Directions on outsourcing of financial services by NBFCs

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Overview

- RBI, on 9th November 2017, issued Directions on Managing Risks and Code of Conduct in Outsourcing of Financial Services by NBFCs.
- These directions are **applicable for all NBFCs**, including CICs, P2Ps, Account Aggregators and Standalone Primary dealers.
- These directions are concerned with managing risks in **outsourcing of financial services** and are not applicable to technology-related issues and activities not related to financial services, such as usage of courier, catering of staff, housekeeping and janitorial services, security of the premises, movement and archiving of records, etc.
- Existing outsourcing agreements by NBFCs will now be required to be self-assessed and have to be made compliant with the directions within a period of **2 months** from the said date.

What is Outsourcing?

- **'Outsourcing'** may be defined as the NBFC'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 NBFC itself, now or in the future.
- Further, **'Continuing basis'** has been defined to include all agreements valid for a limited period.
- NBFCs which desire to outsource financial services would **not require prior approval from RBI**. However, such arrangements would be subject to on-site/ off- site monitoring and inspection/ scrutiny by RBI.
- Typical outsourced financial services include applications processing (loan origination, credit card), document processing, marketing and research, supervision of loans, data processing and back office related activities.

Prohibitions

- NBFCs shall **not** outsource-
  - Core management functions including:
    - Internal Audit
    - Strategic and Compliance functions
  - Decision-making functions such as:
    - determining compliance with KYC norms for opening deposit accounts
    - according sanction for loans
    - management of investment portfolio.
- However, for NBFCs in a group/ conglomerate, these functions may be outsourced within the group, subject to compliance with instructions prescribed in these directions.
- Outsourcing of services relating to credit cards shall be subject to the existing directions of RBI dealing with credit card operations.

Service Provider

- The service provider may either be a member of the group/ conglomerate to which the NBFC belongs, or an unrelated party.
- Service provider shall employ the same high standard of care in performing the services as is expected to be employed by the NBFCs, if the activities were conducted within the NBFCs and not outsourced.
- The service provider shall not impede or interfere with the ability of the NBFC to effectively oversee and manage its activities nor shall it impede the Reserve Bank of India in carrying out its supervisory functions and objectives.
- The service provider, if not a group company of the NBFC, shall not be owned or controlled by any director of the NBFC or their relatives; these terms have the same meaning as assigned under Companies Act, 2013.
- Service providers must develop and establish a robust framework for documenting, maintaining and testing business continuity and recovery procedures and also isolate the NBFC's information, documents and records, and other assets.

Defining Material Outsourcing

- Material outsourcing arrangements are those which, if disrupted, have the potential to significantly impact the business operations, reputation, profitability or customer service provided by the NBFC. The materiality of outsourcing would be based on:
  - the **level of importance** to the NBFC of the activity being outsourced as well as the **significance of the risk posed** by the same;
  - the **potential impact of the outsourcing on the NBFC** on various parameters such as earnings, solvency, liquidity, funding capital and risk profile;
  - the **likely impact on the NBFC's reputation and brand value**, and ability to achieve its business objectives, strategy and plans, should the service provider fail to perform the service;
  - the **cost of the outsourcing** as a proportion of total operating costs of the NBFC;
  - the **aggregate exposure to that particular service provider**, in cases where the NBFC outsources various functions to the same service provider and
  - the **significance of activities outsourced** in context of customer service and protection.

Various types of Risks

The NBFCs shall evaluate and guard against the following risks in outsourcing:

- **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.
- **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.
- **Country Risk** – Due to the political, social or legal climate creating added risk.

Role of the Board and Senior Management

- The outsourcing of any activity does not diminish the obligations of the NBFC, with the Board and the Senior Management bearing the ultimate responsibility for the same.
- NBFCs shall retain ultimate control of the outsourced activity.
- Role of the Board and Senior Management enlisted in the directions with respect to outsourcing of financial service includes the following:
  - Board approved Outsourcing Policy(including outsourcing within a group/ conglomerate, if applicable)
  - Board approved Code of Conduct for DSA/DMAs/ Recovery Agents
  - Board approved framework for evaluation of risks and materiality of all prospective and existing outsourcing arrangements
  - Half-yearly review of the central record of material outsourcing by the Board (it can be delegated to the Risk Management Committee)
  - Regular review of outsourcing strategies and arrangements for their continued relevance, and safety and soundness by the Board
  - Periodical review of effectiveness of policies and procedures
  - Ensuring that there is independent review and audit for compliance with set policies

Outsourcing Policy & Code of Conduct

- An NBFC intending to outsource any of its financial activities shall put in place a comprehensive Board approved **outsourcing policy** which incorporates, inter alia:
  - criteria for selection of such activities as well as service providers
  - delegation of authority depending on risks and materiality
  - systems to monitor and review the operations of these activities.
- NBFCs shall put in place a board approved **Code of conduct** for DSA/ DMA/ Recovery Agents and obtain their undertaking to abide by the code.
  - It is essential that the Recovery Agents refrain from action that could damage the integrity and reputation of the NBFC and that they observe strict customer confidentiality.
- NBFC shall constitute **Grievance Redressal Machinery** as contained in RBI's circular on Grievance Redressal Mechanism.

Monitoring and Control of Outsourced Activities

- Appropriate due diligence shall be performed to assess the capability of the service provider to comply with obligations in the outsourcing agreement
- NBFC shall have in place a management structure to monitor and control its outsourcing activities
- A central record of all material outsourcing must be readily accessible
- Regular audits by either the internal auditors or external auditors of the NBFC to assess the adequacy of the risk management practices adopted in overseeing and managing the outsourcing arrangement
- Review the financial and operational condition of the service provider to assess its ability to continue to meet its outsourcing obligations, at least on an annual basis
- In cases where the service provider deals with the customers, the termination of the outsourcing agreement shall be publicized by displaying at a prominent place in the branch, posting it on the web-site, and informing the customer
- Reconciliation of transactions between the NBFC and the service provider (and/ or its sub-contractor), must be carried out in a timely manner
- Responsibility of the Audit Committee of Board:
  - An ageing analysis of entries pending reconciliation with outsourced vendors
  - Monitoring of the robust system of internal audit of all outsourced activities

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

Outsourcing within a Group/ Conglomerate

Requirements:

- Board approved policy
- service level agreements/ arrangements with their group entities, shall cover demarcation of sharing resources i.e. premises, personnel, etc
- the customers shall be informed specifically about the company which is actually offering the product/ service
- the NBFC shall not compromise the ability to identify and manage risk of the NBFC on a stand-alone basis
- ability to carry out operations in a sound fashion should not be affected if premises or other services (such as IT systems, support staff) provided by the group entities become unavailable
- the NBFC shall not publish any advertisement or enter into any agreement stating or suggesting or giving tacit impression that they are in any way responsible for the obligations of its group entities

Outsourcing Agreement

- Every such agreement shall address the risks and risk mitigation strategies.
- The agreement shall 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.
- The agreement shall also bring out the nature of legal relationship between the parties - i.e. whether agent, principal or otherwise.
- Some of the key provisions of the contract are:
  – 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

Conclusion

- The underlying principles behind these directions are that the regulated entity shall ensure that outsourcing arrangements neither diminish its ability to fulfil its obligations to customers and RBI nor impede effective supervision by RBI.
- NBFCs, therefore, have to take steps to ensure that the service provider employs the same high standard of care in performing the services as is expected to be employed by the NBFCs, if the activities were conducted within the NBFCs and not outsourced.
- Accordingly, NBFCs shall not engage in outsourcing that would result in their internal control, business conduct or reputation being compromised or weakened.

Thank You!