



## Prudential Standard LPS 231

### Outsourcing

#### **Objective and key requirements of this Prudential Standard**

This Prudential Standard aims to ensure that any outsourcing arrangements entered into by a life company are subject to appropriate due diligence, approval and on-going monitoring. All risks arising from outsourcing material business activities should be appropriately managed to ensure that the life company is able to meet both its financial and service obligations to its policyholders.

The key requirements of this Prudential Standard include that:

- a life company must have a policy relating to outsourcing of material business activities;
- a life company must have sufficient monitoring processes in place to manage the outsourcing arrangements of material business activities;
- a life company must, for all outsourcing arrangements of material business activities with third parties, have a legally binding agreement in place, unless APRA otherwise agrees;
- a life company must notify APRA after entering into agreements to outsource material business activities within Australia; and
- a life company must consult with APRA prior to entering into agreements to outsource material business activities to service providers who conduct the activities outside Australia.

## Authority and application

1. This Prudential Standard, made under section 230A of the *Life Insurance Act 1995* (**the Act**), applies to all life companies authorised under the Act.
2. Subject to any specific contrary transition rules set out in Attachment A, a life company must comply with this Prudential Standard from 1 October 2006 (referred to in this Prudential Standard as the “**effective date**”).

## Outsourcing

3. Outsourcing involves a life company entering into an agreement with another party (including a related body corporate) to perform, on a continuing basis, a business activity which currently is, or could be, undertaken by the life company itself.
4. For the purposes of this Prudential Standard, a reference to a related body corporate of a life company is a reference to the meaning of “related body corporate” under section 50 of the *Corporations Act 2001*. A reference to a third party is a reference to an entity that is not the life company or a related body corporate of the life company and a reference to a service provider is a reference to the person providing the outsourced services to the life company.
5. Although outsourcing may result in day-to-day managerial responsibility for the relevant business activity moving to the service provider, the life company remains responsible for complying with all prudential requirements<sup>1</sup> that relate to the outsourced business activity.

## Materiality

6. This Prudential Standard applies to any arrangement to outsource a business activity that is material to a life company’s operations (referred to in this Prudential Standard as a “**material business activity**”). For this purpose, a material business activity is one that has the potential, if disrupted, to have a significant impact on the life company’s business operations or its ability to manage risks effectively, having regard to such factors as:
  - (a) the financial, operational and reputational impact of a failure of the service provider to perform over a given period of time (depending on the importance of the business activity, this may be required to be measured in a time-span of hours);
  - (b) the cost of the outsourcing arrangement as a share of total costs;
  - (c) the degree of difficulty, including the time taken, in finding an alternative service provider or bringing the business activity “in-house”;

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<sup>1</sup> Prudential requirements include all requirements under the Act, regulations made under the *Life Insurance Act 1995*, prudential standards, the *Financial Sector (Collection of Data) Act 2001*, reporting standards, conditions on a life company registration and any other requirements imposed by APRA in writing.

- (d) the ability of the life company to meet regulatory requirements if there are problems with the service provider;
  - (e) potential losses to the life company's customers and other affected parties in the event of a service provider failure; and
  - (f) affiliation or other relationship between the life company and the service provider.
7. The internal audit function is a material business activity. Prior to making any application to APRA under *Prudential Standard LPS 510 Governance* for internal audit to be undertaken via an outsourcing arrangement, a life company must be satisfied that the external auditor is free of any conflicts of interest and capable of exercising objective and impartial judgement on all issues in which the auditor is engaged. This includes the life company satisfying itself that the auditor (and the firm for which they act) meets any applicable auditor independence requirements.

### **Outsourcing policy**

8. A life company must develop an outsourcing policy that sets out its approach to outsourcing, including a detailed framework for managing outsourcing arrangements.
9. Procedures must be in place to ensure that all relevant business units of the life company are fully aware of, and comply with, the outsourcing policy.
10. The life company's risk management framework must deal with the risks associated with the outsourcing of a material business activity.
11. A life company's outsourcing policy must deal with specific requirements in relation to outsourcing to related bodies corporate and outsourcing to service providers conducting the material business activity outside Australia.

### **Assessment of outsourcing options**

12. For the purposes of this Prudential Standard, "offshoring" means the outsourcing by a life company of a material business activity to a service provider (including a related body corporate), where the outsourced activity is to be conducted outside Australia. Offshoring includes arrangements where the service provider is incorporated in Australia, but the physical location where the outsourced activity is carried out is outside Australia. Conversely, offshoring does not include arrangements where the service provider is not incorporated in Australia, but the physical location where the outsourced activity is carried out is within Australia.
13. When assessing the options for outsourcing a material business activity to third parties, a life company must be able to demonstrate that it has:
- (a) prepared a business case for outsourcing the material business activity;
  - (b) undertaken a tender or other selection process for service providers;

- (c) undertaken a due diligence review of the chosen service provider;
  - (d) involved the Board, a delegated committee or an accountable senior manager in approving the agreement;
  - (e) considered all factors to be included in the outsourcing agreement itself;
  - (f) implemented procedures for monitoring performance under the outsourcing agreement (including specific factors in relation to outsourcing to related bodies corporate and outsourcing to service providers conducting the material business activity outside Australia);
  - (g) addressed the renewal process for outsourcing arrangements and how the renewal will be conducted;
  - (h) developed contingency plans if the outsourced process needs to be brought back in-house; and
  - (i) considered any other factors viewed as relevant by the life company.
14. When assessing the options for outsourcing a material business activity to related bodies corporate, a life company must consider:
- (a) the changes to the risk profile of the business activity that arise from outsourcing the activity to a related body corporate and how this changed risk profile is addressed within the life company's risk management framework;
  - (b) whether the related body corporate has the ability to conduct the business activity on an ongoing basis;
  - (c) the required monitoring procedures to ensure the related body corporate is performing effectively and how inadequate performance would be addressed;
  - (d) contingency issues in accordance with any policy or procedure the life company has in place relating to business continuity management if the outsourced process needs to be brought back in-house; and
  - (e) the need to apply any of the requirements set out in paragraph 13 as they apply to third party outsourcing arrangements.

### **The outsourcing agreement**

15. Otherwise than as provided under paragraph 18, all arrangements to outsource a material business activity must be evidenced by a written, legally binding agreement.
16. In the case of outsourcing to third parties, the agreement must be executed before the outsourcing commences.
17. At a minimum, the agreement must address the following issues:

- (a) the scope of the arrangement and services to be supplied;
  - (b) pricing and fee structure;
  - (c) service levels and performance requirements;
  - (d) audit and monitoring procedures;
  - (e) business continuity management;
  - (f) confidentiality, privacy and security of information;
  - (g) default arrangements and termination provisions;
  - (h) dispute resolution arrangements;
  - (i) liability and indemnity;
  - (j) subcontracting;
  - (k) insurance; and
  - (l) to the extent applicable, offshoring arrangements (including through subcontracting).
18. Subject to paragraph 20, paragraph 15 does not apply to arrangements to outsource a material business activity to a related body corporate unless APRA notifies the life company in writing that the outsourcing arrangement must be evidenced by a written legally binding agreement after having consulted with the life company.
19. If paragraph 15 does not apply to an arrangement to outsource a material business activity to a related body corporate, the Board or the accountable senior manager must be satisfied that subparagraphs 17(a) to (d) have been agreed upon between the life company and the related body corporate.
20. If another prudential standard requires an arrangement to outsource a material business activity to a related body corporate to be undertaken using a written, legally binding agreement, that requirement supersedes the effect of paragraph 18.
21. Where a life company enters into an arrangement to outsource a material business activity by reason of an unexpected extreme event which results in:
- (a) the life company invoking its business continuity plan (or any equivalent procedure, by whatever name called), if any; or
  - (b) the sudden financial or operational failure of an existing service provider,
- the provisions of paragraphs 12 to 20, 23 and 24 need not be complied with except to the extent that is reasonably possible having regard to the nature of the

emergency. The life company must notify APRA as soon as practicable of an outsourcing arrangement to which this paragraph applies.

### **APRA access to service providers**

22. An agreement to outsource a material business activity must include a clause giving APRA access to documentation related to the outsourcing arrangement. It must include the right to conduct on-site visits to the service provider if APRA considers this necessary in its role as prudential supervisor, and APRA would expect the service provider to cooperate with APRA's requests for information and assistance. For related body corporate arrangements, the Board must ensure that access by APRA will not be impeded. In the normal course, APRA would seek to obtain whatever information it requires through the life company itself. Where APRA intends to undertake an on-site visit to a service provider, it would normally inform the life company of its intention to do so. The life company should take all reasonable steps to ensure that service providers will not disclose or advertise that APRA has conducted such a visit, except as necessary to coordinate with other institutions regulated by APRA which are existing clients of the service provider.

### **Notification requirement**

23. A life company must notify APRA as soon as possible after entering into any agreements to outsource a material business activity to a service provider conducting the outsourced activity within Australia (and in any event no later than 20 business days after execution of the agreement between the life company and the service provider). This notification requirement applies to all outsourcing arrangements of any material business activity, including those with third parties and those with related bodies corporate.
24. The life company should provide a summary to APRA of the key risks involved in the outsourcing arrangement and the risk mitigation strategies put in place to address these risks. APRA may request additional material where it considers it necessary to do so in order to understand and assess the impact of the outsourcing arrangement on the life company's risk profile.

### **Offshoring arrangements – requirement for consultation**

25. A life company must consult with APRA prior to entering into any offshoring agreement so that APRA may understand and assess the impact of the offshoring arrangement on the life company's risk profile.
26. Where a life company has not consulted with APRA prior to entering into an offshoring agreement and, in APRA's view, the agreement involves undue risks that the life company is not managing appropriately, APRA may require the life company to make alternative arrangements for the outsourced activity as soon as practicable.

**Monitoring the relationship**

27. The life company must devote sufficient resources to managing and monitoring the outsourcing relationship. The type and extent of resources required would depend on the materiality of the outsourced business activity. At a minimum, monitoring would include:
  - (a) maintaining appropriate levels of regular contact with the service provider. This would range from daily operational contact to senior management involvement; and
  - (b) a process for regular monitoring of performance under the agreement, including meeting criteria concerning service levels.
28. The life company must advise APRA of any significant problems that have the potential to materially affect the outsourcing arrangement and, as a consequence, materially affect the business operations, profitability or reputation of the life company.
29. When a life company terminates an arrangement to outsource a material business activity, it must notify APRA as soon as practicable, together with a statement as to the transition arrangement and future strategies for carrying out the outsourced material business activity.

**Audit arrangements**

30. The internal audit function within a life company must cover any arrangements to outsource a material business activity and auditors must regularly review and report to the Board or Board Audit Committee on compliance with the life company's outsourcing policy.
31. APRA may request the external auditor of the life company, or an appropriate external expert, to provide an assessment of the risk management processes in place with respect to an arrangement to outsource a material business activity. This could cover areas such as IT systems, data security, internal control frameworks and business continuity plans. Such reports will be paid for by the life company and must be made available to APRA.

## Attachment A

### Transition Rules

#### Expiry Date of this Attachment

This Attachment will no longer have effect after 31 December 2007

#### Specific Transition Rules

In relation to paragraph 23, a life company has 20 business days from the effective date to notify APRA of all existing outsourcing agreements, both within and outside Australia, involving material business activities.

Any existing outsourcing agreement will not have to comply with the requirements under this Prudential Standard until the agreement is reviewed at a time after the effective date.

Any existing agreements renegotiated before the effective date will not have to comply with the requirements under this Prudential Standard. However, when such agreements come up for review on, or after, the effective date, they must be reviewed in accordance with the requirements under this Prudential Standard.

#### Application for a Later Date to Comply with Particular Requirements

APRA has the ability to determine a later date to comply with particular requirements of this Prudential Standard (referred to in this Prudential Standard as the “**compliance date**”), provided that APRA shall not determine a compliance date later than 31 December 2007. APRA cannot exercise this discretion where the failure of the life company to be able to comply by the effective date is due to the inaction of the Board or management in making adequate preparations to comply with this Prudential Standard.

In relation to an application for a compliance date later than the effective date, the criteria that APRA will consider in assessing the application are:

- (a) the life company has submitted the application to APRA 20 business days before the effective date;
- (b) the life company can demonstrate that since the determination date of this Prudential Standard, it has been taking reasonable actions to ensure that it will be in a position to comply with this Prudential Standard by the effective date; and
- (c) the life company can demonstrate that since the determination date of this Prudential Standard, one of the following issues has given rise to the inability of the life company to comply with this Prudential Standard by the effective date:

- (i) an event has occurred, that is outside the life company's control, that has led to it being in a position where it cannot comply with this Prudential Standard (e.g. loss of a key person); or
- (ii) the life company has not been able to retain human resources of sufficient skill and experience after a genuine market search within a period that would enable the life company to put in place the necessary policies, systems and procedures to ensure compliance with this Prudential Standard by the effective date.