



OUTSOURCING WORKING GROUP (OWG)

An industry response to the FSA's
Dear CEO Letter on Outsourcing

9 December 2013
(Addendum added in November 2016)






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01

EXECUTIVE SUMMARY

Background

In December 2012, the Financial Services Authority (FSA) issued a 'Dear CEO Letter'¹ to asset managers following a Thematic Review of outsourcing arrangements within UK asset managers in early 2012. During the first quarter of 2013 industry participants convened to address the issues raised in the letter, which ultimately led to the formation of the Outsourcing Working Group.

The FSA Review concluded that many asset managers were not fully in compliance with existing regulations governing outsourced services, and the Dear CEO letter highlighted their concerns in relation to the risks associated with outsourced functions.

The FSA made it clear they would like to see the industry formulate solutions to address their concerns in two main areas:

- **Oversight:** Firms should exercise due skill, care and diligence when entering into, managing or terminating an outsource arrangement;
- **Resilience:** Firms should have adequate resilience plans in place to enable them to carry out regulated activities if a service provider were to fail.

It is in the interest of all participants to resolve this issue to the satisfaction of the Financial Conduct Authority (FCA) – the successor organisation to the FSA – and, in doing so, help to reinforce the leading role of the UK financial services sector.

Approach

In response to the Dear CEO Letter, an industry-wide group was formed in July 2013 called the Outsourcing Working Group (OWG). The OWG set out to consider the issues raised by the regulator and identify some practical measures that asset management firms and self-managed asset owners could consider in relation to their outsourced arrangements.

The OWG was formed specifically to address the issues raised by the FSA (hereafter referred to as the FCA) from the perspective of both the asset management industry and the service providers to which asset managers outsource activities. The OWG has worked to develop principles to guide the industry towards practical solutions that are viable, robust and realistic, in order to address the issues raised by the FCA.

The OWG comprises asset managers, key service providers and the Investment Management Association (IMA). The OWG work streams and Steering Committee have been facilitated by the 'Big Four' consultants: Deloitte, EY, KPMG and PwC. In rallying around this collaborative effort, the OWG members recognise there is little, if any, competitive advantage to be gained by service providers, asset management firms or self-managed asset owners tackling the issues individually. This spirit of collaboration has been a hallmark of the OWG's approach.

Key findings

Within this report, the OWG presents its conclusions in terms of the 'Guiding Principles' and 'Considerations' that firms should take into account depending on the nature, size and scope of their outsourced arrangements. As there are many types of outsourced

relationships, we have specifically refrained from producing a checklist, as we recognise each firm has a bespoke operating model.

We therefore expect firms will apply these findings in a way that is proportionate and most appropriate for their business.

Our findings are presented under the following headings, which reflect the output of each work stream:

- **Oversight:** We propose some key principles for firms to consider applying to their oversight framework, including suggested modifications over the life cycle of an outsourced relationship.
- **Exit planning:** We have identified seven guiding principles for effective Exit Planning and highlight some of the key additional factors to consider when developing an Exit Plan.
- **Standardisation:** We discuss the challenges and opportunities associated with achieving greater standardisation and suggest some possible areas of focus, with examples.

While we have separated these topics for practical purposes, they are closely interrelated and our intention is that our findings be considered as a whole.

Next steps

We suggest that firms review their outsourced arrangements in the light of the Guiding Principles and Considerations highlighted in this report and consider what is appropriate for their specific business model. We encourage firms to document their rationale and procedures in order to help demonstrate compliance with the regulations.

We are pleased to see reference to the OWG guiding principles within the FCA's Thematic Project Findings Report (TR13/10)². It is likely that the FCA will be interested to revisit firms to assess progress made since their last thematic visit on this topic.

The OWG plan to hold an industry briefing to present our findings at some point in early 2014, and we expect that the IMA may wish to include the OWG findings as part of their on-going education and training schedule.



02

BACKGROUND

Background

During the past decade, asset management firms have made increasing use of outsourcing to the extent that it is now a standard part of the operating model for many firms. The UK has been a leading marketplace for the development of outsourced operations by global service providers, which are often part of large banking groups. After a number of early lift-outs, most service providers now operate functionalised global operating models, often using offshore service centres.

The global financial crisis of 2007-2008 highlighted the risks posed by many financial institutions perceived as ‘too big to fail’. Subsequently, the consensus is that such institutions should be allowed to fail in a controlled manner in order to protect financial stability and public funds.

Several regulators, including the FCA, have since reaffirmed existing regulations governing outsourcing. Asset management firms have been reminded that while they may outsource a function, they may not outsource their responsibility for that function. In particular, firms should not rely on a service provider being too big to fail.

The FCA is primarily concerned that consumers may suffer detriment if an outsource provider were to face financial distress or severe operational disruption. Since firms cannot rely on their service provider being too big to fail, the focus is on contingency plans that firms should have in place to deal with such a scenario.

Following its Thematic Review in 2012, the FCA identified three main contingency plans used by firms:

- Taking outsourced activities back in-house;
- Transferring outsourced activities to another provider;
- Exercising 'step-in' rights.

In its Dear CEO Letter, the FCA highlighted its concerns with relying on these approaches, which has resulted in the current requirement that firms should focus on the oversight of outsourced operations and review their resilience plans to deal with a service provider failure. The FCA has however, acknowledged there is no single solution to this challenge, and expects that firms will need to consider a number of scenarios.

Industry response

The past year has seen unprecedented cross-industry collaboration in the UK to respond to the Dear CEO Letter on outsourcing and it is worth reflecting briefly on this sequence of events.

During the first half of 2013, a number of industry events were convened to discuss the issues raised by the letter. These events were typically hosted by consultants, lawyers or industry bodies. Many were focused on either asset managers or service providers and generated a wide range of theoretical, albeit untested, solutions.

The foremost initiative in the asset management industry was the IMA Outsourcer Working Group, which was set up to analyse the issues raised in the Dear CEO Letter and the implications for asset managers. This was followed by the publication of an IMA White Paper³ on 28 May 2013, which contained a series of 11 ideas for consideration by firms.

In April 2013, the Outsource Service Provider Group (OSPG) was established to represent the service provider industry and formulate a consolidated industry response to the areas of focus for the FCA. The group had senior representatives from each of the main outsourcing service providers. It developed recommendations in three key areas that were presented to the FCA on 15 May 2013 namely; oversight, exit planning and standardisation.

Formation of OWG

Towards the end of May 2013, representatives of the OSPG met with the IMA and FCA to discuss the current status and a possible way forward. The objective was to deliver a consolidated and comprehensive industry-wide response by the end of 2013, within a year of the original Dear CEO Letter.

The agreed approach was for a representative number of 15 individuals from asset managers to join the existing seven service providers to form a new and larger combined group. As the service providers each had two representatives on the OSPG, the new OWG would have a membership of approximately 30 individuals (see Appendix 4).

We felt it was important that the IMA should be a member of each of the OWG work streams (see below), in order to represent the views of the many asset managers who were not direct participants. Finally, the OWG requested assistance from the Big Four consultancy firms to provide administrative support and governance for the group. The full OWG membership met for the first time on 3 July 2013 to kick off the initiative. A Steering Committee was established and composition of the three working groups was agreed.



OWG approach

The OWG had three distinct work streams to focus on each of the key topics:

- Oversight;
- Exit planning;
- Standardisation.

Co-chairs for each work stream were nominated from service providers and asset managers, with one of the Big Four assigned to each work stream, mainly to facilitate, but also to provide independent challenge to the group. An OWG Steering Committee was formed, facilitated by one of the Big Four and comprising two asset managers, two service providers and the IMA to ensure overall governance of the work streams and project.

Each work stream was tasked with considering their topic, defining Terms of Reference and working concurrently towards agreed objectives, before coming together to consolidate findings towards the end of 2013.

On 8 July 2013, the FCA was informed of the formation of the OWG and the success of the initial meeting. The FCA confirmed the three work streams were focused on the correct topics in order to collectively address critical areas in the timeframe outlined.

From the outset, the OWG has made available minutes of the work stream meetings on the member area of the IMA website. An update on the work-to-date of the OWG was presented to a wider industry group of asset managers and service providers on 30 September 2013. These initial recommendations were also shared with the FCA, and the OWG Steering Committee reviewed these with the FCA on 16 October 2013.

The OWG Steering Committee met the FCA again on the 21 November 2013 to present and discuss the final materials in detail, prior to publication of this document.

Scope and definitions

A number of guidelines exist on outsourcing and the Dear CEO Letter from the FCA fits within a wider context, ultimately driven by the definition of 'outsourcing' within the Markets in Financial Instruments Directive (MiFID), as well as the European Banking Authority's Guidelines on Outsourcing, published in 2006⁴.

This is therefore a European issue, as evidenced by guidance issued by regulators in Germany⁵, France⁶ and Luxembourg⁷. In addition, readers should note that the Central Bank of Ireland issued a 'Dear CEO Letter' highlighting specific outsourcing guidelines and requirements in May 2013.

Initially, many in the industry assumed that the Dear CEO Letter referred only to middle office services (i.e., investment operations). However, the FCA subsequently clarified that fund administration and transfer agency functions were also to be considered within the scope of our review. We welcome the FCA looking at this, although some of these services may not necessarily fall within the definition of outsourcing;

'Outsourcing means an arrangement of any form between an investment firm and a service provider by which that service provider performs a process, a service or an activity which would otherwise be undertaken by the investment firm itself.'

MiFID Implementing Directive 2006/73/EC, Chapter 1, Article 2(6)⁸

This definition of outsourcing captures a range of agreements that cover the outsourcing of either regulated activities or functions which are 'critical and important' to regulated activities.

Specific rules on outsourcing are set out in Chapter 8 of the Senior Management Arrangements, Systems and Controls sourcebook (SYSC 8)⁹. These mandatory rules implement within the UK the outsourcing requirements of MiFID and apply to common platform firms.

Please note that custody was excluded from the scope of outsourced services considered by this initiative.

The wider context

To enable the OWG to focus on areas where its efforts can have the most impact, we excluded from our analysis the alignment of cross-border regulation and issues that form part of the wider banking reform agenda. Both of these topics were discussed with the FCA, who agreed that such matters are being addressed elsewhere and warrant further consideration by the FCA and the Prudential Regulation Authority (PRA), in due course.

Asset managers should therefore keep abreast of developments in this area and the impact they may have on their outsource service provider.

03

KEY FINDINGS FROM OWG WORK STREAMS

3.1 Oversight

Key Principles of an Oversight Model

Asset managers should understand that there is no prescriptive approach to oversight. To establish an effective oversight model for outsourced functions, firms should apply the following key principles in line with the scale, scope, complexity and nature of their business model. A firm's consideration of these principles should be supported by appropriate documentary evidence.

One of the assumptions of the Oversight work stream is that asset managers should have robust oversight procedures in place, but that these should not require the asset manager to replicate functions they have outsourced. Replication of outsourced functions (e.g., maintaining dual records) would negate the efficiencies gained by outsourcing in the first place.

Key Oversight principles:

Oversight Principle 1: Know Your Outsourcing (KYO): Firms should understand the scope, nature, locations and contractual terms surrounding the services being outsourced when designing their oversight model, i.e., 'Know Your Outsourcing' or KYO.

The effective management and oversight of any outsourced relationship depends on firms having a comprehensive understanding of the scope and nature of the services being outsourced. This should include a full understanding of the following:

- Exact functions and processes that are outsourced;
- Assessment of service criticality – as identified by BAU (Business As Usual) oversight/governance;
- Operating model of the service provider and the extent of any material delegation by them (including the use of sub-contracted parties);
- Degree of customisation, complexity and any associated Intellectual Property considerations;
- Critical data inputs and outputs of the services involved;
- Details of the contracting party and its regulatory status;
- Geographic location(s) from which the service is provided or where data is held;
- Key technology used.

Oversight Principle 2: Risk-based assessment: Firms should perform a risk-based assessment of outsourced arrangements, including understanding the impact of those activities on the end client and the firm itself.

Considerations could include:

- Characteristics of asset manager and service(s) provided, including an assessment of service criticality and complexity, and the firm's capabilities;

- Service provider characteristics: an assessment of the provider itself, including; capabilities, control framework, maturity of service provision, financial position, industry credentials and reputation;
- Impact on the end client, (i.e. investors): consideration of the potential consequence of service failure/ disruption on the end client, and the mitigants and controls that are in place;
- Contractual characteristics: an assessment of relevant contractual provisions, including: commercial terms, service, governance, termination provisions, notice periods, exit planning, business continuity, risk and control transparency;
- Periodic review: the risk-based assessment should be reviewed on a periodic basis and in response to significant events.

Oversight Principle 3: Ownership: The asset manager should establish an appropriate level of ownership at a senior level for the outsourced activities, reflecting the size, nature and scale of the firm and the activities outsourced.

Considerations could include the following:

- Clear ownership of the outsourcing relationship at both a commercial and operational level;
- Accountability being retained for mitigating operational risks;
- Retention of appropriate in-house knowledge and expertise of outsourced functions;
- Understanding of relevant regulatory requirements;
- Ownership includes responsibility for the oversight model.

Oversight Principle 4: Governance Framework: Firms should establish an appropriate framework of oversight considering the following areas:

- Governance – both internal and external;
- People and organisation;
- Operational Oversight;
- Change management.

Please see Appendix 1 for additional detail on Oversight principles and how these change during the lifecycle of the outsourced relationship.

3.2 Exit Planning

An exit plan describes the process for transitioning business from one service provider to another. While the Asset Manager owns the Exit Plan and is responsible for it, their incumbent service provider will clearly have a high degree of input to describe in the Exit Plan what it would provide to an incoming service provider.

The exit plan therefore presents the out-going side of the transition and cannot be executed until an incoming provider has been appointed, who contractually agrees to take on the business and the operational transfer proposed.

In normal circumstances, when an asset manager invokes the right to move Service Providers, it triggers a sequence of events to engage a project management team to develop a detailed Exit Plan in accordance with the asset manager's requirements. This process is usually governed by the Change Control process for the relationship. The transition process is typically run by the incoming service provider and the asset manager.

There are clearly significant dependencies between all three parties involved and service providers routinely work closely together to transition business in a safe and efficient way. Indeed, we note that there are current examples of significant operational transitions between service providers. The overriding priority for all parties involved in executing a transition is to ensure continuity of service and no impact to end investors.

One of the key conclusions of this work stream is that there is only one type of exit plan, regardless of whether it is executed under normal circumstances or in a distress scenario. The logic for this is that the same transition activities must still be carried out, regardless of any other considerations. However, there may be decisions made by the authorities in a distress scenario that modify the transition plan in some way (e.g. changing daily valued funds to a monthly valuation).

As an illustration, an exit plan for a large asset manager with outsourced operations may typically take approximately 12-24 months' elapsed time. A less rigorous approach to the transition would not be consistent with maintaining market stability or confidence in the market. Indeed, it would be more likely to cause detriment to end investors.

It is important to highlight that we have not attempted to address the scenario where an exit plan is used to migrate from one service provider to another over a weekend, or similar period (i.e. in the case of the failure of an outsource provider). There are considerable operational challenges inherent in a transfer and the probability is that this could not be implemented swiftly enough to protect customers if an outsource provider were to fail. We understand that this type of scenario remains a core concern of the FCA. However, we believe the Guiding Principles and considerations in this report will help to put firms in a better position.

Readers may conclude that where the service provider is a regulated entity, increased regulatory involvement may result in greater confidence for clients. We note below the importance of firms being familiar with the details of their contracting party, and with the publically available component of the Resolution Plan published by the service provider, where available.

Seven Guiding Principles

Seven guiding principles for exit planning have been developed and we list these below (in no priority) in order to provide guidance for asset managers and service providers as they apply these to specific service relationships.

Exit Planning Principle 1: Comprehensive exit plan
Asset managers should have an exit plan that includes all relevant outsourced functions, as required by SYSC 8. Exit plans for each outsourced function should form part of a firm's resilience arrangements and be developed and maintained in consultation with the service provider(s).

Exit Planning Principle 2: Governance framework
The existence and content of exit plans should be overseen by the firm's wider governance framework.

Exit Planning Principle 3: Periodic review
Plans should be reviewed at least annually and additionally on any material changes to the outsourcing profile of the firm. Reviews should be performed in conjunction with the service provider.

Exit Planning Principle 4: Single approach

Exit plans should cover the arrangements in place for a controlled BAU exit from an outsource relationship, but may also include considerations associated with exit in the event of a provider's severe operational distress, especially any potential impact to the end investor.

Exit Planning Principle 5: Key documentation

Exit plans should record the detail of relevant outsourcing arrangements, or refer to other documents that do (e.g. Service Level Agreements). This detail should include at minimum:

- Which function(s) are outsourced;
- The contracted entity;
- Where the work is performed.

Exit Planning Principle 6: End-to-end transition

Exit plans should consider end-to-end transition from old to new provider.

Exit Planning Principle 7: Transition governance

Exit plans should identify a governance framework to oversee a transition, and a migration plan by which a transition would be effected.

Key Considerations for Exit Planning

In addition to the seven principles above, we also highlight a number of key considerations for effective exit planning:

- Detailed awareness of what is outsourced and to whom – Know Your Outsourcing (KYO);
- Creation of transition plans for both off-boarding and on-boarding;
- Governance and maintenance of the exit plan.

Know Your Outsourcing (KYO)

Key areas to consider include the following:

- Functions that are outsourced;
- Assessment of service criticality – as identified by BAU oversight/governance;
- Degree of customisation and complexity, and any associated Intellectual Property retained by the asset manager;
- Critical data inputs and outputs of the services involved;
- Details of the contracting party and their regulatory status – with particular regard to familiarising themselves with the publically available component of the Resolution Plans published by the service provider, where available;
- Geographic location from which the service is provided;
- Key technology utilised;
- Internal staff or readily available resources with expertise in the area;
- Signposting of key documents – including, but not limited to, the contract, SLAs, change order(s);
- Standard management information (MI) reporting and relevant governance documents;
- Identifying any relevant triggers in place to instigate the possible termination of service provision;
- An understanding on how the contract would operate in a termination event;
- Awareness of other service providers' capability to provide the service.



Exit Planning Governance Considerations

Key areas to consider include the following:

- Clarity of ownership and accountability for exit plans – likely to rest with senior management of the asset manager;
- Review, challenge and approval of exit plans by senior management – including at least an annual review and additionally at the point of any material changes to outsourcing arrangements;
- Periodic walk-through of off-boarding arrangements with relevant providers;
- Consideration of quantity and expertise of available resources associated with possible future transitions;
- Review of exit plans by assurance functions (internal audit, compliance and operational risk).

Exit Planning Transition Arrangements

Key areas to consider include the maintenance of a skeleton transition project plan, including:

- Accountabilities for effecting the transition;
- High-level options and associated risks;
- Resource requirements within the relevant parties;
- Consideration of continuity of business and regulatory requirements through a transition (e.g., new products, fund launches, legacy business and M&A);
- Consider including in the Exit Plan a high-level timeline which could set out how the firm will undertake key activities, including, for example:
 - Analysis and articulation of the service requirements;
 - RFP and due diligence;
 - IT and data analysis/transition;
 - Management of key resourcing issues – including staff transfer and future training requirements;
 - Management of the pre go-live phase, including testing and rehearsal regimes.

Please see Appendix 2 for a sample Exit Plan, with headings which firms may wish to consider including.

3.3 Standardisation

Historically, the financial services industry has a strong track record of embracing standardisation for reasons of efficiency, cost reduction and risk reduction. These efforts have resulted in high STP rates which allow major transfers of custody assets in relatively short timeframes. However, this was the result of many years of investment, global collaboration and industry-wide focus on standardisation.

Transitions for material outsourcing arrangements tend to be time-consuming and complex because of the degree of customisation, which varies from one asset manager to another. Adopting standard terminology and documentation, data interfaces and testing processes will assist asset managers and service providers to manage more effectively the transition of outsourced services. Having these agreed in advance should also help to reduce the time taken when transitioning to a new service provider.

However, there are several reasons why the situation with outsourced investment operations is not comparable to the previous work on custody. For example, investment operations is still a relatively immature product, with variations in scope of services and service levels. Additionally, it is a people-intensive function, as demonstrated by the numbers of staff taken on by service providers with early 'lift-out' deals. This means an incoming service provider needs to be able to make enough skilled staff available to take on new business.

It is broadly accepted that improved standardisation would be beneficial to the industry and should provide incremental improvements in transition times. However, this would still not enable a transition between providers to occur over a weekend or similar timeframe.

Accordingly, we believe there is a need for the industry to clearly identify objectives and perform a cost/benefit analysis before initiating further work in this area. We also conclude that a structure and framework needs to be in place, including wider participants such as technology vendors, standards bodies and other intermediaries.

For these reasons, the standardisation work stream proved to be the most difficult in defining the scope and objectives given the breadth of the subject matter and the OWG commitment to respond fully to the FCA by December 2013. We therefore focused on areas where the deliverables could have a direct impact on the goal of reduced transition timescales and could be delivered within the agreed timeframe.

The areas of our focus were:

- Providing guidance on how to document the overall operating model (including service definitions and service level agreements) so that the asset manager and the service provider are aligned. This should also reduce future transition timescales, as the service and data requirements will be pre-defined to a format that the new provider will be able to use.
- Defining a high-level framework for determining minimum service and data requirements when transitioning to a new service provider.
- Proposing that a testing methodology be established for use during the transition process.



Guidance on documentation of the operating model

Many asset managers and service providers have documented their operating model in whole or in part (including the processes and interactions that form the service provision). We believe that standards could be agreed for this documentation, which is vital to on-going governance and key when establishing new relationships and operating models.

That way, firms will be able to more efficiently coordinate technology, business and operations to invoke plans for an unexpected service interruption. These should ensure appropriate focus on critical functions and, as far as possible, mitigate the detrimental impact to customers.

Furthermore, this allows the firm to consider whether their non-standard processes are necessary, or a legacy process that could be changed to conform to a more standard operating model.

Based on its experience, the group suggested a standard suite of documents that may assist asset managers in ensuring effective management over outsourced services:

Operating model

A sufficiently detailed operating model should set out processes, services and inter-dependencies for the relationship. An example diagrammatic representation is shown in Appendix 3.

Location model

We suggest a location model where multi-jurisdictional services are provided. This will help ensure that the asset manager is clear on what services are undertaken and the governance model in operation within the service provider across these locations (including Joint-Ventures and Third parties). An example of a location model template is shown in Appendix 3.

Functional breakdown

We suggest a functional breakdown document containing a detailed list (from the high-level operating model) of sub-functions, providing their definition, classification, reference/index and input /output

functions. An example of a functional breakdown template is shown in Appendix 3.

Service definitions (KYO)

A comprehensive list of all services delivered within the relationship, in an agreed format, such that the asset manager's business, technology, operations and control functions have a common understanding of the service components. An example of a Service Definition template is shown in Appendix 3.

Service level agreement (SLA)

For each outsourced activity, the SLA should contain details of the agreed service levels, KPIs, the dependencies and related processes for both parties (the asset manager and the service provider). An example of a Service Level Agreement template is shown in Appendix 3.

SLA Appendices

Specific lists of core service details, i.e., lists of funds, clients, reports, data delivery files, specific processes and accounting rules, derivative pricing policies, data definitions and an overview of where data is stored. A suggested data definitions template is shown in Appendix 3.

Data and functions required for transition to another service provider

Asset managers should have critical data and functions defined (those deemed mandatory for day one of any transition) including data elements, definitions, delivery timings, delivery mechanism, contingency method and related impact on third parties or customers of non-delivery.

Furthermore, consideration should be given by asset managers ensuring critical and non-critical functions map to the service provider's standard and bespoke services. This would make it easier to assess priorities in different scenarios. It is advisable to have consensus between all relevant parties on the critical and non-critical function definitions and impact to any transition plan (whether planned or not).

Documentation should set out how existing service providers would provide static data, account profiles and portfolio data. Establishing such documentation enables both asset managers and service providers to develop and maintain testing criteria and approach as part of transition process planning.

Example file extracts and criticality for Investment operations functions are shown in Appendix 3.

Proposed approach to testing methodology

We felt that standardisation of testing methodology would assist asset managers and their service providers to expedite a transition. By this, we mean plans can be quickly made available to the new service provider, or discussed as part of alternative service provider due diligence, so that all parties understand what is expected. While there are common elements that can be standardised in a plan, it is understood that each asset manager will have its own testing protocols and timeframes.

In the event of a transition, it is important that all impacted parties engage at the earliest opportunity to determine and agree a testing strategy. Appropriate testing resources and experience will be needed, and therefore it is important to identify resource and assign individual responsibilities within the plan. All through the testing phase, issues and risks must be identified and assessed and mitigated prior to signing off the transition. A standardised approach will help all parties to expedite the transition, while maintaining governance and control.

An example of a testing strategy document structure is included in Appendix 3.



04

CONCLUSION AND NEXT STEPS

It is widely recognised that both the diversified operating models of service providers and the variation in asset managers' business models make the challenge of oversight more complicated. The challenges around resilience planning are further compounded by the differences in regulation and insolvency law across international borders.

The Guiding Principles outlined in this report are seen as areas where asset management firms can make considerable improvements in their oversight and resilience plans by working in conjunction with their service provider.

We hope our findings provide some practical actions that firms can use to develop viable, robust and realistic solutions to enhance their oversight and resilience plans to address the issues raised in the Dear CEO Letter.

We anticipate that it will take firms a number of months to review and digest these findings and apply them to their own business models, as appropriate.

OWG Mandate

We have received feedback during the course of this initiative that the OWG has been a very useful vehicle for industry engagement on this specific issue. However, the OWG is not an official body and it has no formal mandate or intention to continue after this point.

However, it has been suggested that, given the unique nature of this group, it may be beneficial to meet in six months' time to review progress.

The creation of an industry-wide body has allowed two-way communication with the FCA, who we have kept updated throughout this project. The FCA made specific reference to the work of the OWG in its Thematic Review on outsourcing (TR13/10), and representatives of the OWG Steering Committee were asked to contribute to the breakout session on outsourcing at the FCA's Annual Asset Management Conference in October 2013.

Acknowledgements

We would like to acknowledge the support of the many individuals who have selflessly given their time in order to help address this issue on behalf of the rest of the industry. They have also provided access to the facilities and resources of their organisations to enable the group to operate quickly and effectively, without having to put in place formal structures or any funding mechanism.


The views expressed here are those of the members of the OWG and do not necessarily reflect the views of the organisations they work for.

A list of the participants in the OWG is provided in Appendix 4.



05

REFERENCES AND FURTHER READING

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1. FSA Dear CEO Letter: 'Review of Outsourcing Arrangements in the Asset Management Sector (11 December, 2012).
 2. Outsourcing in the Asset Management Industry: FCA Thematic Project Findings Report TR13/10 (November 2013).
 3. IMA White Paper on key issues arising for Asset Managers from the Regulatory Regime on Outsourcing (28 May, 2013).
 4. Committee of European Banking Supervisors (CEBS) Guidelines on Outsourcing (14 December, 2006).
 5. Outsourcing: BaFin compares outsourcing by institutions (15 August, 2013).
 6. Outsourcing Risk Guideline (April 2009, updated June 2010). The Autorité des Marchés Financiers (AMF).
 7. Circular 13/563: Update of Circular 12/552 on the central administration, internal governance and risk management. (19 March 2013). Commission de Surveillance du Secteur Financier (CSSF).
 8. MiFID Implementing Directive 2006/73/EC, Chapter 1, Article 2(6).
 9. FSA Handbook, Senior Management Arrangements, Systems and Controls, Chapter 8, Outsourcing.

For a full discussion of the regulatory structure that applies when fund managers outsource, we recommend the following article (subscription-only journal);

'*Outsourcing for fund managers: Demystifying the regulatory structure*', Amanda Lewis and Emma Radmore, Journal of Securities Operations and Custody Vol. 4 No.4, pp 295-307, 1 May 2012.



06

APPENDICES

Appendix 1 – Key Oversight Activities

Appointment and transition process

Focus on setting up the oversight model and establishing good working relationships and practices across the firm and service provider.

Governance – internal and external	People and organisation	Oversight	Change management
<p>Complete selection due diligence – consider including:</p> <ul style="list-style-type: none"> • Financial strength • Service provider control reports • Site visits • Internal audit, risk, compliance and security programmes • Business continuity planning/disaster recovery <p>Comprehensive legal contracts in place – consider including:</p> <ul style="list-style-type: none"> • SLA – defined services and required performance levels • Key KPIs • Tools to manage failure • Rate Cards • Process for agreeing an exit plan • Change management process <p>Ensure appropriate understanding of outsourced activities across the firm</p> <p>Confirm readiness for live environment</p>	<p>Clearly define internal roles, and assign responsibilities and reporting lines</p> <p>Establish teams with appropriate skills and expertise to manage/oversee the transition process including control functions (Audit, Risk and Compliance) and consider the transfer of knowledge from due diligence into oversight team</p> <p>Establish and train the oversight team with the appropriate skills, expertise and capacity to manage the outsourced activities</p> <p>Confirm and communicate readiness for live environment</p>	<p>On-going monitoring of transition process MI – consider including:</p> <ul style="list-style-type: none"> • Risk and issues logs • Key decision points • Scope changes • Key milestone reporting • Escalation process • Key dependencies <p>Convene appropriate governance meetings – consider including:</p> <ul style="list-style-type: none"> • Joint steering committee • Internal steering committee • Project team meetings <p>Set up regular contact to resolve issues and maintain a strong business-as-usual relationship</p> <p>Confirm readiness for live environment</p>	<p>Establish processes to manage regulatory change, business change and scope change for the life of the transition</p> <p>Confirm readiness for live environment</p>

Live Environment

Focus on setting up the oversight model and establishing good working relationships and practices across the firm and service provider.

Governance – internal and external	People and organisation	Oversight	Change management
<p>Perform formal periodic review of extent of arrangements, risk assessment and ownership consistent with Principles 1, 2 and 3</p> <p>Ensure appropriate engagement of and reporting to senior management in accordance with Principle 3</p> <p>Perform formal periodic review of documentation governing the service provider relationship and contractual arrangements to ensure they remain appropriate to nature, scale and complexity – consider including:</p> <ul style="list-style-type: none"> • Key KPIs • Rate cards • Exit plan • Terms of reference for joint governance meetings <p>Review and address key changes in the end-to-end operating model, including people, processes, locations and systems</p> <ul style="list-style-type: none"> • Perform periodic due diligence – consider including: • Financial strength • Service provider control reports • Site visits • Internal audit and compliance programmes • Business continuity planning/ disaster recovery <p>Perform internal assessment of compliance with regulatory requirements, e.g., SYSC 8</p>	<p>Ensure teams continue to have appropriate skills, industry awareness, capacity and expertise to manage/oversee the outsourced activities. Consider participating in industry forums/ user groups as appropriate.</p> <p>Maintain clearly defined internal roles, responsibilities and reporting lines</p> <p>Maintain clearly defined ownership of the outsourced arrangements</p>	<p>Ensure appropriate engagement and ownership from operations and control functions (Audit, Risk and Compliance)</p> <p>Assess appropriateness of the service provider's resourcing model</p> <p>Perform ongoing monitoring at appropriate frequencies and retain supporting evidence</p> <p>Assess, escalate and resolve errors, service exceptions and control failures</p> <p>Ensure regular contact to resolve issues and maintain a strong business-as-usual relationship</p> <p>Maintain appropriate working relationships, oversight activities and MI</p> <p>Consider the use of benchmarking and/ or implementing a continuous improvement plan</p>	<p>Operate and monitor the change management process as agreed</p> <p>Jointly engage on changes, the change pipeline and associated scheduling</p>

Incremental Oversight during Exit

Focus on ensuring continued quality of service while the relationship is in transition.

Governance – internal and external	People and organisation	Oversight	Change management
<p>Understand the contractual provisions for exit and assess the need for change to governance arrangements – consider including:</p> <ul style="list-style-type: none"> • Joint governance meetings with transitions management group • Membership, frequency and agenda of governance meetings <p>Perform risk assessment considering that existing arrangements are now in exit</p>	<p>Assess the capacity of existing resources and need for additional oversight resources with appropriate skills and expertise to manage the transitional period, including oversight of outgoing provider, migration and onboarding of new service provider</p>	<p>Assess the need for changes – consider including:</p> <ul style="list-style-type: none"> • Increased frequency of checks • Revised SLA checks/ KPIs • Key Staff turnover at supplier <p>Consider increased focus on critical services and changes to error rates and trends</p>	<p>Consider reducing non-essential activities, e.g.:</p> <ul style="list-style-type: none"> • Continuous improvement programme • Benchmarking • Non-critical change

Appendix 2 – Exit Planning

This illustration is designed to serve as an example of typical headings which an asset manager and service provider may consider in order to ensure an orderly transition of services from one service provider to another.

Principles

This Exit Plan sets out the principles on which, following a termination of this Agreement each of the Client and Provider will effect the orderly transition of the services from Provider to the Replacement Supplier.

General Principles:

1. Provider recognises that these relationships, including middle office outsourcing, need to be portable. Therefore, Provider will engage in thorough, good faith discussions on how to achieve that need.
2. Provider will work with the Client to develop an orderly transition plan and implementation schedule.
3. As per the transition plan agreed with the Client, Provider staff will provide the resources it requires to see to the orderly transition of the assets. Provider will work with the Replacement Supplier to conduct a smooth transition.
4. With respect to systems, to the extent the systems and platforms are proprietary to Provider, the systems and platforms previously used by Provider to provide the Services should not be subject to any lift out provisions. The Client and the Replacement Supplier should determine which of the Replacement Supplier's systems are appropriate for the purposes of provision of the Services to the Client.
5. Certain migration preparation activities and post migration support may be subject to separately negotiated tariffs. Provider anticipates that the agreed Disengagement Plan (as defined in Section 1 below) would identify these tariffs.
6. Notwithstanding the above, the parties will co-operate to use all reasonable endeavours to minimise all costs incurred in relation to the Exit Plan.
7. The impact on the parties' respective businesses (including their personnel and customers) and the internal and third party costs incurred by each of them are minimised.
8. The Services which are being terminated ('Terminated Services') continue to be performed by Provider in accordance with the provisions of the Agreement until the date of termination.
9. Each of the parties' shall provide experienced personnel at appropriate levels of seniority to procure the performance of the services to be provided upon exit ('Exit Services') in accordance with the parties respective obligations set out or referred to in this Agreement, this Schedule and/or the Disengagement Plan.
10. The Client shall procure that the Replacement Supplier enters into a confidentiality agreement with Provider on terms acceptable to Provider.
11. The Joint Steering Group shall oversee the Exit Services and the transfer of the Terminated Services to the Replacement Supplier(s).

Appendix 2 – Sample exit plan

Section	Client Obligation	Provider Obligation
1	<p>Disengagement planning</p> <p>Review and identify all systems, equipment and software utilised by the Client in the receipt of the Services from Provider.</p> <p>Provide Provider with full and complete details of any Client or Replacement Supplier dependencies.</p> <p>Provide a guide time table and key milestones for incorporation into the Disengagement Plan.</p>	<p>Prepare for review, comment and agreement by the Joint Steering Group within 60 days following the date of a notice terminating all or part of the Services or terminating this Agreement, a plan for transferring the relevant Terminated Services from Provider to the Replacement Supplier ('Disengagement Plan') that satisfies the requirements set out below:</p> <p>The Exit Plan shall clearly and in sufficient detail to enable the relevant personnel of both parties to fully understand their respective obligations under the Exit Plan:</p> <p>The Disengagement Plan shall:</p> <ol style="list-style-type: none"> 1.1 address the approach and timetable for transferring the Terminated Services as may be reasonably specified by the Client. 1.2 describe the Exit Services and how they shall be performed by Provider; 1.3 incorporate any Client or Replacement Supplier's dependencies necessary for Provider to perform the Exit Services; 1.4 set out the timetable for the handover of each element of the Terminated Services (including key milestones to track the progress of the handover); 1.5 set out the reports to be provided and the frequency of their provision; 1.6 set out the procedure for identifying and documenting issues that arise during the exit process ('In Flight Issues'); and 1.7 address such other matters relating to the termination of all or part of the Services and the Exit Services as either party may reasonably propose.
		<p>Identify and prepare for delivery to Client, all Client-owned reports and documentation (which are deemed to be 'Client Proprietary Information').</p>
		<p>Provide to the Client information regarding the Services reasonably required for the Client or the Replacement Supplier to perform the Terminated Services. Such information will include identifying key support contacts (names and telephone numbers) of Provider Personnel and third party providers.</p>
		<p>Provide the Client with any other support and assistance set out in the Disengagement Plan or reasonably requested by the Client or its designee to facilitate the transfer of the Services from Provider to the Client or the Replacement Supplier.</p>

Sample exit plan

Section	Client Obligation	Provider Obligation
2	Prior to the transfer of responsibility	
	Identify software changes in process that relate to the provision of services wholly and exclusively to the Client's products by Provider.	To the extent reasonably practicable and where agreed with the Client, freeze software changes.
		Provide the Client multiple copies of Client data, as the Client may request in a reasonably generic format.
		Provide asset listings and configuration information for the equipment, including maintenance and firmware levels, as well as any other information regarding the equipment requested by the Client.
		Assist the Client in notifying third party suppliers of any procedures to be followed during the transfer.
		Provide for the orderly hand-off of ongoing projects, including, without limitation, providing the status of current and pending projects, along with relevant project plans.
		Provide to the Client or its designee any problem management records, as these exist as of the effective date of the termination or expiration of any definitive agreement(s).
	Create and implement a plan for in preparing for and conducting migration testing.	Provide reasonable assistance to the Client or its designee, in connection with such testing.
	The Client shall: provide a senior project manager who shall be primary point of contact for Provider during the Exit Period; maintain a log of issues that arise during the Exit Period.	Provider shall: provide a senior project manager who shall be responsible for the overall implementation of the Exit Services and who shall be the primary point of contact for the Client during the Exit Period; and provide the reports to the Client on the frequency as set out in the Disengagement Plan.
3	At the time of transfer of responsibility	
		Provider will provide the following services to avoid any disruptions in the Replacement Supplier's takeover of the Terminated Services, including, without limitation, the following:
		Cooperate and provide assistance at the time of the cutover of the Services and reasonably support the Replacement Supplier's Services commencement.
		Upload requested the Client data from the systems used to provide the Terminated Services to the Replacement Supplier's systems in a standard format (without the need to engage in any data conversion).
		Provide assistance to the Client in loading the data files.

Appendix 3 – Standardisation examples

Operating model



In house
 Partially Outsourced
 Completely Outsourced

Appendices cont...

Location model

Function	Australia	Canada	China	France	Germany	Hong Kong	India	Luxembourg	Poland	Singapore	UK
Legal Entity											
Governance location											
Investment Operations											
Trade Processing	X	X					X				X
Reconciliations							X		X		X
Recordkeeping		X		X			X				X
Fund Accounting											
Security Pricing	X					X		X		X	X
NAV Calculation	X		X	X	X	X		X	X	X	X
Daily, Monthly Reporting	X	X	X	X	X	X		X	X	X	X
Transfer Agency											
Contact Centre	X					X		X		X	X
Dealing	X					X		X		X	X
Box Management	X					X		X		X	X

Functional breakdown

Department/ Team	Client Services – Pan European	Client Services – Pan European
Process Name	Daily trade reporting – German reporting	Daily trade reporting – German reporting
Inbound/ Outbound	Inbound	Outbound
Supplier of Report/Data/ Service, e.g., team or system	Recordkeeping	Client Services
Recipient of report/data/ service	Client Services	Derivatives team
What is communicated? e.g., form, report, message	Futures soft trades	Request for futures information
Communication method, e.g., e-mail, phone, paper, file placed on network	File on network	Email
Frequency	Daily	Monthly
Time Criticality	Medium	Medium
Touch points comments, e.g., Signature required	Portfolio no. forms a subset of this reporting	Trading typically done at month end so requests only get sent when there is a futures trade
Cross boundary system update	No	No
Criticality H/M/L	Medium	Medium

Appendices cont...

Service definitions (KYO)

Service Detail	Service Description
Investment operations Trade processing	<ul style="list-style-type: none">• Trade matching• Trade settlement• Trade notification to interested third parties• Failed trade management
Fund accounting NAV calculation	<ul style="list-style-type: none">• Daily and weekly NAV calculation, validation and release• Capture daily transfer agency in flows/outflows and unit reconciliations• Fair value NAV pricing to cater for market events• Reporting of errors and completion of NAV reworks and error calculations for the fund range• Periodic re-calculation of notional dealing charges and dilution levies for fund NAV pricing
Transfer agency dealing	<ul style="list-style-type: none">• New account set-up• Adding agent details to the account where applicable• Checking the identity of clients• Set up regular contribution• Process ad hoc lump sum top-ups• Check against product rules, e.g., ISA limits

Service level agreement (SLA)

Ref	Service Activity	Service Specification	Dependency	Service Standard	KPI Ref
3A.1	Trade capture – acknowledge and process	[SERVICE PROVIDER] will acknowledge all automated and manual trade instructions from [CLIENT], and process into [SERVICE PROVIDER]'s accounting system	<p>[CLIENT] will send authenticated trade instructions to [SERVICE PROVIDER] in the agreed electronic and manual formats within agreed deal capture cut-off times</p> <p>Instructions must include agreed minimum data requirements that are clear, accurate, complete and populated on the correctly formatted file prior to instruction execution, or as otherwise agreed between the parties</p>	<p>To:</p> <p>a. Acknowledge all automated instructions via the Hub within 15 minutes of instruction receipt and all manual instructions by return of a manual acknowledgement within 30 minutes of instruction receipt, and</p> <p>b. Process all instructions into [SERVICE PROVIDER]'s accounting system within agreed deal capture cut-off times</p> <p>If [SERVICE PROVIDER] is unable to process a trade, [SERVICE PROVIDER] will notify [CLIENT] within 1 Business Hour of identification but no later than 10:00 on the next Business Day after identification</p>	
3A.2	Trade capture – cancellation	[SERVICE PROVIDER] will process cancellation of trade instructions from [CLIENT]	<p>[CLIENT] will send authenticated trade cancellation instructions to [SERVICE PROVIDER] in the agreed electronic and manual formats within agreed deal capture cut-off times</p> <p>Instructions must include agreed minimum data requirements that are clear, accurate, complete and populated on the correctly formatted file prior to instruction execution, or as otherwise agreed between the parties</p>	<p>To cancel accordingly with the custodian within agreed deal capture cut-off times</p> <p>If [SERVICE PROVIDER] is unable to process a trade cancellation, [SERVICE PROVIDER] will notify [CLIENT] within 1 Business Hour of identification and no later than 10:00 on the next Business Day after identification</p>	

Appendices cont...

SLA appendices

File #	Extract/ Feed Name	Description	Frequency	Format	Distribution list	Delivery format	Criticality
1	PR1	Prices file	Daily	CSV	Asset management front office system	File	High

Example file extracts and criticality for Investment operations functions

Extract/ Feed Name	Description	Criticality
Summary Level Holdings	Detailed valuation data for each portfolio, based on latest positions and current day's prices. Valuations can be provided for traded and settled bases, COB and SOD, confirmed and unconfirmed positions	High
Security Master	Security master attributes	High
Exchange (FX) Rates	Exchange rate data for a full range of spot and forward data points: 2, 30, 60, 90, 180 days, 1 and 2 years	High
FX Transactions	All FX transactions entered on current day	High
Price	Prices according to price source agreement (PSA)	High
Transactions	All transactions entered on current day, including trades, maturities, corporate actions, income	High
Cash Forecast	Extract of cash forecast data, can be updated and supplied intra day	High
Broker	Broker reference data	Medium
Exchange (Market) Codes	Market exchange reference data	Medium
Fixed Income Extended Reference Data	Fixed Income Extended Reference Data – Ratings Data	Medium
Position Status	Detailed information on the breakdown of each position by status, e.g., available, short sale, collateral in/out, borrowed, proxy voting, corp action	Medium
Portfolio Account	Standard attributes of client portfolios	Medium
Security Classifications	Security classifications can be sourced from external vendors, client custom list or derived from security attributes	Medium
Transaction Fees	Detailed breakdown of fees by transaction, e.g., market fees, stamp duty, custodian fees	Medium
Derivative Analytics	e.g., delta, gamma, implied volatility	Low
Portfolio Totals	Summary of the total market value of each portfolio	Low
Equity Analytics	e.g., annual dividend forecast, volume, earnings per share	Low
Fixed Income Analytics	e.g., convexity, current yield, life, Macaulay duration	Low

Example of a testing strategy document structure

As an example, a high-level testing strategy could be standardised and cover the following:

1. Testing scope

- i. Provide an overview that describes what is being tested. Make reference to anything that is out of scope, any assumptions made and constraints that may impact the delivery of the testing plan and agreed governance protocols between the parties

2. Testing approach

- i. Joint testing requirements should be pre-determined by the asset manager
- ii. Agreement of testing criteria and deliverables
- iii. Test execution plan, consideration of resource requirements and sequencing of test cycles

3. Test environment/data management

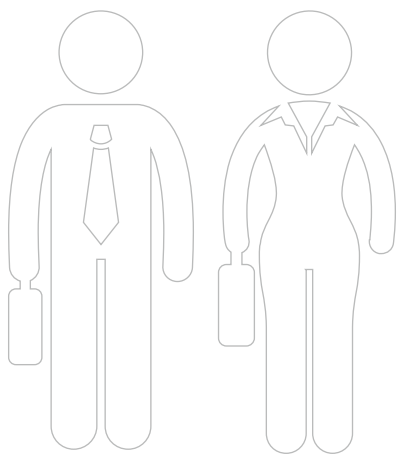
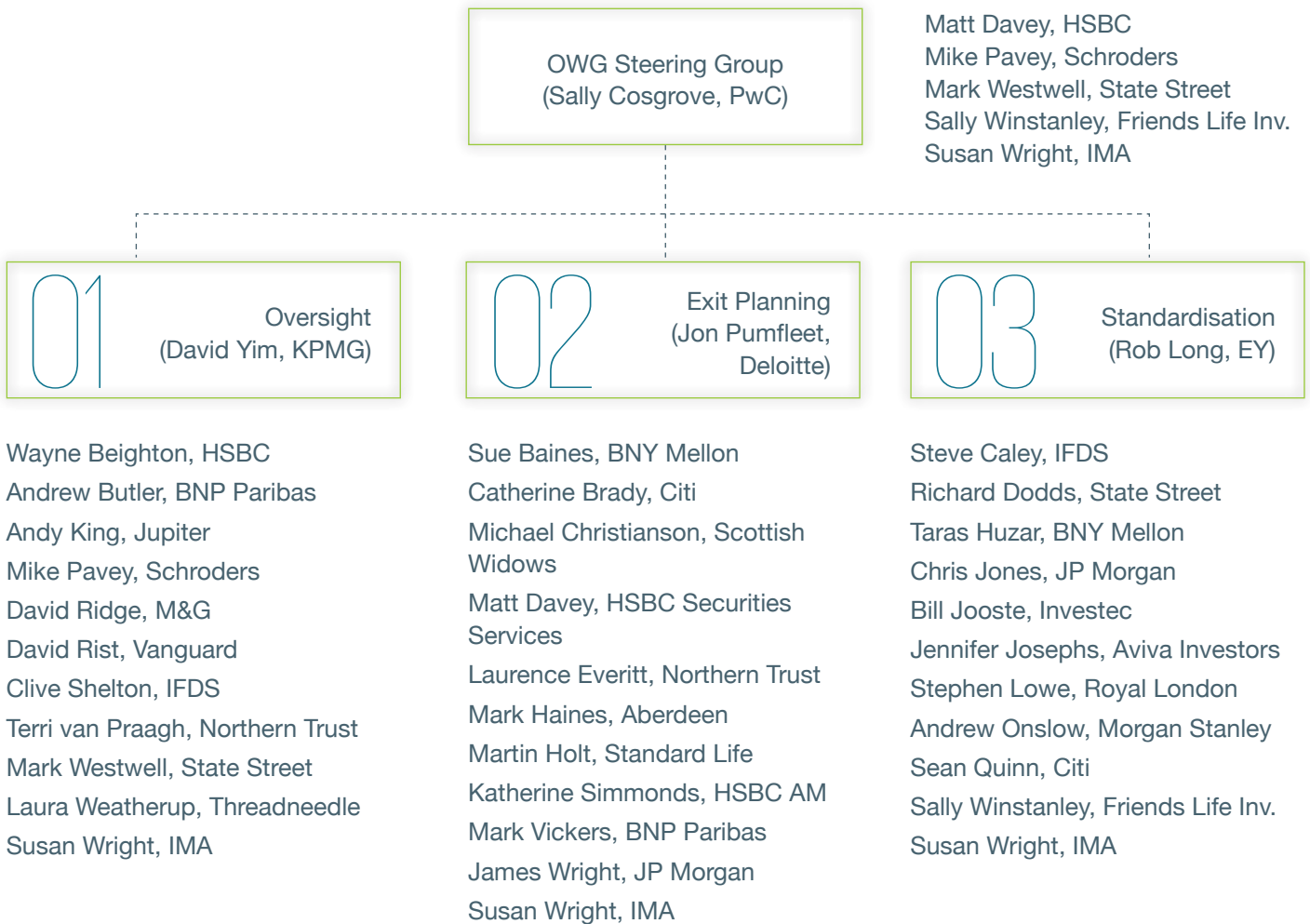
This is generally the most detailed section as it covers the technical environment for individual and joint testing, as well as the system availability and support of the system environment's data requirements and management.

- i. This section should list out the joint system integration tests (JSITs), joint system access tests (JSATs) and model office. It should also explain how the testing environments are deployed and configured, for example deployment and code freezes, build drops and defect fixes
- ii. It should also identify different application packages impacted, e.g., order management systems, performance systems, pricing vendors, etc.

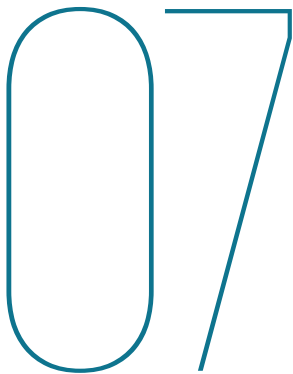
4. Entry/exit criteria

The asset manager should define the entry and exit criteria used to determine how to move through the different testing phases including defect management.

Appendix 4 – OWG membership



N.B. The names listed are the ‘lead individuals’ and for simplicity we have not shown details of the many delegates who have been active participants in these work groups.



OWG ADDENDUM – 2016

Introduction

Asset Managers have been considering how they can implement and demonstrate efficient and effective oversight models that are proportionate and appropriate to the nature and scale of their businesses and associated outsourced arrangements. This is especially important following the FSA's (now FCA) 2012 Dear CEO Letter to Asset Managers on Outsourcing and the subsequent industry response by the Outsourcing Working Group (OWG)¹ in 2013.

In addition, a number of asset managers have given greater consideration to how to deliver on their obligations to identify and manage outsourced operational risks. This may include where service providers employ a global operating model and therefore outsource or offshore elements of their services.

The absence of specific guidance has led to a broad interpretation of what constitutes effective and appropriate oversight. This has resulted in a diverse range of approaches as to how firms approach their oversight responsibilities.

Given the apparent need for more industry guidance on the topic of appropriate oversight, a representative group from the OWG, comprised of the OWG Steering Committee and key representatives from the oversight workstream reformed recently.

This group met to agree how best to build upon the original ‘guiding principles’ and ‘considerations’ for effective oversight. The FCA was informed of the initiative and the approach that this group was taking.

The key objective of this Addendum is to provide asset managers with further considerations on how they may gain comfort regarding their oversight obligations for outsourced functions and services. In particular, we have focused on Oversight Principle 2 of the OWG report, which highlighted the importance of Risk Based Assessment. It is intended that this Addendum is read in conjunction with the original report issued by the OWG and not used in isolation to address oversight requirements.

Background

In the three years since publication, the Asset Management industry has embraced the OWG ‘guiding principles’ and ‘considerations’ and incorporated them within individual oversight programmes. In doing so, firms have considered what is proportionate and appropriate for their specific operating model. Although the Dear CEO letter focused upon middle office outsourcing, fund accounting and transfer agency, it is recognised that oversight now has a more general application, with an increased focus on supply-chain dependencies and technology resilience.

Whilst oversight, exit planning and standardisation remain the core areas for managers to consider, it is oversight that remains a particular focus for the industry and regulator alike. Importantly, the regulation (SYSC8) has not changed and the guiding principles set out in the OWG report still apply.

It is recognised that when focusing on their oversight obligations, firms may not satisfy the expectations of the regulator by solely relying on attestations from service providers without due consideration of the risks, supported by documented rationale. As highlighted in the OWG report, firms are reminded that whilst they may outsource a function, they may not outsource their responsibility for that function.

Expectations of Asset Managers

As a reminder, the OWG identified the following four key principles for oversight:

- 1) Know Your Outsourcing (KYO)
- 2) Risk Based Assessment
- 3) Ownership at a Senior Level
- 4) Governance Framework

In applying these principles, judgement is required based on the nature and extent of the outsourced services. Key factors for consideration will be the scale of the dependency on the service provider, the types of services provided and the operating model of the service provider on a location by location basis.

In reviewing how best to provide further considerations, it was agreed that the focus should be on Oversight Principle 2 – Risk Based Assessment. This was recognised as being consistent with the FCA’s original intent that managers should find practical solutions that are viable, robust and realistic.

Asset managers may find it helpful to consider the FCA’s approach to risk management more generally. For context, we include this extract from the FCA website²:

“We consider risk to be the combination of impact (the potential harm that could be caused) and probability (the likelihood of the particular issue or event occurring). In the FCA context, we combine these impact and probability factors to give us a measure of the overall risk posed to our statutory objectives. We then use this measure to prioritise risks and make decisions on what, if anything, our regulatory response should be. We also use it to set our strategic aims and outcomes and to allocate resources based on our regulatory priorities.

Risk for the FCA = IMPACT of the problem if it occurs x PROBABILITY of the problem occurring

In short, it is designed to:

- identify the main risks to our objectives as they arise;
- measure the importance of the risk;
- mitigate risks; and
- monitor the progress of the risk.”

Risk Based Assessment

Oversight Principle 2 of the original OWG report contains considerations which could be included in a Risk Based Assessment. The following is an enhanced version of those considerations:

Firms should perform a risk-based assessment of outsourced arrangements, including understanding the impact of those activities on the end client and the firm itself. Considerations could include but are not limited to:

- Characteristics of asset manager and service(s) provided, including an assessment of service criticality and complexity, and the firm's capabilities;
- Service provider characteristics: an assessment of the provider itself, including; capabilities, risk appetite, risk and control framework, maturity of service provision, financial stability, industry credentials, and reputation;
- Impact on the end client, (i.e. investors): consideration of the potential consequence of service failure/ disruption on the end client, and the mitigants and controls that are in place;
- Contractual characteristics: an assessment of relevant contractual provisions, including: commercial terms, service, governance, termination provisions, notice periods, exit planning, business continuity, risk and control transparency;
- Types of risk and changes in risk as a result of an outsource relationship including, but not limited to; operational, financial, regulatory, conduct, reputational and jurisdictional risk;
- Control characteristics: including an assessment of control processes and personnel, location oversight, management information, oversight and monitoring, and adherence to regulatory obligations and prevailing market standards.

Periodic review: the risk-based assessment should be reviewed on a periodic basis, with the frequency assessed and determined according to business as usual scenarios and in response to significant events.

The Risk Based Assessment work should form the foundation upon which subsequent periodic assessments are undertaken. The performance of this Risk Based Assessment should always be evidenced. Consideration should be given to all three stages of the oversight lifecycle (Appointment, Live and Exit) in order to properly evidence oversight of outsourced functions.

Mitigating Factors to Risk

a) Management Information and Data – Principle 1 – Know Your Outsourcing

Further consideration should be given to the Management Information and Data currently received along with its availability and relevance, considering whether this is sufficient for effective oversight. This could include, but is not limited to:

- Exit Planning
- Technology
- Operating Model
- Service Level Agreements (SLAs) and measurements
- Legal Frameworks
- Governance Frameworks
- Business Continuity Planning (BCP)
- Audit & Compliance Framework
- People and Organisation

b) Engagement – Principles 3 and 4 – Ownership at Senior Level and Governance Framework

Asset managers need to ensure they have an effective governance framework in operation to monitor the activities they have delegated to the service provider. This could include but is not limited to:

- Senior level ownership of the relationship with the service provider;
- Whether the oversight team have the appropriate skills, expertise and capacity to understand and challenge the service provider;
- Quality of relationship with service provider and level of transparency; and
- Quality and frequency of communication including clear channels of escalation.

c) On-site reviews

As part of their Risk Based Assessment, the asset manager should consider whether or not to conduct on-site reviews. Where these on-site reviews are deemed to be required, they may be periodic, ad hoc, or event-driven. The frequency and locations of periodic reviews will be determined by each asset manager's specific circumstances.

Where an on-site review is deemed of value, it is helpful to both the asset manager and the service provider to agree effective ways to achieve this. A well-planned visit for a bespoke and client specific review is likely to result in the best outcome as the service provider will understand the objectives of the asset manager's visit and will have time to prepare and provide relevant information in advance.

Similarly, asset managers may want to consider co-ordinating joint visits to service provider locations where generic issues can be addressed. Increased use of technology may further enable virtual meetings and real time screen sharing, which can be effective in better understanding how the services are performed.

The schematic shown in the Appendix is an illustration of how asset managers could perform a

risk based assessment. This should not be used as a comprehensive checklist, as each set of arrangements is specific to each asset manager.

d) Further Considerations

When seeking to reduce residual risk, Asset Managers may wish to consider the following areas to enhance their oversight procedures:

i) Additional Management Information (MI)

- Is more MI/data required?
- What specifically is needed? for example;
 - Process specific
 - Site specific
 - People specific
- Which service provider location is this required from?

ii) Increased engagement

- Is more engagement required?
- What is the purpose of the engagement? for example;
 - Subject Matter Expertise (ad hoc)
 - Ongoing governance (regular)
- What form of engagement is required? for example;
 - Remote – phone, video etc.
 - In person – on site visit at Service Provider or Service Provider visit to firm location

iii) Extent of on-site reviews

- Is an on-site review required?
- What is the purpose of the review? for example;
 - Relationship building
 - Specific process and control review(s)
- What form of review is required? for example;
 - Unplanned visits
 - Pre-arranged visits
 - More senior engagement
 - Joint visits with other clients on generic issues

Conclusion

It remains the responsibility of each asset manager to assess and evidence their own definition of what is appropriate and proportionate, and by doing so continue to develop their existing oversight models.

It is not possible to address all scenarios as many will be bespoke and specific to each asset manager and therefore we recognise that this document is not exhaustive, but an enhancement to the original OWG report.

It should also be recognised that prevailing market practices and the regulatory framework continues to evolve. Asset managers need to keep abreast of such changes, for example, the planned introduction of the Senior Manager's Regime to the Asset Management industry and how this will impact on their approaches to oversight.

References

1. Outsourcing Working Group (OWG) – An industry response to the FSA's Dear CEO Letter on Outsourcing, (December 2013)

www.theinvestmentassociation.org/assets/files/press/2013/20131209-owgreport.pdf

2. FCA market-based approach to supervising firms: risk management

<https://www.the-fca.org.uk/about/supervision/risk-management>

Appendix: Risk Based Assessment Schematic



continued on the following page...

5. Assess inherent risk

For each specific risk identified, assess the inherent risk according to the agreed scoring mechanism (e.g. impact x probability). Considerations include but are not limited to:

- Criticality / level of reliance on the service
- Complexity of the service
- Impact to end client and Asset Manager of service disruption / failure
- Service model including locations of service provision



6. Identify controls / mitigants

Consider the existing internal controls (preventative / detective, automated / manual) and map the controls to risks. Where there are no controls, consider mitigating factors and map these to risks. Considerations include, but are not limited to, the Service Provider's:

- Financial stability, business and operational resilience. continuity
- Operating model and location of key controls and processes
- Performance vs KPIs/KRIs and management information on history of errors/failures
- Technology performance
- Staff turnover and resource model



7. Assess residual risk

Consider the effect of the controls or mitigating factors on reducing the inherent risk, and assess according to the agreed scoring mechanism (e.g. impact x probability).



8. Determine outsourcing oversight approach

Determine the appropriate approach to oversight considering how the residual risk compares with the defined risk appetite.

- Where residual risk is above risk appetite, oversight activities may need to be enhanced to bring within risk appetite.
- The nature of the risks should be considered to determine relevant and effective oversight procedures.

