McMillan Binch LLP

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OSFI Releases Revised Guideline for Federally Regulated Financial Institutions that Outsource Business Activities, Functions and Processes

On December 15, 2003, the Office of the Superintendent of Financial Institutions ("OSFI") released the revised Guideline B-10 – *Outsourcing of Business Activities, Functions and Processes*. The revised Guideline is the final form of the draft outsourcing Guideline that was released by OSFI in August 2003. The revised Guideline applies to federally regulated financial institutions such as banks and insurance companies, subsidiaries and parent companies of such institutions, and Canadian branches of foreign financial institutions, as well as bank holding companies and insurance 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 activity, function or process 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 revised Guideline sets out OSFI's expectations for FRFIs that outsource or contemplate outsourcing business functions or activities to service providers. Although the former Guideline B-10 was released as recently as May 2001, OSFI believes that the revised Guideline is necessary due to the increase in outsourcing activity and the increasing reliance by FRFIs on such arrangements. Outsourcing has grown in part because of the growth of information technology enabled processes and the emergence of offshore outsourcing as a business strategy. The following is a general overview that has been prepared to help FRFIs understand the obligations they face under the revised Guideline.

What's New? A Summary of the Changes in the Revised Guideline

- 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 revised Guideline introduces more flexible expectations for federally incorporated financial institutions that obtain services from wholly owned subsidiaries or a federally regulated parent.
- Institutions are expected to apply more comprehensive criteria to determine the materiality of outsourcing arrangements and to ensure the robustness of risk management is commensurate with the materiality of the arrangements.
- Institutions are prohibited from outsourcing certain internal audit and actuarial services to the external auditor, except in limited circumstances.
- Applications for approval to process data outside of Canada will be assessed taking into account the factors identified in the revised Guideline, and Guideline E-3 – *Processing Information Outside Canada*, will be revoked on December 15, 2004.
- Institutions are expected to maintain a centralized list of material outsourcing arrangements and to exercise more centralized monitoring and control over outsourcing activities.

Application of the Revised Guideline

The revised Guideline applies 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 generally not subject to the revised Guideline.

In applying the revised Guideline, a FRFI is expected to consider the impact on the FRFI and its consolidated operations of outsourcing arrangements entered into by the FRFI and all its subsidiaries and business operations. 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, all outsourcing arrangements that involve the processing of specified information or data outside of Canada are subject to the expectations contained in the revised Guideline, and the Superintendent must approve all such outsourcing arrangements, regardless of the materiality of the arrangement.

Generally, an outsourcing arrangement is material if it has the potential to have an important quantitative or qualitative influence on a significant line of business of the consolidated operations of the FRFI. OSFI will always consider the outsourcing of all or substantially all of a management oversight function to be material unless the function is outsourced to a parent or subsidiary of 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 management of outsourcing risks and the rigour of the risk mitigants utilized by the FRFI 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 Revised Guideline

It is a premise of the revised 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 former Guideline B-10 required FRFIs to develop a risk-management program to identify and manage those risks. The revised 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 for assessing and managing the risks associated with outsourcing arrangements against the expectations set out in the revised Guideline.

Evaluation of Risk – Materiality and Risk Management Programs

The revised 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. OSFI advises FRFIs that individual outsourcing arrangements and the materiality assessment of a particular outsourcing arrangement may be subject to supervisory scrutiny.

Another way in which the revised 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 revised Guideline eliminates specific materiality thresholds for the materiality criteria. For example, the former Guideline B-10 provided 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 revised

Guideline FRFIs are 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 former Guideline provided a framework which FRFIs could use to evaluate the significance of their outsourcing activities. The revised Guideline builds on this framework by providing a more comprehensive set of criteria to consider in assessing the materiality of 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 revised Guideline is more instructive and more useful to FRFIs.

Responsibilities and Accountabilities of Management

The revised 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 revised 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. OSFI expects the chief agent or principal officer to be accountable for the business in Canada, regardless of whether a particular business activity or function has been outsourced.

Prohibitions Regarding Outsourced Business Activities

One important change in the revised Guideline is that FRFIs are 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. OSFI notes that guidelines respecting outsourcing to an external auditor may be adjusted in light of future amendments to the *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 to the extent feasible and reasonable, 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, a FRFI must obtain the approval of the Superintendent if it 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 are required to follow the risk management program set out in the revised Guideline, regardless of whether the arrangement is material, and regardless of whether the processing is done by a related entity or by a third party. OSFI advises that the Superintendent may consider the criteria set out in the revised Guideline in assessing applications for approval to process information outside Canada, and that Guideline E-3 – *Processing Information Outside Canada* will be revoked on December 15, 2004. More information about the requirements respecting an application for approval to process data outside Canada is available in the Deemed Approval Instruction Document No. 10 – *Processing Information Outside Canada*.

Centralized List of Material Outsourcing Arrangements

Another new requirement is that OSFI expects 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 revised Guideline provides a one-year transition period and specifies the timing of the application of the various requirements for both new and existing outsourcing arrangements. Existing outsourcing arrangements are expected to come into compliance with the provisions in the revised Guideline regarding risk management programs at the first opportunity after December 15, 2004 (i.e. the time when the outsourcing contract is amended, renewed or extended). Existing outsourcing arrangements are expected to comply with all other provisions in the revised Guideline, including the requirement to conduct a materiality assessment of existing outsourcing arrangements, by December 15, 2004. All outsourcing arrangements entered into on or after December 15, 2004 will be expected to comply fully with the revised Guideline.

A copy of the revised Guideline is available on the OSFI website at www.osfi-bsif.gc.ca. For further information about any of these requirements, please contact your McMillan Binch LLP lawyer or one of the lawyers listed below:

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