



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Chief Executive Officer / Director

7 March 2017

Re: Outsourcing of Fund Administration Activities

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Cúirt Uíbh Eachach, Bloc D, Bóthar Fhearchair,
Baile Átha Cliath 2, Éire.

Iveagh Court, Block D, Harcourt Road, Dublin 2, Ireland.

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Dear Sir / Madam

The Central Bank of Ireland's (the Central Bank) Requirements on Outsourcing of Administration Activities in Relation to Investment Funds (Outsourcing Requirements¹) are structured so that all Fund Administration Firms maintain a consistent standard of oversight of Outsourcing Service Providers (OSP) and retain ultimate responsibility for the outsourced activities.

The Central Bank regularly reviews the controls and procedures in place surrounding outsourcing arrangements to assess compliance with the Outsourcing Requirements and to evaluate best practice in the industry. During the first half of 2016, the Central Bank carried out a review of outsourcing arrangements concentrating on the following areas (i) the extent to which certain Fund Administrators outsource their activities and (ii) the relevant control environment (governance and oversight arrangements) in place within certain Fund Administrators in Ireland.

Scale of Outsourcing Activities

The extent of outsourcing amongst certain larger Irish Fund Administrators is extensive and is continuing to grow – levels of between 48% and 61% of fund administration activities were carried out by Full Time Equivalents (FTEs) located in OSPs as at 31 December 2015 based on the five firms that formed part of this review. The following key observations were also noted:

- Firms under review outsourced on average to 10 locations.
- Firms under review outsourced primarily to other group entities.
- Firms under review were subject to a concentration exposure to one or multiple outsourced locations, with these being primarily related to two foreign jurisdictions.

It should be noted that the Central Bank will now consider proposed outsourcing submissions by Fund Administrators on the basis of the cumulative effect / impact (i.e. the level of activities carried out by OSPs) the proposed outsourcing arrangement will have on the relevant firm when reviewed in conjunction with all current operating outsourcing models. The Central Bank's view is that the level of outsourcing observed in this review is likely to be at or close to the outer limit of what is appropriate for this industry. In this regard, the Central Bank is undertaking a review of outsourcing across all financial sectors.

¹ These requirements are currently set out Annex II of Chapter 5 of the Central Bank's AIF Rulebook. In accordance with the Public Consultation process recently undertaken by the Central Bank in consultation papers CP97/100, these requirements are expected to be re-issued shortly in the format of regulations issued under the Central Bank (Supervision & Enforcement) Act 2013.



Governance and Oversight

The Central Bank noted that firms are outsourcing more business processes and functions in order to find new efficiencies / reduce costs. Notwithstanding this position, outsourcing presents challenges for firms as they remain responsible under and are obliged to comply with the Outsourcing Requirements. While many potential risks arising from outsourcing can be effectively managed through robust oversight and governance arrangements being adopted, concerns still exist for the Central Bank regarding the standards / arrangements that are in place to adequately oversee all outsourced activities. The following key observations were noted:

- Not all firms under review demonstrated that comprehensive outsourcing records are maintained.
- For the most part, OSPs are not regulated or if regulated, are not regulated in the same way as Fund Administrators in Ireland.
- The majority of firms under review have no tolerance levels set in respect of the amount of outsourcing permitted for a specific Fund Administration activity.

The Central Bank is cognisant of the growth in scale and complexity of outsourcing arrangements within the Fund Administration Services industry in Ireland in recent years, however, the evolution of Fund Administrators' outsourcing arrangements to globally located OSPs presents challenges to the Central Bank's supervisory approach to such Fund Administrators. Outsourcing is a key area in relation to Operational Risk and is now integral to the business model of a significant number of Irish Fund Administrators. Therefore, it is imperative for firms to concentrate on having strong controls in place around the governance and oversight of all outsourcing arrangements.

Following the completion of this review, the attached observations / recommendations (see Appendix 1) are being issued to assist Fund Administrators who outsource their activities. The information provided (i) outlines examples of good practice and (ii) aims to support the development of consistent industry practices to assist in ensuring compliance by firms with the Outsourcing Requirements. These recommendations are not exhaustive and firms should, at all times, be evaluating their own risks related to outsourcing. As noted above, a review by the Central Bank of outsourcing across all financial sectors is ongoing. This letter is required to be brought to the attention of all Board members and Senior Management.

Should you have any queries in relation to the contents of this letter, please contact your supervisor in the Asset Management Supervision Division.

Yours sincerely

A handwritten signature in blue ink that reads "Michael Hodson".

Michael Hodson

Director - Asset Management Supervision Directorate

C.C. Compliance Officer

APPENDIX 1

Observations and Recommendations

The following observations and recommendations arise from analysis of all information assessed during the Outsourcing Review conducted in 2016 along with recent experiences of Supervisors regarding outsourcing arrangements within Irish Fund Administrators. The observations and recommendations are made in relation to current practices observed in the course of this review. Firms are at all times required to comply fully with the Outsourcing Requirements.

1 First Line of Defence – Management Controls / Internal Control Measures

1.1 Dedicated Outsourcing Manager / Dedicated Outsourcing Team

The appointment of a Dedicated Outsourcing Manager is a more recent development in outsourcing governance oversight arrangements and one that is reflective of the increasing level of outsourcing amongst the firms under review. Examples of the practice observed in this area ranged from (i) having a Dedicated Outsourcing Manager who is actively involved in the oversight of outsourced arrangements and with a wide remit which included onsite testing to (ii) the Outsourcing Manager role being solely focused on co-ordination matters and not on oversight of any outsourced activities and to (iii) not having appointed a dedicated individual to this role.

Supervisors noted in other cases there is a dedicated outsourcing oversight team in place. The remit of such teams included owning the outsourcing policy, maintaining the inventory of outsourcing and / or attending operational calls / meetings with the relevant OSPs.

1.2 Outsourcing Governance Forum / Committee

All firms under review had a formalised Outsourcing Governance Forum / Committee in place charged with responsibility for (i) initial approval of the outsourcing arrangements and (ii) on-going oversight of outsourced activities. The frequency of meetings for each firm varied from monthly to quarterly and attendees across all firms included representatives from Risk, Compliance, the Board and Operational Teams.

1.3 Formalised Documented Outsourcing Policy

All firms under review had a documented Outsourcing Policy in place which is subject to review on an annual basis. This review is typically performed by the Compliance Function with any amendments to the policy being ratified by the Outsourcing Governance Forum / Committee.

Recommendation

The firm should consider, at a minimum, the following issues during its decision making phase on outsourcing (i) all risks (including country and concentration risks), (ii) the strategic purposes / complexity of the proposal (iii) determine whether any financial benefits outweigh the estimated costs to control the risks involved, (iv) how the proposal impacts the firm's overall strategy, (v) the impact on employees, (vi) the nature of client interaction with the OSP, (vii) potential information

security implications, (viii) the extent to which the activities are subject to specific laws and regulations, (ix) consistency with group policies, (x) how the firm will conduct oversight of the OSP, (xi) risks to the level of service provided to clients and (xii) the scale of outsourcing already conducted.

1.4 Maintenance of Outsourcing Records

Supervisors observed weaknesses with the outsourcing record maintenance processes within some firms under review. In light of weaknesses within the record maintenance processes some firms were undergoing reviews with a focus on enhancing the process of maintaining their outsourcing records. Given the current scale of activities outsourced combined with the number of locations being utilised, it is important that firms maintain comprehensive up to date records.

Recommendation

The firm should maintain a comprehensive centralised log of all outsourcing arrangements which should be updated on an on-going basis. The Central Bank should have access to the log upon request.

1.5 Concentration Exposure and Risk

For certain firms under review, no tolerance levels were set in respect of the amount of outsourcing permitted for a specific Fund Administration activity (i.e. in respect of the level of activities or the level of staff that can be outsourced to one location). Supervisors noted that concentration risk was generally assessed from a global group perspective.

Corporate / group prescribed limits existed wherein (i) a business may not locate more than a certain percentage of FTEs in an offshore country, (ii) a business may not locate more than a certain percentage of FTEs in a single city in an offshore country and (iii) if the job function is classified as "critical" (i.e. functions that have a recovery time objective of less than 24 hours) no more than a certain percentage of FTEs can be located in that city.

Recommendation

Under the Outsourcing Requirements, firms are required to carry out regular assessments of the concentration risk associated with their outsourcing arrangements. Firms should pay particular attention to concentration risks when outsourced services are provided by a limited number of service providers or are concentrated in limited geographic locations. Risk concentrations, limits on the acceptable overall level of outsourced activities and risks arising from outsourcing multiple activities to the same OSP should also be considered.

1.6 Take Back Testing

Some firms under review demonstrated good practice with regard to the take back of activities from OSP locations such as (i) operating Cross Regional Recovery testing on an annual basis (at a minimum) (ii) take back testing being performed on a rolling sample basis for fund accounting, in which the firm aims to take back 10% of funds annually (selection based on product and funds types)

(iii) performing annual take back testing within 90 days of a new outsourcing arrangement going live as well as performing take back testing on Final NAV arrangements and (iv) annual testing being conducted for critical functions along with an annual attestation of a designated person's knowledge.

Less effective practices included (i) take back testing not being completed for outsourced Final NAVs (ii) take back testing being informal, not taking place on an annual basis and not covering all OSP locations. In isolated instances, take back testing was not completed for outsourced activities due to a reluctance to disturb day-to-day operations.

Recommendation

Outsourcing has an impact on the skillsets being retained in various highly specialised areas within Fund Administrators. The firm should ensure that undue reliance is not being placed on the OSPs own expertise and controls and that appropriate staff are retained to oversee the outsourced activities. It is essential that firms maintain expertise and competence in relation to overseeing all outsourced activities. The firm should be able to demonstrate that it is conducting take back testing on activities which have been outsourced and has all necessary expertise to manage the risks associated with the outsourcing arrangement. Such tests should be reasonable and be conducted on an annual basis at a minimum.

The testing should at a minimum cover (i) assessing capabilities and resources (ii) the timeframe required to transition the activity while still managing legal, regulatory, customer and other impacts that might arise (iii) the risks associated with data retention and destruction, (iv) information system connections and access control issues, (v) reputational risks to the outsourcing Fund Administrator if the termination happens as a result of the OSPs inability to meet expectations. Additionally, the identification of a 'stand-by' OSP would help with reducing the time it takes to transfer between service providers.

1.7 Formalised Disaster Recovery / Business Continuity Planning

From the information provided by the firms under review all OSPs had formalised disaster recovery and BCPs in place. These plans addressed the process for transferring the activity to an alternate site or back-to-base in a disaster recovery scenario. For some firms the criticality of the activity was specified to ensure priority for transfer. Certain firms identified the potential to transfer an activity from one OSP to another (who would perform this activity for the firm or other group entities) rather than transfer the activity back to Ireland during a disaster recovery scenario. BCPs were reviewed annually and the majority of OSPs had their own dedicated BCP officer and they all conducted annual testing of their BCP arrangements. In some cases, this was driven by the Irish firm but in all cases the results of the test were reviewed by the Irish firm.

Recommendation

The firm's contingency plans should contain items such as the following (i) assessing the adequacy and effectiveness of an OSPs contingency plan and alignment to its own plan, (ii) documenting the

roles and responsibilities for maintaining and testing the OSPs contingency plans, (iii) developing and maintaining an incident response plan to define roles and responsibilities, (iv) testing of the OSPs contingency plans on a periodic basis (at least annually) to ensure adequacy and effectiveness, (v) documenting the criticality of activities to be prioritised in a disaster scenario and (vi) maintaining an exit strategy, including a pool of comparable OSPs, in the event that a contracted OSP is unable to perform. Consideration should also be given to the concentration risk of BCP sites for those locations in which multiple firms have OSPs.

1.8 Outsourced Activities – SLA, SOP, KPI Risk Assessment

All firms under review had a legally binding Service Level Agreement (SLA) in place for all outsourcing arrangements as is required under the Outsourcing Requirements. The SLA outlined the requirements relating to the servicing between the two parties and was agreed by the firm and OSP management. SLAs for all firms were reviewed at least annually however some were reviewed on a monthly or quarterly basis.

All firms had Standard Operating Procedures (SOPs) in place for outsourced activities. These were updated on an annual basis and the ultimate responsibility for the management of these lay with Operational Teams.

All firms had Key Performance Indicators (KPIs) in place as a means of monitoring the performance of OSPs. KPIs were agreed between the firm and OSP and reviewed on a frequent basis by the Operational Teams, typically subject to monthly review (some specific KPIs were reviewed daily).

Recommendation

The firm's SLAs, SOPs and KPIs should be reviewed at least annually by a relevant control function to ensure adequate management of all outsourced activities is in place.

1.9 Operational Oversight

Each firm under review had a Risk Control Self-Assessment (RCSA) process sitting within the first line of defence which assessed the risks and control environment. On a daily, weekly, fortnightly and monthly basis calls and meetings were held between the staff in the OSP (each OSP is represented) and the onshore location. On an intra-day basis, onshore staff monitored the progress of the OSP through system workflow tools with internal deadlines for completion of work applied in many cases. Firms and OSPs utilised the same systems with restrictions in place based on (i) seniority and (ii) applicable activity or client / funds. Checklists were completed in OSPs on the same maker / checker basis as in place for Irish based staff.

Operations Teams conducted onsite and desk-based due diligence reviews of the OSPs on an annual basis in the majority of cases (the frequency was dependent upon the scale and criticality of the activity). The onsite visits ranged from three days to two weeks. In some cases, staff transferred to the location to perform training or enhancements to the operating model for a period of time. The due diligence reviews generally had a set format within the firm with pre-determined questions

and areas to focus on but this varied across the firms. Following the due diligence visit, a report was produced to be reviewed by operational management and the Outsourcing Governance Forum / Committee. Any issues arising were highlighted to the Outsourcing Governance Forum / Committee who track the completion of any remediation plans.

The Outsourcing Requirements outline that due diligence checks on the OSP, including both pre-contractual and on-going due diligence checks, should be conducted and that these checks should include periodic visits to the OSP. The firms under review generally conducted onsite due diligence reviews on an annual basis. However, the matters that firms included within the scope of their review varied on a firm-by-firm basis.

Recommendation

The following should be conducted by the firm, at a minimum, as part of an onsite due diligence review (i) assess the human, financial and technical resources, (ii) assess the experience of staff performing the activity to be outsourced, (iii) review the regulatory status of the OSP, (iv) confirm appropriate insurance cover, (v) assess the ability to safeguard the confidentiality, integrity and availability of information entrusted, (v) review the corporate governance, risk management, security, internal controls, reporting and monitoring processes, (vi) review reputation, complaints or pending litigation issues, (vii) assess business continuity arrangements and contingency plans and (viii) review the business culture and how the OSP aligns with the outsourcing firm's own policies and culture.

1.10 Outsourcing Training

Good examples of training carried out by the firms under review included the following (i) conducted on an annual basis (ii) the Dedicated Outsourcing Manager travelled to outsourced locations and conducted workshops on Irish Regulatory Requirements (iii) the Compliance Team provided Outsourcing Requirements training in OSP locations and (iv) Outsourcing Requirements training was rolled out to all staff working on Final NAV model funds in outsourced locations.

Recommendation

The firm should consider arranging for all staff in the OSP involved in the provision of services to the firm to have access to the details of the Outsourcing Requirements and ensure that there is a formalised training programme in place regarding the Outsourcing Requirements. All staff of the OSP involved in the provision of services to the firm should (i) receive Outsourcing Requirements training prior to the provision of services to the firm, (ii) be aware of and have access to the provisions of the Outsourcing Requirements and (iii) attend regular Outsourcing Requirements related training (at least on an annual basis). Records demonstrating (i) the training that was conducted in the OSP and (ii) all staff attending the training from the OSP should be maintained and be kept up to date.

2 Second Line of Defence – Support Function Oversight / Monitoring

2.1 Role of Risk Function

The role of the Risk Manager within firms included the identification, assessment and mitigation of risks to which the firm has exposure in line with the risk profile established by Senior Management. The Risk Function worked closely with Operational Teams and provided advice on any required changes to control processes and procedures. All firms had a Risk Committee wherein risks applicable to the firm's outsourcing activities are tracked and discussed.

2.2 Role of Compliance Function

Within all firms under review, approval from the Compliance Function is required before any activity is outsourced. Compliance Function staff were represented on the Outsourcing Governance Forum / Committee and reviewed any new outsourcing proposal to ensure it is in compliance with the Outsourcing Requirements. Once an activity is outsourced the Compliance Function involvement incorporated a variety of the following activities (i) conducting onsite reviews, (ii) conducting remote reviews of processes & controls, (iii) monitoring training programmes and (iv) conducting monthly meetings with the OSP Compliance Function.

During the review, it was identified that the Compliance Function of some firms did not visit the OSPs. In one case, the Dedicated Outsourcing Manager conducted the onsite review on behalf of the Compliance Function. However, in another case the Compliance Function did not participate in onsite reviews and did not contribute to the questionnaires for due diligence checks. The Central Bank has previously requested firms to ensure that their Compliance Function is conducting onsite reviews or at least contributing to other onsite reviews to be satisfied that the outsourcing arrangement is in compliance with the Outsourcing Requirements. A good example of Compliance Function staff involvement in the oversight of outsourced activities observed was one where the Compliance Function took a leading role by carrying out extensive, in depth onsite visits and reviews at the OSP and produced detailed reports. A less effective Compliance Function staff oversight role observed was one where the Compliance Function simply checked that control processes were being followed by the OSP with no verification taking place that the inputs and outputs of those processes were accurate.

Recommendation

The firm should ensure that its Compliance monitoring programme evaluates that all outsourced business activities are being conducted in compliance with regulatory obligations and that all control measures remain effective and appropriate. This monitoring programme should establish priorities ensuring that Compliance risk in respect of outsourced arrangements is comprehensively reviewed. In addition, the firm's arrangements should have measures in place so that the firm's Board is furnished with the necessary information regarding any risks of regulatory concern in relation to the operation of all outsourced arrangements.

2.3 Presence of Control Functions onsite within OSPs

The Supervision Team collected information from the firms under review regarding the onsite presence of control functions (Compliance, Risk, and Internal Audit etc.) in the OSPs. This subject was raised in previous industry letters issued by the Central Bank in 2014 and 2015 (with a particular focus on Compliance resourcing). In general, there was an onsite presence in the OSPs and in situations where there was not a control function onsite, support was provided by another office within the country or region. However, some circumstances arose where significant numbers of staff were located in OSPs but there was no dedicated Compliance presence in the relevant location.

Recommendation

The firm should ensure that sufficient permanent Compliance resources are situated within the offices / location of the OSP to ensure effective oversight is in place for Irish outsourced activities while taking into account the scale of the operations carried out at each OSP office.

2.4 12 Month Compliance Reports

Best practice was observed by firms under review who demonstrated that both sides of the process were reviewed (i.e. OSP and Ireland). Such firms either performed the review onsite in the OSP or utilised the relevant control function in the OSP. Other firms reviewed the controls in place in Ireland but a review of both sides of the outsourcing arrangement was not conducted.

Recommendation

The firm should consider the extent of the 12 Month Compliance Review depending on the nature, scale and complexity of the outsourced activity. A review of the controls on both sides of the outsourcing arrangement may be required. The firm should be able to demonstrate the rationale for the extent of each Compliance review conducted along with mechanisms used.

2.5 Format of 12 Month Reports (Compliance and Internal Audit)

Good practice was demonstrated by firms under review that utilised compliance templates that were comprehensively detailed and closely aligned to the Outsourcing Requirements clearly identifying which outsourcing arrangement the review covered. In some firms, the reports produced were lacking in detail and were not always clear in terms of which outsourcing arrangements the reviews covered (particularly for Internal Audit Reviews).

Recommendation

The firm should ensure that the 12 Month Reports (Compliance and Internal Audit reviews) completed on outsourcing arrangements are sufficiently detailed and confirms compliance with the Outsourcing Requirements. The reports should clearly identify which outsourcing arrangement the relevant review covers (i.e. contain details of the OSP / activities outsourced / Central Bank clearance date / commencement date of outsourcing arrangement / date of report / preparer and approver names).

3 Third Line of Defence – Independent Assurance

3.1 Regulatory Status of OSPs / Group Relationship

In general, for the firms under review OSPs located in two main jurisdictions to which activities are outsourced were unregulated entities - significant levels of work is being outsourced to these jurisdictions. These two jurisdictions represented more than half of the total FTEs in all OSP locations utilised by the relevant firms. In some cases, OSPs may be regulated but the specific fund administration activities may or may not be subject to regulation.

All firms that formed part of this review primarily used OSPs that are considered to be affiliates / group entities.

3.2 Internal Audit - Tracking the current status of the firm's outsourced activities to ensure relevant reviews are performed

For all firms under review, Internal Audit was notified by either (i) the Operations Team or (ii) the Compliance Team post go-live of any outsourced activity. The Supervision Team noted that Internal Audit across all firms regularly attended the Outsourcing Governance Forum / Committee and this was a key communication tool in respect of being notified of live outsourcing activities.

3.3 12 Month Internal Audit Review - Focus on Home and Host Offices

Most firms under review demonstrated an adequate approach which sees Internal Audit review the processes in Ireland and the OSP location as part of the 12-month review undertaken. There was a focus on (i) control and oversight of work performed by teams in Ireland and (ii) a review of outsourcing in conjunction with Internal Audit Teams from the OSP location. On occasion, the Internal Audit Team leveraged off the Internal Audit presence in other OSP locations or completed a review remotely. In such cases, Internal Audit Teams reviewed the work performed by Internal Audit at the OSP (or region) to ensure a consistency of approach. In some cases, the Internal Audit Team only focused on the oversight being performed in Ireland. The OSP was reviewed under a local audit plan, however there was no specific element being reviewed in the context of the Outsourcing Requirements.

Recommendation

The role of Internal Audit in reviewing outsourcing arrangements is very important and relevant reviews should, at a minimum, assess the adequacy of the firm's process for (i) ensuring OSP relationships align with the firm's business strategy, (ii) identifying, assessing, managing, and reporting on all risks, (iii) responding to material breaches or service disruptions and (iv) ensuring appropriate staffing and expertise is in place to perform due diligence and on-going monitoring / management of OSPs. In addition, Internal Audit should review the firm's process for identifying and managing concentration risks that may arise from relying on a single third party for multiple activities, or from geographic concentration of business due to either direct contracting or subcontracting agreements to the same location.

3.4 Client Notification

For the firms under review, clients were notified of outsourcing arrangements which impact the service provided to them through (i) client service relationship managers (ii) Board presentations (iii) correspondence such as letters, emails, verbally and (iv) client office visits. Additionally, many of the firms' clients conducted due diligence visits to OSPs, particularly the larger OSPs.

Recommendation

Client notification records within the firm should be sufficient to evidence that clients have been notified of the outsourcing arrangement. Such records should be available for inspection by the Central Bank and where the record is retained in electronic form it should be capable of being produced in a timely manner for review.