Draft guidelines on outsourcing of financial services by NBFCs

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- Vinod Kothari Consultants Pvt. Limited,
- We are a team of consultants, advisors & qualified professionals having over 25 years of experience.

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Draft guidelines on outsourcing of financial services by NBFCs

- By way of a press release on 10th April, 2015, RBI has come out with the *Draft Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by NBFCs* , which is open for comments
- A similar set of guidelines is already in place for Banks
- The guidelines does not specifically restricts its applicability to Systematically Important NBFCs only, hence the same would be applicable to all NBFCs

Highlights of the guidelines 1/5

- Definition of outsourcing as per the guidelines for banks –
  - *'Outsourcing' may be defined as a bank'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 bank itself, now or in the future.*
  - RBI has adopted the same definition for NBFCs as well

Highlights of the guidelines 2/5

- No need to obtain prior approval from RBI to outsource financial services
  - However, the same should be subject to on-site/ off-site monitoring and inspection/ scrutiny by the RBI
- Outsourcing of services relating to credit cards shall be subject to the existing directions of RBI dealing with credit card operations
- Restriction on outsourcing of certain core management operations like –
  - Internal Audit
  - Compliance function
  - Decision making functions like –
    - Determining compliance with KYC norms for opening deposit accounts
    - Sanctioning of loans
    - Management of investment portfolio

Highlights of the guidelines 3/5

- The service provider should not be located outside India
- Even if the services are outsourced, the liability of the company, its directors and senior management still remains
- The NBFCs should ensure that the a proper grievance redressal mechanism is in place
- The service provider, if not a subsidiary of the company, cannot be an entity owned or controlled by any director or officer / employee of the NBFC or their relatives having the same meaning as assigned under Section 2(77) and *draft rules notified on 09.09.2013* with reference to Section 2(77)(iii)) under Companies Act, 2013.
- The company should have in place a comprehensive outsourcing policy, duly approved by its board.

Highlights of the guidelines 4/5

- Role of the Board and Senior Management enlisted in the guidelines with respect to outsourcing of financial service. Includes the likes of –
  - Approval of outsourcing policy, framework of evaluation of risks associated
  - Review of outsourcing strategies and arrangements for their continued relevance, and safety and soundness
  - Periodical review of effectiveness of policies and procedures
  - Ensuring that there is independent review and audit for compliance with set policies
- Various risks like – strategic risk, reputation risk, compliance risk, operational risk, legal risk counter party risk, exit strategy risk, contractual risk, concentration and systematic risk, have been explained in the guidelines

Highlights of the guidelines 5/5

- Outsourcing should be done on the basis of an agreement
- The service providers to develop and establish Business Continuity and Management of Disaster Recovery Plan
  - NBFCs to ensure that the service provider periodically tests such plan
- For existing outsourcing agreements, NBFCs may conduct a self assessment to bring them in line with the guidelines by way of time bound plan

Outsourcing policy

- Board to approve outsourcing policy
- The same should contain the following –
  - Criteria for selection
    - For selection of financial activities to be outsourced
    - For selection of service provider
  - Delegation of authority depending on the risks and materiality
  - System to monitor and review the operations of these activities

Various types of risks as identified in the guidelines 1/2

- **Strategic Risk** – Where the service provider conducts business on its own behalf, inconsistent with the overall strategic goals of the NBFC.
- **Reputation Risk** – Where the service provided is poor and customer interaction is not consistent with the overall standards expected of the NBFC.
- **Compliance Risk** – Where privacy, consumer and prudential laws are not adequately complied with by the service provider.
- **Operational Risk –** Arising out of technology failure, fraud, error, inadequate financial capacity to fulfil obligations and / or to provide remedies.
- **Legal Risk –** Where the NBFC is subjected to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements due to omissions and commissions of the service provider.
- **Exit Strategy Risk –** Where the NBFC is over-reliant on one firm, the loss of relevant skills in the NBFC itself preventing it from bringing the activity back in-house and where NBFC has entered into contracts that make speedy exits prohibitively expensive.

Various types of risks as identified in the guidelines 2/2

- **Counter party Risk –** Where there is inappropriate underwriting or credit assessments.
- **Contractual Risk –** Where the NBFC may not have the ability to enforce the contract.
- **Concentration and Systemic Risk –** Where the overall industry has considerable exposure to one service provider and hence the NBFC may lack control over the service provider.

Outsourcing agreement

- The agreement should bring out the nature of legal relationship between the parties - i.e. whether agent, principal or otherwise.
- The agreement should be sufficiently flexible to allow the NBFC to retain an appropriate level of control over the outsourcing and the right to intervene with appropriate measures to meet legal and regulatory obligations
- Some of key provisions of the contract should be –
  - Activities to be outsourced should be clearly defined including appropriate service and performance standards;
  - NBFCs' right to access all books, records and information relevant to the outsourced activity;
  - Controls to ensure customer data confidentiality and service providers' liability
  - NBFCs' right to conduct audit on the service providers, either by way of internal or external auditor
  - Clauses to allow RBI to access documents relating the outsourced activities stored by the service provider
  - Clause to allow RBI to cause an inspection of the service provider

Confidentiality and Security

- NBFCs should seek to ensure preservation and protection of the security and confidentiality of customer information in the custody or possession of the service provider
- Access to customer information by staff of the service provider should be on 'need to know' basis
- The NBFC should ensure that the service provider is able to isolate and clearly identify the NBFC's customer information, documents, records and assets to protect the confidentiality of the information
- The NBFC should review and monitor the security practices and control processes of the service provider on a regular basis
- Any breach of security or leakage of confidential customer information should be immediately reported by the NBFC to the RBI

List of policies to be prepared by the NBFCs once these guidelines are notified

- In addition to the requirements under the Companies Act, 2013, an NBFC has to have the following policies in place as per the various RBI notifications –
  - Risk Management Policy
  - Demand/ Call Loan Policy
  - Outsourcing Policy
  - Policy to ascertain fit and proper criteria at the time of appointment of the directors
  - Investment Policy
  - Policy for verification of gold (For companies carrying out gold lending)
  - Policy for long term projects in infrastructure and core industries
  - Fair Practice Code

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Our various write ups on NBFCs can be viewed at: http://www.india-financing.com/staff-publications-nbfc.html

Thank You