



CONSULTATION DRAFT
SUPERVISORY AND REGULATORY GUIDELINES: 2004-1
Minimum Standards for Outsourcing
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**MINIMUM STANDARDS FOR THE OUTSOURCING
OF MATERIAL FUNCTIONS**

I. INTRODUCTION

The Central Bank of The Bahamas (“*the Central Bank*”) is responsible for the licensing, regulation and supervision of banks and trust companies operating in and from within The Bahamas pursuant to The Banks and Trust Companies Regulation Act, 2000, and The Central Bank of The Bahamas Act, 2000. Additionally, The Central Bank has the duty, in collaboration with financial institutions, to promote and maintain high standards of conduct and management in the provision of banking and trust services.

All licensees are expected to adhere to the Central Bank’s licensing and prudential requirements and ongoing supervisory programmes, including periodic on-site examinations, and required regulatory reporting. Licensees are also expected to conduct their affairs in conformity with all other Bahamian legal requirements.

II. PURPOSE

For the purpose of these Guidelines, outsourcing involves a licensee entering into an arrangement with another party (including an entity affiliated or related to the licensee) to perform a business activity which currently is, or could be, undertaken by the licensee itself. The Central Bank recognises the need to provide guidance to its licensees on the subject of outsourcing. These Guidelines set out the Central Bank’s approach to outsourcing and the major issues to be considered by licensees when entering into outsourcing arrangements.

These Guidelines have not been issued to encourage outsourcing, rather, the Central Bank, for prudential reasons, continues to favour the performance of material functions by licensees. However, the Central Bank recognises that licensees’ may have sound reasons to outsource functions, such as the ability to achieve economies of scale or to improve the quality of service to clients (i.e., customers, depositors or investors). While taking into consideration the very valid reasons why outsourcing is desirable or attractive from a licensee’s point of view, the Central Bank requires that, given the outsourcing of functions, licensees must continue to comply with the physical presence requirements outlined in *Guidelines for the Minimum Physical Presence Requirements for Banks and Trust Companies Licensed in The Bahamas*, unless the Governor grants specific exception. Additionally, the Central Bank would also be concerned if the delegation of

functions appeared likely to reduce the protection available to depositors or investors or, if it appeared that such delegation might be used as a way of avoiding compliance with regulatory requirements.

III. APPLICABILITY

These Guidelines apply to all **material outsourcing arrangements** of a licensee. Licensees should conduct a self-assessment of all existing outsourcing arrangements against these Guidelines. Where the outsourcing is found to be material and has not received the prior approval of the Central Bank, licensees should seek approval, within two months from the date of issue of these Guidelines. The Central Bank expects that licensees will rectify the deficiencies identified in the self-assessment **no later than one year** from the date of issue of these Guidelines. Where the rectification concerns an existing contractual agreement, it can be made when the agreements are substantially amended, renewed or extended, whichever is earliest. Nevertheless, the Central Bank expects a licensee to have in place measures to mitigate the risks in the interim, if a deficiency identified from the self-assessment process is significant.

Annex 1 provides examples of outsourcing to which these Guidelines are applicable, and arrangements that are generally not intended to be subject to these Guidelines. These are only examples and are not meant to circumscribe the application of the Guidelines to arrangements that are not listed. Licensees should consider the materiality of outsourcing in applying the Guidelines. It should not be misconstrued that activities and operations not listed as outsourcing need not be subject to adequate risk management and sound internal controls.

IV. APPROVAL REQUIREMENTS

1. A licensee **must seek the prior approval** of the Central Bank to enter into a **material outsourcing arrangement**, or to vary, renew or extend such an arrangement. Licensees should expect to engage and demonstrate to the Central Bank their adherence to these Guidelines. The Central Bank may take other supervisory actions and require licensees to take additional measures, depending on the potential impact of the outsourcing on the institution and the financial system, depending on the circumstances of the case. The Central Bank may also directly communicate with the home and/or host regulator of the institution and its service provider, on their ability and willingness to cooperate with the Central Bank in supervising the outsourcing risks to the institution.
2. Prior to seeking the Central Bank's approval, the outsourcing arrangement should be approved by the Board of Directors (in the case of subsidiaries and stand-alone entities) or by the head office (in the case of branches of foreign banks). Licensees should also seek a legal opinion that the outsourcing arrangement complies with relevant statutory requirements related to client confidentiality (particularly Section 19 of the Banks and Trust Companies Regulation Act, 2000), other Bahamian legal requirements and Guidelines issued by the Central Bank.

3. When seeking the Central Bank's approval, information submitted by licensees should include:
 - a) copy of the outsourcing agreement,;
 - b) copy of the legal opinion mentioned in the paragraph two (2) above;
 - c) a statement certifying that the Board of Directors (in the case of subsidiaries and stand alone entities) or by the head office (in the case of branches of foreign banks) has approved the outsourcing arrangement;
 - d) details of the functions to be outsourced as well as the rationale for the outsourcing; and
 - e) details relating to the proposed service provider and a description of the methods that the licensee will employ to ensure that it retains its ability to control and monitor the outsourced functions.

V. MATERIALITY OF FUNCTIONS

1. The materiality of an outsourcing arrangement will depend on the extent to which it has the potential to have a critical impact—both qualitative and quantitative—on a significant line of business of the consolidated operations on the licensee or the Bahamas operations of a foreign branch or subsidiary. Licensees should subject all outsourcing arrangements to the materiality assessment set out in Section VI of these Guidelines.
2. Licensees should consult with the Central Bank where they are uncertain as to whether a business activity that is to be outsourced would be regarded as “material” for the purposes of these Guidelines.

VI. MATERIALITY ASSESSMENT FOR OUTSOURCING ARRANGMENTS

1. The Central Bank recognizes that the outsourcing arrangements undertaken by licensees will have differing degrees of materiality and may not be readily classified as either material or immaterial. The materiality of the outsourcing arrangement is often subjective and depends on the nature, size, scale and scope of operations and complexity of a licensee's business.
2. Without limiting the scope of the materiality assessment, factors that should be considered include:
 - a) the impact of the outsourcing arrangement on the finances, reputation and operations the licensee, or significant business line, particularly if the service

- provider or group of affiliated service providers, should fail to perform over a given period;
- b) the ability of the licensee to maintain important controls and meet supervisory and regulatory requirements, particularly if the service provider were to experience problems;
 - c) the cost of the outsourcing arrangement; and
 - d) the degree of difficulty and time required to find an alternative service provider or to return the outsourced activity in-house.
3. The materiality of an outsourcing arrangement may also arise when the service provider in a material outsourcing plans to sub-contract the service or makes significant changes to its sub-contracting arrangements.
 4. Licensees should periodically reassess an outsourcing arrangement's materiality. In cases where an arrangement is reassessed as material, it should comply with the principles set out in these Guidelines at the first opportunity, such as when the outsourcing contract or agreement is substantively amended, renewed or extended.
 5. Annex II contains a set of suggested questions that a licensee might consider in assessing the materiality of outsourcing arrangements.

VII. RISK MANAGEMENT PROGRAMME

The Central Bank expects that a licensee will design a risk management programme that applies to all its outsourcing arrangements, except those that are clearly immaterial, and that the risk mitigants employed under this programme will be appropriate to the particular outsourcing arrangement.

1. Board of Directors and Senior Management Responsibilities

- A. It is the responsibility of the Board and senior management to ensure that adequate risk mitigation practices are in place for the effective oversight and management of outsourcing arrangements.
- B. The Board, or responsible Committee, should:
 - i. Review and approve risk management policies for outsourcing;
 - ii. Regularly review compliance with the outsourcing policy;
 - iii. Approve all outsourcing arrangements of material business activities;

- iv. Regularly review reports on outsourcing arrangements; and
- v. Ensure that the audit function covers any outsourcing arrangements and report on compliance with the policy.

C. Senior Management of the licensee should:

- i. Develop a risk management framework for outsourcing arrangements that reflects the Board's approved policy;
- ii. Establish and implement an oversight process that ensures that outsourcing arrangements, and outsourcing of material business activities in particular, are reported to and approved by the Board prior to implementation;
- iii. Ensure that, for each outsourcing arrangement, there is a formal evaluation of the service provider, that a contract with appropriate service level agreements is in place, and that the confidentiality provisions and security needs are adequately addressed;
- iv. Ensure that appropriate reporting regimes are in place, including to the Board and the Central Bank, to enable effective management and control of outsourcing arrangements and to identify potential problems at an early stage; and
- v. Ensure that there is an independent review and audit for compliance with set policies.

2. **Accountability**

- A. In any outsourcing arrangement, the Board of Directors (in the case of subsidiaries and stand-alone entities) or head office (in the case of branches of foreign banks) and the licensee's management retain ultimate accountability for the outsourced activity. While outsourcing may result in day-to-day managerial responsibility moving to the service provider, accountability for the business activity remains with the licensee. It is important for licensees to recognise that outsourcing a business activity does not transfer all of the risks associated with the activity to the service provider. It remains the responsibility of the licensee to ensure that all risks associated with the business activity are addressed to the same extent, as they would be if the activity were performed "in house". While outsourcing can be of significant benefit to a licensee, and may reduce some risks, it may also give rise to other risks, which the licensee needs to assess and appropriately manage. The licensee should have policies and processes in place to address the additional risks arising from outsourcing a business activity. Such policies and processes can be captured within existing risk management policies and procedures of the licensee.

- B. When a material outsourcing arrangement results in services being provided outside The Bahamas, a licensee's risk management programme should be enhanced to address any additional concerns linked to the economic and political environment, technological sophistication, and the legal and regulatory risk profile of the foreign jurisdiction(s).
- C. The licensee's management should maintain a centralised list of all its material outsourcing arrangements. The list should contain information pertaining to the name of the service provider, the location where the service is provided, the expiry or renewal date of the contract or outsourcing agreement and the value of the contract or outsourcing agreement. The list should be updated periodically (no less than quarterly) and should be a part of the senior management's reports to the licensee's Board of Directors (in the case of subsidiaries and stand-alone entities) or to the head office (in the case of branches of foreign banks).
- D. The licensee's management must satisfy the Central Bank that adequate procedures are in place and that it has the ongoing ability to monitor and control all material outsourced arrangements. The Central Bank will hold the licensee's Board and senior management responsible for ensuring that the outsourced functions are performed to an appropriate standard and that the integrity of the licensee's systems and controls is maintained.

3. Due Diligence

- A. In selecting a service provider, or renewing a contract or outsourcing arrangement, licensees are expected to undertake a due diligence process that fully assesses the risks associated with the outsourcing arrangement, which includes all factors that would affect the service provider's ability to perform the outsourced activity.
- B. The Central Bank recognises that the level of due diligence conducted will vary depending on the prospective outsourcing partner¹. However, at a minimum, the due diligence process should assess the financial health, technical ability and capacity of the service provider to deliver the required services. The evaluation process would include an assessment of the service provider's control framework, performance standards, policies, procedures, compliance, reporting and monitoring processes. The due diligence process should also address other issues, such as potential conflicts of interest where the service provider is related to the licensee, or where it provides services to competitors.
- C. Where the proposal is to outsource to a third party (i.e. to an entity not affiliated or related to the licensee), the third party should be an entity in a jurisdiction

¹ It follows therefore that a reduced level of due diligence may be appropriate if the prospective outsourcing partner is an entity affiliated or related to the licensee.

acceptable to the Central Bank.² In such cases, the Central Bank will expect the licensee to conduct detailed due diligence on the third party to ensure that it meets the ‘fit and proper’ criteria that is applied by the Central Bank to the licensee itself (see *Guidelines for Assessing the Fitness and Propriety of Applicants for Regulated Functions* and *General Instructions and Guidelines for Licence Applications*).

- D. Due diligence undertaken during the selection process should be documented and re-performed periodically as part of the monitoring and control processes of outsourcing. The due diligence process can vary depending on the nature of the outsourcing arrangement e.g. reduced due diligence may be sufficient where no developments or changes have arisen to affect an existing outsourcing arrangement or where the outsourcing is to a member of the group. A licensee should ensure that the information used for due diligence evaluation is current and should not be more than **twelve (12) months old**.

4. Confidentiality of Outsourced Functions

- A. Licensees should have controls in place to ensure that the requirements of customer data confidentiality are observed and proper safeguards are established to protect the integrity and confidentiality of customer information. Licensees should not undertake outsourcing arrangements that may result in the disclosure of client information to third parties without the prior consent of the client.

5. Anti-Money Laundering Requirements

- A. Licensees must be able to demonstrate to the Central Bank, if required, that under the outsourcing arrangement, statutory requirements on anti-money laundering or record keeping procedures and practices will continue to be met (see requirements under the Financial Transactions Reporting Act, 2000 and the Financial Intelligence Unit Act, 2000 and all applicable Regulations and Guidelines.).

6. Business Continuity Planning

- A. Where a material function is outsourced, the licensee should ensure that its business continuity plan addresses foreseeable situations (either temporary or permanent) where the arrangement is suddenly terminated or the service provider is unable to fulfil its obligations under the outsourcing agreement for any reason. In particular, a licensee should make provision in its business continuity plan for the retention of and ready access to all records necessary to allow it to sustain business operations, meet its statutory obligations, and provide such information as may be required by the Central Bank to exercise its regulatory powers or perform its supervisory functions.

7. Audit and Examination

² A jurisdiction which adheres to the Basel Core Principles for Effective Banking Supervision

- A. Licensees should ensure that the outsourcing arrangement does not impede its ability to effectively, manage and monitor outsourcing arrangements or hinder the Central Bank's ability to perform its supervisory functions. Therefore, licensees should ensure that the terms of the contract or outsourcing agreement include clauses that allow:
- i. The licensee to conduct audits on the service provider, whether by its internal or external auditors, or by agents appointed by the licensee;
 - ii. The licensee to obtain copies of any report and finding made on the service provider in conjunction with the service performed for the institution; and
 - iii. The Central Bank, or any agent appointed by Central Bank, to access both the service provider and the licensee to obtain records and documents, of transactions, and information of the licensee given to, stored at or processed by the service provider and the right to access any report and finding made on the service provider.
- B. Licensees should ensure that these requirements are met in its arrangements with the service provider as well as any sub-contractor that the service provider may engage for the outsourcing, including any disaster recovery and backup service providers.
- C. Licensees are required to submit copies of audit reports, at least annually, on material outsourcing arrangements to the Central Bank.

VIII. CONTINUED CENTRAL BANK SUPERVISION

1. The Central Bank must be in a position to continue its supervision of the outsourced functions, and must be given access to documentation and accounting records related to the outsourced activities. This implies that the Central Bank is unlikely to allow functions to be outsourced to entities or jurisdictions where visits by the licensee's staff, external auditors or the Central Bank's examiners would be impractical or prohibited. Exceptions may be made where, for example, the outsourcing is to other group entities or where alternative arrangements can be made with external auditors or with home/host supervisors in these other jurisdictions to exchange supervisory information.
2. In general, the Central Bank will only allow functions to be outsourced to entities outside The Bahamas where the outsourcing is to an entity in a jurisdiction with an equivalent standard of regulation or supervision as exists in The Bahamas. If the Central Bank so requires, a service provider that is also a regulated entity, must give its consent to its home supervisor to release any relevant information in relation to its

operations that the Central Bank would wish to receive and in no case should it be prohibited, implicitly or explicitly, from doing so.

3. On-site examinations of the licensee may include a review of outsourced functions, where appropriate.
4. The Central Bank must be notified if a service provider, to which a licensee proposes to outsource (or has outsourced) functions, has plans to further outsource (sub-contract) any of the material functions to another entity.
5. Licensees should also notify the Central Bank of any adverse development arising in outsourcing that could significantly affect their operations, including any events that could potentially lead to the termination and early exit from the outsourcing arrangement.
6. The Central Bank reserves its right in all cases to require a licensee to modify, make alternative arrangements or re-integrate an outsourced function(s) into its operations where:
 - i. the licensee fails or is unable to implement adequate measures to address the risks and deficiencies arising from its outsourcing in a satisfactory and timely manner;
 - ii. adverse developments arise from the outsourcing that could significantly affect the licensee;
 - iii. the Central Bank's examiners or agents are prevented, for whatever reason, from carrying out their responsibilities; or
 - iv. the Central Bank's supervisory powers and ability to carry out its supervisory functions are, in any way, hindered.

IX. THE OUTSOURCING AGREEMENT

- A. Outsourcing arrangements should be undertaken using a written, legally binding agreement. At a minimum, the contract should address the following issues:
 - i. Service levels and performance requirements;
 - ii. Audit and monitoring procedures³;
 - iii. Business continuity plans⁴;
 - iv. Default arrangements and termination provisions;

³ Refer to VII 7

⁴ Refer to VII 6

- v. Pricing and fee structure;
- vi. Dispute resolution arrangements;
- vii. Sub-contracting;
- viii. Liability and indemnity; and
- ix. Confidentiality, privacy and security of information⁵.

⁵ Refer to VII 4

ANNEX I

EXAMPLES OF OUTSOURCING ARRANGEMENTS

The following are examples of some services that may be regarded as outsourcing for the purposes of these Guidelines:

- Information system management and maintenance (e.g. data entry and processing, data centres, facilities management, end-user support, local area networks, help desks);
- Document processing (e.g., cheques, credit card slips, bill payments, bank statements, other corporate payments);
- Application processing (e.g. loan originations, credit cards);
- Policy administration (e.g., premium collection, policy assembly, invoicing, endorsements);
- Loan administration (e.g., loan negotiations, loan processing, collateral management, collection of bad loans);
- Investment management (e.g., portfolio management, cash management);
- Marketing and research (e.g., product development, data warehousing and mining, advertising, media relations, call centres, telemarketing);
- Back office management (e.g., electronic funds transfer, payroll processing, custody operations, quality control, purchasing);
- Real estate administration (e.g., building maintenance, lease negotiation, property evaluation, rent collection);
- Professional services related to the business activities of the licensee (e.g., accounting, internal audit, actuarial);
- Human resources (e.g., benefits administration, recruiting); and
- Business continuity and disaster recovery capacity and capabilities.

The following are arrangements that would **not** be considered outsourcing for the purposes of these Guidelines:

- Courier services, regular mail, utilities, telephone;
- Procurement of specialized training;
- Discrete advisory services (e.g., legal opinions, certain investment advisory services that do not result directly in investment decisions, independent appraisals, trustees in bankruptcy);
- Purchase of goods, wares, commercially available software and other commodities Independent audit reviews;
- Credit background and background investigation and information services;
- Market information services (e.g., Bloomberg, Moody's, Standard & Poor's, Fitch);
- Independent consulting;
- Services the licensee is not legally able to provide;
- Printing services;

- Repair and maintenance of fixed assets;
- Supply and service of leased telecommunication equipment;
- Travel agency and transportation services;
- Correspondent banking services;
- Maintenance and support of licensed software;
- Temporary help and contract personnel;
- Fleet leasing services;
- Specialized recruitment;
- External conferences;
- Clearing and settlement arrangements between members or participants of recognized clearing and settlement systems;
- Sales of insurance policies by agents or brokers;
- Ceded insurance and reinsurance ceded; and
- Syndication of loans.

ANNEX II

SAMPLE QUESTIONS TO ASSESS THE MATERIALITY OF OUTSOURCING ARRANGEMENTS

In assessing the materiality of a specific outsourcing arrangement, a licensee may want to consider, among others, these questions:

1. Is the business activity important in relation to the licensee's core business?
2. Is a significant share of revenue derived from that particular activity?
3. What is the outsourcing arrangement's potential impact on earnings, solvency, liquidity, funding, capital, reputation, brand value, or system of internal controls, or its importance to achieving and implementing business objectives, business strategy and business plans?
4. What is the licensee's aggregate exposure to a particular service provider?
5. Does the organization outsource a variety of activities to the same service provider?
6. What is the size of contractual expenditures as a share of non-interest expenses of the licensee or line of business?
7. If the service provider is unable to perform the service over a given period of time:
 - (a) What is the expected impact on the licensee's customers?
 - (b) What is the likelihood that it would harm the licensee's reputation?
 - (c) Would it have a material impact on the licensee's risk profile?
 - (d) Would the licensee be able to engage an alternative service provider?
 - (e) How long would it take and what costs would be involved?