



Monetary Authority of Singapore

RESPONSE TO FEEDBACK ON THE
CONSULTATION PAPER ON
GUIDELINES ON OUTSOURCING

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MAS published a consultation paper on 12 March 2004 to seek feedback on the Guidelines on Outsourcing (the “Guidelines”), which set out MAS’ expectations on institutions engaging in outsourcing.

The consultation closed on 12 April 2004. The respondents are listed in the Appendix. MAS has considered the comments received and incorporated them into the Guidelines, where appropriate.

In general, the industry expressed appreciation for the guidance provided by MAS on this issue but felt that full adherence to the proposals in the Guidelines would be costly and could outweigh the benefits of outsourcing. We emphasise that the Guidelines are to be implemented to the extent and degree commensurate with the nature and materiality and risks of the outsourcing to the institution.

MAS notes that the Guidelines contain prudent practices and are broadly in line with those promulgated in other jurisdictions. The Guidelines are also consistent with the principles set out in a consultative document issued on 2 Aug 2004 by The Joint Forum, which comprises the Basle Committee on Banking Supervision, International Organization of Securities Commissions and International Association of Insurance Supervisors.

MAS thanks all respondents for their contributions. We highlight below, the comments that are of wider interest and our responses to them.

1. Retrospective Application

Some respondents commented that retrospective application of the Guidelines would result in unnecessary burden and cost as institutions would have to renegotiate contracts mid-stream to ensure that they comply with the requirements of the Guidelines.

MAS’ Response

MAS has taken note of the comment. Where the rectification to be made concerns an existing contractual agreement with a service provider, the Guidelines now clarify that the rectifications can be made within one year from the date of issue of the Guidelines or when the agreements are

renegotiated or renewed, whichever is earliest. Nevertheless, if a deficiency identified from the self-assessment process is significant, MAS expects an institution to have in place measures to mitigate the risks.

2. Definition of Outsourcing

The definition of outsourcing in the Guidelines was generally thought to be too broad and can be interpreted to include any contract for the supply of services. Clarification was sought on a variety of specific arrangements and whether they were considered outsourcing based on the definition and examples provided in Annex 1 of the Guidelines. Several respondents suggested that the definition of outsourcing be narrowed by setting out additional guiding principles.

MAS' Response

Annex 1 of the Guidelines provides examples of outsourcing where the Guidelines are commonly applicable and will be reviewed and updated as necessary in future. It should not be misconstrued that other services procured by institutions need not be subject to adequate risk management and internal control.

Nevertheless, MAS has accepted some of the suggestions and included guiding principles on the definition of outsourcing. The examples in Annex 1 have also been categorized into groups to provide clarity and guidance to help institutions determine if specific arrangements are subject to the Guidelines. Rather than just relying on the definition of what constitutes outsourcing, institutions should assess if an arrangement it is planning or has entered into, brings about risks that can be mitigated through the application of the Guidelines. If so, it will be in the interest of the institution to use the guidance provided in the Guidelines to improve its own risk management process.

3. Material Outsourcing

Some respondents sought further guidance on what constitutes material outsourcing. In addition, it was viewed that the interpretation of “material” would be largely at MAS’ discretion. Several respondents also suggested providing quantitative guidance or thresholds based on accounting concepts of materiality.

MAS' Response

We decided to provide only qualitative criteria as guidance, as materiality will vary between institutions and circumstances.

The onus lies with the institution to assess if an outsourcing arrangement is material, based on the qualitative criteria provided in the Guidelines, and any other factors that the institution should appropriately consider. The objective is for the board and senior management of the institution to undertake a systematic process to identify risks to which their institution is exposed. While MAS' concurrence is not required, we expect an institution to be able to demonstrate and justify its assessment when required.

We have also decided not to include quantitative measures of materiality, as this approach tends to be mechanistic and can lead to failure to take into account the different circumstances surrounding each outsourcing arrangement. It also tends to circumscribe consideration of the less easily quantifiable but nevertheless significant reputation and strategic risks facing an institution. Institutions may include quantitative criteria in their assessment as appropriate but should be careful about the assumptions they make.

4. Role of the Board and Senior Management

Some respondents questioned the expectations placed by the Guidelines on the board of directors of foreign-incorporated institutions, including being actively involved in decisions to outsource and approving material outsourcing arrangements. There were mixed views on the relevant party who should take on the responsibilities that the Guidelines had required of the board. One view was that it should be sufficient for local management to be responsible for setting the framework as major outsourcing decisions would have been approved by their respective head offices. Another suggestion was that these duties could be entrusted to either senior management, a management committee or body responsible for the overall supervision of the entity in Singapore.

MAS' Response

The functions of the board in the case of a foreign-incorporated institution can be delegated to and performed by a management committee or body beyond local management that is empowered to oversee and supervise the local office (e.g. a regional risk management committee). Where an outsourcing arrangement is material, MAS may request from an institution, information on the processes and structure by which its board or delegated

committee discharges its responsibility in managing the risks from outsourcing. It is expected that institutions with high standards of risk management would have in place good corporate governance processes and structure that addresses the board responsibilities stated in the Guidelines.

5. Capability of Service Providers

Some respondents commented that the due diligence requirements in the Guidelines were onerous and difficult to satisfy, for example, the assessment of the service provider's financial strength and resources, reputation, culture and information on complaints and litigation.

A respondent also suggested that a single due diligence should suffice where more than one institution employed the services of a service provider.

MAS' Response

MAS would like to highlight that an institution should conduct appropriate due diligence on a service provider to assess its ability to perform the outsourcing, as the board and/or senior management of the institution are ultimately responsible for managing the risks arising from its operations in Singapore. The various aspects of due diligence stated in the Guidelines are areas MAS believes would help institutions in making this assessment. The Guidelines do not prohibit an institution from reasonably leveraging on the due diligence performed by another institution as it is stated that all available information should be taken into account. It would be an abrogation of responsibility not to even evaluate that the capability of the service provider is commensurate with the nature, scope and complexity of the outsourcing intended by the institution.

6. Outsourcing Agreement

Some respondents expressed concern over the spillover effect on sub-contractors via the inclusion of rules and limitations on sub-contracting in outsourcing agreements. It was noted that it is not commercially feasible for a service provider to perform due diligence on sub-contractors and obtain prior approval from the institution before engaging sub-contractors, as sub-contracting may be integral to the service provider's modus operandi. The governance model, according to one respondent, should be

the responsibility of the service provider regardless of the degree of further downstream or sub-contracting. Some respondents suggested the inclusion of provisions in the outsourcing agreement to make the service provider contractually liable to apply the same standards of service to the sub-contractors.

MAS' Response

Notwithstanding the concerns expressed, it is important for an institution to retain an appropriate level of control over its outsourcing arrangements to safeguard its interests. The inclusion of contractual obligations on a service provider to ensure that the same standards of service are applied to a sub-contractor, may limit potential pecuniary damages to an institution in the event of failure by shifting the cost onto the service provider. However, this may not adequately address losses arising from operational, reputation and strategic risks facing the institution. Where sub-contracting by a service provider is material, it can tantamount to a material change of contract. An institution should safeguard its interests with appropriate clauses in their outsourcing agreements to limit sub-contracting or where the sub-contracting of that service is material, to require its prior approval.

In addition, the outsourcing agreement must include clauses to allow MAS or its agents to access both the service provider and the institution to obtain documents, records of transactions, and information of the institution given to, stored at or processed by the service provider and the right to access any report and finding made on the service provider. This is applicable to the service provider and any sub-contractor that the service provider may use, including any disaster recovery and backup service provider.

7. Confidentiality and Security

Some respondents expressed that the obligations to review the security practices and control processes or obtain periodic expert reports on security adequacy and compliance, and to ensure the service provider takes measures to maintain confidentiality of customer information were costly and onerous.

MAS' Response

We are of the view that safeguards are necessary to ensure that confidentiality and security of customer information are not compromised by outsourcing. In obtaining periodic expert reports, an institution can rely

on its in-house experts. Notwithstanding, banks and merchant banks are reminded of their legal obligations under MAS Notice to Banks 634 and MAS Notice to Merchant Banks 1108 Banking Secrecy – Conditions for Outsourcing, respectively, on the preparation of an independent report on the service provider’s control environment in relation to confidentiality of customer information.

8. Business Continuity Management (BCM)

Some respondents disagreed with the need to conduct joint BCM testing and recovery exercises with the service providers, citing cost and impracticality reasons, particularly when the requirement is imposed on the service provider by more than one institution which had outsourced to the service provider and/or where the service provider was located outside Singapore.

MAS’ Response

The Guidelines reiterate the sound principles and standards of the Business Continuity Management (BCM) Guidelines issued by MAS in June 2003. BCM needs to be commensurate with the nature, scope and complexity of the outsourcing. Testing is a vital element for effective BCM as changes in business processes and roles and responsibilities within the institution or service provider can ultimately affect the business continuity preparedness of the institution. For assurance of functionality and effectiveness, the BCM Guidelines recommend that business continuity plans (BCP) are to be regularly, completely and meaningfully tested in coordination with external parties to validate the plans as well as to be assured of the awareness and preparedness of their own staff.

9. Audit and Inspection

Due to the costs involved, a respondent suggested that an independent report on the service provider be required on a case-by-case basis where there is reason to believe that risks have increased, rather than annually. Respondents also sought clarification on the degree of independence required on the audit of the service provider, e.g. whether a report prepared by the internal auditor of the service provider can be accepted, where the service provider is an intra-group entity.

MAS' Response

MAS accepts that the frequency and scope of audits to be performed on the service provider may be commensurate with the nature and materiality of the outsourcing arrangement.

An institution should, at least annually, review the financial and operational condition of the service provider to assess its ability to continue to meet outsourcing obligations. This can be done based on available information about the service provider. In addition, an institution should periodically commission independent audit and expert assessments on the security and control environment of the service provider where these are important considerations in the outsourcing e.g. internet banking, or where there has been a demonstrable deterioration in the ability of the service provider to perform the service as contracted and remedial action is required.

Such assessments and reports on the service provider, regardless of whether it is an intra-group entity, may be performed and prepared by the institution's internal or external auditors, or by agents appointed by the institution. The appointed persons should possess the requisite knowledge and skills to perform the engagement, and are independent of the unit or function performing the outsourced activity.

10. Outsourcing Outside Singapore

Some respondents commented that it would be difficult to determine which jurisdictions would restrict access to information by MAS or its appointed agents, and consequently where they should not outsource to. Several respondents had reservations about MAS' cross-jurisdictional supervisory powers, in that the jurisdiction of the service provider's domicile may limit MAS' supervisory powers. Institutions, they believed, should not be held responsible or accountable for the regulatory regime there.

MAS' Response

As a supervisory authority, it is necessary for MAS to be satisfied that it has access to information, wherever located, of the supervised institution. This is key to the effective exercise of MAS' supervisory powers over the institution and is a standard practice among international regulators. Institutions should therefore not outsource to service providers that are impeded or are unwilling to cooperate to grant such access. The Guidelines continue to reflect this. An institution must at least commit to retrieve information required by MAS readily from the service provider and

confirm the rights of access to the institution's information, reports and findings at the service provider.

11. Outsourcing Within a Group

The Guidelines generally apply to outsourcing within a group. Most respondents urged for some flexibility in the Guidelines for intra-group outsourcing, particularly in the areas of due diligence, commissioning of independent audit reports and requiring outsourcing agreements, as group entities were usually subjected to similar stringent risk management requirements.

Some respondents were of the opinion that internal audit, middle office type functions, financial accounting and intra-group IT should not be subject to the Guidelines. The rationale was that although there were risks, these will be much lower than in the case of an external service provider.

Some respondents requested that the Guidelines be amended to provide flexibility in determining how the risks can be addressed. Where it is clear that the service provider has the same access to resources as the institution and follow the same risk management procedures, some respondents felt that it was unnecessary for the Singapore office to commission a report.

MAS' Response

MAS maintains the view that intra-group outsourcing should be subject to the Guidelines, including middle office type functions. The risks may not necessarily be lower where an intra-group outsourcing relationship is not arm's length and/or the service provider is faced with competing interests. If an intra-group service provider complies with stringent risk management and internal control policies promulgated on a group-wide basis, it should be fairly easy for the institution to demonstrate that the requirements in the Guidelines pertaining to capability of the service provider, service level agreements, BCM, monitoring and control, audit and inspection, are met.

While outsourcing may be managed by Head Office or regional management, local management is expected to understand and address risks specific to the local office, e.g. local management would need to take steps to ensure the regularity and comprehensiveness of internal audit, compliance and BCM plans of the group, are commensurate and responsive to its changing risk profile, such that the office is able to operate soundly and comply with local rules, regulations and guidelines.

The intention of subjecting intra-group outsourcing to the Guidelines is to avoid gaps in oversight and management of outsourcing. Where the extent of intra-group outsourcing is significant, it is of the interest of the institution and its Head Office to ensure that the relevant functions are subjected to regular internal and/or external audit. Copies or highlights of audit reports should be obtained and reviewed.

LIST OF RESPONDENTS

1. Accenture Singapore
2. Association of Banks in Singapore
3. AIA
4. Asia Life
5. Aviva
6. AXA Insurance Singapore Pte Ltd
7. Bermuda Trust (Singapore) Limited
8. Commerzbank International Trust (Singapore) Ltd.
9. CSFB
10. Deutsche Bank and Deutsche Asset Management Asia Limited
11. Dexia Trust Services Singapore Ltd
12. EDS
13. Fidelity Investment Management (HK) Limited
14. Gen Re
15. General Insurance Association
16. Goldman Sachs
17. HSBC Insurance
18. ING Bank NV
19. Life Insurance Association
20. Merrill Lynch
21. Morgan Stanley
22. Nikko Merchant Bank
23. Prudential Asset Management (Singapore) Limited
24. Royal Bank of Scotland
25. Schrodgers Investment Management (Singapore) Ltd
26. Skandinaviska Enskilda Banken
27. Singapore Exchange
28. Tata Consultancy
29. Templeton Asset Management Ltd
30. UBS
31. UOB Life