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OSFI RELEASES NEW GUIDELINE FOR FEDERALLY REGULATED FINANCIAL INSTITUTIONS THAT OUTSOURCE BUSINESS FUNCTIONS

The Office of the Superintendent of Financial Institutions (“OSFI”) recently released for comment a draft of a new Guideline B-10 – *Outsourcing of Business Functions*. The new Guideline will apply to federally regulated financial institutions such as banks and insurance companies, subsidiaries and parent companies of such institutions, and foreign financial institution branches, as well as bank holding companies (collectively, for the purposes of this bulletin, “FRFIs”). Outsourcing arrangements involve an agreement between a FRFI and a service provider pursuant to which the service provider performs a business function that would otherwise be performed by the FRFI. Some business functions which are commonly outsourced are information system management and maintenance, document processing, application processing, loan administration and human resources functions.

The new Guideline sets out OSFI’s expectations for FRFIs that outsource business functions to service providers. Although the current Guideline B-10 was released as recently as May 2001, OSFI believes that the new Guideline is necessary due to the increase in outsourcing activity and the increasing reliance by FRFIs on such arrangements.

WHAT’S NEW?

- Guideline B-10 has been reorganized and streamlined.
- OSFI clarifies how foreign financial institution branches are expected to manage the risks associated with services provided by the home office or third parties.
- The new Guideline introduces more flexible expectations for federally incorporated financial institutions that obtain services from wholly owned subsidiaries or a federally regulated parent.
- Institutions will be expected to apply more comprehensive criteria to determine the materiality of outsourcing arrangements and to ensure the management of the risks is commensurate with the materiality of the arrangements.
- Institutions will be prohibited from outsourcing certain internal audit and actuarial services to the external auditor.
- OSFI’s expectations for data processing outside of Canada will be incorporated into the new Guideline, and Guideline E-3 – *Processing Information Outside Canada*, will be revoked.
- Institutions will be expected to maintain a centralized list of material outsourcing arrangements and to exercise more centralized control over outsourcing.

OSFI has invited FRFIs to comment on the new Guideline through their respective industry associations by October 15, 2003. The following is a general overview that has been prepared to help FRFIs understand the changes to the Guideline and the obligations they will face under the new Guideline.

APPLICATION OF THE NEW GUIDELINE

The new Guideline will apply to all outsourcing arrangements of a FRFI, whether entered into in Canada or in foreign jurisdictions, with a few exceptions. Clearing arrangements, sales of financial products by independent agents or brokers, ceded insurance and reinsurance ceded, and loan syndications are not subject to the new Guideline.

FRFIs are expected to design a risk management program that applies to all of their outsourcing arrangements except for those outsourcing arrangements which are clearly immaterial to the FRFI. However, this requirement will apply to all outsourcing arrangements that involve the processing of specified information or data outside of Canada, regardless of the materiality of the data processing outsourcing arrangement.

Generally, an outsourcing arrangement is immaterial if it does not have the potential to have an important quantitative or qualitative influence on the FRFI. OSFI acknowledges that outsourcing arrangements exhibit varying degrees of materiality and that while risk management programs must apply to all material outsourcing arrangements, the vigour of the FRFI's management of outsourcing risks should be proportionate to the materiality of the arrangement. Accordingly, OSFI's specific expectations for a FRFI will vary depending on the degree of materiality of the particular outsourcing arrangement.

FRAMEWORK OF THE NEW GUIDELINE

It is a premise of both the current Guideline B-10 and the new Guideline that FRFIs must retain ultimate accountability for all of their outsourced business activities and that reliance on a third party service provider must not compromise OSFI's ability to

supervise a FRFI. Outsourcing business functions to a service provider introduces new risks to an organization. As part of OSFI's risk-focused supervisory process, the current Guideline B-10 requires FRFIs to develop a risk-management program to identify and manage those risks. The new Guideline builds on this requirement and provides a more comprehensive set of criteria for FRFIs to apply in evaluating the risks associated with outsourcing arrangements and implementing a program to ensure that the management of those risks is commensurate with the significance of the outsourcing arrangement. OSFI suggests that FRFIs evaluate their policies and procedures against the expectations set out in the new Guideline.

EVALUATION OF RISK - MATERIALITY AND RISK MANAGEMENT PROGRAMS

The new Guideline introduces greater flexibility into the regulatory regime because it allows OSFI to apply reduced expectations for risk management programs in circumstances where the outsourcing arrangement has a low degree of materiality, where the outsourcing arrangement is between a foreign financial institution branch and its home office, or where the arrangement is between FRFIs that are affiliated with one another. It should also be noted that OSFI advises FRFIs that individual outsourcing arrangements may be subject to supervisory scrutiny.

Another way in which the new Guideline introduces greater flexibility into the regulatory regime is that it takes a principle based approach to assessing the materiality of outsourcing arrangements, rather than a quantitative approach. The new Guideline eliminates specific materiality thresholds for the materiality criteria. For example, the current Guideline B-10 provides a bright-line test where contractual expenditures for an outsourcing arrangement exceed one per cent of a FRFI's net assets. Such expenditures increase the materiality of the outsourcing arrangement and also the likelihood that the arrangement will be subject to the provisions in the Guideline. In contrast, under the new Guideline FRFIs will be expected to

consider the size of contractual expenditures as a share of the non-interest expenses of the FRFI or the line of business in assessing the materiality of an outsourcing arrangement, but there is no threshold set out to indicate whether the expenditure increases the materiality of the arrangement.

The current Guideline provides a framework which FRFIs may use to evaluate the significance of their outsourcing activities. The new Guideline builds on this framework by providing a more comprehensive set of criteria to consider in assessing outsourcing arrangements, so that FRFIs may identify their expectations regarding the costs and benefits of outsourcing arrangements and ensure that their risk management programs are appropriate. In this respect, the new Guideline is more instructive and more useful to FRFIs.

RESPONSIBILITIES AND ACCOUNTABILITIES OF MANAGEMENT

The new Guideline sets out in greater detail the responsibilities of management regarding the FRFI's risk management policies and practices, and also includes particular responsibilities for the chief agent or principal officer of a foreign financial institution branch. With regard to the latter, the changes to the new Guideline parallel proposed changes to Guideline E-4 – *Role of the Canadian Chief Agent and Record Keeping Requirements*, which will clarify OSFI's expectations regarding the role of the chief agent or principal officer in corporate governance and compliance activities.

PROHIBITIONS REGARDING OUTSOURCED BUSINESS ACTIVITIES

One important change in the new Guideline is that FRFIs will be prohibited from outsourcing to an external auditor certain business functions, including actuarial services and internal audit services related to internal accounting controls, financial systems, or financial statements. There is an exception where it is reasonable to conclude that the results of the outsourced function would not be subject to audit procedures during an audit of the FRFI's financial statements. This

amendment reflects provisions in the draft *Independence Standards for Auditors* issued by the Canadian Institute of Chartered Accountants.

CONTENTS OF AN ACCEPTABLE CONTRACT FOR SERVICES

OSFI has expanded the elements of the outsourcing arrangement that should be included in the outsourcing contract. Material outsourcing arrangements should be documented by a written contract that addresses all elements of the arrangement, which elements will include, where applicable, provisions regarding the ownership of and access to all assets related to the outsourcing arrangement, enhanced audit rights and access rights for OSFI in respect of the service being performed and any rules or limitations regarding subcontracting by the service provider. The contract should also require the service provider to disclose general information regarding its insurance coverage and notify the FRFI about significant changes in its insurance coverage.

DATA PROCESSING IN FOREIGN JURISDICTIONS

Currently, the approval of the Superintendent is required if a FRFI wishes to process certain types of information outside Canada. Guideline E-3 – *Processing Information Outside Canada* describes the circumstances in which OSFI may exempt a FRFI from the statutory requirement that the FRFI maintain and process in Canada any information or data relating to the preparation and maintenance of certain records. Outsourcing arrangements that involve data processing in foreign jurisdictions will be required to follow the risk management program set out in the new Guideline, whether the arrangement is material or not. Three months after the final version of the new Guideline is posted, Guideline E-3 – *Processing Information Outside Canada* will be revoked and the Superintendent may consider the criteria set out in the new Guideline in assessing applications for approval to process information outside Canada.

CENTRALIZED LIST OF MATERIAL OUTSOURCING ARRANGEMENTS

Another new requirement is that OSFI will expect FRFIs to maintain a centralized list of all material outsourcing arrangements, which is to be provided to OSFI upon request. The list should summarize the key elements of the outsourcing arrangements.

TRANSITION PERIOD – WHAT IS EXPECTED OF FRFIS

The new Guideline specifies the timing of the application of the various requirements for both new and existing outsourcing arrangements. FRFIs will be required to comply with the requirements of the new Guideline in stages during the six months after the final version of the new Guideline is posted.

** This bulletin was prepared by Stephanie Robinson.*

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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