Comments about Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships

Subject : Outsourcing and third-party relationships

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Banking institutions have outsourced services to third parties[1] for decades; where the improvement of technology has forced these Auxiliary Services Companies (CSA) as they are known in Ecuador, to reformulate their strategies and align themselves with the best international practices and continuous improvement at the technological level.

In order to respond to the statement sent by the ASBA through No. SBA / SG / 118/20, of November 10, 2020; where it is indicated that: *"The FSB is inviting comments on this Discussion Paper and the questions set out below. Responses should be sent to fsb@fsb.org by 8 January 2021",* the following considerations are indicated by chapter of the document:

1. Overview of existing regulatory and supervisory landscape on outsourcing and third-party relationships.

With regard to section 1, it is important to mention the relevance of:

- All those surveyed by the FSB[2] subscribe to the principle that outsourcing and relationships with third parties cannot exempt a bank, its board of directors, or top management from their responsibility to ensure public deposits.
- Regulatory requirements and supervisory expectations regarding how banks should supervise these relationships (outsourcing and relationships with third parties) , with a particular focus on those that are critical or important to financial stability; the safety and soundness of banking entities ; or the provision of critical or important functions.
- Legislation or regulation may include the ability to request information directly from third parties that is relevant to the objectives of the authorities; conduct on-site inspections; and / or supervise the provision of certain third-party services as if they were being performed by banks.
- **Regulatory scope:** The term outsourcing includes the definition of current regulatory standards, it may not capture all relationships with third parties with a potential impact on financial stability or the safety and soundness of banking institutions.
- **Information Technology (IT) Outsourcing:** They are addressing the risks and leveraging the benefits of the cloud, described as "enabling technology" , for Fintech activities and other solutions
- **Data protection:** Introduction of new or revised regulatory requirements for data protection
- **Rights of access to audit information:** The contractual rights must allow supervisors to access, audit and obtain information from those third parties.

[1] Auxiliary Services Companies (CSA)

[2] FSB: Financial Stability Board

- **Supply chain management:** Managing risks in complex supply chains involved in some outsourcing and third-party arrangements can be difficult in practice.

SB Comments

Based on the Risk-Based Supervision (SBR) methodology for Auxiliary Service Companies (CSA), the compound risk is defined, in order to evaluate the entities associated with outsourced services with third parties according to risk and to the defense lines of these entities.

2. Supervisory approaches for managing outsourcing and third-party risks

In this section 2, it is important to mention the following:

- For outsourcing with third parties, they are considered critical or important for the financial stability, security and soundness of the entities or the provision of critical or important functions for critical shared services.
- The management of third-party risks is based on the internal controls established and adequate governance.
- To ensure that agreements between banking entities and service subcontracts with third parties comply with legal and regulatory obligations, allowing risk management
- We must strengthen legal powers in order to directly access :
    - Request information on services with controlled entities.
    - Carry out on-site inspections to third parties.
    - Supervise the services provided to financial entities by third parties as if they were being performed by the financial entities themselves.
    - Incorporate third parties who meet certain criteria in their direct supervision scope.

SB Comments

The SB has the faculty to carry out supervisions for subcontracting and third party risks, in accordance with the provisions of the Organic Monetary and Financial Code, Articles 280, 281 and 282, the supervisions covered are:

- Preventive supervision
- Corrective supervision
- Intensive supervision

3. Regulatory and supervisory challenges

In this paragraph 3 regarding regulatory and supervisory challenges, despite the progress made by the SB, we should examine the processes:

- Identification, monitoring and management of potential systemic risks associated with the use of subcontracting agreements with third parties by financial institutions, in particular due to the concentration in the provision of third party services and lack of relevant information.
- Lack of relevant resources and skills in information technology

- Limitations of access, audit and information rights.
- Challenges and problems related to the ability of banking institutions to negotiate and exercise rights of access, audit and adequate information on subcontracting arrangements and third, both FIs and their supervisory authorities and resolution.
- Third parties are sometimes unaware of their clients' regulatory obligations or face difficulties in facilitating compliance.
- Cross-border complexities can create challenges for resolution authorities in particular, as they may limit their ability to exercise resolution intervention rights, especially when critical data or systems are located in a foreign jurisdiction.
- Major disruption or failure in one of these third parties could create a single point of failure with potential adverse consequences for the financial stability and / or the safety and soundness of multiple banking institutions.

SB Comments

Among the regulatory challenges are:

- Proposals for improvements in the regulatory environment in order to incorporate fintech and the different services they offer in the market.
- It is necessary that the contracts signed with the service provider clearly establish the quality, the guarantees, the detail of the sufficient, qualified and trained personnel to provide the service, information security, fines and penalties in case of non-compliance.

4. Conclusion

In this section 4, it is important to indicate the following:

- Supervisors and the SB are focusing on issues resulting from technological developments and a greater search for digital transformation strategies; due to just as the use of technology can improve its resilience, innovation and cost reduction; It could also expand or transform other risks, and possibly create new ones, if they are managed ineffectively.
- When financial institutions use external providers, it could make the understanding and management of these risks more complex; accordingly, further analysis is required to better understand the risks posed by the changing landscape of outsourcing and third party relationships; and, the impact on financial stability.

QUESTIONS: "Subcontracting and relations with third parties"

1. What do you consider the key challenges in identifying, managing and mitigating the risks relating to outsourcing and third-party relationships, including risks in sub-contractors and the broader supply chain?

The cooperation of external providers (outsourcing of third-party services) brings many benefits to financial institutions, such as increasing efficiency, introduction of new technologies, however there are risks associated with data security, incidents that may interrupt the service, problems financial resources that these external providers may face[3].

In order to mitigate risks, it is important to identify whether banking institutions and overall financial system has a corporate governance structure robust aligned to best practices, which consider establishing policies, setting maximum ceilings and minimums that would take to the timing of outsourcing of services, levels of approval, supervision, monitoring and reporting the most relevant risks associated with outsourcing activities to the different supervisory functions of banking institutions .

The banking institutions and Auxiliary Services Companies (CSA) - outsourcing of services; Within its supervisory functions that fall within the Risk Based Supervision (SBR) methodology, it should include consideration of whether an applicant has paid due attention to the following aspects when selecting a service from a provider:

- Comprehensive assessment of the nature, scope and complexity of the contractual arrangement, this should involve an assessment of the roles and responsibilities of the service provider, including their obligation to cooperate and implement controls , and whether internal expertise is adequate and resources are available to mitigate the risk of the service provided.
- The level of dependence of the banking institutions on the service provider (s) , it should assess the risk of assigning several significant activities to a single supplier.
- Compliance by the service provider with the legal and regulatory requirements to operate in the country.
- The actions that the cloud service provider will take, in case of failure of its systems, to continue providing the service to financial institutions.
- The level of protection of personal and confidential data established in the level of service.

Likewise, it is important to point out that banking institutions must ensure that their critical suppliers have appropriate business continuity plans in place, in order to ensure that there is a pre-established measure in case of service interruptions; and, control and monitor the information security infrastructure provided by the provider, in order to protect the information assets present in the critical contracted services, independent of the controls provided by the provider.

[3] External service providers are known as: Auxiliary Service Companies (CSA)

2. What are possible ways to address these challenges and mitigate related risks? Are there any concerns with potential approaches that might increase risks, complexity or costs?

Ways to address challenges in order to mitigate them include:

- It is necessary that the contracts signed with the service provider clearly establish the quality, the guarantees, the detail of the sufficient, qualified and trained personnel to provide the service, information security, fines and penalties in case of non-compliance.
- It must be identified if the company is a critical or strategic provider for the banking institution, that is, if the service it provides supports a critical process of the banking institution and the failure of its service could have a negative impact on the development of its business. Therefore, if it is critical, the service received from the company must be permanently monitored.
- It is of great importance that the banking institution knows its service provider, prior to contracting, that is, to analyze its financial situation, operational capacity, the quality of the service it is providing, information security, since these companies are exposed to various risks.
- For this, the banking institution must comply with the provisions of the regulations of the control body on services provided by third parties.
- In the contractual review of the banking institutions, compensation should be considered for the cancellation of the contract in the event of non-compliance for both the provider and the banking institutions.

The concern of potential approaches that could increase risks are :

- The Bank use outsourcing services to reduce costs, improve efficiency and quality of service, focus on core business activities, access to qualified personnel, streamline processes and reduce time and risk sharing them with a third party; However, by not having a service control and monitoring system , as well as defined policies, manuals and procedures, there is a high risk that the service provided by these companies may have interruptions and therefore negative implications that would be reflected in the final service that the bank gives to the end user, and migrating to another provider would also imply high costs.
- To achieve a complete exercise, companies must at least guarantee that they have made a correct identification and assessment of risks in different stages of contracting the supplier.
- Changes in the supply of banking services have caused operational risk to shift away from supervised entities to companies to which they outsource critical functions, such as data storage, reporting and transaction processing. Outsourcing critical functions does not reduce the disruption its failure would cause to the financial system and its customers.

3. What are possible ways in which financial institutions, third-party service providers and supervisory authorities could collaborate to address these challenges on a cross-border basis?

The financial industry is changing worldwide and therefore the implication that this has on the national banking system is relevant. Here is what could be done to address these challenges:

- The supervisory authorities have made proposals of improvements in the regulatory environment in order to incorporate the Fintech and the various services offered on the market.
- Banking institutions must assess the rise of fintech in the markets; which increases non-bank platforms and therefore the fact of adjusting technologically and operationally to the new reality.
- Banking institutions must develop controls that allow the mitigation of risks associated with possible failures or vulnerabilities in the systems of the entities that provide outsourcing services and third-party services.
- Advanced analytics, the macro data, data science and artificial intelligence, will enable supervisors of SB the recognition of patterns of risk, early warning signs, hazard identification and subsequent of rules and regulations to concentrate and warn about these new options.
- The attention of the supervision and the supervision teams should be directed towards the correct identification of the significant activities and most relevant sub-activities of the system and the entity, such as loans, payments and data storage.
- Supervisors must be trained and at the forefront of the development of new market trends.

4. What lessons have been learned from the COVID-19 pandemic regarding managing and mitigating risks relating to outsourcing and third-party relationships, including risks arising in sub-contractors and the broader supply chain?

The product lockdown of the pandemic Covid-19, has made the greatest number of users adapt to digital technology through the use of virtual platforms provided by the banks, which has promoted financial inclusion it becomes necessary in times like the current COVID-19, in order to increase access and use of financial services adjusted to the needs of the population, including the underserved population excluded from the financial system. However, since banking institutions have a high demand for transactions, they have had to strengthen the systems that support these operations.

It is necessary to have advanced analytical data, macro data and artificial intelligence, allowing supervisors of SB, the early recognition of patterns of risk, early warning signs, hazard identification, finding sources and social listening.

5. What type of supervision is covered by the law for the execution of subcontracting (outsourcing) and the risks of third parties?

The supervisions currently covered by current regulations (Articles 280, 281 and 282 of the Organic Monetary and Financial Code - COMF) are :

Preventive supervision[4]

Corrective supervision[5]

Intensive supervision[6]

[4] COMF, art 281.- Preventive supervision. It consists of the supervision applied to financial entities determined by the corresponding control body as having a very low or low risk profile, understood as those entities whose economic-financial condition, quality of corporate or cooperative governance and management of Risks, among other conditions determined by the control body, are considered sufficient for the size and complexity of its operations or that present minor recommendations that do not generate significant concern for the supervisor.

[5] COMF, Art 282.- Corrective supervision. It consists of the supervision that is applied to financial entities determined by the corresponding control body as having a medium risk profile, understood as such entities whose economic-financial condition, quality of corporate or cooperative governance, or risk management, among other conditions determined by the control body, show moderate to significant weaknesses compared to the size and complexity of their operations and that merit strict monitoring of the supervisor's recommendations.

[6] Article 283.- Intensive supervision. It consists of the supervision that is applied to financial entities determined by the corresponding control body as having a high and critical risk profile, understood as those entities whose economic and financial condition, quality of corporate or cooperative governance, or management of Risks, among other conditions determined by the control body, are considered from inadequate to deficient for the size and complexity of its operations, which require significant improvements or which present clear prospects of not meeting the minimum solvency requirements or have not met them.