

Chapter 13

Operational risk: systems and controls for insurers

13.9 Outsourcing

- 13.9.1** **G** As **SYSC 3.2.4 G** explains, a *firm* cannot contract out its regulatory obligations and should take reasonable care to supervise the discharge of outsourced functions. This section provides additional *guidance* on managing *outsourcing* arrangements (and will be relevant, to some extent, to other forms of third party dependency) in relation to operational risk. *Outsourcing* may affect a *firm's* exposure to operational risk through significant changes to, and reduced control over, people, processes and systems used in outsourced activities.
- 13.9.2** **G** *Firms* should take particular care to manage *material outsourcing* arrangements and, as **SUP 15.3.8 G (1)(e)** explains, a *firm* should notify the FCA when it intends to enter into a *material outsourcing* arrangement.
- 13.9.3** **G** A *firm* should not assume that because a service provider is either a regulated *firm* or an intra-group entity an *outsourcing* arrangement with that provider will, in itself, necessarily imply a reduction in operational risk.
- 13.9.4** **G** Before entering into, or significantly changing, an *outsourcing* arrangement, a *firm* should:
- (1) analyse how the arrangement will fit with its organisation and reporting structure; business strategy; overall risk profile; and ability to meet its regulatory obligations;
 - (2) consider whether the agreements establishing the arrangement will allow it to monitor and control its operational risk exposure relating to the *outsourcing*;
 - (3) conduct appropriate due diligence of the service provider's financial stability and expertise;
 - (4) consider how it will ensure a smooth transition of its operations from its current arrangements to a new or changed *outsourcing* arrangement (including what will happen on the termination of the contract); and
 - (5) consider any concentration risk implications such as the business continuity implications that may arise if a single service provider is used by several *firms*.

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In negotiating its contract with a service provider, a *firm* should have regard to:

- (1) reporting or notification requirements it may wish to impose on the service provider;
- (2) whether sufficient access will be available to its internal auditors, external auditors or *actuaries* (see section 341 of the Act) and to the FCA (see ■ SUP 2.3.5 R (Access to premises) and ■ SUP 2.3.7 R (Suppliers under material outsourcing arrangements);
- (3) information ownership rights, confidentiality agreements and *Chinese walls* to protect *client* and other information (including arrangements at the termination of the contract);
- (4) the adequacy of any guarantees and indemnities;
- (5) the extent to which the service provider must comply with the *firm's* policies and procedures (covering, for example, information security);
- (6) the extent to which a service provider will provide business continuity for outsourced operations, and whether exclusive access to its resources is agreed;
- (7) the need for continued availability of software following difficulty at a third party supplier;
- (8) the processes for making changes to the *outsourcing* arrangement (for example, changes in processing volumes, activities and other contractual terms) and the conditions under which the *firm* or service provider can choose to change or terminate the *outsourcing* arrangement, such as where there is:
 - (a) a change of ownership or *control* (including insolvency or receivership) of the service provider or *firm*; or
 - (b) significant change in the business operations (including sub-contracting) of the service provider or *firm*; or
 - (c) inadequate provision of services that may lead to the *firm* being unable to meet its regulatory obligations.

13.9.6

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In implementing a relationship management framework, and drafting the service level agreement with the service provider, a *firm* should have regard to:

- (1) the identification of qualitative and quantitative performance targets to assess the adequacy of service provision, to both the *firm* and its *clients*, where appropriate;
- (2) the evaluation of performance through service delivery reports and periodic self certification or independent review by internal or external auditors; and
- (3) remedial action and escalation processes for dealing with inadequate performance.

- 13.9.7** G In some circumstances, a *firm* may find it beneficial to use externally validated reports commissioned by the service provider, to seek comfort as to the adequacy and effectiveness of its systems and controls. The use of such reports does not absolve the *firm* of responsibility to maintain other oversight. In addition, the *firm* should not normally have to forfeit its right to access, for itself or its agents, to the service provider's premises.
- 13.9.8** G A *firm* should ensure that it has appropriate contingency arrangements to allow business continuity in the event of a significant loss of services from the service provider. Particular issues to consider include a significant loss of resources at, or financial failure of, the service provider, and unexpected termination of the *outsourcing* arrangement.
- 13.9.9** G
- (1) Parts of the *guidance* in ■ SYSC 13.9 do not apply to a *Solvency II firm*. They are ■ SYSC 13.9.3G, ■ SYSC 13.9.4G(1), (2), (4) and (5) and ■ SYSC 13.9.5G(6).
 - (2) A *Solvency II firm* is subject to the outsourcing requirements in PRA Rulebook: Solvency II firms: Conditions Governing Business 7.
 - (3) The *Solvency II Regulation* (EU) 2015/35 of 10 October 2014 (article 274) also imposes specific requirements on *firms* which outsource, or propose to outsource, functions or insurance activities.
 - (4) EIOPA guidelines on systems of governance dated 28 January 2015 (EIOPA-BoS-14/253 EN) include guidelines on, or relating to, outsourcing.
 - (5) The FCA will take the requirements and guidelines in (2) to (4) into account when considering a *firm's* outsourcing arrangements.