



BERMUDA MONETARY AUTHORITY

CONSULTATION PAPER

**NEW OUTSOURCING GUIDANCE FOR BANKS, CREDIT UNIONS,
TRUST COMPANIES, BERMUDA STOCK EXCHANGE,
CORPORATE SERVICE PROVIDERS, MONEY SERVICE
BUSINESSES, INVESTMENT FIRMS & FUND ADMINISTRATORS**

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*Licensed entities subject to this proposed new guidance and other interested parties are invited to submit their views on the proposals set out in this paper. Comments should be sent to the Authority and addressed to outsourcing@bma.bm no later than **4 January 2019**.*

I. EXECUTIVE SUMMARY

1. The purpose of this paper is to consult on new guidance the Bermuda Monetary Authority (the Authority or BMA) proposes to introduce on 1 January 2020, on the evaluation, management and monitoring of risks from the outsourcing of activities by licenced entities in Bermuda to third-party service providers. The new proposed guidance is set out in Section II of this paper.

Scope of new guidance

2. This guidance will apply to a Relevant Licenced Entity (RLE), which is defined in the guidance as any Bank, Credit Union, Trust Company, Corporate Service Provider, Money Service Business, Investment Business or Fund Administrator licenced by the Bermuda Monetary Authority. This guidance will also apply to the Bermuda Stock Exchange.
3. The guidance will apply to outsourcing of activities by an RLE to a third-party service provider. The third-party service provider is defined in this guidance as covering both external outsourcing service providers, as well as outsourcing to service providers who are part of the RLE's own corporate group. Therefore, this consultation paper will also be of interest to those entities that are outsourcing service providers to RLEs in Bermuda.
4. This guidance will apply to all outsourcing arrangements except those explicitly covered by guidance notes 5.149 to 5.174 for Anti-Money Laundering/Anti-Terrorist Financing (AML/ATF) Regulated Financial Institutions on AML/ATF published in September 2016. In developing this new prudential guidance, the Authority has had regard for the AML guidance notes so that licenced entities subject to both sets of guidance should be broadly able to implement one set of policies and procedures that comply with both AML and Prudential guidance.
5. The guidance is applicable to all outsourcing. However, specific focus will be on what is defined in the guidance as 'material outsourcing' where prior approval from the Authority will be required before an RLE enters into such an agreement. A material outsourcing for the purposes of this guidance is the outsourcing of critical activities or services as deemed by the senior management of the RLE to a third-party. For the purposes of this guidance and activity, service of function is regarded as critical if a defect or failure in its performance would cause or materially impair continuing regulatory compliance of the firm, the reputation or financial performance of the firm.

Why propose new guidance now?

6. Over the last three years, the Authority has seen a general increase in the use of outsourcing by RLEs in Bermuda. This trend is likely to continue going forward.

At the same time, albeit with some exceptions, our experience, based on outcomes from on-site inspections, is that management of RLEs need to increase their focus in this area to ensure risks from outsourcing are always appropriately managed. It is for these reasons that the Authority believes now is an appropriate time to commence consultation on introducing this new guidance.

What does the guidance contain?

7. The guidance covers our general expectations regarding the policies and procedures that management of RLEs should have in place to manage risk from all outsourcing. It will require RLEs to review their existing outsourcing policies and procedures to ensure compliance with this new guidance. In particular, it will require RLEs to have policies and procedures that: establish the RLE's risk appetite for outsourcing; define what constitutes a material outsourcing for that specific RLE; and that covers the four stages of outsourcing starting with the decision to outsource, deciding the appropriate service provider, deciding the contractual terms and conditions, and finally, the ongoing monitoring of the outsourcing post contract signing.
8. Additionally, it requires all RLEs, where it is deemed by an RLE's management, that the activity to be outsourced is a material outsourcing to obtain prior approval from the Authority before entering into these agreements.

Link to Authority's existing legislation

9. Non-compliance with the guidance would be deemed by the Authority as casting serious doubt on an RLE's compliance with requirements in the relevant Acts to conduct its business in a prudent manner, and with integrity and skill. On this basis, no amendments to existing legislation are required to implement this guidance.

Process undertaken by the Authority in developing this guidance

10. In developing this guidance, the Authority has benchmarked it for consistency, relevance and proportionality against those outsourcing rules and guidance in operation in Singapore, Jersey, Guernsey and the United Kingdom. Additionally, the Authority pre-consulted with a number of RLEs in various sectors and their feedback has been incorporated into the final proposed guidance set out in Section II below.

Feedback on proposed guidance

11. Licenced entities subject to this proposed new guidance and other interested parties are invited to submit their views on the proposals set out in this paper. Comments should be sent to the Authority and addressed to outsourcing@bma.bm no later than **4 January 2019**.

SECTION II – PROPOSED GUIDANCE

Application of this guidance

1. This paper contains new guidance applicable to Banks, Deposit Companies, the Bermuda Stock Exchange, Corporate Service Providers, Trust Companies, Money Service Businesses, Investment Businesses, Fund Administrators and the Credit Union licenced by the Bermuda Monetary Authority. It requires these licenced entities to have in place adequate policies and procedures to manage and monitor existing activities that have been outsourced, as well as to assess the risks arising from outsourcing new activities. For the purposes of this guidance, those entities within the scope outlined will be defined as ‘Relevant Licenced Entity’ (RLE). This paper replaces existing guidance on outsourcing for Banks and Deposit Companies published in May 2007.
2. This guidance applies to all outsourcing arrangements except those explicitly covered by guidance notes 5.149 to 5.174 inclusive contained in ‘Guidance Notes for AML-ATF Regulated Financial Institutions on AML and ATF 2016 (BMA) Notice 2016’.
3. Subject to paragraph 2 above, this guidance is applicable to all outsourcing of activities by RLEs. Specific focus, though will be on any ‘material outsourcing’ undertaken by RLEs. A material outsourcing is one where the activity being outsourced is deemed by the senior management of an RLE to be a critical activity. For the purposes of this guidance, an activity is regarded as critical if a defect or failure in its performance would cause or materially impair continuing regulatory compliance, and the reputation and /or financial performance of that RLE.

Implementation of new guidance and timeline for submission of prior approvals/ CEO attestations

4. This guidance will come into force from 1 January 2020. Where it is the case that having reviewed this guidance the senior management of an RLE identify an existing outsourcing that constitutes a material outsourcing, they will either:
 - have to seek prior approval for this outsourcing from the Authority prior to implementation of this guidance; or
 - the CEO of the RLE can write to the Authority formally attesting that the existing material outsourcing complies with all aspects of this new guidance. This attestation will subsequently be verified through the Authority’s ongoing supervisory programme post guidance implementation.
5. In cases where the prior approval route for an existing outsourcing is followed the RLE will need to submit a complete application for each outsourcing it deems to constitute a material outsourcing to the Authority for approval no later than 30 August 2019. The need for these RLE submissions to be complete and comprehensive in terms of demonstrating compliance with this guidance cannot be over-emphasised. This is

because the Authority will review all submissions when first submitted and if any are deemed to be incomplete submissions these will be returned to the RLE. At this point the pre-approval route will no longer be available for that outsourcing and the RLE will need to utilise the CEO attestation route instead.

6. Where the attestation route is being utilised, an attestation for each outsourcing deemed to be material by the management of the RLE will need to be provided to the Authority no later than 23 December 2019.

Definitions for the purpose of this guidance

7. For the purposes of this guidance, the following is meant by:

Relevant Licenced Entity (RLE): a Bank, Credit Union, Trust Company, Corporate Service Provider, Bermuda Stock Exchange, Money Services Business, Investment Business or Fund Administrator licenced by the Bermuda Monetary Authority.

Outsourcing: an arrangement in which the RLE uses a third-party (the outsourcing service provider) to perform activities on an ongoing basis that are integral to the provision of services by the RLE itself that would otherwise be undertaken by that licenced entity.

Activities: a general term covering individual activities, an entire service or a complete function that has been outsourced.

Purchased services not deemed to be outsourcing: Purchased services deemed not to be outsourcing are:

- 1) The provision to the RLE of services which do not form part of the services and activities provided by that RLE itself. This would include, but is not limited to:
 - the supply of external advisory services to the RLE that do not form part of the services and activities of the RLE;
 - provision of external legal advice to the RLE;
 - the provision of external training of staff; and
 - the external security, management and maintenance of an RLE's premises and personnel.

With regard to (1) if a trust company acting as trustee arranges the supply of investment management services to a trust, this could fall within this definition depending on individual circumstances. This activity would generally not be deemed to be outsourcing by a trust company acting as an individual trustee except in cases where the trust company held itself out as providing investment management services as part of its individual trustee service. However, if the ongoing monitoring of the performance of the investment management company

providing these services to the trust is outsourced by the trust company acting as trustee to another third-party provider, this would constitute an outsourcing.

- 2) The provision of standardised services such as office equipment, stationary or photocopying servicing.

Outsourcing service provider: a third-party legal entity that provides a service to the RLE. This third-party entity may be licenced or not and may be an affiliated entity within the RLE's own corporate group or an entity that is external to the RLE's group.

Sub-contracting/sub-outsourcing /chain outsourcing: means an arrangement where an outsourcing service provider which has an outsourcing arrangement with a RLE to perform an activity, then sub-contracts the provision of all or part of that activity to other service providers.

Outsourcing agreement: means a written agreement setting out the contractual terms and conditions governing relationships, obligations, responsibilities, rights and expectations of the contracting parties in an outsourcing arrangement. This term would also cover performance agreements set out in Service Level Agreements (SLAs) between the contracting parties.

Material outsourcing: an outsourcing arrangement where critical activities as determined by senior management of the RLE have been outsourced to a third-party.

Critical activities: an activity is regarded as critical if a defect or failure in the provision or performance of that activity would materially impact a licenced entity's:

- business operations, reputation or financial performance; or
- ability to manage risk; or
- compliance with all applicable laws and regulations.

General guidance

Management responsibilities

8. An RLE's management should have in place policy and procedures for the management of outsourcing that includes:
 - a. The risk appetite for outsourcing activities and what activities constitute outsourcing at the RLE;
 - b. Criteria for determining what constitutes a material outsourcing at the RLE;
 - c. The evaluation process as to whether and how an activity should be outsourced;

- d. The due diligence to be undertaken in selecting an appropriate service provider;
 - e. The structure and content of the outsourcing arrangement between RLE and service provider. Outsourcing relationships should be governed by written agreements that clearly detail all material elements of that arrangement; and
 - f. The ongoing management and monitoring of outsourcing arrangements post-implementation.
9. With regard to 8) above, management of the RLE are reminded that while activities can be outsourced, responsibility for those outsourcing activities remains with management. RLE management should always ensure that an outsourcing arrangement in no way impedes the RLE's obligations to customers and regulators.
10. With regard to 8 a. and b. above, defining what constitutes outsourcing and then material outsourcing by management in each RLE will be essential in developing a credible risk-based approach to managing outsourcing risk. Not all activities outsourced will be critical activities, therefore, management will need to determine the factors that should be used when determining what activities are critical and what are not. For example, if the delivery of an activity that has been outsourced is time critical, then defining criticality on the basis of how long a service is not available before it damages reputation, causes a regulatory breach or incurs material financial penalties could be the appropriate metric for determining the criticality in this case. Whatever metrics are used to determine materiality, these will need to be formalised, and be clearly articulated in the RLE's policy and procedures with senior management able to explain why these specific metrics were chosen.
11. With regard to 8 e. and f. above, where the activity being outsourced is deemed by management of the RLE not to be a critical activity, the implementation of this guidance can be applied proportionally to the risk that a failure in the delivery of that outsourced service would pose to the RLE from a financial, regulatory and reputational perspective. The RLE though will need to be able to explain the rationale behind why it is appropriate and proportionate not to fully apply all the guidelines.

Provision of innovative technologies of outsourcing service providers

12. Senior management will also need to consider whether the provision of innovative technology supporting its business (including but not limited to Artificial Intelligence, Distributed Ledger Technology or cloud services) by a third-party constitutes an outsourcing and, if so, whether that constitutes a material outsourcing. The risks arising from the provision of these innovative technologies by a third-party to the RLE will be similar to other types of outsourcing. Where senior management does consider the supply of these innovative technologies to constitute outsourcing, then these guidelines apply.
13. Set out below is proposed guidance relating to each stage of the outsourcing process starting with risk evaluation prior to outsourcing.

Risk evaluation

14. The Authority will expect to see clear evidence of a risk evaluation process having been undertaken by the RLE prior to entering into an outsourcing arrangement that clearly articulates the rationale as to why the outsourcing option was/is being pursued. This evaluation will need to set out the benefits of the outsourcing and how any risks arising from it are to be mitigated/managed. There will be specific focus on this risk evaluation by the Authority in cases where:

- A material outsourcing is being contemplated or re-negotiated;
- Multiple activities are to be/have been outsourced to a single service provider due to the heightened concentration risk this exposes the RLE to; or
- Activities are to be/have been outsourced and post-outsourcing, there is/will be little or no realistic ability to transfer those activities back so they can be delivered by the licenced entity itself in a reasonable time period. The Authority accepts that in some cases it may not be commercially or operationally possible to transfer an outsourcing back to the RLE in a reasonable time period and to do so may actually increase operational risk not reduce it. Where this is the case, the complete reliance for the provision of this activity of the service provider poses a significant extra risk to the RLE. In these cases the Authority will:
 - Expect the RLE's risk evaluation assessment to clearly articulate why the benefits still outweigh the risks of pursuing this outsourcing option;
 - Focus on the due diligence undertaken by the RLE as to the robustness and resilience of the service provider's Business Continuity Plans and Disaster Recovery Plans;
 - Require more regular testing of these contingency plans at the service provider than for outsourcing where the service can be easily transferred back to the RLE. This increased frequency of testing to be explicitly included in the written agreement;
 - Require more intense monitoring of the performance of the service provider by the RLE than for outsourcing where the service can be easily transferred back to the RLE. This increased monitoring is to be explicitly included in the written agreement;
 - Require, as part of the written agreement, the service provider to immediately disclose to the RLE at the point when it first becomes aware of any legal, operational, technological, financial, resource or regulatory adverse development that may affect the service provider's ability to provide the outsourced activity;
 - Require the development by the RLE of more detailed contingency plans that could be utilised in the event that the service provider is unable to provide the outsourced activity. In this case, the contingency plan would relate to the ability to transfer the activity to other service providers in the same jurisdiction in a timely manner;
 - Activities are outsourced to service providers outside Bermuda due to the increased cross-border and timing risks these pose; or
 - All of the above are present.

15. Once the risk evaluation process has determined that outsourcing is the preferred option for an activity, the next stage will be due diligence on the service provider.

Due diligence on the service provider

16. An RLE considering an outsourcing arrangement should undertake due diligence on the service provider under consideration. This due diligence should include, but not be limited to evaluating that the service provider:

- Has the quantity and quality of staff with the requisite skills and experience to effectively deliver the outsourced activities, as well as having any authorisations required by law to perform the outsourced activity reliably and professionally throughout the life of the outsourcing;
- Has the relevant technology, cyber security, operational infrastructure, and financial capacity to undertake the outsourcing arrangement effectively and efficiently;
- Has appropriate information and data security to protect any and all confidential information relating to the RLE and its clients;
- Has an appropriate risk management framework and controls to ensure that the carrying out of the outsourced activity is properly supervised and any risks associated with the outsourcing are effectively managed;
- Has appropriate Business Continuity Plans (BCP) and Disaster Recovery Plans (DRP) and can demonstrate to the RLE a successful track record of BCP and Disaster Recovery testing;
- Will provide access to all documents and data relating to the outsourced activity to the RLE, its auditors and its competent authority, as well as access to the business premises of the outsourcing service provider.

Contingency plan(s) in the event this service provider was unable to provide the outsourced activity for any reason should be considered. For example, are there other service providers in the jurisdiction that could take on the outsourced activity in an emergency?

The outsourcing agreement

17. The RLE and the outsourcing service provider should execute a legally binding written agreement setting out the contractual terms and conditions governing relationships, obligations, responsibilities, rights and expectations of the contracting parties in the outsourcing arrangement.

18. The content of this written agreement should explicitly address any issues identified in the RLE's risk evaluation and due diligence of the service provider. While it will depend on the activity being outsourced, the Authority would expect the written agreement to:

- Specify the activities to be outsourced and laws/regulations applicable to the agreement;
- Specify the responsibilities of the RLE and service provider in the agreement;
- Specify the policies, procedures and controls to ensure the ongoing security and confidentiality of information provided by the RLE to the service provider;
- Impose an obligation on the service provider to comply with all relevant data protection and data privacy rules and regulations;
- Impose an obligation on the service provider to maintain appropriate risk management standards and internal controls through the life of the outsourcing;
- Impose an obligation on the service provider to provide regular updates on its financial soundness, and that it retains the human expertise, and technological and operational capacity to provide the contracted activities through the life of the outsourcing;
- Impose an adverse disclosure obligation on the service provider to immediately disclose to the RLE any legal, operational, technological, financial, resource or regulatory adverse development that **may** affect the service provider's ability to provide the outsourced activity on an on-going basis;
- Specify agreed quantitative and qualitative service level standards, and performance targets to be met by the service provider in performing this activity, and set out the method and frequency by which these quality standards and performance metrics will be monitored by the RLE through the life of the outsourcing;
- Specify the reporting and escalation process where performance standards are not met, and the dispute escalation and resolution process agreed by both parties;
- Impose an obligation on the service provider to:
 - regularly update the RLE on the adequateness of its Business Continuity Plans (BCP) and Disaster Recovery Plans (DRP),
 - update the RLE on any material changes in its BCP/DRP that would affect the provision of the RLE's activity; and
 - undertake regular testing of its BCP/DRP (in conjunction with the RLE if requested) and to disclose the results of these tests to the RLE.
- Specify whether sub-contracting is allowed in the agreement, and the conditions and liabilities imposed on the service provider and the sub-contractor where this is allowed;
- Specify the triggers that would allow either party to terminate or exit early from the agreement; and
- Impose an obligation on the service provider to provide access to all documents and data relating to the outsourced activity to the RLE, its auditors and its competent authority, as well as provide access to the business premises of the outsourcing service provider for these parties if required.

Ongoing monitoring of the outsourcing

19. Post-contract signing, the Authority will expect the RLE to be able to demonstrate that it is monitoring all its outsourcing arrangements through the use of management

information, calls, meetings and visits to the service provider. The level of monitoring for each outsourcing activity should be proportionate to the risks to the RLE from that arrangement.

New material outsourcing - prior approval from the Authority now required

20. Post implementation of this guidance, all new proposals to outsource material activities must be submitted by the RLE to the Authority in writing at least 60 calendar days in advance of the date on which the RLE would wish the outsourcing to commence. Prior to submission, the Authority would expect the new proposal to have been Board approved.

Content of proposal submission

21. The Authority would expect the proposal for a new material outsourcing to contain at a minimum a high-level summary explaining the reason(s) the RLE wishes to enter into an outsourcing with this service provider including:

- Details of the service provider and, where applicable, its regulator;
- The proposed start date of the outsourcing arrangement;
- Details and documentation of the risk evaluation and due diligence undertaken on this service provider by the RLE;
- Any specific risks arising from this proposal identified by the RLE, and how the RLE proposes to mitigate and manage that risk on an ongoing basis;
- A contingency plan in the event the RLE has to terminate this contract for poor or non-performance;
- A draft of the outsourcing agreement between the RLE and service provider; and
- Details on how the RLE proposes to monitor this outsourcing post approval and contract signing.

22. As set out in paragraphs 4 to 6 above, the introduction of this new guidance on outsourcing will require all RLEs to review whether any existing outsourcings are material or not. Where the senior management of an RLE identifies an existing outsourcing that it deems material, the Authority will require the RLE to make a complete and comprehensive material outsourcing submission to the Authority by no later than 30 August 2019. Alternatively, the CEO of the RLE can formally attest in writing that the existing material outsourcing identified complies with this new guidance. These attestations are to reach the Authority no later than 23 December 2019.