



CENTRAL BANK OF
TRINIDAD & TOBAGO

**Outsourcing Guidelines
for Financial Institutions**

DRAFT (FOR CONSULTATION)

October 2015

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1. INTRODUCTION

- 1.1 Recent trends have shown that the use of third parties (or service providers) to carry out business activities and processes that the financial institutions themselves would normally undertake are increasing. Studies indicate that outsourcing in the financial services industry was initially limited to activities that did not pertain to the firm's primary business, such as payroll processing. More recently however, commonly outsourced activities have included information technology, accounting, audit, electronic funds transfer, investment management and human resources.
- 1.2 The main reasons for outsourcing are to reduce and control operating costs and to meet the challenges of technological innovation, increased specialization and heightened competition.
- 1.3 The outsourcing of business activities can however increase the financial institution's dependence on third parties which may heighten its risk profile and jeopardize overall safety and soundness, particularly where material business activities, services or processes are outsourced to an unregulated third party or an overseas service provider.
- 1.4 Outsourced services are also becoming increasingly complex and may increase an institution's exposure to strategic, reputation, compliance, operational, country and transaction risks¹. Consequently, many regulators have issued guidelines to their regulated financial institutions to ensure that they effectively manage the risks associated with outsourcing activities.
- 1.5 In light of the foregoing, the Central Bank of Trinidad and Tobago (Central Bank) will consider the impact of the outsourced services when conducting a risk assessment of a regulated entity. The assessment will include *inter alia* a determination of whether the outsourcing arrangement hampers in any way the financial institution's ability to meet its regulatory requirements.
- 1.6 Moreover, the Central Bank will consider the potential system risks posed where outsourced activities of multiple regulated entities are concentrated in a single or limited number of service providers.

2. DEFINITIONS

- 2.1 **Material outsourcing**– outsourcing of a business activity, function process or service which, if disrupted, has the potential to significantly impact the financial institution's business operations, reputation or profitability.
- 2.2 **Outsourcing**²– is defined as the regulated entity's use of a third party or service provider (either an affiliated entity within a corporate group or an entity that is external to the group) to perform activities on a continuing basis that would normally be undertaken by the regulated entity.
- 2.3 **Regulated Financial Institution (RFI)** - a financial institution that is regulated by the Central Bank and includes a financial institution either licensed or issued a financial holding company permit under the Financial Institutions Act 2008 (FIA), registered under the Insurance Act Chap: 84:01 (IA), licensed under the Exchange Control Act (ECA), or a Systemically Important Financial Institution (SIFI)³.

¹ Explanations of the outsourcing risks are provided under Section 6.2 of this document.

² Pg. 4 of The Joint Forum "Outsourcing in Financial Services", Basel Committee of Banking Supervision, February 2005.

³ A SIFI is a systemically important financial institution and in this case refers to those SIFIs that are not regulated under other statutes like the FIA or IA and include the Home Mortgage Bank (HMB), the Trinidad and Tobago Mortgage Finance Company Limited (TTMF), the Agricultural Development Bank (ADB), the National Insurance Board (NIB) and the Trinidad and Tobago Unit Trust Corporation (UTC).

2.4 **Third party or Service provider** - the provider of the outsourced activity or service.

3. PURPOSE, APPLICATION AND SCOPE

3.1 This Guideline sets out the expectations of the Central Bank regarding the risks arising from the management of outsourcing contracts by its Regulated Financial Institutions (RFIs).

3.2 This Guideline therefore establishes **minimum standards** for the management of outsourcing risks by an RFI. As such, the principles detailed in the Guideline should be applied according to the degree of materiality of the outsourced activity or service. However, even where the activity or service is not material, RFIs should consider the appropriateness of applying the principles. This Guideline also provides guidance on business activities, functions, processes or services that should not be outsourced.

3.3 This Guideline applies to all outsourcing by a RFI or its Group. The RFI is expected to consider the impact on the RFI and the Group, where applicable, of all outsourcing contracts including those put in place by local and foreign subsidiaries.

4. TRANSITION PERIOD

4.1 RFIs which have existing outsourcing contracts in place that do not meet the requirements in this Guideline are required to:

- a) Review those contracts and ensure compliance with this Guideline the earlier of the renewal date or July 31, 2017; and
- b) Notify the Inspector of Financial Institutions within three (3) months of the issuance of this Guideline of the following:
 - i. **All** outsourcing contracts using Appendix 1; and
 - ii. **Material** contracts identified in i. above which do not comply with this Guideline **and the areas of non-compliance**. This should be submitted on a separate schedule.

5. IDENTIFYING MATERIAL OUTSOURCING

5.1 In determining whether to outsource an activity, function, process or service, the management of the RFI should take a proactive role to assess the **materiality** of the activity, function, process or service to be outsourced. Criteria that can be used to determine whether an outsourcing contract is material include:

- 5.1.1 **the impact on significant business lines** if the service provider should fail to perform over a given period of time and would result in potential losses to the RFI's customers and their counterparts;

- 5.1.2 the **level of contribution of the outsourced activity** to the RFI's income and profit, including the cost of the outsourcing arrangement as a proportion of its total operating costs;
 - 5.1.3 the **ability of the RFI to maintain appropriate internal controls and meet regulatory requirements**, if the service providers were to experience operational problems;
 - 5.1.4 the **interrelationship of the outsourced activity with other activities of the RFI**;
 - 5.1.5 the **degree of difficulty and time that would be necessary to find an alternative service provider** or to bring the business activity in-house;
 - 5.1.6 the **ability to control the risks** where more than one service provider collaborates to deliver an end-to-end outsourcing solution; or
 - 5.1.7 the aggregate exposure to a particular service provider in cases where the RFI outsources various functions to the same service provider.
- 5.2 An RFI should maintain a centralized list of all its outsourcing contracts which should be updated on an on-going basis and submitted to the Central Bank upon request. The RFI should also identify the material outsourced services on the list using the criteria specified in this section. A template of the centralized list that RFIs may use as a guide is provided at Appendix 1.
- 5.3 Where an RFI intends to outsource a material activity, service, business process or function it should notify the Central Bank in a timely manner prior to entering into the contract, so as to allow for a proper review of the documentation and assessment of the risks.

6. OUTSOURCING PRINCIPLES

Effective corporate governance and risk management of outsourcing require that the RFI adopt certain sound principles. Each of these principles is discussed in turn in this section and specific guidance is provided on how these principles should be implemented.

6.1 PRINCIPLE 1

The RFIs must have in place a comprehensive policy to guide the assessment of whether and how the RFI's activities, functions, processes and services can be appropriately outsourced. The Board of Directors must retain responsibility for the outsourcing policy and related overall responsibility for activities undertaken under that policy.

In particular, the RFI's **Board** should:-

- 6.1.1 Ensure that specific policies and criteria for making decisions about outsourcing are established prior to outsourcing; and
- 6.1.2 Approve the RFI's outsourcing policy (established by senior management) that governs the service provider's risk management process and identifies material activities.

6.1.3 Approve material outsourcing contracts.

In addition, the RFI's **Senior Management** should:

6.1.4 Be held accountable for effective due diligence, oversight and management of outsourcing relationships and responsible for all outsourcing decisions;

6.1.5 Implement an effective process to manage risks related to service provider relationships in a manner consistent with the RFI's strategic goals, organizational objectives and risk appetite; and

6.1.5 Maintain all ongoing outsourcing arrangements and relationships in accordance with the Board approved outsourcing policy.

6.2. PRINCIPLE 2

A RFI's Senior Management should establish a comprehensive risk management framework to address the outsourced activities and the relationship with the service provider.

The risk management framework should ensure that:-

6.2.1 Senior Management and employees within the lines of businesses who manage the service provider **relationships** have distinct but interrelated responsibilities to ensure that outsourcing contracts are managed effectively and commensurate with the RFI's level of risk and complexity;

6.2.2 Systematic risk evaluation is conducted to ensure that the outsourcing arrangement does not result in the internal controls, business conduct or reputation of the RFI being compromised or weakened. This evaluation should also be performed at least annually on existing arrangements as part of the review processes of the RFI and be made available to the Central Bank upon request; and

6.2.3 Key risks and risk mitigation strategies are identified and the impact and potential benefits of the outsourcing arrangements are analyzed. For example, where outsourcing risks are higher such as, where the RFI outsources to an unregulated third party or to a service provider located in an overseas jurisdiction, the RFI must ensure that risk mitigation strategies are more robust (see Section 9 of this Guideline).

The main risks associated with outsourcing arrangements are presented in Table 1 below.

TABLE 1: Main Risks Inherent in Outsourcing

Inherent Outsourcing Risk	Description
Strategic Risk	The risk arising from adverse business decisions, or the failure to implement appropriate business decisions in a manner that is consistent with the RFI's strategic goals. Where a service provider does not adequately perform services that assist the RFI in achieving its corporate strategic goals nor provides an adequate return on its investments, it exposes the RFI to strategic risk.

Inherent Outsourcing Risk	Description
Reputation Risk	The risk arising from negative public opinion. Third-party relationships that result in dissatisfied customers; unexpected customer financial loss; inconsistent interactions with the RFI's policies; inappropriate recommendations; security breaches resulting in the disclosure of customer information; and violations of laws and regulations are all examples that could harm the reputation and standing of the RFI. Any negative publicity involving the service provider, whether or not the publicity is related to the RFI's use of the service provider, could result in reputation risk.
Compliance Risk	The risk arising from violations of laws, rules, or regulations, or from noncompliance with the RFI's internal policies or procedures or business standards. This risk exists when the products or activities of a service provider are not consistent with governing laws, rules, regulations, policies, or ethical standards. Some examples include: <ul style="list-style-type: none"> • Third parties may engage in deceptive product marketing practices or discriminatory lending practices that are in violation of applicable laws and regulations. • The ability of the service provider to maintain the privacy of customer records and to implement an appropriate information security and disclosure program.
Operational Risk	The risk of loss resulting from inadequate or failed internal processes, people, systems, or external events. Third-party relationships often integrate the internal processes of other organizations with the RFI's processes and can increase the overall operational complexity. RFIs should be cautious about outsourcing services from a service provider that supplies services to multiple RFIs as operational risks are correspondingly concentrated and may pose a systemic threat.
Country Risk	The exposure to the economic, social and political conditions and events in a foreign country that may adversely affect the ability of a cross border third-party service provider (CBSP) to meet the level of service required by the arrangement, resulting in harm to the RFI. In extreme cases, this exposure could result in the loss of data, research and development efforts, or other assets.
Transaction Risk	The risk arising from problems associated with service or product delivery. A third-party's failure to perform as expected by customers or the RFI due to inadequate capacity, technological failure, human error, or fraud, exposes the RFI to transaction risk. The lack of effective business contingency plans increases transaction risk. Weak control over technology used in the third-party arrangement may result in threats to security and the integrity of systems and resources. These issues could result in unauthorized transactions or the inability to transact business as expected.

6.3 PRINCIPLE 3

RFIs should ensure that outsourcing neither diminishes their ability to fulfill their obligations to customers and the Central Bank, nor impedes effective supervision by the Central Bank. The RFI should ensure that:

- 6.3.1 There is proper monitoring and control of the outsourced services. The service provider should be required to maintain policies and procedures which address the RFI's right to monitor and conduct periodic reviews so as to verify the service provider's compliance with the RFI's policies and expectations.
- 6.3.2 Any transfer of customer information under the terms of a contract should be with the customer's consent. Where the service provider has access to confidential data, the provisions within the contract should prohibit the inappropriate use or disclosure of such information.

- 6.3.3 Audit requirements, the Central Bank's examination rights and the rights of both the service provider and the RFI are stipulated in the outsourcing contract. The RFI should have the right to evaluate the service provider or alternatively, to cause an independent auditor to evaluate, on its behalf, the service provider's internal control environment and risk management practices.
- 6.3.4 The outsourcing contract permits the RFI to require remedial or corrective action by the service provider for issues that arise which compromise the integrity of the activity being provided or where non-compliance with applicable laws and regulations is detected.
- 6.3.5 Outsourcing does not impair the Central Bank's ability to exercise its regulatory responsibilities. The Central Bank should be granted the right to undertake an examination of the service provider independently. Additionally, the Central Bank and the RFI should be granted access to internal and external audit reports prepared on the service provider in respect of the outsourced activity, function, process or service. Books, records and information of the service provider about the performance of the outsourcing should be accessible to the Central Bank.
- 6.3.6 The Central Bank is notified of any material changes to the terms and conditions of the contract. The RFI and the service provider should also acknowledge that the Central Bank may require changes to the performance of the services, and work together in good faith to implement such changes.

6.4 PRINCIPLE 4

RFIs should conduct appropriate due diligence in selecting a service provider.

- 6.4.1 Criteria should be developed that enables an RFI to assess, prior to selection, the service provider's capacity and ability to perform the outsourced activities effectively, reliably and to a high standard. The criteria should be approved by the Board.
- 6.4.2 The intended service to be provided should be subject to appropriate due diligence and a thorough investigation into the affairs of the service provider should be performed before management considers hiring their services. The RFIs' assessment of the service provider should include a review of:
- a) the experience and the technical competence of its management and relevant staff to implement and support the proposed activity;
 - b) the security, technological and internal controls, reporting and monitoring environment;
 - c) its financial soundness and ability to service commitments;
 - d) its business reputation and culture, complaints, pending litigation;
 - e) its business goals, objectives, continuity management and strategies; and
 - f) whether a licence will be required to conduct the outsourced activities.
- 6.4.3 In its ongoing due diligence, the RFI should be able to monitor the service provider's performance and compliance with its contractual obligations. To achieve this, the RFI should:-
- a) Identify and establish clearly defined metrics to monitor the service provider, measure the service level, and specify what service levels are required; and

- b) Establish measures to identify and report instances of non-compliance or unsatisfactory performance to the RFI, as well as, the ability to assess the quality of services performed by the service provider on a regular basis.

6.5 PRINCIPLE 5

Outsourcing relationships should be governed by written contracts that clearly describe all material aspects of the outsourcing relationship, such as the nature and scope of the service being provided and including the rights, responsibilities and expectations of all parties.

6.5.1 The contract should be sufficiently flexible to allow for renegotiation and renewal to enable the RFI to retain an appropriate level of control over outsourcing and the right to intervene with appropriate measures to meet legal and regulatory obligations. Therefore, key provisions of the outsourcing contract should include *inter alia*:

- a) Limitations or conditions, if any, on the service provider's ability to subcontract. However, where subcontracting is permitted, it should require the prior consent of the RFI, and any obligations pertaining to the subcontract should be clearly stipulated;
- b) Requirements that the service provider comply with the same (or higher) standards relating to IT, security and confidentiality which the RFI is required to comply, especially as it relates to customer information;
- c) Guarantees and indemnities;
- d) Obligation of the service provider to provide, upon request, records, information and/or assistance concerning outsourced activities to the RFI's auditors and/or its regulators;
- e) Mechanisms to resolve disputes that might arise under the outsourcing arrangement;
- f) Business continuity provisions;
- g) Provisions for the termination of the contract, transfer of information and exit strategies; and
- h) Responsibility of the service provider for compliance with local laws and regulations as required.

6.5.2 The minimum elements to be included in an outsourcing contract or agreement are detailed in Appendix 3 of this Guideline.

6.6 PRINCIPLE 6

RFIs and their service providers should establish and maintain contingency plans, including a plan for disaster recovery and periodic testing of backup facilities.

6.6.1 Business continuity and contingency plans, should be included in the outsourcing contract, and should specify the service provider's measures for ensuring the continuation of the outsourced

service in the event of problems such as a system breakdown or natural disaster that may affect the service provider's operation. Provisions should also be included in the contract for transfer of the RFI's activities to another service provider without penalty, in the event of the service provider's bankruptcy or business failure.

6.6.2 Specific contingency plans should be developed separately for each outsourcing arrangement which becomes more important based on the degree of materiality. Back-up arrangements should be tested at least annually and the results provided to the RFI, together with any significant changes in the business resumption plan. The service provider should inform the RFI of material changes to their business continuity plans.

6.6.3 There are also risks where multiple service providers depend on the same provider of business continuity services with a common disaster recovery site. Any disruption that affects a large number of RFIs may result in a lack of capacity for the business continuity services.

6.7 PRINCIPLE 7

RFIs should take appropriate steps to require that service providers protect confidential information of both the RFI and its clients from intentional or inadvertent disclosure to unauthorized persons.

6.7.1 The RFI must take steps to prevent the disclosure of confidential information to unauthorized persons by service providers. For example, the RFI should ensure that the service provider implements appropriate security measures to safeguard customers' confidential information, taking into account any regulatory or statutory provisions that may be applicable.

6.7.2 The RFI should be proactive in identifying and specifying requirements for confidentiality and security in the outsourcing arrangements.

6.7.3 Appropriate data confidentiality, security and separation of property provisions should form part of the outsourcing contract. The rights of customers should not be affected because of the outsourcing between the service provider and the RFI.

7. BUSINESS ACTIVITIES / SERVICES THAT SHOULD NOT BE OUTSOURCED

7.1 RFIs should not outsource certain core management functions pertaining to internal controls, compliance, and decision-making functions, such as:

- a) Corporate planning, organization, risk management and control;
- b) Determining compliance with Know Your Customers (KYC) norms for opening accounts; and
- c) Loan approvals.

7.2 However, where an RFI outsources a service or activity to a service provider, the RFI remains ultimately responsible and accountable to the Central Bank and the customer for any error or breach by the service provider.

8. OUTSOURCING ARRANGEMENTS WITH AN EXTERNAL AUDITOR

8.1 A RFI may at times outsource certain non-audit services to its external auditor. Non-audit services performed by external auditors fall into three main categories:

8.1.1 Services required by legislation or contract to be undertaken by the auditors of the business and include regulatory returns; legal requirements to report on certain matters; contractual requirements to report to lenders or vendors on net assets etc.

8.1.2 Services considered most efficient for the auditors to provide because of their existing knowledge of the business, or because the information required is a by-product of the audit process. These include services such as those listed in 8.1.1 above that the auditors are **not required by law** to undertake, but where the information largely derives from the audited financial records; tax compliance; reports required in acquisition or reorganization situation where completion is necessary in a short timeframe.

8.1.3 Services that could be provided by a number of firms, in this case, the fact that the firm is the auditor is incidental and it would generally only be chosen because it has won the tender process. Examples of such services include management consultancy, tax advice and human resources consultancy.

8.2 Notwithstanding, 8.1, there are certain non-audit services that must not be outsourced to the RFI's external auditor⁴. Such non-audit services include:

8.2.1 Actuarial services;

8.2.2 Internal audit services related to the internal accounting controls, AML/CFT compliance, financial systems, or financial statements of the RFI, unless it is reasonable to conclude that the results of the service will not be subject to audit procedures during an audit of the RFI's financial statements. This does not prohibit the external auditor from providing a non-recurring service to evaluate a discrete item or program, if the service is not, in substance, the outsourcing of an internal audit function;

8.2.3 Book-keeping or other services related to its accounting records or financial statements;

8.2.4 Financial information systems design and implementation services; and

8.2.5 Such other non-audit related services as the Central Bank may from time to time prescribe.

9. OUTSOURCING TO A CROSS-BORDER SERVICE PROVIDER (CBSP)

9.1 An RFI should closely monitor government policies and political, social, economic and legal conditions in countries where the service provider is based and establish sound procedures for dealing with country risk. RFIs can face significant adversity from foreign political, economic and social conditions in other countries which may negatively affect the service provider's ability to provide the service.

⁴ See section 81(9) of the FIA.

- 9.2 In addition to the requirements for written outsourcing contracts in 6.5.1, an RFI engaged in outsourcing arrangements with a CBSP should:
- 9.2.1 Enter (in principle) into arrangements only with service providers operating in jurisdictions that generally uphold confidentiality clauses and agreements;
 - 9.2.2 Clearly specify the governing law of the arrangement;
 - 9.2.3 Ensure that the outsourced activity is conducted in a manner so as not to hinder efforts to supervise or reconstruct the Trinidad and Tobago activities of the RFI (that is, from its books, accounts and documents) in a timely manner; and
 - 9.2.4 Notify the Central Bank if any overseas authority was to seek access to its customer information or if a situation was to arise where the rights of access of the RFI and the Central Bank have been restricted or denied.
- 9.3 Management should evaluate what this outsourcing arrangement will provide for the RFI's overall operation before engaging with a CBSP. The evaluation would include:
- 9.3.1 Conducting an appropriate risk assessment including the monitoring of economic, social, and political conditions as well as government policies within the foreign jurisdiction;
 - 9.3.2 Assessing the CBSP's ability to meet the RFI's needs, given the laws, regulatory requirements, local business practices, accounting standards and legal environment in the foreign jurisdiction; and
 - 9.3.3 Examining the operational risks as it relates to security and confidentiality of the RFI and customers' information. The institution should ensure that the confidentiality of customer information is in accordance with relevant laws and the provisions in the contract between the customer and the RFI.

APPENDIX 1 – TEMPLATE OF CENTRALIZED LIST

Name of Service Provider	Outsourced Service	Indicate whether material to the RFI or Group	Short description of arrangement	Country from which service is provided	Expiry/Renewal date of contract or outsourcing agreement	Estimated annual spending on arrangement	Estimated \$ Value of contract or outsourcing agreement

APPENDIX 2 – EXAMPLES OF COMMONLY OUTSOURCED ACTIVITIES & SERVICES

- Information system management and maintenance (e.g. data entry and processing, data centres, facilities management, end-user support, local area networks, help desks);
- Document processing (e.g. cheques, credit card slips, bill payments, bank statements, other corporate payments);
- Application processing (e.g. insurance policies, loan originations, credit cards);
- Policy administration (e.g. premium collection, policy assembly, invoicing, endorsements);
- Claims administration (e.g. loss reporting, adjusting);
- Loan administration (e.g. loan processing, collateral management, collection of bad loans);
- Investment management (e.g. portfolio management, cash management);
- Marketing and research (e.g. product development, data warehousing and mining, advertising, media relations, call centres, telemarketing);
- Back office management (e.g. payroll processing, custody operations, quality control, purchasing);
- Real estate administration (e.g. building maintenance, lease negotiation, property evaluation, rent collection);
- Professional services related to the business activities of the RFI (e.g. accounting, internal audit, actuarial); and
- Human resources (e.g. benefits administration, recruiting).

APPENDIX 3 – MINIMUM ELEMENTS OF OUTSOURCING CONTRACTS

1. Nature and scope of the service being outsourced to the service provider. (Section 6.5)
2. Service level and Performance Standards – e.g. timing of delivery; metrics to measure performance; procedures for managing problems. (Section 6.4.3)
3. Ownership and Access – e.g. ownership of assets; rights of the access of the service provider to RFI's assets etc. (Section 6.3.2)
4. Fees
5. Insurance, Guarantees, Indemnities (Section 6.5.1(c))
6. Reporting Requirements – e.g. the type and frequency of reporting by the service provider. (Sections 6.3.1 and 6.5.1(d))
7. Audit and Examination Rights – e.g. rights of the RFI to audit the service provider or appoint an auditor to do same; rights of the Central Bank to audit/ inspect the service provider; rights of access by the RFI and the Central Bank to any reports on the service provider by its internal or external auditors. (Sections 6.3.3 and 6.3.5)
8. Business Continuity Plans (Section 6.6)
9. Default and Termination of the Contract (Section 6.5.1(g))
10. Dispute Settlement (Section 6.5.1(e))
11. Documentation/ Information Retention (Sections 6.3.5 and 6.5.1(d))
12. Confidentiality, Security of Customer Information (Sections 6.5.1(b) and 6.7)
13. Activities of Sub-Contractors (if applicable) (Section 6.5.1(a))

This list is not considered exhaustive and the Central Bank may amend it periodically.