Managing risks and code of conduct in outsourcing of financial services - Our assessment of the Draft Master Direction

November 2023

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Master Direction – Reserve Bank of India (Managing Risks and Code of Conduct in Outsourcing of Financial Services) Directions, 2023

Background

The Reserve Bank of India, on 26 October 2023, released Draft Master Direction – Reserve Bank of India (Managing Risks and Code of Conduct in Outsourcing of Financial Services) Directions, 2023 (hereinafter referred to as 'Revised draft guidelines').

This is in line with the RBI's Monetary Policy Statement on Development and Regulatory Policies dated 5th August 2022, with the objective of ensuring harmonisation of extant guidelines issued to the different categories of regulated entities (REs).

In addition to harmonisation of regulations for the existing entities, the scope of the revised draft guidelines has also been extended to include regional rural banks (RRBs), local area banks (LABs), All India financial institutions, credit information companies, and non-scheduled payments banks.

While acknowledging the need for using outsourcing as a means for reducing costs as well as for availing expertise not available internally, the RBI has also reiterated the criticality of ensuring stringent and robust risk management systems in the context of outsourced financial services.

The RBI has also additionally reiterated that the ultimate responsibility for the outsourced activities shall continue to rest on the regulated entity and focused on the need for board and senior management oversight on the activities being outsourced.

Summary of key changes proposed under draft guidelines

Applicability

The primary objective of the Master Direction - Reserve Bank of India (Managing Risks and Code of Conduct in Outsourcing of Financial Services) Directions, 2023, is to ensure the consolidation of instructions for all categories of regulated entities.

The RBI has consolidated the guidelines on the outsourcing of financial services under one guideline applicable to all commercial banks, AIFIs, NBFCs and HFCs, cooperative banks, and credit information companies. This has been primarily done with the intent of harmonising the extant directions/guidelines/instructions to enable REs to have all current instructions on the outsourcing of financial services at one place for reference.

Accordingly, the revised draft guidelines shall be applicable to all the below mentioned categories of regulated entities –

- All commercial banks (including local area banks, regional rural banks, payments banks, and small finance banks)
- All-India financial institutions (viz. Exim Bank, NABARD, NHB, SIDBI, and NaBFID)
- All non-banking financial companies, including housing finance companies (HFCs)
- All urban cooperative banks, state cooperative banks, and central cooperative banks
- All credit information companies
- While the guidelines have been issued by the Reserve Bank of India, the Supervisory Authority shall depend on the category of the RE, namely –
- The RBI in case of commercial banks (including LABs, PBs, SFBs, and UCBs), NBFCs, CICs, and AIFIs.
- NABARD in case of StCBs, CCBs, and RRBs.
- The NHB in case of HFCs
- The REs shall be provided with a period of 3-6 months to bring their existing outsourcing agreements in compliance with the final Master Direction.

Summary of key changes proposed under draft guidelines

Activities that shall not be outsourced

- The Reserve Bank of India has now specifically included policy formulation as a core management function that cannot be outsourced under the draft guidelines.
- Further, the RBI has strengthened the provisions of the extant guidelines for loan sanctions as an outsourced activity. The RBI has reiterated that the RE shall take the final call on loan sanction, and where a template-based pre-defined criteria is used for loan sanction through a service provider, the RE shall be able to demonstrate to the supervisor that the role of the service provider is limited only to that of a facilitator in the arrangement.

Material outsourcing

The RBI has added two additional criteria to the extant guidelines in determining the material outsourcing –

- The REs shall also consider the degree of difficulty in finding an alternative service provider or bringing the outsourced activity in-house in determining whether the same constitutes material outsourcing.
- Additionally, The REs shall also consider the impact on the REs counterparties and the financial market, should the service provider fail to perform the services.

Regulatory and supervisory requirements and role of Res

The RBI has stressed upon the requirements of putting a strong risk management framework for outsourcing of financial services.

In addition to the existing requirements, under the proposed draft guidelines, the REs shall also ensure the following –

- Establish an inventory of services provided by the service providers (including key entities involved in their supply chains) to map their dependency on third parties and periodically evaluate the information they receive from the service providers. The REs shall now evaluate concentration risk in a more enhanced manner and ensure that they put in place policies that determine a framework to prevent concentration risk.
- The REs shall be responsible for the entire ambit of services outsourced, which includes actions of the service providers, as well as their sub-agents. The responsibility for the confidentiality of customer information shall also rest with the RE.
- In order to ensure appropriate controls towards related party arrangements, the RBI has included key managerial personnel and the approver of outsourcing arrangements of the REs to the existing list of personnel who cannot own or control the service provider. An exception to this requirement may be made with the approval of the board or a committee of the board, followed by appropriate disclosure.
- The RBI also requires the REs to have a stringent grievance redressal mechanism, including grievance redressal for outsourced financial services, and this activity cannot be outsourced.

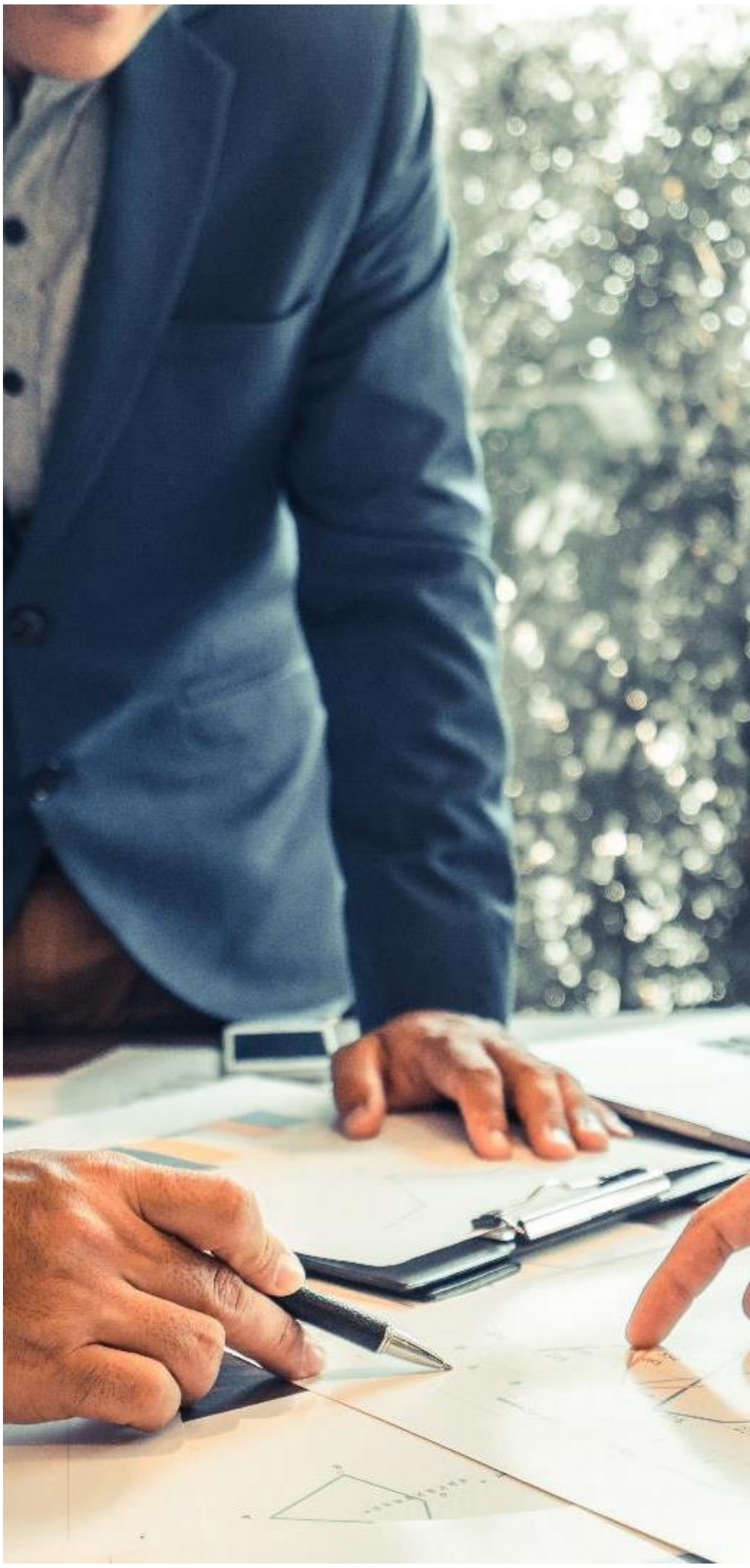
Summary of key changes proposed under draft guidelines

Evaluating the capability of the service provider

- The RBI has stressed upon the need for ensuring holistic coverage of financial, operational, qualitative, quantitative, and reputational factors in conducting the due diligence of the service provider.
- The REs shall particularly focus on evaluating conflict of interest when engaging with a service provider.
- The REs shall also evaluate business continuity management, audit coverage, internal controls, security, and reporting and monitoring environment of the service provider.

Additionally, the following factors shall also be considered, in addition to the aspects specified in the extant guidelines –

- External factors such as economic, legal, political, and social environment of the jurisdiction in which the service provider operates and other events that may impact service performance;
- The ability to effectively service all the customers with confidentiality where a service provider has exposure to multiple REs;
- Disaster recovery arrangements and track record;
- Degree of reliance on sub-contractors; and
- Adequacy of the service provider's insurance coverage.



Summary of key changes proposed under draft guidelines

Outsourcing agreement

The RBI has strengthened the requirements towards monitoring the performance of the service providers in line with the service level agreements agreed for the purpose of outsourced financial services.

- The SLAs shall clearly establish the performance criteria and expectations to measure the quality and quantity of service levels.
- The SLAs shall also include contingency plans to ensure business continuity.
- Where the service providers are using sub-contractors for the performance of services to the REs, the RBI has placed additional responsibility on the RE to review the sub-contracting arrangement in compliance with the revised guidelines before according approval.
- While the current guidelines permit the supervisor to access the documents and records, the revised draft guidelines also require the REs to ensure that adequate provisions are available that permit the supervisor to cause an inspection of the service provider and its books and accounts.
- The SLAs with service providers shall also additionally include a provision requiring the service provider to ensure compliance with the guidelines.
- The SLAs shall specify the type of material adverse events (e.g., data breaches, service unavailability, etc.) and incident reporting requirements under which the service provider should report to the RE, so as to enable the RE to take prompt risk mitigation measures.
- The SLAs shall specify the events of default, and the indemnities, resolution process, remedies and recourse of the respective parties in the agreement; and
- For all material outsourcing arrangements, the SLAs shall also specify the location(s) (i.e., regions or countries) where the function will be provided and/or where relevant data will be processed, and the conditions to be met, including a requirement to notify the RE, if the service provider proposes to change the location(s).

Summary of key changes proposed under draft guidelines

Monitoring and control of outsourced activities

In addition to the existing provisions for the monitoring of outsourced activities, the RBI has also stipulated that the RE shall perform comprehensive pre- and post-implementation review of new outsourcing arrangements or when amendments are made to the outsourcing arrangements.

While the RBI required regular audits to be conducted, they have now clarified that such audits shall take place at least annually by either the internal or external auditors of the RE and the audits shall assess the adequacy of the risk management practices adopted in managing and overseeing the outsourcing arrangement.

Additionally, a report of these audits shall be placed before the board or ACB of the RE.

REs shall also submit an annual compliance certificate, giving the particulars of outsourcing contracts, the prescribed periodicity of audit by the internal/external auditor, major findings of the audit and action taken through the board, to their respective supervisory authorities.

In the event of the termination of any outsourcing agreement, on account of the below-mentioned reasons (indicative in nature), where the service provider deals with customers, the REs shall publicise the information by publishing in the leading local newspaper with sufficient circulation in the locality, in addition to its branches and website. Such events have been clarified to include –

- Fraud committed by the service provider;
- Leakage of information/data;
- Breach of confidentiality or code of conduct by the service provider; and
- Blacklisting of the service provider by GoI, RBI, SEBI, or any other regulator/supervisory authority.

The REs shall immediately notify the supervisory authority in the event of any significant problems that have the potential to materially affect the outsourcing arrangement and, as a consequence, materially affect the business operations, profitability, reputation or strategies of the RE.

Summary of key changes proposed under draft guidelines

Confidentiality and security

- In order to reiterate the criticality of data protection, the RBI has stipulated that the sharing of data by the RE with the service provider shall only be done through secure channels. Both sharing and storage of data with the service provider shall be in an encrypted manner. The RE shall also ensure that there is a structured process in place for secured removal/disposal/ destruction of data by the service provider.

Business continuity and management of disaster recovery plan

- In the case of material outsourcing, the RBI has specified the frequency at which the RE shall conduct occasional joint testing and recovery exercises with its service provider. The same shall be done at least annually and the RE shall put in place the required provisions as part of the SLA.

Incentive compensation review

- REs shall also ensure that an effective process is in place to review and approve any incentive compensation that may be embedded in service provider contracts, including a review of whether the existing governance and controls are adequate in light of the risks arising from incentive compensation arrangements.
- As the service provider may, in certain instances of outsourcing, represent the RE by selling products or services on its behalf, the RE should consider whether the incentives provided might encourage the service provider to take imprudent risks.
- Inappropriately structured incentives may result in reputational damage, increased litigation, or other risks to the RE. An example of an inappropriate incentive would be one where variable fees or commissions encourage the service provider to direct customers to products of the RE with higher profit margins without due consideration to the suitability of such products for the customer.

Summary of key changes proposed under draft guidelines

Centralised list of outsourced agents

If a service provider's contract is terminated prematurely prior to the completion of the contracted period of service, on account of the reasons mentioned below (indicative in nature), the Indian Banks' Association (IBA) / respective RBI-recognised self-regulatory organisations (SROs) would have to be informed about the reasons for the termination:

- Fraud committed by the service provider;
- Leakage of information/data;
- Breach of confidentiality or code of conduct by the service provider; and
- Blacklisting of the service provider by the government of India, the RBI, SEBI, or any other regulator/supervisory authority.

IBA/respective RBI-recognised SROs would be maintaining a caution list of such service providers for sharing among themselves and the respective member REs.

Outsourcing within a group/ conglomerate

The RBI has reiterated that the selection of a group entity should be based on objective reasons and that the conditions of the outsourcing arrangement should be set at an arm's length and explicitly deal with conflicts of interest that such an outsourcing arrangement may entail.

Our point of view and assessment

As the RBI is increasingly moving towards principle-based regulations, harmonisation of regulations across regulated entities is a step in the right direction. As outsourcing arrangements are becoming complex, it is necessary to evaluate the risk of regulated entities' over-reliance on outsourcing, in the context of impacting the ongoing viability of the entity, as well as its obligations towards customers.

Additionally, the RBI is also concerned with how outsourcing potentially could impede the ability of regulated entities to demonstrate to regulators that they are taking appropriate steps to manage their risks and comply with applicable regulations. Given the above, the RBI has placed a renewed emphasis on enhancing the risk culture towards outsourcing.

Some of the key impact themes emanating from the revised draft guidelines are included below.

Coverage of outsourcing –

With the advent of fintechs and new-age digital lending partners, the REs will need to ensure that they are able to demonstrate to the supervisor that the entire activity around loan sanctions has been done in-house.

Regulatory compliances

The RBI has enhanced the regulatory reporting framework towards outsourcing activities. The REs shall ensure the below from a regulatory compliance framework –

- Assess readiness towards data availability for regulatory reporting, including the data across geographic locations.
- Internal/external audit shall be conducted on the risk management and compliance controls adopted by the RE and the board/ACB shall also review the same.
- All REs shall ensure that an annual compliance certificate is submitted in a timely manner.

Due diligence of service providers

- The REs shall put in place policies to define and evaluate concentration risk and conflict of interest.
- The REs shall evaluate the BCP framework, and internal controls framework of the service provider.
- Sub-contracting arrangements shall also be looked at.
- Confidentiality protocols and controls of the service provider shall also be evaluated.
- The REs shall also adequately define and monitor service levels as part of the SLA.

Data confidentiality

- In order to reinforce aspects around data protection, the REs shall need to ensure that secure data channels are created for sharing data with service providers, along with data encryption.
- The ultimate responsibility for customer information and confidentiality shall lie with the REs.

As immediate steps, the REs shall assess their readiness towards adopting the revised guidelines and make necessary changes to the policy framework.

Acknowledgement

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