payments and crypto network

Compliance Arrangements

A series of guides addressing operational compliance issues for UK authorised Electronic Money Institutions ("EMI") and Payment Institutions ("PI").

Guidance is provided for firms and is not intended as legal advice.

Guide 5: Outsourcing Policy

Background

UK authorised EMI and PI businesses must adhere to the regulatory requirements defined in the Electronic Money Regulations 2011 ("EMR") and the Payment Service Regulations 2017 ("PSR") as well as and associated guidance from the UK's Financial Conduct Authority ("FCA").

In addition, following the UK's exit from the EU, the FCA continue to expect the firms that they regulate to comply with, to the extent that they remain relevant, guidelines published by the European Banking Authority ("EBA Guidelines"). One such set of EBA Guidelines are those relating to outsourcing arrangements (reference: EBA/GL/2019/02).

Firms may outsource functions that are required to deliver their regulated services, either in whole or in part, to service providers (who may be within or outside the firms' group of companies).

Where outsourcing takes place, the FCA require UK authorised EMI and PI businesses to control such arrangements through:

- Clearly defined services and service levels
- Contractual arrangements governing the outsourcing relationship; and
- Oversight of the outsourced functions.

The provision of certain business activities by third-parties may not constitute 'outsourcing', for example, in relation to support functions that do not form part of the regulated services. The provision of legal advice or training, or the purchase of standardised services such as market information services (e.g. as used to perform sanctions screening and identify verification) are common examples of activities which are not 'outsourcing'. An easy way to think about what constitutes an outsourced function is to consider whether the firm could perform the function itself but chooses not to and instead seek assistance from a third-party.

In order to ensure compliance with regulatory requirements, an EMI or PI will need to maintain a number of outsourcing policies and procedures. These would need to be documented somewhere, e.g. in an Outsourcing Policy document.

Purpose of an Outsourcing Policy

The purpose of an Outsourcing Policy document is to provide staff with guidance on the processes that a firm will operate when entering into an outsourcing arrangement with a third-party, including:

- the outsourcing policies that are designed to meet operational and regulatory requirements, and
- the procedures that are operated to implement these policies.

This Outsourcing Policy should form part of the compliance arrangements operated by the firm and should be used / read in conjunction with other key compliance documents, including the Compliance Manual. The Compliance Manual would typically provide high-level details regarding the outsourcing arrangements maintained by the firm and reference the Outsourcing Policy, as a supporting document, for additional policy and operational detail.

As with all documentation relating to the compliance arrangements that are maintained by the firm, the Outsourcing Policy should be reviewed on a periodic basis, for example through the operation of the Compliance Monitoring Programme.

The scope of the Outsourcing Policy should apply to all outsourcing undertaken by the firm and with particular regard to the outsourcing of “critical” and “important” functions (as referenced in the EBA Guidelines), i.e. those functions that are necessary to perform activities of “core business lines”.

The subjects of developing a Compliance Manual and Compliance Monitoring Programme are addressed here:

- ***Compliance Arrangements Guide 2: Developing a Compliance Manual***
- ***Compliance Arrangements Guide 3: Building a Compliance Monitoring Programme***

Responsibility

Responsibility for the maintenance of appropriate outsourcing arrangements should be structured in accordance with the three lines of defence model, involving direct operational responsibilities as well as senior management and the Board oversight. Typically, the Compliance Manager (or similar role) would be responsible for ensuring that the firms’ outsourcing arrangements comply with regulatory requirements (at the second line of defence) and would directly accountable to the Board (at the third-line of defence). Responsibilities should be documented in role specific job descriptions.

Regulatory requirements

The EMR and PSR contain specific provisions in relation to the outsourcing of “important” operational functions, including:

- the outsourcing is not undertaken in such a way as to impair the quality of internal control or the FCA’s ability to monitor and retrace compliance with the PSR / EMR
- the outsourcing does not result in any delegation by the senior management of responsibility for complying with the PSR / EMR

- the relationship and obligations of the firm towards its customers under the PSR / EMR, are not substantially altered
- compliance with the conditions which the firm must observe in order to be authorised and remain so is not adversely affected; and
- none of the conditions of the firm's authorisation require removal or variation.

These requirements essentially point to outsourced functions remaining the responsibility of the firm, as if the function were performed by the firm itself. Whilst there is no difference in this responsibility, outsourcing might introduce additional risks, which could affect authorisation requirements or the services provided, if not properly managed.

In practice the majority of outsourced functions should be classified as 'important' and will therefore need to meet these FCA requirements.

It will be likely that these functions will also be classified as either 'critical' or 'important' in accordance with EBA Guidelines and will therefore need to meet the specific requirements referenced in the EBA Guidelines, as outlined further below, for such functions.

<u>Outsourcing life cycle</u>

The process of outsourcing important or critical functions should be undertaken in accordance with a defined outsourcing 'life cycle'. An outsourcing life cycle would include a number of distinct stages within which certain controls will be operated. Typical stages would comprise:

- **Planning process** – planning whether it is appropriate to outsource a particular business function and how the firm would control such an arrangement. The development of a service definition and service levels would take place at this stage
- **Risk assessment** – assessing the risks associated with outsourcing a particular function and understanding how these risks would be controlled by the firm. This would lead to approval in principle to outsource a particular function (that is, if the associated risks are capable of being controlled within the firms' risk appetite)
- **Tendering process** – obtaining quotes for the proposed outsourced services
- **Due diligence** – performing due diligence on potential service providers, leading to a short-list of suppliers or an initial choice of supplier
- **Contractual negotiations** – contractual negotiations regarding service delivery, regulatory and commercial requirements with the potential suppliers, leading to a choice of preferred supplier.
- **Approval** – approval of the relationship with the proposed service provider. The Board should have final approval authority before concluding an outsourcing relationship
- **Implementation** – establishing the operational arrangements that will enable the outsourcing of the business function to the proposed service provider
- **Monitoring** – monitoring the delivery of the services in accordance with contractual provisions and service levels; this constitutes the 'oversight' of the outsourced function; and
- **Termination** – following conclusion of the outsourcing relationship the arrangements will need to be terminated, in accordance with contractual provisions, and an agreed 'exit plan' initiated. Termination may take place if the service provider is not able to meet requirements (e.g. service levels), if the firm wishes to bring the function in house or if the outsourced function is no longer required. Termination and exit planning would also feature in the firms' Wind Down Plan.

Outsourcing controls

Controls will need to be operated at each stage within the outsourcing life cycle. Key outsourcing controls would typically comprise:

- **Agreed service definitions** – business functions that are outsourced should be detailed in documented service definitions, with associated service levels. These should be agreed by the Board.
- **Service provider due diligence** – all potential service providers should be subject to due diligence, including a risk assessment, designed to ensure that they are able to provide the required services to the required standards.
- **Board approval** – the Board should approve all outsourcing relationships.
- **Contractual arrangements** – contractual arrangements should be put in place with service providers and detail the required services, service levels and provisions designed to meet commercial, operational and regulatory requirements (e.g. including audit rights, termination and exit clauses).
- **Outsourcing summary** – a summary of the outsourced services and details relating to the associated service providers should be maintained in accordance with EBA Guidelines.
- **Oversight arrangements** – all outsourced functions should be subject to oversight by an appropriate role within the business.
- **Monitoring arrangements** – the delivery of outsourced services should be subject to ongoing monitoring (as part of the oversight arrangements) and the firms' outsourcing policies and procedures subject to ongoing review and development. Monitoring of a firms' approach to outsourcing would interact with other operations of the firm, e.g. the use of a Compliance monitoring Programme and the Risk Register.
- **Management information reporting** – to support oversight of the outsourcing arrangements, management information should be provided through the functional reporting lines and, in particular, to the Board (at the third-line of defence) as part of the regular reporting information provided ahead of each Board meeting.

Controls to ensure the maintenance and monitoring of outsourcing arrangements will not function in isolation; the outsourcing controls should interact with other control processes operated by the business and throughout the three-lines of defence. For example, interactions with the risk management framework, business continuity, disaster recovery and wind down planning processes would also be expected.

Notifications to FCA

The FCA must be notified in relation to outsourcing arrangements where the firm will be relying on a third party to provide an operational function relating to the provision of its regulated services. All 'important' outsourced functions would require a notification to be submitted to the FCA.

Note: an Outsourcing Policy document has been developed by PACNET that could be used by firms as a starting point for developing their own policy document. This is a template document and should be updated by the firm itself. Contact enquiries@tudorstride.co.uk