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POV on Draft Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by NBFCs

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Draft Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by NBFCs

Background & Objective

In order to get access to specialist expertise and to reduce operational costs, Non-Banking Financial Companies (NBFCs) extensively outsource some of their operations. These outsourced activities were hitherto not regulated and hence, exposed the NBFCs as well as their customers to considerable risks, such as strategic risk, reputation risk, compliance risk, operational risk, legal risk etc. Hence, a need was felt to put in place appropriate safeguards for addressing these risks as well as to comply with the recommendations of the Financial Sector Legislative Reforms Commission (FSLRC). The draft guidelines have been issued with a view to lay down a framework for outsourcing for NBFCs. These draft guidelines are applicable to all NBFCs including Core Investment Companies and Primary Dealers.

Extract of the regulation

1. Introduction

- The guidelines are applicable to outsourcing arrangements entered into by an NBFC with a service provider located in India or elsewhere. The service provider may either be a member of the group / conglomerate to which the NBFC belongs, or an unrelated party.
- NBFCs have to take steps to ensure that the service provider employs the same high standard of care in performing the services as is expected to be employed by the NBFCs, if the activities were conducted within the NBFCs and not outsourced. Accordingly NBFCs should not engage in outsourcing that would result in their internal control, business conduct or reputation being compromised or weakened.
- NBFCs which desire to outsource financial services would not require prior approval from RBI. However, arrangements would be subject to on-site / off- site monitoring and inspection / scrutiny by RBI.
- In regard to outsourced services relating to credit cards, RBI's detailed instructions contained in its circular on credit card activities vide DBOD.FSD.BC.49/24.01.011/2005-06 dated November 21, 2005 would be applicable.

2. Activities that should not be Outsourced

NBFCs should not outsource core management functions including Internal Audit, Compliance function and decision-making functions like determining compliance with KYC norms for opening deposit accounts, according sanction for loans and management of investment portfolio. Moreover, service providers should not be located outside India.

3. NBFC's role and Regulatory and Supervisory Requirements

- The outsourcing of any activity by NBFC does not diminish its obligations, and those of its Board and senior management, who have the ultimate responsibility for the outsourced activity. NBFCs would therefore be responsible for the actions of their service provider including Direct Sales Agents / Direct Marketing Agents and recovery agents and the confidentiality of information pertaining to the customers that is available with the service provider. NBFCs should retain ultimate control of the outsourced activity.

- It is imperative for the NBFC, when performing its due diligence in relation to outsourcing, to consider all relevant laws, regulations, guidelines and conditions of approval, licensing or registration.
- Outsourcing arrangements should not affect the rights of a customer against the NBFC, including the ability of the customer to obtain redress as applicable under relevant laws. Since the customers are required to deal with the service providers in the process of dealing with the NBFC, NBFCs should incorporate a clause in the product literature / brochures etc., stating that they may use the services of agents in sales / marketing etc. of the products. The role of agents may be indicated in broad terms.
- The service provider should not impede or interfere with the ability of the NBFC to effectively oversee and manage its activities nor should it impede the Reserve Bank of India in carrying out its supervisory functions and objectives.
- NBFCs need to have a robust grievance redress mechanism, which in no way should be compromised on account of outsourcing.
- The service provider, if it is not a subsidiary of the NBFC, should not be owned or controlled by any director or officer / employee of the NBFC or their relatives having the same meaning as assigned under Section 2(77) and draft rules notified on 09.09.2013 with reference to Section 2(77) (iii)) under Companies Act, 2013.

4. Risk Management practices for Outsourced Financial Services

- **Outsourcing Policy:** An NBFC intending to outsource any of its financial activities should put in place a comprehensive outsourcing policy, approved by its Board, which incorporates, inter alia, criteria for selection of such activities as well as service providers, delegation of authority depending on risks and materiality and systems to monitor and review the operations of these activities.
- **Role of the Board and Senior Management:** The Board of the NBFC, or a Committee of the Board to which powers have been delegated should be responsible *inter alia* for the following:

i. Approving a framework to evaluate the risks and materiality of all existing and prospective outsourcing and the policies that apply to such arrangements;

ii. Laying down appropriate approval authorities for outsourcing depending on risks and materiality.

iii. Undertaking regular review of outsourcing strategies and arrangements for their continued relevance, and safety and soundness and

iv. Deciding on business activities of a material nature to be outsourced, and approving such arrangements.

- **Responsibilities of the Senior Management**

i. Evaluating the risks and materiality of all existing and prospective outsourcing, based on the framework approved by the Board;

ii. Developing and implementing sound and prudent outsourcing policies and procedures commensurate with the nature, scope and complexity of the outsourcing activity;

iii. Reviewing periodically the effectiveness of policies and procedures;

iv. Communicating information pertaining to material outsourcing risks to the Board in a timely manner;

v. Ensuring that contingency plans, based on realistic and probable disruptive scenarios, are in place and tested;

vi. Ensuring that there is independent review and audit for compliance with set policies.

vii. Undertaking periodic review of outsourcing arrangements to identify new material outsourcing risks as they arise.

- **Evaluation of the Risks**

The NBFCs should evaluate and guard against the strategic risk, reputation risk, compliance risk, operational risk, legal risk, exit strategy risk, counter party risk, contractual risk, concentration and systemic risk in outsourcing.

- **Evaluating the Capability of the Service Provider**

i. In considering or renewing an outsourcing arrangement, appropriate due diligence should be performed to assess the capability of the service provider to comply with obligations in the outsourcing agreement. Due diligence should take into consideration qualitative and quantitative, financial, operational and reputational factors. NBFCs should consider whether the service providers' systems are compatible with their own and also whether their standards of performance including in the area of customer service are acceptable to it.

ii. Due diligence should involve an evaluation of all available information about the service provider, including but not limited to the following:

a. Past experience and competence to implement and support the proposed activity over the contracted period;

b. Financial soundness and ability to service commitments even under adverse conditions;

c. Business reputation and culture, compliance, complaints and outstanding or potential litigation;

d. Security and internal control, audit coverage, reporting and monitoring environment, business continuity management;

e. Ensuring due diligence by service provider of its employees.

- **The Outsourcing Agreement**

The terms and conditions governing the contract between the NBFC and the service provider should be carefully defined in written agreements and vetted by NBFC's legal counsel on their legal effect and enforceability. Every such agreement should address the risks and risk mitigation strategies. The agreement should be sufficiently flexible to allow the NBFC to retain an appropriate level of control over the outsourcing and the right to intervene with appropriate measures to meet legal and regulatory obligations. The agreement should also bring out the nature of legal relationship between the parties - i.e. whether agent, principal or otherwise. Some of the key provisions of the contract should be the following:

i. The contract should clearly define what activities are going to be outsourced including appropriate service and performance standards;

ii. The NBFC must ensure it has the ability to access all books, records and information relevant to the outsourced activity available with the service provider;

iii. The contract should provide for continuous monitoring and assessment by the NBFC of the service provider so that any necessary corrective measure can be taken immediately;

iv. A termination clause and minimum period to execute a termination provision, if deemed necessary, should be included;

v. Controls to ensure customer data confidentiality and service providers' liability in case of breach of security and leakage of confidential customer related information should be incorporated;

vi. There must be contingency plans to ensure business continuity;

vii. The contract should provide for the prior approval / consent by the NBFC of the use of subcontractors by the service provider for all or part of an outsourced activity;

viii. It should provide the NBFC with the right to conduct audits on the service provider whether by its internal or external auditors, or by agents appointed to act on its behalf and to obtain copies of any audit or review reports and findings made on the service provider in conjunction with the services performed for the NBFC;

ix. Outsourcing agreements should include clauses to allow the Reserve Bank of India or persons authorised by it to access the NBFC's documents, records of transactions, and other necessary information given to, stored or processed by the service provider within a reasonable time.

x. Outsourcing agreement should also include a clause to recognise the right of the Reserve Bank to cause an inspection to be made of a service provider of an NBFC and its books and account by one or more of its officers or employees or other persons.

xi. The outsourcing agreement should also provide that confidentiality of customer's information should be maintained even after the contract expires or gets terminated.

xii. The outsourcing agreement should provide for the preservation of documents and data by the service provider in accordance with the legal / regulatory obligation of the NBFC in this regard.

– **Confidentiality and Security**

i. Access to customer information by staff of the service provider should be on 'need to know' basis i.e., limited to those areas where the information is required in order to perform the outsourced function.

ii. The NBFC should ensure that the service provider is able to isolate and clearly identify the NBFC's customer information, documents, records and assets to protect the confidentiality of the information. In instances, where service provider acts as an outsourcing agent for multiple NBFCs, care should be taken to build strong safeguards so that there is no comingling of information / documents, records and assets.

iii. The NBFC should review and monitor the security practices and control processes of the service provider on a regular basis and require the service provider to disclose security breaches.

iv. The NBFC should immediately notify RBI in the event of any breach of security and leakage of confidential customer related information. In these eventualities, the NBFC would be liable to its customers for any damages.

– **Responsibilities of DSA / DMA / Recovery Agents**

i. NBFCs should ensure that the Direct Sales Agents / Direct Marketing Agents / Recovery Agents are properly trained to handle with care and sensitivity, their responsibilities particularly aspects like soliciting customers, hours of calling, privacy of customer information and conveying the correct terms and conditions of the products on offer etc.

ii. NBFCs should put in place a board approved Code of conduct for Direct Sales Agents / Direct Marketing Agents / Recovery Agents In addition, Recovery Agents should adhere to extant instructions on Fair Practices Code for NBFCs as also their own code for collection of dues and repossession of security. It is essential that the Recovery Agents refrain from action that could damage the integrity and reputation of the NBFC and that they observe strict customer confidentiality.

iii. The NBFC and their agents should not resort to intimidation or harassment of any kind either verbal or physical against any person in their debt collection efforts, including acts intended to humiliate publicly or intrude the privacy of the debtors' family members, referees and friends, making threatening and anonymous calls or making false and misleading representations.

– **Business Continuity and Management of Disaster Recovery Plan**

i. An NBFC should require its service providers to develop and establish a robust framework for documenting, maintaining and testing business continuity and recovery procedures. NBFCs need to ensure that the service provider periodically tests the Business Continuity and Recovery Plan and may also consider occasional joint testing and recovery exercises with its service provider.

ii. In order to mitigate the risk of unexpected termination of the outsourcing agreement or liquidation of the service provider, NBFCs should retain an appropriate level of control over their outsourcing and the right to intervene with appropriate measures to continue its business operations in such cases without incurring prohibitive expenses and without any break in the operations of the NBFC and its services to the customers.

iii. In establishing a viable contingency plan, NBFCs should consider the availability of alternative service providers or the possibility of bringing the outsourced activity back in-house in an emergency and the costs, time and resources that would be involved.

iv. Outsourcing often leads to the sharing of facilities operated by the service provider. The NBFC should ensure that service providers are able to isolate the NBFC's information, documents and records, and other assets.

- **Monitoring and Control of Outsourced Activities**

i. The NBFC should have in place a management structure to monitor and control its outsourcing activities. It should ensure that outsourcing agreements with the service provider contain provisions to address their monitoring and control of outsourced activities.

ii. A central record of all material outsourcing that is readily accessible for review by the Board and senior management of the NBFC should be maintained. The records should be updated promptly and half yearly reviews should be placed before the Board.

iii. Regular audits by either the internal auditors or external auditors of the NBFC should assess the adequacy of the risk management practices adopted in overseeing and managing the outsourcing arrangement, the NBFC's compliance with its risk management framework and the requirements of these guidelines.

iv. NBFCs should at least on an annual basis, review the financial and operational condition of the service provider to assess its ability to continue to meet its outsourcing obligations. Such due diligence reviews, which can be based on all available information about the service provider should highlight any deterioration or breach in performance standards, confidentiality and security, and in business continuity preparedness.

v. In the event of termination of the agreement for any reason, this should be publicized so as to ensure that the customers do not continue to entertain the service provider.

- **Redress of Grievances related to Outsourced Services**

i. NBFCs should constitute Grievance Redressal Machinery as contained in RBI's circular on Grievance Redressal Mechanism vide DNBS. CC. PD. No. 320/03. 10. 01/2012-13 dated February 18, 2013 and give wide publicity about it through electronic and print media. The name and contact number of designated grievance redressal officer of the NBFC should be made known and widely publicised. It should be clearly indicated that NBFCs' Grievance Redressal Machinery will also deal with the issue relating to services provided by the outsourced agency.

ii. Generally, a time limit of 30 days may be given to the customers for preferring their complaints / grievances. The grievance redressal procedure of the NBFC and the time frame fixed for responding to the complaints should be placed on the NBFC's website.

- **Reporting of transactions to FIU or other competent authorities**

NBFCs would be responsible for making Currency Transactions Reports and Suspicious Transactions Reports to FIU or any other competent authority in respect of the NBFCs' customer related activities carried out by the service providers.

5. Outsourcing within a Group / Conglomerate

The risk management practices expected to be adopted by an NBFC while outsourcing to a related party (i.e. party within the Group / Conglomerate) would be identical to those specified in Para 4 of this guidelines.

6. Self-Assessment of Existing / Proposed Outsourcing Arrangements

NBFCs may conduct a self-assessment of their existing outsourcing agreements within a time bound plan and bring them in line with the above guidelines expeditiously.

Impact Assessment

RBI has proposed tough norms regarding outsourcing of work by NBFCs so as to ensure protection of customer interests and information and to discourage all forms of intimidation or harassment by their recovery agents. The major implications of these draft guidelines for NBFCs are given below:

- NBFCs should not outsource core management and decision-making functions. This would ensure that the NBFC retains adequate control over its business and only those activities which require specialist expertise and are not feasible to be performed internally are outsourced.
- The service provider should be located in India
- NBFCs should have an outsourcing policy in place. The policy should be approved by its Board and should include criteria for selection of activities (to be outsourced) as well as service providers, delegation of authority (depending on risks and materiality) and systems to monitor and review the operations of these activities.
- A clause should be included in the NBFC's product literature / brochures etc., stating that they may use the services of agents in sales / marketing etc. of the products along with their role in broad terms.
- The Board, or a committee setup by the Board of the NBFC should approve the framework to evaluate the risks and materiality of all existing and prospective outsourcing, lay down the approving authority for outsourcing, conduct regular review of outsourcing strategies and arrangements and take decisions whether an activity should/ should not be outsourced.
- The Senior Management of the NBFC should evaluate the risks and materiality of all existing and prospective outsourcing, develop as well as periodically review the outsourcing policies and procedures, communicate material outsourcing risks to the Board, ensure that periodic reviews and audits take place, undertake periodic review of outsourcing arrangements and ensure that contingency plans are regularly tested.
- While considering or renewing an outsourcing arrangement, NBFCs should conduct appropriate due diligence, taking into account qualitative and quantitative, financial, operational and reputational factors. Also, NBFCs should, at least on an annual basis, conduct due diligence review of the financial and operational condition of the service provider.
- NBFCs should ensure that their permission is taken for the use of subcontractors by the service provider for all or part of an outsourced activity.
- NBFCs should ensure that the outsourcing agreement is in place and covers all the key provisions enlisted in the guidelines. Outsourcing agreement would contain terms and conditions governing the contract between the NBFC and the service provider and would be admissible in the court of law, in the event of disputes.
- NBFCs should ensure that security and confidentiality of customer information is maintained, even if the same is in possession of the service provider. The NBFC should regularly review and monitor the security practices and control processes of the service provider and require them to disclose all instances of security breaches.
- In the event of any breach of security or leakage of customer related confidential information, the NBFC should immediately notify the RBI.
- NBFCs should provide adequate training to Direct Sales Agents / Direct Marketing Agents / Recovery Agents on dealing with customer and ensure that their recovery agents do not resort to intimidation or harassment of borrowers. They should also put in place a board approved Code of conduct for Direct Sales Agents / Direct Marketing Agents / Recovery Agents. Additionally, the Recovery Agents should adhere to

instructions on Fair Practices Code for NBFCs as well as their own code for collection of dues and repossession of security

- NBFCs should ensure that the service provider‘s Business Continuity and Recovery Plans are adequate and that the same are periodically tested.
- NBFCs should consider whether alternative service providers are available so that their services may be used during contingencies. The possibility of bringing the outsourced activity back in-house in an emergency and the costs, time and resources that would be involved should also be considered.
- In case outsourcing leads to sharing of facilities by the service provider, the NBFC should ensure that the service provider is able to isolate the NBFC’s information, documents, records and other assets from those of other entities.
- NBFCs should maintain a central record of all material outsourcing, which should be readily accessible for review by the Board and senior management, updated regularly. Half yearly reviews of these records should be placed before the Board.
- The adequacy of the risk management practices adopted by NBFCs in overseeing and managing the outsourcing arrangement as well as compliance with these guidelines should also be covered as part of audits, either by internal auditors or by external auditors.
- If the outsourcing agreement is terminated for any reason, the same should be publicized so as to ensure that customers do not continue to entertain the service provider.
- NBFCs should constitute Grievance Redressal Machinery as contained in RBI’s circular on Grievance Redressal Mechanism and publicise it widely through electronic and print media. It should be clearly indicated that NBFCs' Grievance Redressal Machinery will also deal with the issue relating to services provided by the outsourced agency.
- The name and contact number of designated grievance redressal officer of the NBFC should be made known and widely publicised. The designated officer should redress genuine customer complaints promptly.
- A time limit of 30 days should be given to the customers for preferring their complaints / grievances. The grievance redressal procedure of the NBFC and the time frame fixed for responding to the complaints should be placed on the NBFC's website.
- Currency Transactions Reports and Suspicious Transactions Reports should be submitted to FIU or any other competent authority in respect of the NBFCs' customer related activities carried out by the service providers. This would help in curbing money laundering.
- NBFCs should conduct a self-assessment of their existing outsourcing agreements within a time bound plan so as to assess their compliance with these guidelines and bring them in compliance with these guidelines.

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