OUTSOURCING GUIDELINE

1. INTRODUCTION

The Central Bank of Barbados (Bank), in furtherance of its responsibility for the regulation and supervision of licensees under the Financial Institutions Act, 1996-16 (FIA) and the International Financial Services Act, 2002-5 (IFSA), has developed this Guideline on licensees' obligations as it relates to the outsourcing of business functions and processes.

The Bank recognises that, while it offers potential benefits to licensees, outsourcing may also increase a licensee's risk profile. Licensees, therefore, have an obligation to ensure that their systems and controls are adequate for the risks they face.

The Guideline sets out the Bank's expectations in relation to the minimum standards with which it expects its licensees to comply as they manage their outsourced activities and processes. It will form an integral part of the framework used by the Bank in assessing how a licensee is managing the risk associated with outsourcing of material activities. Where a licensee outsources non-material functions, it should apply the requirements of this Guideline in a manner proportionate to the risk.

2. APPLICATION

This Guideline applies to all material[1] outsourcing arrangements undertaken by entities that are licensed under the FIA and the IFSA. Licensees are expected to ensure that their subsidiaries and branches comply with this Guideline, and they should consider the impact on their consolidated operations of outsourcing arrangements entered into by their subsidiaries and branches.

For licensees that are part of a wider financial group that makes arrangements for the outsourcing of specific group functions, the licensee is required to ensure compliance with this Guideline.

Licensees which have existing outsourcing arrangements in place that do not meet the requirements set out in this Guideline are expected to comply by the earlier of the renewal date or July 1, 2009. Notwithstanding this exemption, licensees should discuss with their service providers how they can accelerate compliance.

[1] The definition of material is explained in Section 6.

3. OUTSOURCING

Outsourcing may be defined as a regulated entity's use of a third party (either an affiliated entity within a corporate group or an entity that is external to the corporate group) to perform activities on a continuing basis that would normally be undertaken by the regulated entity itself.

Outsourcing may be evidenced by an initial transfer of an activity (or a part of that activity) to a third party or by the further transfer of an activity (or a part thereof) from one third-party service provider to another, sometimes referred to as "sub-contracting."

Outsourcing may encompass a wide range of activities including:

i. Investment management;
ii. Provision of credit risk control and credit risk analysis;
iii. Credit card and payments processing;
iv. Provision of regular compliance, internal audit or risk management services;
v. Provision of day-to-day data entry and processing;
vi. Provision of day-to-day storage; and
vii. Accounting and other back office services.

The definition is not intended to encompass purchasing[2] contracts or the hiring of consultants to provide technical advice on operations or to prepare and install a service. However, the use of service providers to manage the installed service constitutes outsourcing.

4. BENEFITS AND COSTS OF OUTSOURCING

The practice of outsourcing has spread for several reasons, including:

i. Reduced costs;
ii. Access to specialist providers and banks alike;
iii. The opportunities to achieve efficiencies by centralising and consolidating a range of internal functions either within a parent operating bank that provides those functions as business services to its subsidiaries, or within an entity set up to specialise in a particular function, e.g. Information Technology.

However, outsourcing has the potential to transfer risk management and compliance to third parties who may not be regulated or who may be operating cross-border. Some of the key risks include:

i. The vulnerability of licensees to the failure or non-performance of a service provider;

[2] Purchasing is defined, inter alia, as the acquisition of services, goods or facilities from a third party without the transfer of the licensee's non-public proprietary information pertaining to its customers or other information connected with its business activities.

ii. The lost of control of the outsourced activity by the licensee;
iii. The exposure of the financial system to the failure of a single service provider on whom a number of licensees are dependent; and
iv. Reduced capacity for the Bank in carrying out its responsibilities.

5. OUTSOURCING APPROACH

The guidance is consistent with international best practice and is predicated on the principle that:

i. The licensee's management is ultimately accountable for the adequacy of the systems and controls for the outsourced activity;
ii. The Bank is able to exercise its supervisory powers to gather information or to require changes in how the outsourced function is carried out; and
iii. The Bank will pay additional attention to outsourcing when a concentration of operational risk, such as a limited number of service providers or the sharing of common disaster recovery sites, increases systemic risk.

6. MATERIALITY

The Bank recognises that outsourcing arrangements will display varying degrees of materiality according to the nature and circumstances of each licensee. The scope of the risk management programme should reflect the degree of materiality.

For the purposes of this Guideline, the materiality of an outsourcing arrangement will depend on the extent to which the arrangement has the potential to have an important influence – whether quantitative or qualitative – on a significant line of business of the operations of the licensee.

In determining materiality, factors that should be considered include:

i. The impact that the outsourcing arrangement may have on the finances, reputation and operations of the licensee or significant business line, particularly if the service provider, or group of affiliated service providers, should fail to perform over a given period of time;
ii. The ability of the regulated licensee to maintain appropriate internal controls and meet regulatory requirements, particularly if the service provider were to experience problems;
iii. The cost of the outsourcing arrangement; and
iv. The degree of difficulty and time required to find an alternative service provider or to bring the business activity 'in-house'.

Where a management oversight function e.g. internal audit, compliance, risk management is outsourced to a party outside the regulated group, the transaction shall be considered to be material.

Where an arrangement is not considered material or the service provider is a regulated affiliate of the licensee, the licensee may relax some aspects of the risk management process. For example, if the service is provided by a regulated affiliate, the licensee may limit the due diligence requirements to those aspects that impact on the licensee's operational needs. However, the licensee must ensure that due diligence is undertaken on immaterial third parties on a risk basis in accordance with the Bank's AML/CFT Guideline issued in October 2007.

Where an arrangement, previously deemed immaterial, becomes material, the licensee should at the earliest opportunity, but not later than the renewal of the contract, adhere to all the requirements of this Guideline. The licensee should comply with the notification timeline established at section 7 (h).

7. BOARD RESPONSIBILITY

Consistent with the Bank's Guideline on Corporate Governance, the Board of Directors is ultimately responsible for effective oversight of all outsourcing arrangements. The Board should:

a) Establish policies and criteria for making decisions about the type of activities that can be outsourced, the permissible level of outsourced activities and concentration / exposure limits to service providers;

b) Require senior management to undertake risk assessments and develop due diligence criteria for assessing third party service providers prior to the arrangement and at periodic intervals[3], including renewal. The licensee may rely on a due diligence review performed by the parent or affiliate if the review was done within the past 18 months and satisfies the requirements of this Guideline. The licensee should at a minimum assess the service provider's:

   i. Financial performance and strength;
   ii. Experience and the technical competence of its management to implement and support the proposed activity;
   iii. Internal controls, reporting and monitoring framework;
   iv. Governance structure;
   v. Business strategy, including its reliance on sub-contractors;
   vi. Business reputation, complaints, pending litigation;
   vii. Business continuity plans;
   viii. Insurance coverage; and
   ix. Human resources policies.

[3] In addition, when outsourcing outside of Barbados is contemplated, the licensee should ensure compliance with the legal requirements of that jurisdiction (See also 10.3).

c) Require senior management to ensure that all outsourcing arrangements are governed by written contracts (See Section 8) and, in turn, approve all outsourcing contracts;

d) Require its senior management to take responsibility for the outsourced activity by developing systems to manage, monitor and control outsourcing risk. This should include monitoring the service provider through periodic reviews (at least annually) to assess the service provider's ability to continue to deliver the service in the expected manner. In addition, internal and external auditors should have access to any information they require to fulfil their responsibilities;

e) Periodically review the performance of its outsourced functions and its outsourcing policy;

f) Satisfy itself that the licensee remains able to comply with all legal and regulatory requirements in both home and host countries;

g) Satisfy itself that the Bank will not be impaired in its ability to supervise the licensee; and

h) Require senior management to inform the Bank within 14 days of the outsourcing of material activities. In addition, the Bank should be made aware of any material problems encountered with an outsourcing arrangement. In informing the Bank, the licensee should provide a description of the contract or arrangement including:

   a) The rationale for the outsourcing arrangement;
   b) The scope of the outsourcing arrangement;
   c) The name of the service provider and the reason for selecting it;
   d) If applicable, the nature of the relationship between the applicant and the service provider, and
   e) The location where the service will be provided.

8. CONTRACT MANAGEMENT

All material outsourcing arrangements must be governed by adequately documented contracts or outsourcing agreements. For all outsourcing arrangements (whether intra-group or external) this means service level agreements, which define issues such as service standards and sanctions for failure by either party to honour the terms of the agreements. Transition arrangements will be essential to help ensure continuity of service both as the contract comes into effect and when the service provider exits the arrangement. The following represent the minimum elements to be included in such contracts.

a. Nature and Scope of the Service Being Provided – The contract should outline the frequency, content and format of the service being provided together with the location where the service will be provided.

b. *Service Level and Performance Standards* – e.g.

i. Time schedules for performance of the service;
ii. Mechanisms to measure and improve performance of the service;
iii. Procedures for managing problems;
iv. Confidentiality, privacy and security requirements; and
v. Human resource hiring practices.

c. *Ownership and Access* – Identification and ownership of all assets (intellectual and physical) related to the outsourcing arrangement should be clearly established, including assets generated or purchased pursuant to the outsourcing arrangement. The contract should state:

i. Whether and how the service provider has the right to use the licensee's assets (e.g. data, hardware and software, system documentation or intellectual property); and
ii. The licensee's right of access to those assets.

d. *Fees* – These should be clearly articulated within the agreement;

e. *Insurance* – The responsibility of each party should be clearly outlined ensuring that outsourced activities are adequately covered. The contract should cover the types of insurance, coverage amounts and procedures for revising the policy. Where the service provider is responsible for payment, evidence of this should be provided on the renewal date to the licensee;

f. *Reporting Requirements* – The contract should specify the type and frequency of information that the service provider will supply to the licensee, including information that enables the licensee to monitor performance and identify events that may have the potential to materially affect the delivery of the service, e.g. material control weaknesses identified by the supplier's internal or external auditors;

g. *Audit and Examination Rights* – The contract must:

i. Grant the licensee the right to audit or appoint an auditor to evaluate the activities of the service provider, including the service provider's internal control environment as it relates to the service being provided;
ii. Grant the Bank the right to undertake an audit of the service provider either independently or in conjunction with the licensee; and
iii. Grant the licensee and the Bank access to internal and external audit reports prepared on the service provider in respect of the outsourced activity.

In the normal course, the Bank will seek to obtain information from the licensee, but in circumstances of systemic risk or significant risk to the licensee, the Bank may undertake its own evaluation of the service provider.

h. ***Business Continuity Plans -*** The contract must outline the service provider's measures for ensuring the continuation of the outsourced service in the event of problems affecting the service provider's operation. Such back-up arrangements should be tested at least annually and the results provided to the licensee together with any significant changes in the business resumption plan. The service provider should inform the licensee of material changes to their business continuity plans.

i. ***Default and Termination of the Contract-*** The contract should define the circumstances that give rise to default and termination of the agreement. These should include the right to terminate in the event that the service provider undergoes a change of ownership, becomes insolvent, or goes into liquidation or receivership. Possible remedies or sanctions and, in the event of termination, the transition process and process for returning the licensee's assets should be specified.

j. ***Dispute Settlement –*** The agreement should outline the procedures for dispute settlement and the minimum service levels to be maintained during dispute. This should bear relevance to governing laws, regulations, guidelines and jurisdictions.

k. ***Documentation / Information Retention –*** The agreement should outline the retention period and mechanisms for retention of information and also ensure regulatory compliance.

l. ***Confidentiality, Security and Separation of Property -*** Appropriate security and data confidentiality protection must be in place. The contract should inter alia address:

   i. Which party has responsibility for protection mechanisms;
   ii. The scope of the information to be protected;
   iii. The powers of each party to change security procedures and requirements;
   iv. Which party may be liable for any losses that might result from a security breach; and notification requirements if there is a breach; and
   v. The requirement for the service provider to be able to logically isolate the licensee's data, records, and items in process from those of other clients at all times, including under adverse conditions.

m. ***Activities of Sub-contractors -*** All sub-contractors must be subject to the same contract requirements as the initial service provider.

9. MONITORING OF OUTSOURCED ACTIVITIES

Licensees should monitor all material outsourcing arrangements to ensure that the service is being delivered in the manner expected and in accordance with the terms of the contract or outsourcing agreement. Monitoring may take the form of regular, formal meetings with the service provider and/or periodic reviews of the outsourcing arrangement's performance measures. Within a reasonable time the licensees should advise the Bank (either formally or informally) about any events that are likely to have a significant negative impact on the delivery of the service.

A licensee should review its material outsourcing arrangements to ensure compliance with its outsourcing risk policy and procedures and with the expectation of this Guideline. Reviews of material outsourcing arrangements should be periodically undertaken by the licensee's internal audit department or another approved independent review function either internal or external to the licensee provided it has the appropriate knowledge and skills. The licensee's board of directors will always retain overall accountability for the outsourcing arrangement. Reviews should test the licensee's risk-management activities for outsourcing in order to:

i. Ensure risk-management policies and procedures for outsourcing are being followed;
ii. Ensure effective management controls over outsourcing activities;
iii. Verify the adequacy and accuracy of management information reports; and
iv. Ensure that personnel involved in risk-management for outsourcing are aware of the licensee's risk-management policies and have the expertise required to make effective decisions consistent with those policies. Management should adjust the scope of the review depending on the nature of the outsourcing arrangement.

Consistent with section 6, some monitoring of immaterial outsourcing arrangements is necessary in order to detect when any such arrangements become material.

10. OTHER

In implementing a programme for outsourcing, licensees need to pay attention to the following:

10.1 Contingency Planning

Notwithstanding, the service provider's contingency plan, a licensee should have and regularly review contingency plans for each outsourcing arrangement to enable it to set up new arrangements if the contract is suddenly terminated or the provider fails or there is a systemic failure brought on by concentration of operational risk. The degree of detail may depend on whether the licensee will use another service provider or undertake the function itself.

10.2 Internal Audit

The Bank recognises that the creation of an Internal Audit department may not be practical for some small licensees. The Bank accepts that where the licensee is part of a larger financial or non-financial group, internal audit services can be outsourced to affiliates within the group. This is not always possible and a licensee may, subject to the Bank's agreement, outsource the operational aspects of the function to a person or firm that is not involved in the auditing or accounting function of the licensee. The scope of outsourced internal audit arrangements may vary, e.g.:

i. The entire audit function may be outsourced; or
ii. The audit function is carried out under the supervision of the licensee's internal audit manager who approves the scope, plan and procedures to be performed.

10.3 Cross-Border Outsourcing

Cross-border outsourcing may increase the risk that licensees face as additional factors including potential foreign political, economic and social conditions, and events may negatively affect the service provider's ability to provide the service. Licensees should, inter alia, therefore:

i. Evaluate the foreign service provider's ability to meet the licensee's needs given the foreign jurisdiction's laws, regulatory requirements, local business practices, accounting standards and legal environment;
ii. Monitor foreign government policies and political, social, economic and legal conditions in countries where they have contractual relationships with service providers;
iii. Provide for the confidentiality of customer information in accordance with relevant laws and the licensee's records in the contract; and
iv. Determine which country's laws will govern the relationship, including the resolution of disputes.

Where a licensee wishes to maintain and process information or data outside of Barbados, it must prior to doing so:

i. Provide to the Bank a detailed description of the information or data to be maintained or processed outside Barbados; and
ii. Include in the contract, a provision requiring the service provider to grant the Bank access to all of the licensee's data and information that are processed and maintained by the service provider and, if any, the back-up or disaster recovery provider, or any other entity to which the maintenance or processing is subcontracted.

10.4 Regulatory Compliance

Each licensee should ensure that outsourcing arrangements do not diminish their ability to fulfil their obligations to customers and regulators, nor impede effective supervision by regulators. When deemed necessary, the Bank may, at the licensee's cost, carry out an on-site review of a licensee's outsourced functions. If the Bank's Examiners are prevented from exercising their function by legal, regulatory or administrative restrictions, the licensee may be required to terminate the outsourcing arrangement.

To facilitate regulatory compliance, the licensee should:

1. Maintain at its Barbados office a centralised list of all material outsourcing contracts / arrangements, identifying the service providers and the service provided;

2. Maintain at its Barbados office copies of all relevant outsourcing contracts;

3. Maintain all records and documentation needed for regulatory purposes within Barbados in English. This includes the results of the licensee's due diligence, risk assessment, ongoing oversight as well as internal and/or external audits arranged by the service provider or the licensee;

4. Make arrangements that allow unimpeded regulatory access to all original books, records and information during onsite inspections;

5. Take steps to have risk management strengthened where deficiencies are identified or terminate the outsourcing relationship; and

6. In the event of involuntary liquidation, ensure that the Bank has unimpeded access to all outsourced services.