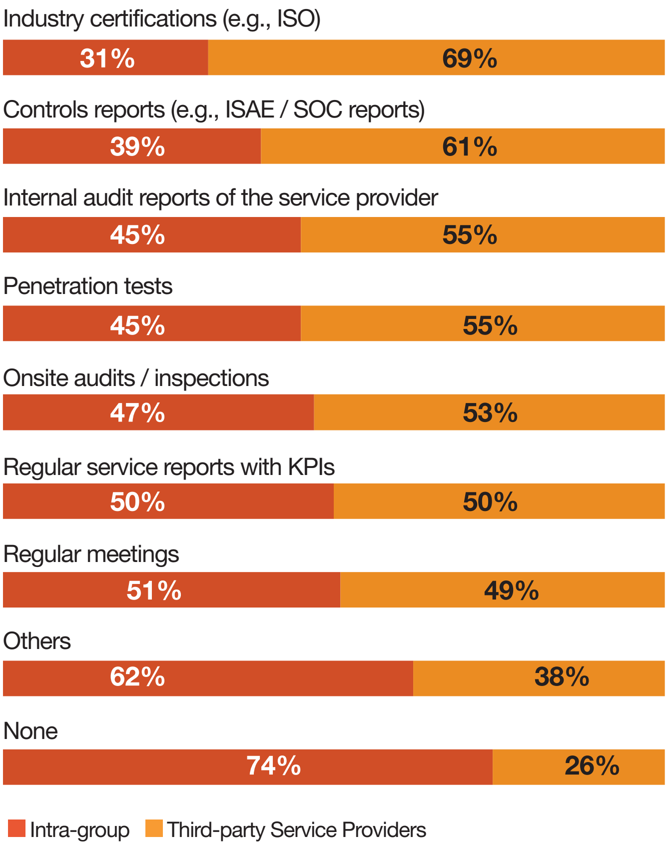
Monitoring options

The main determining factor for how firms choose to monitor their service providers is whether outsourcing has been done within the group or to a third party. It should be noted that the monitoring options shown in Exhibit 21 are not mutually exclusive, and that most firms use multiple monitoring methods.

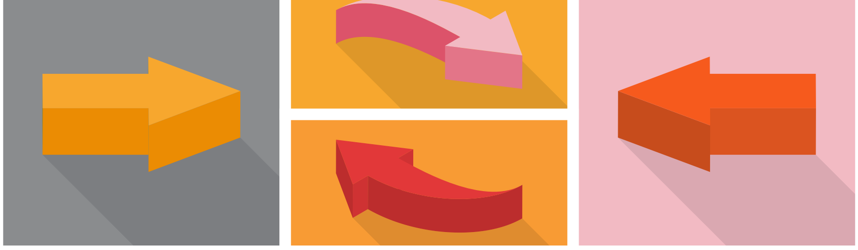
Industry Certifications and Controls Reports are the two methods with the greatest discrepancies between in-group and external service providers. 69% of companies that rely on industry certifications as a monitoring option outsource to external providers. When it comes to firms that prefer Controls Reports, the number stands at 61% (cf. Exhibit 21).

Still, there are some overly lax protocols within the financial sector. 26% of companies that do not carry out any monitoring activities on their outsourced operations have contracted external providers. This will not be allowed for ICT services under DORA. This is not allowed under the CSSF Guidelines either, and is a common problem which the CSSF has highlighted, especially for intragroup outsourcing arrangements.

Exhibit 21: Preferred option for monitoring



Source: PwC AWM & ESG Research Centre



Dealing with incidents

Just like in the 2021 survey, joint investigations is the most popular option for addressing problems with service providers. This is a prudent strategy that helps ensure problems do not occur repeatedly.

In fact, the top four options have remained the same compared to the last edition of the report.

Exhibit 22: Dealing with Service Providers in case of incidents/issues

1. Joint investigations
2. Review of defined KPIs
3. Outsourced to another provider or re-insourcing
4. Financial penalties

Source: PwC AWM & ESG Research Centre

Outsourcing registers

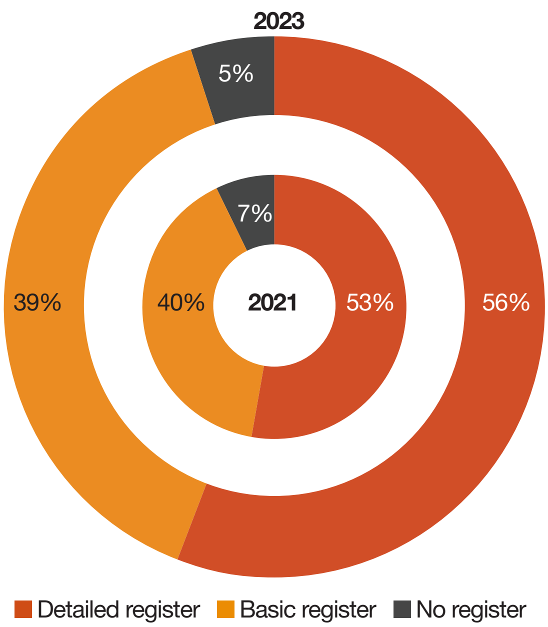
Outsourcing registers are required under EBA Guidelines, CSSF Circular 22/806, and DORA. They are comprehensive lists of all service providers a firm has outsourced to. According to the CSSF, the register can be kept at group level.[23] However, DORA requires that outsourcing registers be kept at entity level,[24] although the regulation only applies to ICT contracts.

Unsurprisingly, the vast majority of respondents have a register – either one that is detailed (56%) or basic (39%) (cf. Exhibit 23). The fact that under current regulations registers can be kept at group level may explain why 5% of entities in Luxembourg do not have a register. However, entities having basic, or no registers will need to implement them by the time DORA becomes applicable.

As a matter of fact, DORA will require entities to maintain multiple consolidated and sub-consolidated registers at both group and entity level. Registers will need to include all outsourcing partners as well as the contractor that the outsourcing partners may themselves contract. It will also require entities to regularly review and update them. As such, registers under DORA will represent a considerably more complex challenge than under previous regulations, one which all respondents – and not just the 5% without a register – should start planning for.

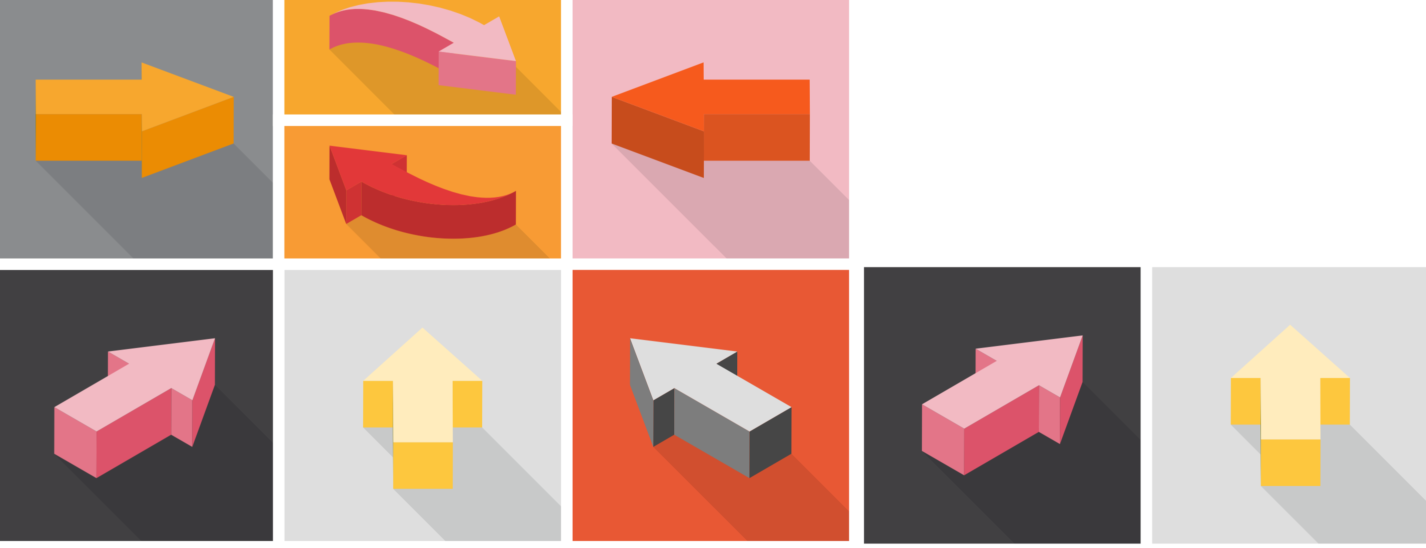
Furthermore, given the greater regulatory scrutiny that DORA implies, it is noteworthy that the percentage of firms that have detailed registers mildly increased to 56% (up from 53% in 2021) (cf. Exhibit 23).

Exhibit 23: Outsourcing register



Source: PwC AWM & ESG Market Research Centre

23. CSSF, Circular 22/806, April 2022
24. Regulation EU 2022/2554, *Digital Operational Resilience Act*, December 2022



Conclusion

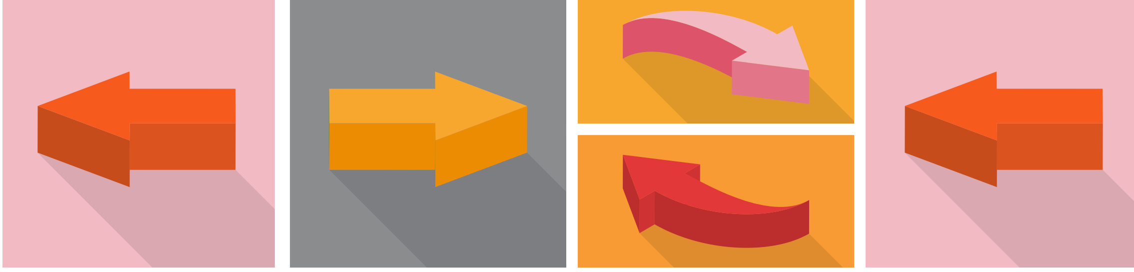
DORA will change outsourcing across the financial sector and regulated entities will need to quickly adapt. The degree to which survey respondents understand this imminent paradigm shift is varied, but the forward-thinking nature of the financial sector suggests that the seriousness with which DORA is handled will increase as its enforcement date approaches. Ultimately, those that prepare for DORA in advance will enjoy the fruits of their labour once the regulation enters into force in January 2025.

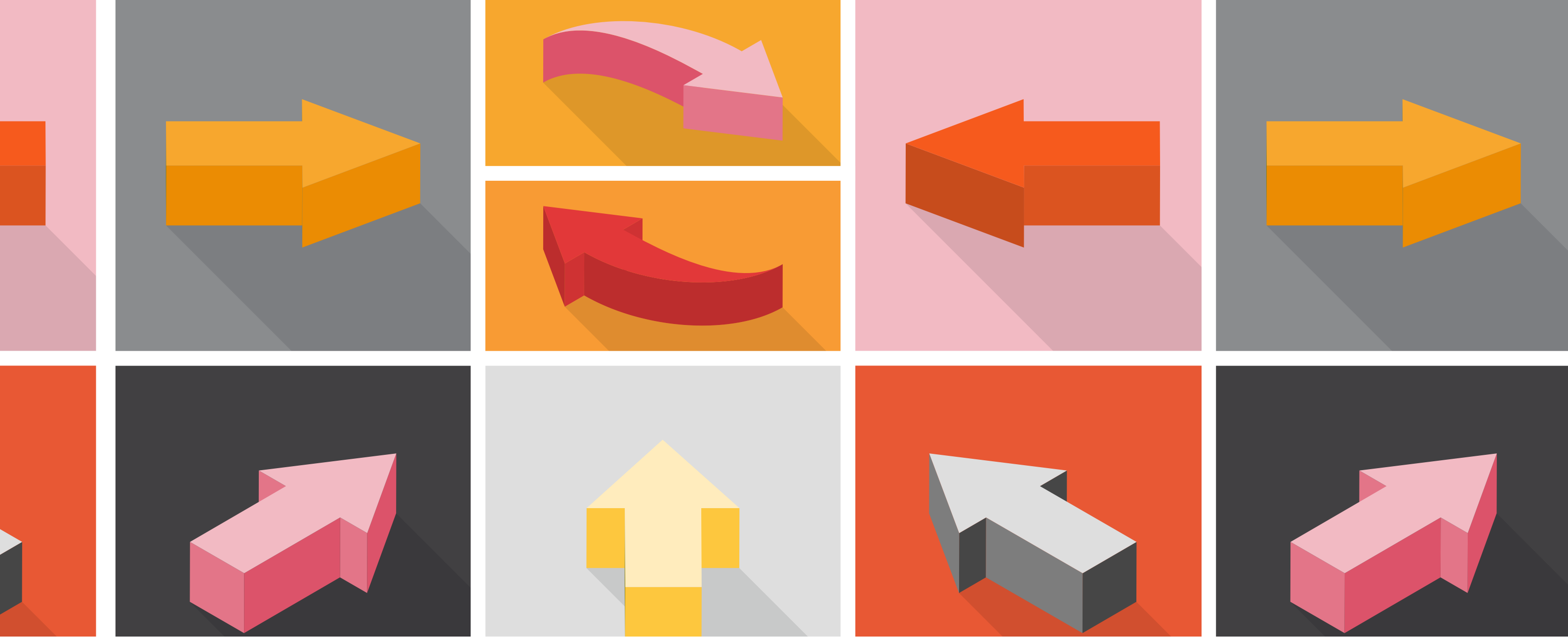
In this context, efficiency is the new normal. Outsourcing remains highly practiced across the financial sector, while full outsourcing has increased. Given the costlier nature of outsourcing, expertise and quality services have become the most important factors for financial firms as they seek to make their operations more streamlined.

Firms are cutting the services they can forgo and externalising others to highly skilled professionals outside their organisations to carry out the tasks they are unprepared for. As information systems become more complex and require increasingly sophisticated management, many new outsourcing arrangements are in technology-focused areas. The advent of AI is only the latest development proving the need for external experts.

The financial sector and the broader economy are both facing new risks as a new economic era sets in. Market conditions are shaping up to be more challenging than in the previous decade, and making the right decisions on which areas of knowledge to invest in and which to outsource has never been more important.

Notes





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