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Oversight & Controls Framework for 3rd Party Arrangements

Regulatory interest in all aspects of outsourcing, whether it is to a third party, intra-group, offshoring or a ManCo using delegated authority, remains high.

Regulatory interest in 'outsource' arrangements used by financial services companies has never been greater and it isn't just the FCA that is taking an interest but other European regulators as well.

When outsourcing of material functions first came into fashion in the mid to late '80's, it was all largely about cost reduction, finding a solution for legacy systems that were creaking under the strain and being able to outsource a problem. With many companies having moved on from 1st generation outsourcing, through 2nd and 3rd generation, the drivers have changed.

Regulation is now key behind business and operating model changes across the industry, as new regulatory requirements increase the cost of doing business and decrease the profitability of previously lucrative activities. The service catalogue offered by third party administrators (TPAs) has also increased considerably, with an ever-widening range of services being made available.

At the same time as TPAs increase their capabilities, financial services firms are increasingly looking at offshoring a broader range of operational activities that have traditional taken place in London. Initially, these tended to be relatively simple, non-client facing back office tasks such as reconciliations and model validation. This has changed over time as the availability of multi-skilled staff has increased considerably in countries such as Poland and India and as a result, financial services companies have grown more comfortable with using third parties and are now willing to consider outsourcing their most material activities.

What do all these arrangements have in common?

The 'outsourcer' needs to be able to evidence:

- That they have **robust oversight** over all key activity
- That there is an **active controls framework** around the outsource
- That all **risks are understood and actively managed**

Regulatory Drivers

UK

- SMCR for Investment managers comes into force on 19th December 2019
- FCA Business plan for 2019/20 under 'Operational Resilience' says a specific area of interest that is 'Assessing third-party service providers'

Ireland

- CBI issued a paper on outsourcing in November 2018 saying "the Central Bank has significantly increased its focus on outsourcing and the management by regulated firms of risks presented by outsourcing arrangements through specific, targeted onsite inspections and wider thematic reviews on outsourcing"
- The CBI also focuses in on intra-group arrangements

Luxembourg

- CSSF Circular 18/698 sets expectations regarding delegation and oversight aspects for Luxembourg Management Companies

Europe

- European Banking Authority (EBA) published a final report on its draft guidelines on outsourcing arrangements on 25th February 2019. It sets out expectations on material outsourcing and intragroup arrangements

Third Party Outsourcing

With SMR already in place for banks and SMCR coming in on 9th December 2019 for investment managers and insurance companies, both bring in the concept of personal accountability for outsource arrangements. Even though this has been in place for several years for banks, the UK regulator is still concerned that these arrangements are not being managed with enough rigor and has yet again indicated this in the FCAs business plan for 2019/20 by flagging up outsourcing as a key focus area. We expect that it will be looking to signal to the market that oversight and controls around these arrangements are critically important by making an example of a senior manager, for failing to ensure adequate controls and oversight were in place over arrangements that they 'own'.

Intra-group

Intra-group arrangements are now receiving a lot more regulatory interest. Many of these arrangements were set up years ago, often on a basis of cost cutting and convenience. As they were intra-group, little in the way of documentation was put in place and oversight was rather patchy.

Things are changing and feedback from financial services companies is telling us the UK regulator is now asking detailed and searching questions about intra-group arrangements with particular interest in contractual arrangements, SLAs, contingency plans and value for money.

Offshoring

The key challenge around offshore arrangements is ensuring that the management information sent to the outsourcer is both timely and provides information that gives an accurate picture of what is happening on a day to day basis. Focus needs to be on the identification and management of all risk, especially around data and AML/KYC on both clients and distributors.

Key Areas of weakness

- The controls framework being managed by a tick box exercise (i.e. have we got a contingency plan.? Yes, then 'tick', rather than reviewing the plan to see if it would work)
- 1st and 2nd line activity is blurred with the 2nd line often doing 1st line activity
- Documentary evidence scattered across the business, rather than in one place
- Risk maps out of date
- Operating model documentation around the arrangement is out of date or missing large sections
- For intra-group arrangements, there is often little in the way of oversight and controls and they are managed on a 'trust' basis
- Activities specified in the contract between the parties often not actually taking place
- Board papers not reflecting the actual risk of the arrangement and the risks on the risk register being overly vague
- Trusting the internal audit team's findings that say that everything is fit for purpose

ManCos

In general, the ManCos operate a largely outsourced model, delegating portfolio management and risk management to an investment manager and fund administration and custody activities to a third-party external administrator and custodian.

Whilst, these functions are outsourced, the ManCo still retains legal responsibility for the proper discharge of these functions. In July 2017, the European Securities and Markets Authority (ESMA) published an opinion which set out the supervisory expectations for EU ManCos delegating functions such as portfolio management to non-EU entities. Recent changes in legislation such as AIFMD, the Luxembourg CSSF circular 12-546 and direction from the Central Bank of Ireland (CBI) have further confirmed local requirements.

These new regulations are beginning to shift attitudes and the compliance models that ManCos have traditionally followed. Ownership and accountability are becoming the new watch words. ManCos need to begin moving rapidly from the 'show me' approach that many have adopted with their outsource partners, to a 'testing' of management information (MI). Directors will need to hone their oversight of their entity in order to discharge their responsibilities and show that they are making informed and relevant decisions. In addition, they need to be able to demonstrate that their oversight and control of third parties is active and effective.

Do please contact us for more information on how to control risks around your 3rd party arrangement

Email: info@commsolassoc.com
Website: www.commsolassociates.com