If your business depends on technology, you can depend on us.
Agenda

- Introduction - Paul Hinton
- Regulatory Backdrop - Lucy Frew
- Practical Compliance and Contracting - Paul Hinton
- Dealing with SYSC in the contract: termination and exit - Paul O’Hare

Also joining us for the Q&A session:

- Andy Nelson – Kemp Little Consulting outsourcing lead and former Group CIO for RSA Insurance amongst other senior CIO roles
1. IT Outsourcing on the increase

- 77% retail banks now outsource at least one significant part of business (World Retail Banking Report)

- 49% of banks plan to increase the use of IT outsourcing during 2015 (Finextra)

- Only 9% of the banks said they will reduce IT outsourcing (Finextra)
2. What is Outsourced? YouGov survey for BNP Paribas

- 86% of respondents outsource to some degree
- 22% outsourcing their entire back office
- 78% outsource as a strategic, long term strategy to help focus on core activity, as opposed to only 4% focused on cost saving

Figure 5 – Outsourcing and drivers and potential drivers (all respondents (n=50))

Q. Regardless of whether your organisation currently outsources or not – how important do you think each of the following factors are as drivers for deciding to outsource?
3. Why outsource? Hudson & Yorke Survey

- 87 per cent of customers cited cost reduction as the motivating factor for outsourcing

- 62 per cent of suppliers expressed a view that the global financial crisis had resulted in harder price negotiations

- 69 per cent of respondents mentioned flexibility as a motivating factor for outsourcing, in contrast to less than 10 per cent in the 2008 survey
4. Project Risks In order of ranking for Financial Institutions

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<th>Tier One</th>
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<tr>
<td>Breach of security/data loss</td>
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<td>Reputational damage</td>
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<th>Tier Two</th>
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<td>Supplier insolvency</td>
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<td>Service performance failure</td>
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<td>Loss of revenue</td>
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<td>Business disruption/service availability</td>
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<th>Tier Three</th>
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<td>Project delay</td>
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<td>Employee issues</td>
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<td>Political/jurisdictional risk</td>
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5. Publicity for IT/Regulated outsource failings

Deutsche Bank fined £4.7m by FCA over reporting blunders

By Daniel Schäfer in London
6. Regulatory focus on IT and outsourcing
Regulatory backdrop
What Handbook sources do you need to be aware of?

- Principle 3 (Management and control)

- Rules and guidance related to outsourcing by all authorised firms are scattered across the Regulators’ Handbooks but in particular the Senior Management Arrangements, Systems and Controls (“SYSC”) sourcebook.

- Additional requirements relate to:
  - banks, building societies and investment firms under SYSC 8
  - insurers under SYSC 13.9
  - outsourcing home finance activities and insurance mediation activities to third party processors under MCOBS and ICOBS and GEN
  - recognised investment exchanges and auction platforms under REC 2.2
  - alternative investment fund managers under FUND 3.10
  - managers, directors and depositaries of UCITS under COLL 6.6
  - all retail product providers and distributors under RPPD
What other sources do you need to be aware of?

Regulatory investigations and enforcement action
For example:
- UNAT Direct Insurance Management Limited
- Zurich Insurance Plc
- Stonebridge International Insurance Limited
- Lloyd Pope and Peter Legerton, former directors of TailorMade Independent Ltd

EU legislation and regulation
For example
- Solvency II
- AIFMD
- UCITS IV
- MIFID and MiFID II

Thematic reviews and other sources
- FSA's 'Offshore Operations: Industry Feedback' report on offshore operations published by the FSA in April 2005
- FCA's Thematic Review TR13/8: The governance of unit-linked funds
- FCA's 'Dear CEO letter’ of 11 December 2012 to the CEOs of Asset Managers
- FCA's Thematic Review TR13/10: Outsourcing in the asset management industry
- FCA's ‘Considerations for firms thinking of using third-party technology (off-the-shelf) banking solutions’
- FCA's Risk Outlook 2014
- FCA's Thematic review report: Delegated authority: Outsourcing in the general insurance market (TR15/7)
How will MiFID II impact outsourcing obligations?

- MiFID and the Level 2 MiFID Implementing Directive are implemented in SYSC 8.
- Is SYSC 8 fit for purpose?
- Member states must adopt and publish by 3 July 2016 the measures transposing the MiFID II Directive into national law, and must apply those provisions from 3 January 2017.
- In its Consultation Paper on MiFID II dated May 2014, ESMA stated that: “Considering that Article 16(2) of MiFID II consists of an identical recast of Article 13(2) of MiFID I, ESMA is of the view that the existing requirements set out in the MiFID Implementing Directive constitute a robust basis from which to build the provisions.”

“An investment firm shall ensure, when relying on a third party for the performance of operational functions which are critical for the provision of continuous and satisfactory service to clients and the performance of investment activities on a continuous and satisfactory basis, that it takes reasonable steps to avoid undue additional operational risk.

Outsourcing of important operational functions may not be undertaken in such a way as to impair materially the quality of its internal control and the ability of the supervisor to monitor the firm’s compliance with all obligations.”
MiFID II – Level 2
Impact on outsourcing obligations

- ESMA's Consultation Paper dated December 2014 - outsourcing requirements for firms and market operators operating an MTF or OTF.

- In ESMA's draft RTS additional outsourcing requirements applicable to:
  - outsourcing or procuring any software or hardware which is used in trading activities by investment firms engaged in algorithmic trading
  - regulated markets
  - multilateral trading facilities
  - organised trading facilities
  - data reporting services providers
How will Solvency II impact outsourcing obligations?

- Article 49 of Solvency II and article 274 of the Solvency II Implementing Directive deal with outsourcing by insurers and reinsurers.
- Implementation date is 1 January 2017.
- Does the EU approach to regulating outsourcing work?

"Member States shall ensure that insurance and reinsurance undertakings remain fully responsible for discharging all of their obligations under this Directive when they outsource functions or any insurance or reinsurance activities.

Outsourcing of critical or important operational functions or activities shall not be undertaken in such a way as to lead to any of the following:

(a) materially impairing the quality of the system of governance of the undertaking concerned;

(b) unduly increasing the operational risk;

(c) impairing the ability of the supervisory authorities to monitor the compliance of the undertaking with its obligations;

(d) undermining continuous and satisfactory service to policy holders."
Regulatory concerns

- Incoming regulatory trend – focus on the increasing interconnectedness of regulated and non-regulated activities.

- In the FCA's Risk Outlook 2014 it recognises that some financial sector businesses “rely on technological systems of firms that are emerging outside the perimeter”.

- It suggests that these unregulated entities can “pose risks to market integrity and consumer protection through technological interfaces with regulated activities. These activities may have the potential to create systemic and financial crime risks that would be outside [the FCA's] perimeter”.

- Concentration risk

- Intra-group outsourcing
Regulators may investigate themselves or use their powers to commission a report by independent external experts (“Skilled Persons” under section 166 of FSMA) – with costs borne by the firm

Regulators also have an extensive range of disciplinary, criminal and civil powers to take action against regulated and non-regulated firms and individuals who are failing or have failed to meet the standards they require

Regulators can take action even if there is no substantive damage

The reputational risk arising from enforcement action and consequential business losses may be at least as damaging as the action itself

Regulators are focussing on senior management responsibility – for outsourcing and generally. Regulators are requiring individuals to attest to the compliance of the a firm’s outsourcing arrangements

Risks of outsourcing arrangements being perceived as not up to standard
Practical compliance and contracting
Key requirements of SYSC 8

5 practical points

- 8.1.1 R Operational risk
- 8.1.4 R Criticality / Importance
- 8.1.5 R Exclusions
- 8.1.6 R Discharge of obligations
- 8.1.7 R Service provider engagement
- 8.1.8 R Processes
- 8.1.9 R Written agreement
- 8.1.10 R Inter-group
- 8.1.11 R Regulatory supervision
1. Senior management focus
SYSC requirements

“A firm must … must ensure that senior personnel and, where appropriate, the supervisory function are responsible for ensuring that the firm complies with its obligations under the regulatory system … and must assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the regulatory system and take appropriate measures to address any deficiencies.

SYSC 4.3.1 R

“If a firm outsources critical or important operational functions or any relevant services and activities, it remains fully responsible for discharging all of its obligations under the regulatory system and must comply in particular, with the following condition[s] [that] the outsourcing must not result in the delegation by senior personnel of their responsibility …

SYSC 8.1.6 R
1. Senior management focus

- Firm’s senior management have ultimate responsibility for ensuring that the firm complies with regulation of outsourcing.
- Attestations from senior personnel are all the rage from the PRA / FCA.
2. Strategic outsourcing policy SYSC requirements

"The management body … must approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks the firm is or might be exposed to …"

SYSC 7.1.4 R

"A firm must have … effective processes to identify, manage, monitor and report the risks it is or might be exposed to[,] and internal control mechanisms…"

SYSC 4.1.1 R

"A firm must … ensure that it takes reasonable steps to avoid undue additional operational risk…"

SYSC 8.1.1 R
2. a) Senior strategic outsourcing policy

Expectation that senior management have given clear strategic direction in the form of a written policy which provides clear direction on:

- what can and can’t be outsourced
- what is considered “critical or important”
  - SYSC 8.1.4 R
  - SYSC 8.1.5 R
- each firm to take its own view and there will be variations

Must ensure consistent interpretation and operation throughout the business
2 b) Implementation policy

Address governance and organisational roles and responsibilities in:

- the firm
- the business unit when outsourcing
- When managing outsourced relationships

Appropriate level of expertise must be retained to enable effective oversight of the outsourced services

The real challenge can be in co-ordinating teams / inputs and information on a global basis in a fast, efficient, consistent and compliant manner

International question – highest standard to apply?
### 2 b) Implementation Policy Contents

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<td>• critical outsourcing inventory kept</td>
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3. Risk assessment
SYSC requirements

A firm must have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms.

SYSC 4.1.1 R

A firm must establish, implement and maintain adequate risk management policies and procedures, including effective procedures for risk assessment, which identify the risks relating to the firm’s activities, processes and systems, and where appropriate, set the level of risk tolerated by the firm.

SYSC 7.1.2 R

A firm must adopt effective arrangements, processes and mechanisms to manage the risk relating to the firm’s activities, processes and systems, in light of that level of risk tolerance.

SYSC 7.1.3 R
3. Risk assessment

- A documented outsourcing risk appetite assessment policy:
  - statements regarding the firm’s outsourcing risk tolerance
  - alignment with firm’s operational risk framework, e.g. Internal Capital Adequacy Assessment Process
- Criticality of each outsourced service consistently assessed based on the firm’s definition and criteria
- Concentration and big picture group wide / supplier risks considered and identified
- Initial and periodic reassessments of individual and aggregated risks
- Appropriate mitigating actions to reduce residual risk to acceptable levels – formal risk acceptance where appropriate as part of the approval process
- Accountability for risk management must not be outsourced
4. Intra-group SYSC requirements

SYSC 8.1.10 ...the firm may take into account the extent to which it controls the service provider or has the ability to influence its actions.

Some firms have heavily relied on this and assumed intra-group outsourcing can be a light touch from a risk perspective.

SYSC 8.1.10 R

If a firm and the service provider are members of the same group, the firm may, for the purpose of complying with SYSC 8.1.7 R to SYSC 8.1.11 R and SYSC 8.2 and SYSC 8.3, take into account the extent to which the common platform firm controls the service provider or has the ability to influence its actions.
4. Intra-group FCA approach

FCA's Thematic Review TR13/8: unit-linked funds identified failings in the oversight of outsource service providers in approximately 50% of the sample:

- 2 of issues arose from intra-group arrangements
  - an ‘informal’ reliance on group control functions to provide assurance on the effectiveness of controls... This approach generally relied on personal relationships as opposed to specific, clear engagement ... a firm should not assume that because an outsource service provider is an intra-group entity an outsourcing arrangement with that provider will, in itself, necessarily imply a reduction in operational risk
  - deficiencies in circumstances where oversight was not direct – for example, where one outsource service provider was overseeing another. These ‘chains’ of outsource service providers led to gaps in accountability which posed risks to customers
4. Intra-group issues

- Has an objective assessment of the service been made or was it simply expedient?
- If outsourcing to a parent can the customer effectively dictate requirements to the parent?
- Lack of focus on the paperwork
- Intra-group outsourcing needs to be considered and documented with the same rigour as external outsourcing unless there are documented and clear rationales for not doing so
5. Procurement and contracting

Table: As early as possible and before RfP:

- Identify whether it is a critical outsource
- Complete risk assessments
- Incorporate key points as requirements
- Identify suggested mitigations or ask suppliers in RfP as to how they might offer fixes
- Draft the contract in light of the above
- A failure to do this can undermine successful procurement and negotiation
- Document how each obligation risk / has been met
Procurement and contracting

Don’t forget the commercial and business risks:

• Clear Strategy and Objectives
• Clear Scope and Business Requirements
• Understand the Market
• Effective Procurement Process
• Get the Pricing Right
• Incentivising service improvement and cost savings
• Commercial and Operational Skills are Key
• Never Forget the Humans
• Post Contract – the obligations are ongoing
  • Revisit the risks and mitigations
  • Change control
Contract issues: effective exit planning
Exit planning: introduction

Two key reasons to focus on exit

- Identified by FCA as a particular area of concern
- And (arguably) highest risk phase of outsourcing contract

Industry approach to exit planning maturing

- Detailed exit schedules capturing full range of possible exit assistance required
- But still scope for improved planning during other phases of outsourcing lifecycle

Looking at exit planning primarily from a customer standpoint
Exit planning – why does it matter?

**Regulatory requirements/concerns**

- SYSC 8.1.8(7): “[firms] must be able to terminate the arrangement for the outsourcing where necessary without detriment to the continuity and quality of its provision of services to clients”

- FCA ‘Dear CEO’ letter to asset management firms – concerns about the ‘considerable operational challenges inherent in a transfer’ to another outsource provider (Dec 2012)

- FCA thematic review – outsourcing in the asset management industry (Nov 2013)
  - IMA white paper response (May 2013)
  - Outsourcing Working Group (OWG) response (Dec 2013)
Exit planning – why does it matter?

**Commercial drivers – cannot assume that supplier will co-operate on exit**

- May provide leverage in any dispute
- Likely to involve co-operation with competitor
- Final opportunity to improve cash position
- Nothing to lose – if acrimonious exit

**Vs**

- Potential of future business
- Damage to reputation

**Recent indications that suppliers may be less concerned about reputational damage**

- H3G v Ericsson, AstraZeneca v IBM
- And lots of others not in public domain
Exit planning: pre-contract planning

Really effective exit planning begins before contract negotiations – at the tender phase

- Address customer exit requirements in RFP
- Ensure supplier responses are reflected outsourcing contract – ideally as a set of overarching principles

Exit references from former customers

- Use information obtained to inform approach to negotiation of exit provisions

Back-up/standby servicer arrangements for business-critical outsrcings (as per securitisation market)

- Addresses FCA concerns about effectiveness of exit arrangements in an unplanned/distressed scenario
- Not as expensive as might be assumed
- May well become a more common feature of the market
Exit planning: transition

Agreeing baseline operational exit plans:

- Describe operationally how exit project will be implemented
- Rarely agreed pre-signature
- Contract should include (i) exit principles (to apply whether or not exit plan has been agreed), and (ii) financial incentive for supplier to deliver by end of transition

Avoid ‘one size fits all’ approach:

- Separate plans for planned and emergency exits
- Key FCA concern

Establishment of supplier user forum:

- To mitigate against risks of supplier financial distress scenarios
Exit planning: ongoing contract governance

Regular testing and updating of exit plans – to reflect any service delivery changes

Updating of process manuals/databases

- Typically honoured more in breach than observance
- Ensure ability to audit/verify that these are up to date (and that these rights are enforced)
- Incentives to ensure testing, updating and reporting actually happen

Regular supplier financial reporting and health checks

- User groups can make this more efficient/palatable to suppliers
- Appointment of single audit firm
- Process to deal with any concerns that audit reveals
Exit planning: exit phase

Be realistic about exit timeframes (and likelihood of slippage)

- Migration cannot start until replacement supplier has been appointed
- 3 way projects – customer, outgoing and incoming suppliers
- Include ability to extend contract & exit period after notice has been given
- Suppliers generally OK with this subject to reasonable checks and balances
  - Overall time limit
  - Notice period
  - Customer non-payment/insolvency
Exit Schedule and Exit Plan

Capture exit principles/objectives in exit schedule
  ▪ Will help resolve ambiguities in contract/exit plan

Ensure phased/gradual migration is permitted
  ▪ By service component/instance (where applicable)

Beware false economy of ‘free’ exit assistance (even if for cause)

Agree baseline fixed price for exit assistance before contract signature
  ▪ Based on resourcing and timing assumptions
  ▪ Changes managed via change control
  ▪ Link payments to milestone achievement†

Supplier personnel freezes
Exit Schedule/exit plan

Information and assistance to facilitate retendering

- Infrastructure and database space/sizing information
- Service delivery-related information – (e.g. resource-types and numbers)
- Ensure this can be obtained and disclosed before start of exit period

Information and assistance to assist migration

- Service/infrastructure set-up and configuration
- Access to process manuals/databases
- Copies of software images
- Asset/software distribution information
- Transfer of assets – hardware, software licences, personnel
- Knowledge transfer – training & assistance (pre- and post-transition)
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