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

1. Introduction

1.1 NBFCs have been outsourcing various activities and are hence exposed to various risks as detailed in para 1.2. Further, the outsourcing activities are to be brought within regulatory purview to a) protect the interest of the customers of NBFCs and b) to ensure that the NBFC concerned and the Reserve Bank of India have access to all books, records and information available with service provider. Typically outsourced financial services include applications processing (loan origination, credit card), document processing, marketing and research, supervision of loans, data processing and back office related activities, besides others.

1.2 Some key risks in outsourcing may be Strategic Risk, Reputation Risk, Compliance Risk, Operational Risk, Legal Risk, Exit Strategy Risk, Counter party Risk, Country Risk, Contractual Risk, Access Risk, Concentration and Systemic Risk. The failure of a service provider in providing a specified service, a breach in security / confidentiality, or non-compliance with legal and regulatory requirements by either the service provider or the outsourcing NBFC can lead to financial losses or loss of reputation for the NBFC and could also lead to systemic risks within the entire financial system in the country.

1.3 It would therefore be imperative for the NBFC outsourcing its activities to ensure sound and responsive risk management practices for effective oversight, due diligence and management of risks arising from such outsourcing activities. The guidelines are applicable to outsourcing arrangements entered into by an NBFC with a service provider located in India or elsewhere. The service provider may either be a member of the group / conglomerate to which the NBFC belongs, or an unrelated party.

1.4 The underlying principles behind these guidelines are that the regulated entity should ensure that outsourcing arrangements neither diminish its ability to fulfil its obligations to customers and RBI nor impede effective supervision by RBI. NBFCs, therefore, have to take steps to ensure that the service provider employs the same high standard of care in performing the services as is expected to be employed by the NBFCs, if the activities were conducted within the NBFCs and not outsourced.

Accordingly NBFCs should not engage in outsourcing that would result in their internal control, business conduct or reputation being compromised or weakened.

1.5 (i) NBFCs which desire to outsource financial services would not require prior approval from RBI. However, arrangements would be subject to on-site / off- site monitoring and inspection / scrutiny by RBI.

(ii) In regard to outsourced services relating to credit cards, RBI's detailed instructions contained in its circular on credit card activities vide DBOD.FSD.BC.49/24.01.011/2005-06 dated 21st November 2005 would be applicable.

2. Activities that should not be Outsourced

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

3. NBFC's role and Regulatory and Supervisory Requirements

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

3.2 It is imperative for the NBFC, when performing its due diligence in relation to outsourcing, to consider all relevant laws, regulations, guidelines and conditions of approval, licensing or registration.

3.3 Outsourcing arrangements should not affect the rights of a customer against the NBFC, including the ability of the customer to obtain redress as applicable under relevant laws. Since the customers are required to deal with the service providers in the process of dealing with the NBFC, NBFCs should incorporate a clause in the product literature / brochures etc., stating that they may use the services of agents in sales / marketing etc. of the products. The role of agents may be indicated in broad terms.

3.4 The service provider should not impede or interfere with the ability of the NBFC to effectively oversee and manage its activities nor should it impede the Reserve Bank of India in carrying out its supervisory functions and objectives.

3.5 NBFCs need to have a robust grievance redress mechanism, which in no way should be compromised on account of outsourcing.

3.6 The service provider, if it is not a subsidiary of the NBFC, should not be owned or controlled by any director or officer / employee of the NBFC or their relatives having the same meaning as assigned under Section 2(77) and draft rules notified on 09.09.2013 with reference to Section 2(77) (iii)) under Companies Act, 2013.

4. Risk Management practices for Outsourced Financial Services

4.1 Outsourcing Policy

An NBFC intending to outsource any of its financial activities should put in place a comprehensive outsourcing policy, approved by its Board, which incorporates, inter alia, criteria for selection of such activities as well as service providers, delegation of authority depending on risks and materiality and systems to monitor and review the operations of these activities.

4.2 Role of the Board and Senior Management

4.2.1 The Board of the NBFC, or a Committee of the Board to which powers have been delegated should be responsible *inter alia* for the following:

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

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

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

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

4.2.2 Responsibilities of the Senior Management

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

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

iii. Reviewing periodically the effectiveness of policies and procedures;

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

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

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

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

4.3 Evaluation of the Risks

The NBFCs should evaluate and guard against the following risks in outsourcing:

i. **Strategic Risk** – Where the service provider conducts business on its own behalf, inconsistent with the overall strategic goals of the NBFC.

ii. **Reputation Risk** – Where the service provided is poor and customer interaction is not consistent with the overall standards expected of the NBFC.

iii. **Compliance Risk** – Where privacy, consumer and prudential laws are not adequately complied with by the service provider.

iv. **Operational Risk** - Arising out of technology failure, fraud, error, inadequate financial capacity to fulfil obligations and / or to provide remedies.

v. **Legal Risk** – Where the NBFC is subjected to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements due to omissions and commissions of the service provider.

vi. **Exit Strategy Risk** – Where the NBFC is over-reliant on one firm, the loss of relevant skills in the NBFC itself preventing it from bringing the activity back in-house and where NBFC has entered into contracts that make speedy exits prohibitively expensive.

vii. **Counter party Risk** – Where there is inappropriate underwriting or credit assessments.

viii. **Contractual Risk** – Where the NBFC may not have the ability to enforce the contract.

ix. **Concentration and Systemic Risk** – Where the overall industry has considerable exposure to one service provider and hence the NBFC may lack control over the service provider.

4.4 Evaluating the Capability of the Service Provider

4.4.1 In considering or renewing an outsourcing arrangement, appropriate due diligence should be performed to assess the capability of the service provider to comply with obligations in the outsourcing agreement. Due diligence should take into consideration qualitative and quantitative, financial, operational and reputational factors. NBFCs should consider whether the service providers' systems are compatible with their own and also whether their standards of performance including in the area of customer service are acceptable to it. NBFCs should also consider, while evaluating the capability of the service provider, issues relating to undue concentration of outsourcing arrangements with a single service provider. Where possible, the NBFC should obtain independent reviews and market feedback on the service provider to supplement its own findings.

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

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

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

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

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

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

4.5 The Outsourcing Agreement

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

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

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

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

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

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

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

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

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

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

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

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

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

4.6 Confidentiality and Security

4.6.1 Public confidence and customer trust in the NBFC is a prerequisite for the stability and reputation of the NBFC. Hence the NBFC should seek to ensure the preservation and protection of the security and confidentiality of customer information in the custody or possession of the service provider.

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

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

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

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

4.7 Responsibilities of DSA / DMA / Recovery Agents

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

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

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

4.8 Business Continuity and Management of Disaster Recovery Plan

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

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

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

4.8.4 Outsourcing often leads to the sharing of facilities operated by the service provider. The NBFC should ensure that service providers are able to isolate the NBFC's information, documents and records, and other assets. This is to ensure that in adverse conditions, all documents, records of transactions and information given to the service provider, and assets of the NBFC, can be removed from the possession of the service provider in order to continue its business operations, or deleted, destroyed or rendered unusable.

4.9 Monitoring and Control of Outsourced Activities

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

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

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

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

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

4.10 Redress of Grievances related to Outsourced Services

i. NBFCs should constitute Grievance Redressal Machinery as contained in RBI's circular on Grievance Redressal Mechanism vide DNBS. CC. PD. No. 320/03. 10. 01/2012-13 dated February 18, 2013 and give wide publicity about it through electronic and print media. The name and contact number of designated grievance redressal officer of the NBFC should be made known and widely publicised. The designated officer should ensure that genuine grievances of customers are redressed promptly without involving delay. It should be clearly indicated that NBFCs' Grievance Redressal Machinery will also deal with the issue relating to services provided by the outsourced agency.

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

4.11 Reporting of transactions to FIU or other competent authorities

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

5. Outsourcing within a Group / Conglomerate

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

6. Self-Assessment of Existing / Proposed Outsourcing Arrangements

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

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