

Outsourcing Risk: a sharp reminder

Regulators have long identified risks inherent in outsourcing in the banking and financial services sectors.

A recent fine levied by the PRA in respect of failures at a small UK-based bank has re-taught a key principle understood for some time - that an authorised firm may outsource important operational functions, but the responsibility to comply with regulation will remain with the firm.

The majority of, if not all, firms are aware of this and understand the expectations of their regulators that they mitigate the risks of outsourcing through due diligence, contractual protections and close oversight. However, this case is a useful reminder that those principles apply equally to intra-group arrangements. (These steps are arguably as important in an intra-group context where the dividing line between outsourcer and outsourcee may not be as clear and where oversight of the service provider and contingency planning are more likely to take a back seat).

The facts

Raphaels Bank, a provider of consumer finance facilities and savings accounts, incurred a £1.3 million fine. The penalty was imposed for a failure to manage outsourcing arrangements in accordance with Principle 3 of the Principles for Businesses, now replaced by the Fundamental Rules in the PRA's Rulebook.

During the relevant period Raphaels was a party to an intra-group joint venture to provide ATMs across the UK. As part of this arrangement, certain aspects of Raphaels' finance function were outsourced to other companies in its group, including "Company C". A number of Company C employees improperly and covertly transferred funds in excess of amounts due under the outsourcing arrangements away from Raphaels to assist Company C with cash-flow issues. As a result, Raphaels unintentionally under-reported its capital requirements to the PRA and failed to understand that it had a large exposure to members of its group of more than 25% of its capital resources, in breach of applicable limits.

Raphaels apparently entered into this intra-group outsourcing without any written arrangements in place at the outset and without undertaking due diligence on its service providers. As can be the case with intra-group arrangements, the formalities that would be adopted as a matter of course for an arms length arrangement were apparently not felt to be necessary - heads of terms and a draft agreement were drawn up, but that agreement was never executed.

Lessons learned

The notice contains some useful clarification for firms that outsource one or more functions, to the effect that they are expected (as a minimum) to have appropriate written agreements in place with, and to conduct suitable due diligence on, their service providers, even where arrangements are intra-group. The agreement should specify the division of powers and responsibilities between the parties and allow the firm appropriate oversight over the arrangements.

Other ways to mitigate risks

So, how else can a firm prevent or mitigate the impact of an unexpectedly bad outcome to outsourcing arrangements?

Outsourcing customers in many sectors, including financial services, are now looking at the risks associated with large prime contractor arrangements and reassessing the benefits of accepting exclusivity arrangements with single suppliers. The idea of 'multi-sourcing' is not new in itself - in 2005 the Joint Forum¹ published high-level principles covering the responsibilities of outsourcing firms and warned regulators to take account of "concentration risks in third party providers when considering systemic risk issues".

Many firms are now considering multi-source arrangements as existing arrangements come up for renewal. Relying on a broader range of suppliers can bring benefits - for example by maintaining competitiveness in the supply chain, enabling the customer to get closer to the full range of its suppliers and choose best of breed, and arguably

¹ Comprising the Basel Committee on Banking Supervisions, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors.

at the same time also spreading risk. However, it also requires strong SIAM (service integration and management) skills and can, if not managed properly, increase a firm's risk and exposure.

Sophisticated governance and audit, both in multi-source and prime contractor arrangements can help prevent issues arising and ensure the level of oversight required by regulators. We would also recommend that firms build regulatory compliance into their outsourcing strategy. A 'compliance by design concept' (akin to the privacy by design model being advocated by regulators in the sphere of privacy and personal data) will help ensure that regulatory compliance is considered at every stage of the outsourcing process. This applies to the nature of the services being outsourced, the way those services are designed (for example to ensure that the customer can step-in or appoint a third party to take over if required) and the extent to which the customer retains internal capabilities to manage and oversee the arrangement.

Comments

As only the second enforcement action to be announced by the PRA, this final notice highlights the importance attached by the regulator to prudent outsourcing by financial services firms. But it is not the first time that intra-group outsourcings have been subject to regulatory intervention. The PRA's first penalty was levied on RBS, NatWest and Ulster Bank for technology and governance failures - interestingly the problem in that case also stemmed from an intra-group outsourcing for the provision of IT services. Before that, Zurich was fined by the FSA in 2010 for the loss of customer data by its South African group member to whom it had outsourced relevant services.

Despite the risks and challenges of outsourcing, regulated firms are increasingly outsourcing significant parts of their activities, often as a strategic, long term strategy². Technological innovations will surely only serve to fuel the next wave of outsourcing services.

Clear messages emerging from the Raphaels final notice:

While a firm may outsource the practical aspects of the outsourced function, it may not outsource its regulatory responsibilities as they relate to the outsourced function. The notice therefore reminds firms that they should, as a minimum, consider the following issues:

- Proper due diligence should be conducted, and documented, on any potential outsourcing, including those where the service provider is a group company.
- Service arrangements should be properly documented to reflect commercial terms, responsibilities and reporting lines between a firm and its service provider. This can sometimes be more difficult to do with intra-group arrangements, as the 'supplier' group company may not have had to scope out and document the services it will provide in the same way that a professional service supplier would have had to do.
- Once properly documented, it is vital that service delivery follows the contractual requirements. The contract should form a working manual for the arrangements, rather than be mothballed until a dispute arises.
- The contract, particularly where it is a long term arrangement, should contain sufficient flexibility to adapt to the customer's changing requirements. This includes agreeing an appropriate mechanism for the negotiation, agreement and implementation of changes to the scope of services (such as a Change Control Procedure).
- There should be suitably strong contractual provisions to allow oversight of the service provider and a firm should monitor provision of the outsourced services. When negotiating outsourcing arrangements, firms should therefore ensure they have strong governance and audit provisions in place which meet their needs, and not treat these clauses as legal 'boilerplate'. That said, firms will want to strike a balance between sufficient oversight and inefficient micromanaging.

While these principles reflect what is generally considered as standard market practice, again it is a useful reminder for firms to check that their internal procurement, audit and approval processes are as rigorous for intra-group arrangements as they are for third party procurements.

² See, for example, the survey of 50 senior figures, representing some of the UK's leading banks and brokers institutions conducted by YouGov for BNP Paribas Securities Services in 2014, which found that 78% outsource as a strategic, long term strategy to help focus on core activity.

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