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Guideline

Subject: Outsourcing of Business Activities, Functions and Processes

Category: Prudential Limits and Restrictions

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1. INTRODUCTION

Financial institutions outsource business activities, functions and processes to meet the challenges of technological innovation, increased specialization, cost control, and heightened competition. However, outsourcing can increase an institution's dependence on third parties, which may increase its risk profile. Many financial sector regulators have responded by introducing guidance related to the management of outsourcing risks.

This Guideline sets out OSFI's expectations for federally regulated entities (FREs) that outsource, or contemplate outsourcing, one or more of their business activities to a service provider. These expectations should be considered prudent practices, procedures or standards that should be applied according to the characteristics of the outsourcing arrangement and the circumstances of the FRE.

FREs have the flexibility to configure their operations in the way most suited to achieving their corporate objectives. However, this Guideline operates on the premise that FREs retain ultimate accountability for all outsourced activities. Furthermore, OSFI's supervisory powers should not be constrained, irrespective of whether an activity is conducted in-house, outsourced, or otherwise obtained from a third party.

Under this Guideline, FREs are expected to:

- evaluate the risks associated with all existing and proposed outsourcing arrangements;
- develop a process for determining the materiality of arrangements;
- implement a program for managing and monitoring risks, depending on the materiality of the arrangements; and
- ensure that the board of directors, chief agent or principal officer receives information sufficient to enable them to discharge their duties under this Guideline.

In addition:

- FREs are expected to refrain from outsourcing certain business activities to the external auditor (see Section 4.3).
- The Superintendent's approval is required if an FRE plans to process certain information or data outside Canada (see Section 8). This Guideline also applies to cases where the foreign branch of an FRE processes specified Canadian data on behalf of the FRE. As a result of this Guideline coming into effect, Guideline E-3, *Processing Information Outside Canada*, will be revoked on December 15, 2004.

OSFI's specific expectations may vary, depending on the nature of the outsourcing arrangement being contemplated and the relationship between the FRE and the service provider. As outlined in the *Supervisory Framework*, OSFI applies a risk-based approach to assessing an FRE's safety and soundness on a consolidated basis. Resources are focused on areas of higher risk and information from other regulators is used as appropriate. For each activity that OSFI identifies as significant[1], OSFI assesses the level of risk, including regulatory risk, and considers the impact of risk mitigation by evaluating the quality of risk management. Institutions that are well managed relative to their risks will require less supervision. Therefore, as part of OSFI's risk-focused supervisory process, an institution's policies and procedures for assessing the materiality of outsourcing arrangements and managing the risks associated with outsourcing arrangements, may be evaluated against the expectations of this Guideline. In addition, individual outsourcing arrangements may be subject to supervisory review.

[1] "Significant" as used by OSFI in "Significant Activities" is defined in the *Supervisory Framework*. Qualitative and quantitative factors are used to assess the significance of an activity to the achievement of the institution's business objectives and strategies.

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2. TRANSITION PERIOD

- The FRE is expected to comply by December 15, 2004 with:
  - Section 4 (Application),
  - Section 5 (Accountability and Control),
  - Section 6 (Materiality Assessment for Outsourcing Arrangements), and
  - Section 7.3.1 (Centralized List of All Material Outsourcing Arrangements).
- All arrangements entered into prior to December 15, 2004 are expected to comply with the following Sections at the first opportunity after December 15, 2004, such as at the time the outsourcing contract, agreement or statement of work (where applicable) is substantially amended, renewed or extended:
  - Section 7.1 (Due Diligence Process),
  - Section 7.2 (Policies and Procedures to Manage Risks Associated with Material Outsourcing),
  - Section 7.3.2 (Monitoring the Outsourcing Arrangement), and
  - Section 7.3.3 (Monitoring the Service Provider).
- All arrangements signed on or after December 15, 2004, are expected to comply with all applicable Sections of this Guideline.

3. DEFINITIONS

3.1 Outsourcing Arrangement

For the purposes of this Guideline, an outsourcing arrangement is an agreement between an FRE and a service provider, whereby the service provider performs a business activity, function or process[2] that is, or could be, undertaken by the individual FRE. FREs may consult with OSFI when they are uncertain whether a particular arrangement falls within this definition. Examples are provided in Annex 1.

3.2 Federally Regulated Entity (FRE)

For the purposes of this Guideline, an FRE is defined as:

a) a bank (listed in Schedule I or II) to which the *Bank Act* applies;
b) a body corporate to which the *Trust and Loan Companies Act* applies;
c) an association to which the *Cooperative Credit Associations Act* applies or a central cooperative credit society for which an order has been made under subsection 473(1) of that Act;
d) an insurance company or a fraternal benefit society incorporated, formed, or continued under the *Insurance Companies Act*;
e) a bank holding company incorporated or formed under Part XV of the *Bank Act*;

[2] In this Guideline, "activity" refers to activity, function or process.

f) an insurance holding company incorporated or formed under Part XVII of the *Insurance Companies Act*;
g) the Canadian branch of a foreign bank in respect of which an order under subsection 524(1) of the *Bank Act* has been made[3];
h) the Canadian branch of a foreign company in respect of which an order under Section 573 of the *Insurance Companies Act* has been made[4].

3.2.1 FRE Group

For the purposes of this Guideline, the FRE group of an entity referred to in any of 3.2.a) to f), includes the FRE and any of the following:

a) the entity that controls the FRE if that entity is also an FRE;
b) a subsidiary of the FRE; and
c) a subsidiary of the entity referred to in a).

3.2.2 RFIP Group - Branches or Subsidiaries with a Regulated Foreign or Provincial Parent

For the purposes of this Guideline, an RFIP group includes:

a) in respect of an entity referred to in 3.2 g), that Canadian branch, head office, and any other branches or agencies of the foreign bank;
b) in respect of an entity referred to in 3.2 h), that Canadian branch, head office, and any other branches or agencies of the foreign company; and
c) in respect of an entity referred to in 3.2 a) to f), the entity that controls the FRE if that entity is regulated by a foreign or provincial financial regulatory body.

4. APPLICATION OF THE GUIDELINE

This Guideline applies to all the outsourcing arrangements of an FRE or an FRE group. In addition, in applying this Guideline, the FRE is expected to consider the impact on the FRE and on its consolidated operations, of outsourcing arrangements entered into by all its subsidiaries and business operations, including those located in foreign jurisdictions. OSFI expects the FRE to ensure that their subsidiaries and branches follow the guideline when entering into material outsourcing arrangements.

All outsourcing arrangements should be subjected to the materiality assessment set out in Section 6 of the Guideline. OSFI recognizes that outsourcing arrangements will exhibit varying degrees of materiality and expects that the robustness of an FRE's management of outsourcing risks would be commensurate with the materiality of the arrangement.

Outsourcing arrangements deemed clearly material are expected to follow the full risk management program detailed in Section 7. However, reduced expectations may be applied, in a

[3] This includes the principal office and all of its other offices in Canada.
[4] This includes the chief agency and all of its other offices in Canada.

manner consistent with Sections 4.1 and 4.2 respectively, where the material outsourcing arrangement is between an FRE and a member of an FRE Group, or between an FRE and a member of an RFIP Group. FREs may consult with OSFI when they are uncertain how to assess a particular combination of intra-group arrangements.

Outsourcing arrangements deemed clearly immaterial are not expected to follow the risk management program outlined in this Guideline. However, all FRE outsourcing arrangements involving the out-of-Canada processing of specified information or data[5] are subject to the expectations contained in Section 8 of this Guideline. As well, an FRE should not outsource certain activities to its external auditor (see Section 4.3).

4.1 Material FRE Intra-group Outsourcing Arrangements

At a minimum, OSFI expects the following to be addressed when a member of an FRE group enters into a material outsourcing arrangement with another entity that is a member of the same FRE group (Section 3.2.1):

a) an outsourcing agreement that details, among other things, the scope of the arrangement, the services to be supplied, the nature of the relationship between the FRE and the service provider, and procedures governing the subcontracting of services;
b) a business continuity plan;
c) a process for monitoring and oversight; and
d) legislative requirements relating to location of records (e.g., Section 7.2.2) and the processing of data outside of Canada (e.g., Section 8).

As appropriate, a parent FRE may address these expectations within enterprise-wide processes or plans, so long as any specific risks to each subsidiary are dealt with, and the board of directors, principal officer or chief agent are able to fulfill their accountabilities. As well, a parent FRE may establish the program and develop and maintain the reporting on behalf of its FRE subsidiaries.

Consistent with the risk-based *Supervisory Framework*, OSFI may have additional expectations for FRE Group arrangements, depending on the risks related to the outsourcing arrangement and the conclusions of OSFI's supervisory review.

[5] Subsection 245(1) of the *Bank Act*, subsection 268 (1) of the *Insurance Companies Act*, subsection 250(1) of the *Trust and Loan Companies Act*, subsection 242(1) of the *Cooperative Credit Associations Act*.

4.2 Material RFIP Intra-group Outsourcing Arrangements

At a minimum, OSFI expects the following to be addressed when a Canadian branch or a Canadian subsidiary enters into a material outsourcing arrangement with another entity that is a member of its RFIP group (Section 3.2.2):

a) a due diligence process that addresses the qualitative aspects of the arrangement, particularly those pertaining to the unique operational requirements of the FRE;
b) an outsourcing agreement that details, among other things, the scope of the arrangement, the services to be supplied, the nature of the relationship between the FRE and the service provider (e.g., roles, responsibilities and expectations), and that addresses the items set out in Section 7.2.1 as appropriate;
c) procedures governing the subcontracting of services;
d) a business continuity plan;
e) a process for monitoring and oversight; and
f) legislative requirements relating to location of records (e.g., Section 7.2.2) and the processing of data outside of Canada (e.g., Section 8).

Consistent with the risk-based *Supervisory Framework,* OSFI may have additional expectations for RFIP Group arrangements, depending on the risks related to the outsourcing arrangement and the conclusions of OSFI’s supervisory review.

4.3 Outsourcing Arrangements with the External Auditor *(Note: if appropriate, OSFI expectations for outsourcing to the external auditor may be adjusted in light of future amendments to the CICA's Independence Standards for Auditors).*

Prior to obtaining non-audit services from its external auditor, the FRE should assure itself that, for the services to be performed by the external auditor for that particular FRE, its external auditor would be in compliance with the relevant auditor independence standards of the Canadian accounting profession, as well as any other applicable auditor independence requirements.

In addition, the FRE should not outsource the following activities to its external auditor:

- Any actuarial service, unless it is reasonable to conclude that the results of the service will not be subject to audit procedures during an audit of the FRE's financial statements. For this purpose, actuarial services relates to the determination of an amount to be recorded in the financial statements of the FRE or work normally undertaken by its appointed actuary[6], and does not include services that involve assisting the FRE in understanding the methods, models, assumptions and inputs used, and advising management on the appropriate actuarial methods and assumptions that will be used. Consistent with Guideline E-15 (Appointed Actuary: Legal Requirements, Qualifications and External Review), the FRE may use an actuary working in the company's external auditor firm for the external review of the appointed actuary's work and reports.

[6] See OSFI Guideline E-15 *Appointed Actuary: Legal Requirements, Qualifications and External Review.*

- Any internal audit service related to the internal accounting controls, financial systems, or financial statements of the FRE, unless it is reasonable to conclude that the results of the service will not be subject to audit procedures during an audit of the FRE's financial statements. This does not prohibit the external auditor from providing a nonrecurring service to evaluate a discrete item or program, if the service is not, in substance, the outsourcing of an internal audit function.

5. ACCOUNTABILITY AND CONTROL

5.1 FRE Board of Directors Responsibilities

As set out in the *OSFI Corporate Governance Guideline*, the board, or a committee of the board, is expected to ensure that an FRE has appropriate risk management policies and practices and that these are regularly reviewed. In terms of the specific risks arising from outsourcing, it is expected that, in carrying out this duty, the board would periodically:

- approve or reaffirm the policies that apply to outsourcing arrangements (e.g., risk philosophy, materiality criteria, risk management program and approval limits); and
- review a list of all the FRE's material outsourcing arrangements (see Section 7.3.1) and other relevant reports when appropriate.

5.2 FRE Management Responsibilities

Management is responsible for developing outsourcing policies for board approval, implementing the policies and any associated procedures, periodically reviewing their effectiveness, and communicating information pertaining to significant outsourcing risks to the board in a timely manner.

The policies and procedures are expected to include:

1) Outsourcing risk philosophy

The FRE's outsourcing risk philosophy would generally comprise a statement of principles, the basis for decision making, and the parameters for controlling outsourcing risks. Outsourcing risk philosophies will vary between FREs, but should address the following:

- Integration of outsourcing arrangements, both individually and in aggregate, with overall business and strategic objectives. This could include an identification of any functions that, for strategic or internal control reasons, the FRE would not contemplate outsourcing.
- Importance and adequacy of internal expertise and management frameworks to oversee and manage the outsourced activity and the relationship with the service provider.
- Business case for outsourcing a significant business activity. The business case should consider the short- and long-term cost implications and all relevant prudential matters. When the service is being supplied from a foreign jurisdiction, the FRE should identify

the issues that may arise as a result of the differing and potentially conflicting requirements among jurisdictions. The business case should also consider the cumulative impacts of all outsourcing arrangements on the overall safety and soundness of the FRE.

2) Materiality assessment for outsourcing arrangements

   This assessment is expected to identify both the processes for determining the materiality of individual outsourcing arrangements and the underlying materiality factors such as those set out in Section 6.

3) Outsourcing risk management program that, at a minimum, includes the expectations contained in Section 7 and is applied consistently throughout the FRE, including operations located in foreign jurisdictions. OSFI expects management to pay particular attention to business continuity planning on an enterprise-wide basis.

4) Limits regarding the level or authority that enables the FRE's officers to approve outsourcing arrangements of varying magnitudes, either individually or in aggregate. This system should be consistent with the outsourcing risk philosophy and materiality criteria.

5.3 Responsibilities of the Chief Agent or Principal Officer

OSFI's expectations of the chief agent or principal officer under this Guideline reflect proposed changes to Guideline E-4 (*Role of the Canadian Chief Agent and Record Keeping Requirements*). These changes are anticipated to clarify that, more generally, OSFI expects the chief agent or principal officer to take on the corporate governance role normally assumed by the board of directors and senior management. The chief agent or principal officer remains accountable for the business in Canada, regardless of whether a particular business activity takes place in Canada or has been outsourced.

OSFI expects the chief agent or principal officer to ensure that the branch has risk management policies for outsourcing and that the expectations set out in Section 5.2 of this Guideline are met. In particular, the chief agent or principal officer would be expected to:

- ensure that materiality assessment criteria are developed and applied;
- ensure that the risk management program is applied; and
- within a reasonable time advise OSFI (either formally or informally) about any events that are likely to have a significant negative impact on the delivery of the service provided for by a material outsourcing arrangement.

6. MATERIALITY ASSESSMENT FOR OUTSOURCING ARRANGEMENTS

As outlined in Section 4, OSFI recognizes that the outsourcing arrangements undertaken by an FRE will have differing degrees of materiality and may not be readily classified as either material or immaterial. In general, OSFI expects that an FRE will design a risk management program that applies to all its outsourcing arrangements, except those that are clearly immaterial, and that the risk mitigants employed under this program will be appropriate to the particular outsourcing arrangement. As such, the risk management program could be scaled to apply different requirements depending on the type of outsourcing arrangement. Those arrangements deemed clearly material should be subject to the full expectations set out in Section 7, unless it is reasonable to conclude that a particular expectation is not appropriate for the outsourcing arrangement in question. OSFI may review an FRE's materiality assessment on a case-by-case basis as part of the supervisory review process.

The materiality of an outsourcing arrangement will depend on the extent to which it has the potential to have an important influence – whether quantitative or qualitative – on a significant line of business of the consolidated operations of the FRE or the Canadian operations of a foreign branch or subsidiary.

The assessment of the materiality of an outsourcing arrangement is often subjective and depends on the circumstances faced by an individual FRE. 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 of the FRE, or a significant business line, particularly if the service provider, or group of affiliated service providers, should fail to perform over a given period of time;

b) the ability of the FRE to maintain appropriate internal controls and meet 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 bring the business activity 'in-house'.

Specific questions an FRE might consider in assessing the materiality of outsourcing arrangements are set out in Annex 2.

Outsourcing all or substantially all of a management oversight function should always be considered material, except in circumstances where the FRE receives such services from another member of the FRE Group. For the purpose of this Guideline, management oversight functions include:

- financial analysis;
- compliance;
- any internal audit services related to the internal accounting controls, financial systems, or financial statements;
- senior management; and
- risk management.

For example, a material arrangement could relate to the outsourcing of a significant part of the FRE's information technology function, investment management, or loan processing. Arrangements that likely do not represent material outsourcing include those where there are numerous similar providers in the marketplace and the cost and inconvenience of switching between providers is low.

Significant changes in the volume or the nature of business conducted should cause the FRE to reassess an outsourcing arrangement's materiality. In cases where an arrangement is reassessed as material, it should come into compliance with all aspects of this Guideline at the first opportunity, such as when the outsourcing contract, agreement or statement of work (where applicable) is substantively amended, renewed or extended.

7. RISK MANAGEMENT PROGRAM FOR MATERIAL OUTSOURCING ARRANGEMENTS

In general, OSFI expects that an FRE will design a risk management program that applies to all outsourcing arrangements of the FRE group, except those that are clearly immaterial, and that the risk mitigants employed will be commensurate with the FRE's assessment of the risks associated with the particular outsourcing arrangement.

7.1 Due Diligence Processes

OSFI expects an FRE to conduct an internal due diligence to determine the nature and scope of the business activity to be outsourced, its relationship to the rest of the FRE's activities, and how the activity is managed.

In selecting a service provider, or renewing a contract or outsourcing arrangement, FREs are also expected to undertake a due diligence process that fully assesses the risks associated with the outsourcing arrangement, and addresses all relevant aspects of the service provider, including qualitative (i.e., operational) and quantitative (i.e., financial) factors (see Annex 3 for a list of factors that could be included when performing due diligence of a service provider). When out-of-Canada outsourcing is being contemplated, the FRE should pay particular attention to the legal requirements of that jurisdiction, as well as the potential foreign political, economic and social conditions, and events that may conspire to reduce the foreign service provider's ability to provide the service, as well as any additional risk factors that may require adjustment to the risk management program.

Due diligence processes will vary depending on the FRE and on the nature of the outsourcing arrangement being contemplated. For example, in the case of renewals where no material change has occurred that would affect the viability of the outsourcing relationship, it may not always be appropriate to conduct a thorough due diligence. If the service provider is a member of an RFIP Group, a streamlined due diligence process may be followed that addresses the qualitative aspects of the arrangement, particularly those pertaining to the unique operational (e.g., Canadian) requirements of the FRE.

The FRE may rely on a due diligence review of the service provider that has been performed by an affiliate or home office within the previous 15 months, provided the review addresses the above-noted requirements as well as the risks particular to the FRE.

7.2 Policies and Procedures to Manage Risks Associated with Material Outsourcing Arrangements

7.2.1 Contract for Services

OSFI expects material outsourcing arrangements to be documented by a written contract that addresses all elements of the arrangement and has been reviewed by the FRE's legal counsel. Some of the items identified below may not be applicable in all circumstances; however, FREs are expected to address all issues relevant to managing the risks associated with each outsourcing arrangement to the extent feasible and reasonable given the circumstances, and having regard to the interests of the FRE. FRE and RFIP intra-group outsourcing arrangements can be documented by an outsourcing agreement that meets the expectations set out in Sections 4.1 and 4.2 respectively.

a) Nature and Scope of the Service Being Provided

The contract or outsourcing agreement is expected to specify the scope of the relationship, which may include provisions that address the frequency, content and format of the service being provided. The contract or outsourcing agreement is expected to detail where the service provider will provide the service.

b) Performance Measures

Performance measures should be established that allow each party to determine whether the commitments contained in the contract are being fulfilled.

c) Reporting Requirements

The contract or outsourcing agreement is expected to specify the type and frequency of information the FRE receives from the service provider. This would include reports that allow the FRE to assess whether the performance measures are being met and any other information required for the FRE's monitoring program (see Section 7.3). In addition, the contract or outsourcing agreement is expected to include procedures and requirements for reporting events to the FRE that may have the potential to materially affect the delivery of the service.

d) Resolution of Differences

OSFI expects the contract or outsourcing agreement to incorporate a protocol for resolving disputes. The contract or outsourcing agreement should specify whether the service provider must continue providing the service during a dispute and the resolution period, as well as the jurisdiction and rules under which the dispute will be settled.

e) Defaults and Termination

A contract or outsourcing agreement is expected to specify what constitutes a default, identify remedies, and allow for opportunities to cure defaults or terminate the agreement. The FRE is expected to ensure that it can reasonably continue to process information and sustain operations in the event that the outsourcing arrangement is terminated or the service provider is unable to supply the service. Appropriate notice should be required for termination of service and the FRE's assets should be returned in a timely fashion. In particular, data and records relating to data processing outsourcing arrangements should be returned to the FRE in a format that would allow the FRE to sustain business operations without prohibitive expense.

The contract or outsourcing agreement should not contain wording that precludes the service from being continued in situations where the Superintendent takes control of the FRE, or where the FRE is in liquidation.

f) Ownership and Access

Identification and ownership of all assets (intellectual and physical) related to the outsourcing arrangement should be clearly established, including assets generated or purchased pursuant to the outsourcing arrangement. The contract or outsourcing agreement should state whether and how the service provider has the right to use the FRE's assets (e.g., data, hardware and software, system documentation or intellectual property) and the FRE's right of access to those assets.

g) Contingency Planning

The contract or outsourcing agreement should outline the service provider's measures for ensuring the continuation of the outsourced business activity in the event of problems affecting the service provider's operation, including systems breakdown and natural disaster and other events. The FRE should ensure that the service provider regularly tests its business recovery system and notifies the FRE of the test results. In addition, the FRE should be notified in the event that the service provider makes significant changes to its business resumption and contingency plans, or encounters other circumstances that might have a serious impact on the service.

h) Audit Rights

The contract or outsourcing agreement is expected to clearly stipulate the audit requirements and rights of both the service provider and the FRE. At a minimum, it should give the FRE the right to evaluate the service provided or, alternatively to cause an independent auditor to evaluate, on its behalf, the service provided. This includes a review of the service provider's internal control environment as it relates to the service being provided[7].

In addition, in all situations, irrespective of whether an activity is conducted in-house, outsourced, or otherwise obtained from a third party, OSFI should retain its supervisory powers[8]. Accordingly, an undertaking from the service provider or a provision in the outsourcing contract, should give OSFI or the Superintendent's representative the right to:

- exercise the contractual rights of the FRE relating to audit;
- accompany the FRE (or its independent auditor) when it exercises its contractual audit rights;
- access and make copies of any internal audit reports (and associated working papers and recommendations) prepared by or for the service provider in respect of the service being performed for the FRE, subject to OSFI agreeing to sign appropriate confidentiality documentation in form and content satisfactory to the service provider; and
- access findings in the external audit of the service provider (and associated working papers and recommendations) that address the service being performed for the FRE, subject to the consent of the service provider's external auditor and OSFI agreeing to sign appropriate confidentiality documentation in form and content satisfactory to the service provider and the external auditor.

In the normal course, OSFI would seek to obtain whatever information it requires through the FRE itself. OSFI would typically use its rights, in respect of auditing the service provider or accessing audit papers from the service provider, only in extreme circumstances (e.g., when there are problems that could affect the solvency of the institution).

i) Subcontracting

The contract or outsourcing agreement is expected to set out any rules or limitations to subcontracting by the service provider. In particular, security and confidentiality standards should apply to subcontracting or outsourcing arrangements by the primary service provider. Consistent with the principles of this Guideline, the audit and inspection rights of both the FRE and OSFI should continue to apply to all significant subcontracting arrangements.

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[7] A CICA 5900 report (Opinion on Control Procedures at Service Organizations) or equivalent may be sufficient.
[8] Under the federal financial institutions legislation OSFI has a right to access any records of the FRE; Section 613, 614, 643, 644, 957 and 958 of the *Bank Act*; section 674, 675, 1000, and 1001 of the *Insurance Companies Act*; section 505 and 506 of the *Trust and Loan Companies Act*; section 437 and 438 of the *Cooperative Credit Associations Act*.

j) Confidentiality, Security and Separation of Property

At a minimum, the contract or outsourcing agreement is expected to set out the FRE's requirements for confidentiality and security. Ideally, the security and confidentiality policies adopted by the service provider would be commensurate with those of the FRE and should meet a reasonable standard in the circumstances. The contract or outsourcing agreement should address which party has responsibility for protection mechanisms, the scope of the information to be protected, the powers of each party to change security procedures and requirements, which party may be liable for any losses that might result from a security breach, and notification requirements if there is a breach of security.

OSFI expects appropriate security and data confidentiality protections to be in place. The service provider is expected to be able to logically isolate the FRE's data, records, and items in process from those of other clients at all times, including under adverse conditions.

k) Pricing

The contract or outsourcing agreement should describe fully the basis for calculating fees and compensation relating to the service being provided.

l) Insurance

The service provider should be required to notify the FRE about significant changes in insurance coverage and disclose general terms and conditions of the insurance coverage.

7.2.2 Location of Records

In accordance with the federal financial institutions legislation, certain records[9], of entities carrying on business in Canada, should be maintained in Canada. In addition, the FRE is expected to ensure that OSFI can access, in Canada any records necessary to enable OSFI to fulfill its mandate.

7.2.3 Business Continuity Plan

An FRE's business continuity plan should address reasonably foreseeable situations (either temporary or permanent) where the service provider fails to continue providing service. The business continuity plan and back-up systems should be commensurate with the risk of a service disruption. In particular, the FRE's business continuity plan should ensure that the FRE has in its possession, or can readily access, all records necessary to allow it to sustain business operations, meet its statutory obligations, and provide all information as may be required by OSFI to meet its legislated mandate, in the event the service provider is unable to provide the service.

[9] Section 238, 239 and 597 of the *Bank Act*; section 243, 244 of the *Trust and Loan Companies Act*; section 261, 262 and 647 of the *Insurance Companies Act*; section 235, 236 of the *Cooperative Credit Associations Act*.

7.2.4 Outsourcing in Foreign Jurisdictions

When the material outsourcing arrangement results in services being provided in a foreign jurisdiction, the FRE's risk management program 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).

7.3 Monitoring and Oversight of Material Outsourcing Arrangements

Every FRE engaged in material outsourcing should develop, implement and oversee procedures to monitor and control outsourcing risks in accordance with its outsourcing risk-management policies. The sophistication of the procedures should be commensurate with the size and complexity of the outsourcing arrangement(s) and with the expectations of this Guideline. Management is expected to prepare reports based on the FRE's monitoring and oversight activities. These reports may outline the success of the outsourcing arrangement and the effectiveness of the risk management program and may be reflected in the documentation delivered to the FRE board of directors. Reports based on the Canadian branch's monitoring and oversight activities should either be prepared or reviewed by the chief agent or principal officer.

7.3.1 Centralized List of All Material Outsourcing Arrangements

The FRE should maintain a centralized list of all its material outsourcing arrangements. A parent FRE may maintain the list on behalf of its subsidiaries[10]. The list should contain information pertaining to the name of the service provider and location where the service is provided, the expiry or renewal date of the contract or outsourcing agreement and the value (dollar amount) of the contract or outsourcing agreement. The list should be updated on an ongoing basis and should form part of the documentation delivered to the FRE board of directors or the branch's chief agent or principal officer. OSFI should, upon request, have access to the list at any time.

7.3.2 Monitoring the Outsourcing Arrangement

The FRE should monitor all material outsourcing arrangements to ensure that the service is being delivered in the manner expected and in accordance with the terms of the contract or outsourcing agreement. Monitoring may take the form of regular, formal meetings with the service provider and/or periodic reviews of the outsourcing arrangement's performance measures. Within a reasonable time the FRE should advise OSFI (either formally or informally) about any events that are likely to have a significant negative impact on the delivery of the service.

An FRE should review its material outsourcing arrangements to ensure compliance with its outsourcing risk policies and procedures and with the expectations of this Guideline. Reviews of material outsourcing arrangements should be periodically undertaken by the FRE's internal audit department or another independent review function either internal or external to the FRE, provided it has the appropriate knowledge and skills. The FRE's board of directors, or the

[10] In the case of a foreign branch or a foreign controlled FRE, the list should only contain information pertaining to its Canadian operations and any of its subsidiaries or offices located in a foreign jurisdiction.

branch's chief agent or principal officer, will always retain overall accountability for the outsourcing arrangement.

Reviews should test the FRE's risk-management activities for outsourcing in order to:

- ensure risk-management policies and procedures for outsourcing are being followed;
- ensure effective management controls over outsourcing activities;
- verify the adequacy and accuracy of management information reports; and
- ensure that personnel involved in risk-management for outsourcing are aware of the FRE's risk-management policies and have the expertise required to make effective decisions consistent with those policies.

Management should adjust the scope of the review depending on the nature of the outsourcing arrangement.

7.3.3 Monitoring the Service Provider

At least annually, the FRE should review the service provider to ascertain its ability to continue to deliver the service in the manner expected. This review could include an assessment of the service provider's circumstances including its financial strength, prospects (except in cases involving the parent or home office of a Canadian subsidiary or branch), and technical competence.

8. DATA PROCESSING IN FOREIGN JURISDICTIONS

In accordance with the financial institutions statutes[11], FREs may not process, directly or indirectly, data related to the maintenance of records outside of Canada without the prior approval of the Superintendent[12]. Information requirements respecting an FRE's application for the Superintendent's approval to process data outside Canada can be found in the Deemed Approval Instruction *Document No. 10 - Processing Information Outside Canada*.

The approval of the Superintendent is required regardless of whether the specified data is processed by a third party, or a member of the FRE or RFIP group. For any data processing arrangement, irrespective of its materiality, the Superintendent's determination of whether the arrangement warrants approval will take into account whether:

a) the contract or an undertaking gives the Superintendent or the Superintendent's representatives access to all of the FRE's records and information that are processed by both the service provider and by the back-up or disaster recovery provider.

[11] Subsection 245(1) and 598 of the *Bank Act*, subsection 268 (1) and section 649 of the *Insurance Companies Act*, subsection 250(1) of the *Trust and Loan Companies Act*, and subsection 242(1) of the *Cooperative Credit Associations Act*.

[12] The requirements relating to Data Processing in Foreign Jurisdictions that are set out in the federal financial institutions legislation do not apply to an FRE's operations located in foreign jurisdictions.

b) the FRE will receive, as part of the business resumption and contingency plans of the service provider, a copy of the disaster recovery provider's test simulation results with respect to the processing of the FRE's records and information or an attestation that the test simulation has been completed successfully.

Furthermore, FREs are expected to ensure that all material data processing outside Canada arrangements which involve outsourcing as defined in Section 3.1 of this Guideline comply with the relevant aspects of this Guideline. In cases where the data is processed by a third party, factors the Superintendent may take into consideration in determining whether the arrangement warrants approval include whether the expectations set out in Sections 7.1, 7.2 and 7.3.1 of this Guideline are met. In cases where the data is processed by another member of the FRE or RFIP group, the Superintendent's determination of whether the arrangement warrants approval will consider whether the expectations set out in Section 4.1 or 4.2 are met.

The scope of the outsourcing arrangement to the foreign jurisdiction (information and/or business processes) is to be outlined in the application materials. Where the applicant wishes to materially expand the scope of the foreign processing beyond that contemplated in any previous application, a new application is required.

- END -

EXAMPLES OF OUTSOURCING ARRANGEMENTS

The outsourcing domain is diverse and growing. Some examples may include:

- 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., insurance policies, loan originations, credit cards);
- Policy administration (e.g., premium collection, policy assembly, invoicing, endorsements);
- Claims administration (e.g., loss reporting, adjusting);
- 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 FRE (e.g., accounting, internal audit, actuarial); and
- Human resources (e.g., benefits administration, recruiting).

This Guideline generally would not apply to the following:

- 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);
- Independent consulting;
- Services the FRE 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.

SAMPLE QUESTIONS TO ASSESS THE MATERIALITY OF OUTSOURCING ARRANGEMENTS

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

- Is the business activity important in relation to the FRE's core business? Is a significant share of revenue derived from that particular activity?

- 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?

- What is the FRE's aggregate exposure to a particular service provider? Does the organization outsource a variety of activities to the same service provider?

- What is the size of contractual expenditures as a share of non-interest expenses of the FRE or line of business?

- If the service provider is unable to perform the service over a given period of time:

  a. What is the expected impact on the FRE's customers?
  b. What is the likelihood that it would harm the FRE's reputation?
  c. Would it have a material impact on the FRE's risk profile?
  d. Would the FRE be able to engage an alternative service provider? How long would it take and what costs would be involved?

DUE DILIGENCE OF SERVICE PROVIDERS

The due diligence of service providers addressed in Section 7.1 may include, but is not necessarily limited to, examining a service provider in light of these factors:

- Experience and technical competence to implement and support the proposed activity;
- Financial strength (e.g., most recent audited financial statements and other relevant information (to the best of the service provider's ability[13]));
- Business reputation, complaints, compliance and pending litigation;
- Internal controls, reporting and monitoring environment;
- Business resumption and contingency plans including technology recovery testing;
- Reliance on and success in dealing with sub-contractors;
- Insurance coverage; and
- Business objectives, human resource policies, service philosophies, business culture, and how they fit with those of the FRE.

[13] The onus is on the FRE to ensure that it obtains the relevant information to assess a service provider's financial strength. However, OSFI recognizes that the service provider is to comply with other legislation (such as securities legislation) and might not be in a position to share certain information with the FRE.