



Discussion Paper

Outsourcing

23 March 2006

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Preamble

This discussion paper presents a harmonised approach to the prudential supervision of risks arising from outsourcing arrangements by APRA-regulated institutions. For the purposes of this discussion paper, 'regulated institution' refers to an authorised deposit-taking institution (ADI), a general insurer or a life company. Attached to the paper are draft prudential standards on outsourcing by ADIs, general insurers and life companies, together with a draft prudential practice guide covering all three industries. The draft standards and guide are also available at www.apra.gov.au.

The draft prudential standards represent a principles-based approach to prudential regulation detailing APRA's minimum requirements for managing risks arising from outsourcing but leaving the way open for regulated institutions to develop their outsourcing policy that complies with the principles.

The draft prudential practice guide aims to assist regulated institutions in complying with APRA's requirements and, more generally, to outline prudent practices in relation to outsourcing. Subject to the requirements in the prudential standards, regulated institutions have the flexibility to configure their approach to outsourcing in the way most suited to achieving their business objectives. The guide is not legally enforceable.

For ADIs, the draft prudential standard and guide substantially replicates *Prudential Standard APS 231 Outsourcing* (APS 231) and the associated (but not binding) *Guidance Note AGN 231.1 Managing Outsourcing*

Arrangements (AGN 231.1), with key enhancements relating to 'offshoring' and intra-group outsourcing arrangements. For general insurers, APRA's proposed approach represents an enhancement to the current requirements for outsourcing in the enforceable *Guidance Note GGN 220.5 Operational Risk*, which forms part of *Prudential Standard GPS 220 Risk Management for General Insurers* (GPS 220). The general insurance industry has been consulted on the development of a prudential standard on outsourcing in response to two earlier discussion papers released in November 2003¹ and May 2005². The draft prudential standards and the introduction of the prudential practice guide reflect the outcome of those consultations. For life companies, this approach will introduce a formal regulatory requirement for outsourcing in the life insurance industry which reflects the criteria applied by APRA in assessing outsourcing by life insurers through its supervisory processes.

APRA proposes to finalise and issue the new prudential standards in the second quarter of 2006. The prudential practice guide will be finalised at the same time.

Written submissions on these proposals should be forwarded via email by 26 May 2006 to apraoutsourcing@apra.gov.au

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¹ APRA policy discussion paper titled *Prudential Supervision of General Insurance Stage 2 Reforms* released on 23 November 2003.

² APRA policy discussion paper titled *Prudential Supervision of General Insurance Stage 2 Reforms: Risk and Financial Management* released on 3 May 2005 with draft *Prudential Standard GPS 221 Outsourcing* attached.

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Introduction

The existing ADI prudential requirements for outsourcing arrangements contained in APS 231 and AGN 231.1 are generally working well. APRA's supervisory experience, however, has identified emerging practices that suggest these requirements need to be reviewed and updated. Consequently, APRA has undertaken this review as part of a cross-industry approach to the supervision of risks arising from outsourcing arrangements. These risks are common across industries regulated by APRA and are best addressed through prudential standards that are harmonised across the industries.

It is acknowledged that this approach will introduce a formal regulatory requirement for outsourcing in the life insurance industry for the first time. To date, APRA has expected life companies to have formal agreements for their outsourcing arrangements and has assessed the arrangements largely based on the requirements set out for the ADI industry. Therefore, the cross-industry approach should have little practical impact on life companies as APRA and the life insurance industry have been working together to ensure that an appropriate approach to outsourcing has been taken in the life insurance industry. The difference the new approach will bring to the life insurance industry is that the principles that APRA has been using to assess existing outsourcing arrangements will become legally enforceable principles via the new prudential standard.

APRA has consulted extensively with the general insurance industry about the proposed prudential standard for that industry. This round of consultation is intended to obtain views from all three regulated industries at the same time since the new standards will be applied in identical form to all regulated institutions.

The introduction of the first harmonised prudential practice guide, *Prudential Practice Guide PPG 231 Outsourcing*, is a significant development in the way that APRA disseminates guidance on prudent practice. Prudential practice guides are not legislative instruments. Not all the practices outlined in the guide will be relevant for every regulated institution and some aspects may vary depending upon the size, complexity and risk profile of the institution.

A harmonised approach to outsourcing will have a number of benefits for regulated institutions:

- a more consistent framework compared with the current separate approaches to supervising outsourcing arrangements;
- conglomerates that have regulated institutions in more than one industry will find it easier to meet APRA's requirements; and
- conformity with international regulatory principles including those promulgated by the Joint Forum, which comprises the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors.

Proposed commencement and transitional arrangements

The new prudential standards are intended to be released in the second quarter of 2006. The new requirements will apply from 1 October 2006.

An outline of the new prudential standards and prudential practice guide

The proposed new prudential standards establish a framework in which a regulated institution is to manage its outsourcing arrangements.

Definition of outsourcing

Outsourcing is defined as an agreement entered into by a regulated institution and another party to perform, on a continuing basis, a business activity which currently is, or could be, undertaken by the regulated institution itself. The regulated institution remains responsible for complying with all prudential requirements relating to the outsourced business activity. This principle is the foundation for the proposed new prudential standards, and regulated institutions must recognise that they remain ultimately responsible for the outsourced business activities.

Materiality

The proposed new prudential standards apply only to the outsourcing of material business activities. A business activity is material if it has the potential, if disrupted, to have a significant impact on a regulated institution's business operations or its ability to manage risks effectively, having regard to a range of factors.

Outsourcing policy

A regulated institution is expected to have a risk management framework. This is a prudential requirement for general insurers and ADIs under current standards.³ Life companies are not required to have a risk management framework under the *Life Insurance Act 1995* but APRA expects all prudently managed life companies to apply modern risk management practices, a key concept of which is a comprehensive risk management framework. A regulated institution is required to address the risks arising from outsourcing in an outsourcing policy that is part of the institution's overall risk management framework.

Assessment of outsourcing options

APS 231 sets out minimum criteria for the risk management framework for outsourcing. In the case of outsourcing to third parties, the proposed new prudential standards expand on these requirements to include:

- a due diligence review of the chosen service provider;
- addressing the renewal process for outsourcing arrangements; and
- the development of contingency plans if the outsourced process needs to be brought back in-house.

APRA has discretion to apply the standard in a flexible manner if the outsourcing is to another regulated institution within the group and APRA has been applying that flexible approach in its ongoing supervision. The proposed new prudential standards extend that flexibility to all related bodies corporate, not just other regulated entities. Separate requirements apply if a regulated institution is assessing outsourcing to a third party or to a related body corporate, although the institution must consider the relevance of the requirements that relate to third party arrangements. This approach acknowledges the reality that outsourcing to related bodies corporate does not require the same level of formality as when dealing with third parties. This approach is a significant departure from the *Draft Prudential Standard – General Insurance Risk and Financial Management GPS 221 Outsourcing (GPS 221)* that was published for consultation in May 2005 and is in direct response to submissions from general insurers.

³ ADIs are required to have risk management systems in accordance with APS 310 and general insurers are required to have a risk management strategy in accordance with GPS 220 (the requirement for a risk management framework is being introduced in the new *Prudential Standard GPS 220 Risk Management*).

The outsourcing agreement

The proposed new prudential standards expand on the minimum requirements for material outsourcing agreements in APS 231 in four areas:

- the scope of the arrangement and services to be provided;
- subcontracting;
- insurance; and
- offshoring arrangements (including through subcontracting).

APRA considers that these expanded requirements are fundamental to establishing a sound arrangement with a service provider.

As with the assessment of outsourcing options, APRA does not expect the same level of formality where the outsourcing arrangement is with a related body corporate. Nonetheless, the agreement between the parties should cover:

- the scope of the arrangement and services to be supplied;
- the pricing and fee structure;
- service levels and performance requirements; and
- audit and monitoring procedures.

APRA access to service providers is also required to be included in outsourcing agreements as per the requirements in APS 231.

Notification requirements

A regulated institution must notify APRA as soon as possible after entering into any outsourcing agreements where the activity is to be conducted in Australia. This is the same requirement as in APS 231. The proposed new prudential standards are different from the draft GPS 221 released in May 2005 as the amount of documentation required to be provided pursuant to that notification has been scaled back to that required under APS 231.

Offshoring

'Offshoring' is the practice of outsourcing business activities to a service provider located outside Australia. Offshoring may occur via a contract with a provider outside Australia, or with an Australian service provider where material elements of the service are provided from abroad.

APRA does not wish to discourage or prohibit prudently structured offshoring arrangements of material business activities. However, APRA is proposing that regulated institutions consult with it prior to entering into a material offshoring contract. This position represents a change from the draft GPS 221 released in May 2005 which proposed prior APRA approval of offshoring arrangements. The requirement to consult is not a quasi-approval mechanism. Offshoring poses a unique set of risks and, in the consultation process, APRA will wish to review the Board's assessment and understanding of these risks and the processes and controls to be introduced to mitigate them. This may involve measures relating to choice of law, security and confidentiality of information and access to information.

In addition, APRA is in the unique position of reviewing emerging trends in offshoring arrangements across the regulated financial sector, allowing it to provide feedback to regulated institutions which are contemplating offshoring.

Consistent with the requirements for domestic outsourcing arrangements, the regulated institution must ensure that it has adequate business continuity management arrangements in the event that the service provider in an offshoring arrangement is unable to fulfil its obligations. This may include the identification of an alternate service provider or a return to in-house service provision.

Monitoring

A regulated institution must devote sufficient resources to managing and monitoring the outsourcing relationship. The proposed new prudential standards set out minimum requirements for this monitoring. In comparison with APS 231, the requirement to elevate issues to the senior management or the Board has been removed, consistent with removing all references to the internal communications to the Board and senior management due to the proposed new governance prudential standards (see below).

Audit arrangements

The proposed new governance standards require regulated institutions to have an internal audit function, but allow outsourcing of this function with APRA approval. The proposed new outsourcing standards clearly define the internal audit function as a material business activity. The new outsourcing standards also require the internal audit function to cover outsourcing arrangements. Internal audit is not discussed in APS 231.

Board and management responsibility

The section on Board and management responsibility in APS 231 and the draft GPS 221 published in May 2005 has not been included in the proposed new outsourcing standards. The proposed new governance standards contain the broad principles relating to Board and management responsibility and there is no need to repeat these in relation to outsourcing arrangements. However, the specific responsibilities of the Board and management in relation to assessment of outsourcing options and outsourcing to related bodies corporate are identified in the new outsourcing standards.

Prudential practice guide

The intent of the prudential practice guide is dealt with in the introduction. The matters dealt with in the guide are:

- materiality;
- resources for managing outsourcing arrangements;
- Business Continuity Management in relation to outsourcing arrangements;
- considerations in developing an outsourcing policy;
- content of contractual agreements ;
- the additional risks of offshoring; and
- outsourcing to related bodies corporate.



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