

Best Practice in Investment Operations Outsourcing

Following the Joint Forum Principles

By Simon Pilkington

Outsourcing has come of age in the financial industry. We can make this statement with confidence for a number of reasons, but foremost among them is the interest being taken in the best practice of outsourcing arrangements by regulatory bodies. In February, the Joint Forum – a cross-industry body which provides guidance on regulatory issues common to the banking, securities and insurance sectors – issued a document called “Outsourcing in Financial Services” which outlines a number of principles aimed at ensuring outsourcing customers and their providers remain in control of their business risks and regulatory responsibilities. These principles were developed in close association with the International Organisation of Securities Commissions (IOSCO), which has also issued a set of complementary principles.

IOSCO’s report followed a survey of industry participants which found that a clear majority of firms in all jurisdictions has some sort of outsourcing arrangement in place. Given the complexity of these arrangements, which require a degree of closeness between both parties that extends beyond a normal business partnership, it is absolutely right for regulators to actively monitor how they are being conducted. The risks of a failed outsourcing partnership are great – companies should certainly not jump on the outsourcing bandwagon for its own sake – and third parties involved in such partnerships may operate offshore and/or in different regulatory environments. So care should be taken when embarking upon an outsourcing journey, and any accepted set of principles which help smooth that journey should be welcomed.

State Street has become the leading global provider for investment operations outsourcing, a business which has grown substantially in recent years. In the

course of this business we have interacted with numerous potential customers: those which have selected us, many which have selected competitors, and a number which concluded that outsourcing is not for them at the present time. Each of these potential customers has adopted different methods for appointing an outsourcing provider – some more unique than others – and through this exposure to a wide variety of ideas we have come up with our own general approach and process for dealing with outsourcing situations. In some cases customers have taken us down different paths from our preferred approach, but the final outcome tends to be the same regardless of the paths followed, and as such we feel we have learned quite a lot about how outsourcing theory and practice tend to come together.

What follows is a discussion of the nine Joint Forum principles as they relate to investment operations outsourcing, based upon our experiences in recent years. The first two principles largely concern the behaviour of our customers; the final two relate to the behaviour of industry regulators. The remainder cover practices reflected in our normal business procedure, and we fully endorse their conclusions. They represent a sensible approach to outsourcing key activities, and they are already practiced by a large proportion of the marketplace.

I. A regulated entity seeking to outsource activities should have in place a comprehensive policy to guide the assessment of whether and how those activities can be appropriately outsourced. The board of directors or equivalent body retains responsibility for the outsourcing policy and related overall responsibility for activities undertaken under that policy.

This is a very sensible approach, but in practice the procedure varies between different potential customers. Not all regulated entities have “comprehensive” outsourcing policies in place, but many have policies for selecting vendors of service providers, and these are often adaptable – certainly all of State Street’s potential customers have adopted a rigorous approach to dealing with the

outsourcing challenge. In investment operations outsourcing, customers tend to have to retain responsibility for the outsourced services as though they were still performing them internally. The key question is whether the service provider, if not a regulated business, performs the activities to the same standard as if they were actually regulated.

II. The regulated entity should establish a comprehensive outsourcing risk management programme to address the outsourced activities and the relationship with the service provider.

Most potential customers recognise the need to implement a control function – sometimes called the “middle office”, as distinct from the “back office” operational functions – to act as a conduit between the client and the service provider. This function is usually involved in operational risk management and control as part of its core function.

III. The regulated entity should ensure that outsourcing arrangements neither diminish its ability to fulfil its obligations to customers and regulators, nor impede effective supervision by regulators.

Maintaining and improving service quality and delivery to customers is one of the primary drivers behind most outsourcing arrangements. All arrangements to-date are covered by service level agreements which allow customers to define and measure the level of service provided. They also include provisions whereby the client, its auditors and its regulators have access to the provider, so that activities can be audited to ensure that they are occurring in a properly controlled environment.

IV. The regulated entity should conduct appropriate due diligence in selecting third-party service providers.

Without exception, all of State Street’s potential outsourcing customers have undertaken a rigorous, multistage selection process to select a provider. This process typically involves a request for information (RFI) from a large number of players, a request for proposal (RFP) involving a shortlist of two or three, and then a period of detailed due diligence with the selected party. Due diligence is usually a two-way process: the provider needs to fully understand the customer’s requirements and any obligations they may be taking on, while the customer needs to ensure that the provider is capable of living up to expectations. “Appropriate” due diligence is therefore normally a very intense and time-consuming process – in reviewing and accounting for every minute detail of an outsourcing partnership, you can’t take shortcuts.

V. Outsourcing relationships should be governed by written contracts that clearly describe all material aspects of the outsourcing arrangement, including the rights, responsibilities and expectations of all parties.

All of our outsourcing arrangements include detailed contractual provisions, plus a service level agreement and key performance indicators, describing all material aspects which govern the customer-provider relationship. Detailed contracts are essential in all arrangements of this nature – they define the partnership and provide protection for both parties in equal measure. We would not become involved with an outsourcing partnership without such a contract.

VI. The regulated entity and its service providers should establish and maintain contingency plans, including a plan for disaster recovery and periodic testing of backup facilities.

Contingency planning is a mandated feature of service provision within financial services – disaster recovery and periodic testing of backup facilities are established practices.

VII. The regulated entity should take appropriate steps to require that service providers protect confidential information of both the regulated entity and its clients from intentional or inadvertent disclosure to unauthorised persons.

Again, provision for the security of confidential information is established practice in financial services – we do not need to make any additional provisions for outsourcing arrangements in order to comply with this requirement.

VIII. Regulators should take into account outsourcing activities as an integral part of their ongoing assessment of the regulated entity.

Regulators should assure themselves by appropriate means that any outsourcing arrangements do not hamper the ability of a regulated entity to meet its regulatory requirements.

Regulators in the jurisdictions where State Street operates are behaving in this manner. Regulators have tended to express interest in the outsourcing arrangements from their outset, both through contract discussions and into ongoing assessment.

IX. Regulators should be aware of the potential risks posed where the outsourced activities of multiple regulated entities are concentrated within a limited number of service providers.

Concentration of providers is a clear concern to regulators in any industry, as this limits choice and can have adverse consequences for the clients. In view of the number of major providers now entering the outsourcing marketplace, this is unlikely to be a concern in the foreseeable future for financial services. Within the asset servicing business, at least 10 major financial institutions are currently providing outsourcing services to the investment manager community.

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In summary, the Joint Forum principles are excellent building blocks upon which detailed regulations concerning outsourcing arrangements could be constructed. For institutions thinking about outsourcing possibilities in the abstract, they are a handy set of guidelines to follow. And for outsourcing providers, following the principles will be necessary both to guard against business risk and remain competitive in a maturing market. The devil is ultimately in the details, for no set of basic principles can encompass the multifaceted complexity and the specific requirements of any properly constructed outsourcing arrangement, but these principles are an effective and fundamental steer toward the safe ground of best practice, and as such they are welcome addition to the outsourcing landscape.

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