The Lending Standards Board

Third Party Outsourcing Themed Review

August 2016

1. Background

While most financial services firms retain a strong in-house processing capability, many have opted to outsource parts of their processes to a third party supplier or set up off-shore operations where the cost/benefit analysis indicates that it makes commercial sense to do so.

With regard to Lending Code (the Code) subscribers, and products covered by the Code, several elements of the fulfilment and operational processes, particularly in respect of credit card are either outsourced or undertaken off-shore; for example card production and issue, letters, statements, and enquiries. At the time of this review the Lending Code was still in existence and therefore the objective and scope is very much focussed towards adherence with Code requirements.

Since completion of this exercise we have concluded the review into the Lending Code which has now been superseded by the Standards of Lending Practice (SLP)

While third party oversight and due diligence were specifically covered by the Code in section 9 on financial difficulty, the requirements in other sections of the Code were, to us, clear that the subscriber was responsible for Code compliance where it outsourced any processes where there was a Code impact.

The new SLP is explicit in the requirement for registered firms to ensure that where any part of the credit process/lifecycle is outsourced they should undertake effective and robust due diligence and exercise effective ongoing oversight.

Seven firms were selected to participate in this review.

2. Objective and scope

The objectives of this review were to assess the adequacy of subscribers' systems, processes and controls to ensure that where processes are outsourced, the Code is complied with and that any breaches are identified, reported and remedied. This included an assessment of:

a. The governance arrangements in place over third party outsourcing;

b. The design and operational effectiveness of the firm's due diligence policies and processes when selecting a process to outsource, taking into account the third party's ability to meet the firm's Lending Code obligations, including business continuity arrangements, data protection requirements and processing capacity;

c. The effectiveness of the subscriber's oversight of any third party, assessing the controls to ensure that customer outcomes are being achieved and regulatory requirements are being met, and that any training needs identified are communicated to the third party, implemented and tested to ensure that the training has been effective;

d. The adequacy of management information available at the subscriber to monitor the third party's performance, including the achievement of customer outcomes, compliance with the Code, system performance and processing capacity; and

e. The change framework in place to ensure that any changes to products, processes or systems take into account third party impact, any Code changes are communicated to the third party and tracked through to implementation, and all changes are tested to ensure that they are working effectively.

We also visited a small sample of third parties to undertake an assessment of their in-house processes, systems and controls insofar as they relate to the Lending Code.

These on-site visits involved meeting with key personnel to discuss areas from the desktop review and gain a better understanding of how the objectives are being met.

The ‘Internal Control Assessment’ tables at appendix 1 detail our summary opinion on the adequacy of the design of the participating firms’ internal controls relating to third party management based on our discussions, observations and review of documentation; no further testing was undertaken to assess the operational effectiveness of the controls listed. Where examples of good practice were identified at any of the firms, we have included a brief description of our findings which can be found below each control statement.

The assessment undertaken and findings from this review remain relevant in the context of the SLP and it is our expectation that any comments or recommendations can be applied following implementation of the new Standards.

3. Key conclusions

All of the firms included in this review have in place well structured and robust management frameworks for third party suppliers. These frameworks ensure a thorough due diligence process is undertaken prior to the start of any service being outsourced. This is supported by regular oversight and performance management reviews, with key information being reported to various stakeholders in the firms concerned.

A key element of the framework is the detailed due diligence process. This covers all necessary steps from the point the business need is first identified through to contractual requirements, financial and non financial checks, on-boarding, service level agreements, business continuity and ongoing performance management requirements. Throughout the whole of the due diligence process the customer impact is kept in focus by firms and the service being provided by the third parties is scrutinised to ensure there is no adverse customer outcome. Regular reviews of contracts and related policies are undertaken and this will also include a customer impact view.

Once a third party supplier has been taken on board and is within a ‘business as usual’ status regular meetings are conducted by dedicated third party managers, to ensure all service levels are being met and any risks, issues or service breaches are identified and raised in a timely manner with responsibility for resolution being managed jointly between firms and the third party. Additional oversight is provided through formal annual audits conducted by supplier managers together with second and third line reviews. The second line of defence usually retains the responsibility for providing advice on regulatory obligations and for undertaking independent testing.

Formal change programmes engage third parties where any change will have a direct impact to the service being provided. This process would ordinarily include input from all stakeholders in the business and require formal agreement before any change can be implemented. At key points throughout the process testing is completed to ensure the change is in line with both the business requirements and to ensure all regulatory and customer requirements are being met. Following implementation further testing may be conducted depending on the nature of the change. For any changes instigated by the third party a similar process will be undertaken by the bank but with the change requirements being driven by the supplier.

Based on the information that was made available to us during this review, it is our opinion that firms operate in a well controlled environment in respect of their outsourcing activities.

4. Next steps

During this review we did not identify any Code breaches or weaknesses in relation to third party supplier relationships. The systems, processes and frameworks in place ensure each subscriber clearly understands how the outsourced service is being fulfilled and is able to manage this successfully.

Although we have not identified any issues, this review has only focused on UK outsourced arrangements, as agreed with the LSB Board at the outset. Most of the firms reviewed also have offshore arrangements in place, some of which extend into voice processes, including collections. We feel that the overseas risk is much greater than domestic outsourcing and the use of third party suppliers will, therefore, continue to be an area for inclusion in the LSB's new oversight strategy, through its focus on customer outcomes at the relationship meetings and the research projects.

The key controls assessed during this process have been embedded within the Governance & Oversight section of the new Standards for Lending Practice. It is our intention to include any identified good practices within the Information for Practitioners document.

Internal Controls Assessment

1. Governance and oversight

Outcome: Systems and controls are adequate to ensure effective oversight by the firm and its third parties.

Control opinion - Effective
1.1 Policies and processes in respect of third party management and oversight for relevant products exist and are adequate
1.2 There is an outsourcing policy in place that covers the requirements that regulatory obligations are met
1.3 There is effective governance over third parties (new or existing) with formal reporting through the committee structure
1.4 There is an adequate assurance framework in place proportionate to the firm that encompasses monitoring and quality assurance of transactions and processes, independent oversight, independent assurance in respect of third party providers
1.5 There is an effective route for escalation, with clear lines of responsibility that allows for regulatory related matters to be reported in a timely manner
1.6 There is complete, accurate and timely MI to ensure effective oversight of third parties

2. Due diligence

Outcome: Thorough due diligence is undertaken in the selection of third party providers, with effective oversight and monitoring of all outsourced arrangements where Standards related activity is carried out.

Control Opinion - Effective
2.1 Adequate due diligence is undertaken on new suppliers that includes how the firm's regulatory obligations will be met by the third party and the resilience of systems to service the firm's requirements
2.2 There is a dedicated relationship manager at the firm for the third party
2.3 A formal contract, signed by relevant stakeholders, is in place between the firm and the third party
2.4 All contracts and service agreements include the supplier's obligations to meet regulatory requirements
2.5 Firm understands how its data will be accessed, used and managed by all third party staff
2.6 When multiple clients exist, there is a documented policy in place regarding segregation of data
2.7 Firm categorises third party according to supplier's risk profile and conduct suitable oversight
2.8 Due diligence includes the identification and implementation of robust controls where the third party will sub-contract its services, whether partially or fully
2.9 The firm undertakes regular assessments of the adequacy of controls, through checking and monitoring, to ensure customer outcomes are being achieved and regulatory requirements are being met
2.10 There is adequate MI to monitor performance of third parties, including processing capacity, business continuity arrangements and data protection requirements
2.11 Adequate monitoring and testing of the third party's system's integrity, performance and resilience is undertaken to ensure that the supplier can maintain operations at all times
Good Practice: ***As part of a robust due diligence programme firms should carry out a range of activities to ensure the third party supplier is able to demonstrate the delivery of fair outcomes for customers. This may be conducted with a risk-based approach depending upon the importance and criticality of the service being provided.*** ***Ongoing reporting between registered firms and their suppliers allows a clear view of performance whilst ensuring any issues are resolved quickly, and, depending on frequency and speed of reporting before they crystallise to become a service breach.***

3. Breach management

Outcome: The breach management system is adequate to ensure breaches are identified, correctly recorded, monitored, reported and cleared.

Control Opinion - Effective
3.1 Controls in place (including accurate MI, regular meetings and an open communication channel) enable prompt identification by the firm of breaches occurred at the third party, with appropriate root cause analysis undertaken
3.2 There is a breach management (service breakdown) process in place that is clearly defined, understood and consistently applied
3.3 All breaches have appropriate remedial action and are reported in line with the LSB's policy on materiality, and progress is adequately tracked at the appropriate level
3.4 MI is produced to identify trends from breaches that have occurred and improve systems and processes, including the prevention of further recurrence

4. Change management

Outcome: Effective processes exist at the firm to identify changes and their impact on systems and processes, including at third parties.

Control Opinion - Effective
4.1 Where a product, systems or processes are changed, or a new product is developed, there is a formal change management framework in place that ensures that the change takes full account of any impact across all business areas
4.2 Firm communicates change promptly to the third party. Accountability for managing the change including implementation, staff training, testing and reporting is agreed and understood by both the firm and the third party
4.3 Post change implementation, adequate training takes place for staff members (at the firm and at the third party) to understand the changes
4.4 Post change implementation, there is adequate testing to ensure that compliance has been achieved
4.5 Adequate reporting is produced regularly and reviewed by all relevant people to ensure any potential weaknesses in the new process are identified and dealt with promptly
Good Practice: ***Firms should consider having well managed controls for pre and post implementation testing following any large scale change.*** ***Through the inclusion of a number of checkpoints, both at the firm and the supplier, together with a formal sign off process, this assists firms in ensuring all key stakeholders are involved and the change process runs smoothly thus avoiding any detrimental customer impact.***

5. People

Outcome: The people undertaking the processes are sufficiently skilled.

Control Opinion - Effective
5.1 There is an adequate training and competence programme in place to capture any regulatory obligations.
5.2 Employees, at the firm and the third party, receive sufficient training on knowledge and skills to fulfil their regulatory requirements
5.3 The firm's oversight framework includes the requirement to identify training needs when new or revised processes are introduced
5.4 Third party retains the responsibility for identifying knowledge gaps at an operational level and to promptly highlight those needs to the firm
Good Practice: ***Whilst we acknowledge the majority of training programmes are correctly focussed on specific job roles within the third party, firms should ensure there is also a customer outcome focus where this is appropriate.*** ***In particular any third party suppliers interacting directly with a firm’s customers should follow a similar training plan to that used for training staff in house.***