REGULATORY GUIDELINE

OUTSOURCING OF BUSINESS ACTIVITIES, FUNCTIONS AND PROCESSES

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1. INTRODUCTION

This regulatory guideline is a Regulatory Guidance Document as contemplated by the Standards of Sound Business Practice (the Standards). It supplements and expands upon section 1, Corporate Governance and section 2, Control Environment of the Standards and must be adhered to by Saskatchewan credit unions.

Financial institutions outsource business activities, functions, and processes to meet the challenges of technological innovation, increased specialization, cost control, and heightened competition. Outsourcing can increase an institution's dependence on third parties, which may increase its risk profile.

This guideline sets out Credit Union Deposit Guarantee Corporation's (the Corporation's) expectations for credit unions pertaining to outsourcing one or more of its business activities to a service provider. These expectations should be considered prudent practices or standards to be applied according to the characteristics of the outsourcing arrangement and the circumstances of the credit union.

Credit unions have the flexibility to configure their operations in the way most suited to achieving their corporate objectives. To this end, this guideline operates on the premise that credit unions retain ultimate accountability for all outsourced activities. Furthermore, the Corporation's supervisory powers should not be constrained, irrespective of whether an activity is conducted in-house, outsourced or otherwise obtained from a third party.

Under this guideline, credit unions are expected to:

- evaluate the risks associated with all existing and proposed outsourcing arrangements;
- develop a process for determining the materiality of arrangements;
- implement a program for managing and monitoring risks, commensurate with the materiality of the arrangements;
- ensure that the board of directors receives information sufficient to enable them to discharge their duties under this guideline; and
- refrain from outsourcing certain business activities to the external auditor (see section 3.1).

The Corporation's specific expectations may vary, depending on the nature of the outsourcing arrangement being contemplated and the relationship between a credit union and the service provider. As part of the Corporation's risk-based supervisory process, a credit union's policies and procedures for assessing the materiality of outsourcing arrangements and managing the risks associated with outsourcing arrangements will be evaluated against the expectations of this guideline. In addition, individual outsourcing arrangements may be subject to supervisory review.

2. OUTSOURCING ARRANGEMENT

For the purposes of this guideline, an outsourcing arrangement is an agreement between a credit union or a credit union subsidiary and a service provider, whereby the service provider performs a business activity, function or process[1] that is, or could be, undertaken by the credit union or subsidiary itself. Credit unions may consult with the Corporation when

[1] In this guideline, "activity" refers to activity, function or process.

they are uncertain whether a particular arrangement falls within this definition. Examples are provided in Appendix 1.

3. APPLICATION OF THE GUIDELINE

This guideline applies to all the outsourcing arrangements of a credit union and its subsidiaries. In applying this guideline, credit unions are expected to consider the impact that outsourcing arrangements may have on the organization and its consolidated operations.

All outsourcing arrangements should be subjected to the materiality assessment set out in section 5 of the guideline. The Corporation expects the robustness of a credit union's management of outsourcing risks to be commensurate with the materiality of the arrangement. With respect to outsourcing arrangements that are deemed material, credit unions are expected to follow the full risk management program detailed in section 6.

3.1. OUTSOURCING ARRANGEMENTS WITH THE EXTERNAL AUDITOR

Prior to obtaining non-audit services from its external auditor, a credit union should assure itself that its external auditor would be in compliance with the relevant auditor independence standards of the Canadian accounting profession, as well as any other applicable auditor independence requirements.

In addition, credit unions should not outsource the following activities to its external auditor:

- any internal audit service related to the internal accounting controls, financial systems, or financial statements of a credit union, unless it is reasonable to conclude that the results of the service will not be subject to audit procedures during an audit of the organization's financial statements. This does not prohibit the external auditor from providing a non-recurring service to evaluate a discrete item or program, if the service is not, in substance, the outsourcing of an internal audit function.

4. ACCOUNTABILITY AND CONTROL

4.1. CREDIT UNION BOARD OF DIRECTORS RESPONSIBILITIES

As set out in the Corporation's Corporate Governance guideline, the board or a committee of the board is expected to ensure that the credit union has appropriate risk management policies and practices, and that they are regularly reviewed. In terms of the specific risks arising from outsourcing, it is expected that the board would periodically:

- approve or reaffirm the policies that apply to outsourcing arrangements (e.g., risk philosophy, materiality criteria, risk management program and approval limits); and
- review a list of all of the credit union's material outsourcing arrangements (see section 6.3.1) and other relevant reports, when appropriate.

4.2. CREDIT UNION MANAGEMENT RESPONSIBILITIES

Management is responsible for:

- developing outsourcing policies for board approval;
- implementing the policies and any associated procedures;

- periodically reviewing their effectiveness;
- communicating information pertaining to significant outsourcing risks to the board in a timely manner; and
- obtaining information from organizations to which work has been outsourced confirming the effectiveness of their risk management processes.

The policies and procedures are expected to include:

1) An outsourcing risk philosophy

   A credit union's outsourcing risk philosophy would generally comprise of a statement of principles, the basis for decision making, and the parameters for controlling outsourcing risks. Outsourcing risk philosophies should address the following:
   - integration of outsourcing arrangements, both individually and in aggregate, with overall business and strategic objectives. This could include the identification of any functions that, for strategic or internal control reasons, the credit union would not contemplate outsourcing.
   - importance and adequacy of internal expertise and management frameworks to oversee and manage the outsourced activity and the relationship with the service provider.
   - business case for outsourcing a significant business activity. The business case should consider the short- and long-term cost implications, and all relevant prudential matters. If the service is being supplied from a foreign jurisdiction[2], the credit union should identify the issues that may arise as a result of the differing and potentially conflicting requirements among jurisdictions. The business case should also consider the cumulative impacts of all outsourcing arrangements on the overall safety and soundness of the credit union.

2) A materiality assessment for outsourcing arrangements

   This assessment is expected to identify both the processes for determining the materiality of individual outsourcing arrangements and the underlying materiality factors such as those set out in section 5.

3) An outsourcing risk management program that, at a minimum, includes the expectations contained in section 6 and is applied consistently throughout the credit union. The Corporation expects management to pay particular attention to business continuity planning on an enterprise-wide basis.

4) Limits regarding the level or authority that enables the credit union's officers to approve outsourcing arrangements of varying magnitudes, either individually or in aggregate. This system should be consistent with the outsourcing risk philosophy and materiality criteria.

5. MATERIALITY ASSESSMENT FOR OUTSOURCING ARRANGEMENTS

As outlined in section 3, the Corporation recognizes that the outsourcing arrangements undertaken by credit unions will have differing degrees of materiality and may not be readily classified as either material or immaterial. In general, the Corporation expects that

[2] A foreign jurisdiction includes any location outside of Canada.

credit unions will design a risk management program that applies to all its outsourcing arrangements, except those that are clearly immaterial, and that the risk mitigants employed under this program will be appropriate to the particular outsourcing arrangement. As such, the risk management program should be scaled to apply different requirements depending on the type of outsourcing arrangement. Material outsourcing arrangements should be subject to the full expectations set out in section 6, unless it is reasonable to conclude that a particular expectation is not appropriate. The Corporation may review a credit union's materiality assessment on a case-by-case basis as part of the supervisory review process.

The materiality of an outsourcing arrangement will depend on the extent to which it has the potential to have an important influence – whether quantitative or qualitative – on a significant line of business of the consolidated operations of the organization.

The assessment of the materiality of an outsourcing arrangement is often subjective and depends on the circumstances faced by an individual credit union. Without limiting the scope of the materiality assessment, factors that credit unions should consider include:

- the impact of the outsourcing arrangement on the finances, reputation and operations of the credit union, or a significant business line, particularly if the service provider should fail to perform over a given period of time;
- the ability of the credit union to maintain appropriate internal controls and meet regulatory requirements, particularly if the service provider were to experience problems;
- the cost of the outsourcing arrangement;
- the degree of difficulty and time required to find an alternative service provider or to bring the business activity 'in-house'; and
- the potential that multiple outsourcing arrangements provided by the same service provider can have an important influence – in aggregate – on the credit union.

Specific questions credit unions might consider in assessing the materiality of outsourcing arrangements are set out in Appendix 2.

Outsourcing all or substantially all of a management oversight function should always be considered material. For the purpose of this guideline, management oversight functions include:

- financial analysis;
- compliance;
- any internal audit services related to the internal accounting controls, financial systems, or financial statements;
- senior management; and
- risk management.

For example, a material arrangement could relate to the outsourcing of a significant part of a credit union's information technology or investment management function. Arrangements that likely do not represent material outsourcing include those where there are numerous similar providers in the marketplace and the cost and inconvenience of switching between providers is low.

Significant changes in the volume or nature of business conducted should cause a credit union to reassess an outsourcing arrangement's materiality. In cases where an arrangement is reassessed as material, it should come into compliance with all aspects of this guideline at the first opportunity, such as when the outsourcing contract, agreement or statement of work is substantively amended, renewed or extended.

6. RISK MANAGEMENT PROGRAM FOR MATERIAL OUTSOURCING ARRANGEMENTS

In general, the Corporation expects that credit unions will design a risk management program that applies to all outsourcing arrangements of the credit union and its subsidiaries, except those that are clearly immaterial. The risk mitigants employed should be commensurate with the credit unions' assessment of the risks associated with the particular outsourcing arrangement.

6.1. DUE DILIGENCE PROCESSES

The Corporation expects credit unions to conduct internal due diligence to determine the nature and scope of the business activity to be outsourced, its relationship to the rest of the organization's activities, and how the activity is managed.

In selecting a service provider or substantially amending or renewing a contract or outsourcing agreement, a credit union is expected to undertake a due diligence process that fully assesses the risks associated with the outsourcing arrangement, and addresses all relevant aspects of the service provider, including the effectiveness of risk mitigation strategies. See Appendix 3 for a list of factors that could be included when performing due diligence of a service provider. When out-of-Canada outsourcing is being contemplated, credit unions must pay particular attention to the legal requirements of that jurisdiction, as well as the potential political, economic and social conditions, and events that may conspire to reduce the foreign service provider's[3] ability to provide the service, as well as any additional risk factors that may require adjustment to the risk management program.

Due diligence processes will vary depending on the nature of the outsourcing arrangement being contemplated. For example, in the case of renewals where no material change has occurred that would affect the viability of the outsourcing relationship, it may be appropriate to conduct more streamlined due diligence.

Credit unions may rely on a due diligence review of the service provider that has been performed within the previous 12 months, provided the review addresses the above-noted requirements as well as the risks particular to the credit union.

6.2. POLICIES AND PROCEDURES TO MANAGE RISKS ASSOCIATED WITH MATERIAL OUTSOURCING ARRANGEMENTS

6.2.1. Contract for Services

The Corporation expects material outsourcing arrangements to be documented by a written contract that addresses all elements of the arrangement and has been reviewed by the credit union's legal counsel. Some of the items identified below may not be applicable in all circumstances; however, credit unions are expected to address all issues relevant to managing the risks associated with each outsourcing arrangement to the extent feasible and reasonable.

[3] A foreign service provider is an organization operating outside of Canada, regardless of whether ownership is Canadian.

Nature and Scope of the Service Being Provided

The contract or outsourcing agreement is expected to specify the scope of the relationship, including provisions that address the frequency, content and format of the service being provided. The contract or outsourcing agreement is also expected to detail the physical location where the service provider will provide the service.

Performance Measures

Performance measures should be established that allow each party to determine whether the commitments contained in the contract are being fulfilled.

Reporting Requirements

The contract or outsourcing agreement is expected to specify the type and frequency of information a credit union receives from the service provider. This would include reports that allow the credit union to assess whether the performance measures are being met, assurance that risk is managed appropriately, and any other information required for its monitoring program (see section 6.3). In addition, the contract or outsourcing agreement is expected to include procedures and requirements for the service provider to report events to the credit union that may have the potential to materially affect the delivery of the service.

Resolution of Differences

The Corporation expects the contract or outsourcing agreement to incorporate a protocol for resolving disputes. The contract or outsourcing agreement should specify whether the service provider must continue providing the service during a dispute and the resolution period, as well as the jurisdiction and rules under which the dispute will be settled.

Defaults and Termination

The contract or outsourcing agreement should specify what constitutes a default, identify remedies, and allow for opportunities to cure defaults or terminate the agreement. A credit union is expected to ensure that it can reasonably continue to process information and sustain operations in the event that the outsourcing arrangement is terminated or the service provider is unable to supply the service. Appropriate notice should be required for termination of service and the credit union's assets should be returned in a timely fashion. In particular, data and records should be returned to the credit union in a format that would allow business operations to resume without prohibitive expense.

The contract or outsourcing agreement should not contain wording that precludes the service from being continued in situations where the Corporation takes control of the credit union, or where the credit union is in liquidation.

Ownership and Access

Identification and ownership of all assets (intellectual and physical) related to the outsourcing arrangement should be clearly established, including assets generated or purchased pursuant to the outsourcing arrangement. The contract or outsourcing agreement should state whether and how the service provider has the right to use the credit union's assets (e.g., data, hardware and software, system documentation or intellectual property) and the credit union's right of access to those assets.

Contingency Planning

The contract or outsourcing agreement is to outline the service provider's measures for ensuring the continuation of the outsourced business activity in the event of problems and events that may affect the service provider's operation, including systems breakdown and natural disaster, and other reasonably foreseeable events. Credit unions are expected to ensure that the service provider regularly tests its business recovery system as it pertains to the outsourced activity, notifies the credit union of the test results, and addresses any material deficiencies. In addition the credit union should be notified in the event that the service provider makes significant changes to its business resumption and contingency plans, or encounters other circumstances that might have a serious impact on the service.

Audit Rights

The contract or outsourcing agreement is expected to clearly stipulate the audit requirements and rights of both the service provider and credit union. At a minimum, it should give the credit union or an independent auditor the right to evaluate the service provided. This includes a review of the service provider's internal control environment as it relates to the service being provided.[4]

In addition, in all situations, irrespective of whether an activity is conducted in-house or outsourced, or otherwise obtained from a third party, the Corporation retains its supervisory powers. Accordingly, an undertaking from the service provider or a provision in the outsourcing contract should give the Corporation the right to:

- exercise the contractual rights of the credit union relating to audit;
- accompany the credit union (or its independent auditor) when it exercises its contractual audit rights;
- access and make copies of any internal audit reports (and associated working papers and recommendations) prepared by or for the service provider in respect of the service being performed for the credit union, subject to the Corporation agreeing to sign appropriate confidentiality documentation in form and content satisfactory to the service provider; and
- access findings in the external audit of the service provider (and associated working papers and recommendations) that address the service being performed for the credit union, subject to the consent of the service provider's external auditor and the Corporation agreeing to sign appropriate confidentiality documentation in form and content satisfactory to the service provider and the external auditor.

The Corporation will provide a credit union with reasonable notice of intent to exercise its audit rights and will share its findings with the credit union where appropriate. In the normal course, the Corporation would seek to obtain information it requires through the credit union itself.

Subcontracting

The contract or outsourcing agreement is expected to set out any rules or limitations to subcontracting by the service provider. In particular, security and confidentiality requirements should apply to subcontracting or outsourcing arrangements by the primary

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[4] A CSAE 3416 report (Auditor's Report on Controls at a Service Organization) or an alternate report that is commensurate with the materiality of the outsourced service may be sufficient. Note that a CSAE 3416 report focuses on financial reporting controls and does not intend to provide an audit of operations and other controls (such as business continuity planning).

service provider. Consistent with the principles of this guideline, the audit and inspection rights of the credit union and the Corporation should continue to apply to all significant subcontracting arrangements.

Confidentiality, Security and Separation of Property

At a minimum, the contract or outsourcing agreement is expected to set out a credit union's requirements for confidentiality and security. Ideally, the security and confidentiality policies adopted by the service provider would be commensurate with those of the credit union and should meet a reasonable standard in the circumstances. The contract or outsourcing agreement should address which party has responsibility for protection mechanisms, the scope of the information to be protected, the powers of each party to change security procedures and requirements, which party may be liable for any losses that might result from a security breach, and notification requirements if there is a breach of security.

The Corporation expects appropriate security and data confidentiality protections to be in place. The service provider is expected to have the ability to isolate a credit union's data, records, and items in process from those of other clients at all times, including under adverse conditions.

Pricing

The contract or outsourcing agreement should fully describe the basis for calculating fees and compensation relating to the service being provided.

Insurance

The service provider should be required to notify a credit union about significant changes in insurance coverage and disclose general terms and conditions of the insurance coverage.

6.2.2. Location of Records

In accordance with provincial legislation, certain records[5] of entities carrying on business in Canada should be maintained in Canada. In addition, a credit union is expected to ensure that the Corporation can access in Canada any records necessary to enable it to fulfill its mandate.

6.2.3. Business Continuity Plan

A credit union's business continuity plan should address reasonably foreseeable situations (either temporary or permanent) where the service provider fails to continue providing service. The business continuity plan and back-up systems should be commensurate with the risk of a service disruption. In particular, a credit union's business continuity plan should ensure that it has in its possession, or can readily access, all records necessary to allow it to sustain business operations, meet its statutory obligations, and provide all information as may be required by the Corporation to meet its mandate, in the event the service provider is unable to provide the service.

[5] Section 28 (1) & (2) of the *Credit Union Act, 1998*.

6.2.4. Outsourcing in Foreign Jurisdictions (If Applicable)

When the material outsourcing arrangement results in services being provided in a foreign jurisdiction, a credit union's risk management program should be enhanced to address any additional concerns linked to the economic and political environment, technological sophistication, and the legal and regulatory risk profile of the foreign jurisdiction(s).

6.3. MONITORING AND OVERSIGHT OF MATERIAL OUTSOURCING ARRANGEMENTS

Credit unions should develop, implement and oversee procedures to monitor and control outsourcing risks in accordance with its outsourcing risk-management policies. The sophistication of the procedures should be commensurate with the size and complexity of the outsourcing arrangement(s) and with the expectations contained in this guideline. Management is expected to prepare reports based on the credit union's monitoring and oversight activities. These reports should outline the success (or lack thereof) of all material outsourcing arrangements and the effectiveness of the risk management program. This information should be reflected in the documentation delivered to the credit union's board of directors.

6.3.1. Centralized List of All Material Outsourcing Arrangements

Credit unions are expected to maintain a centralized list of all its material outsourcing arrangements, including those of its subsidiaries. The list should contain information pertaining to the name of the service provider, the location where the service is provided, the expiry or renewal date of the contract or outsourcing agreement and the estimated value (dollar amount) of the contract or outsourcing agreement The list should be updated on an ongoing basis and should form part of the documentation delivered to the credit union's board of directors. The Corporation should have access to this list upon request.

6.3.2. Monitoring the Outsourcing Arrangement

Credit unions are expected to monitor all material outsourcing arrangements to ensure that the service is being delivered in the manner expected and in accordance with the terms of the agreement. Monitoring may take the form of regular meetings with the service provider and/or periodic reviews of the outsourcing arrangement's performance measures. Within a reasonable time, a credit union should advise the Corporation about any events that are likely to have a significant negative impact on the delivery of the service.

Credit unions should review material outsourcing arrangements to ensure compliance with outsourcing risk policies and procedures and with the expectations contained in this guideline. Reviews of material outsourcing arrangements should be periodically undertaken by a credit union's internal audit function or other independent review function, either internal or external to the credit union. The credit union's board of directors will always retain overall accountability for the outsourcing arrangements.

Reviews should test a credit union's risk-management activities for outsourcing in order to:

- ensure risk-management policies and procedures for outsourcing are being followed;
- ensure effective management controls over outsourcing activities;
- verify the adequacy and accuracy of management information reports;
- confirm the data integrity of reports received from third party vendors; and

- ensure that personnel involved in risk-management for outsourcing are aware of the credit union's risk-management policies and have the expertise required to make effective decisions consistent with those policies.

Management has the responsibility to adjust the scope of the review depending on the nature of the outsourcing arrangement.

6.3.3. Monitoring the Service Provider

Credit unions should regularly review the service provider to ascertain its ability to continue to deliver the service in the manner expected. The frequency and depth of the review would be commensurate with the level of risk involved and could include an assessment of the service provider's circumstances including its financial strength, prospects, technical competence, risk mitigation strategies, and use and performance of significant subcontractors.

6.4. IMPLEMENTATION

Credit unions are required to comply with the requirements contained in this guideline on the date it is issued.

APPENDIX 1 - EXAMPLES OF OUTSOURCING ARRANGEMENTS

The outsourcing domain is diverse and growing. Some examples may include:

- information system management and maintenance (e.g., information processing, data centres, facilities management, end-user support, local area networks, help desks);
- document processing (e.g., cheques, credit card slips, bill payments, bank statements, other corporate payments);
- application processing (e.g., loan originations);
- loan administration (e.g., loan negotiations, loan processing, collateral management, collection of bad loans);
- investment management (e.g., portfolio management, cash management);
- marketing and research (e.g., product development, data warehousing and mining, advertising, media relations, call centres, telemarketing);
- back office management (e.g., electronic funds transfer, payroll processing, custody operations, quality control, purchasing);
- real estate administration (e.g., building maintenance, lease negotiation, property evaluation, rent collection);
- professional services related to business activities of a credit union (e.g., accounting, internal audit); and
- human resources (e.g., benefits administration, recruiting).

This guideline generally would not apply to the following:

- courier services, regular mail, utilities, telephone;
- procurement of specialized training;
- discrete advisory services (e.g., legal opinions, certain investment advisory services that do not result directly in investment decisions, independent appraisals, trustees in bankruptcy);
- purchase of goods, wares, commercially available software and other commodities
- independent audit reviews;
- credit background, background investigation and information services;
- market information services (e.g., Bloomberg, Moody's);
- independent consulting;
- printing services;
- repair and maintenance of fixed assets;
- supply and service of leased telecommunication equipment;
- travel agency and transportation services;
- correspondent banking services;
- maintenance and support of licensed software;
- temporary help and contract personnel;
- fleet leasing services;
- specialized recruitment;
- external conferences;
- clearing and settlement arrangements between members or participants of recognized clearing and settlement systems;
- sales of insurance policies by agents or brokers;
- ceded insurance and reinsurance ceded; and
- syndication of loans.

APPENDIX 2 - SAMPLE QUESTIONS TO ASSESS THE MATERIALITY OF OUTSOURCING ARRANGEMENTS

In assessing the materiality of a specific outsourcing arrangement, a credit union may want to consider the following questions:

- What is the relationship between the business activity and the credit union's core business?
- What is the outsourcing arrangement's potential impact on earnings, solvency, liquidity, funding, capital, reputation, internal expertise and capacity of the credit union, brand value, or system of internal controls?
- What is the outsourcing arrangement's importance to achieving and implementing business objectives, strategy and plans?
- What is the credit union's aggregate exposure to a particular service provider? Is the credit union exposed to additional outsourcing risk as a result of multiple outsourcing arrangements with a service provider?
- What is the size of contractual expenditures as a share of non-interest expenses of the credit union or line of business?
- If the service provider is unable to perform the service over a given period of time:
    - What is the expected impact on the credit union's members?
    - What is the likely impact on the credit union's reputation?
    - Would it have a material impact on the credit union's risk profile?
    - Would the credit union be able to engage an alternative service provider? How long would it take and what costs would be involved?

APPENDIX 3 - DUE DILIGENCE OF SERVICE PROVIDERS

The due diligence of service providers addressed in section 6.1 may include, but is not limited to, examining a service provider in light of these factors:

- experience and technical competence of the service provider to implement and support the outsourced activity (this could include a review of the experience and technical competence of significant subcontractors where feasible);
- financial strength (e.g., most recent audited financial statements and other relevant information (to the best of the service provider's ability[6]);
- business reputation, complaints, compliance and pending litigation;
- internal controls, reporting and monitoring environment;
- risk mitigation strategies utilized by the service provider;
- the service provider's business continuity and contingency measures, including recovery testing, for ensuring the continuation of the outsourced business activity in the event of problems and events that may affect the service provider's operation;
- reliance on and success in dealing with sub-contractors;
- insurance coverage; and
- business objectives, human resource policies, service philosophies, business culture, and how they fit with those of a credit union.

[6] The onus is on the credit union to ensure that it obtains the relevant information to assess a service provider's financial strength. However, the Corporation recognizes that the service provider is required to comply with other legislation (such as securities legislation) and might not be in a position to share certain information with the credit union.