Linklaters

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New expectations for financial institution outsourcing and cloud arrangements in Singapore

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Publication of new Guidelines on Outsourcing

Summary

On 27 July 2016, the Monetary Authority of Singapore ("**MAS**") issued new Guidelines on Outsourcing (the "**Guidelines**"), together with a response to industry feedback and an FAQ document. The Guidelines replace the previous MAS Outsourcing Guidelines and Circular on Information Technology Outsourcing. The Guidelines revise and update the expectations, particularly in relation to the management of risk, imposed by the MAS on financial institutions when they enter into any kind of outsourcing arrangement.

The Guidelines set out broad, overarching standards that financial institutions will be expected to interpret and apply on a case-by-case basis. We set out below some of the key considerations to bear in mind when assessing the impact of the Guidelines on your business.

Alongside the Guidelines, the Association of Banks in Singapore ("**ABS**") with support from MAS has released an Implementation Guide in respect of cloud-based outsourcing in the financial industry (the "**ABS Guide**"). Together with the Guidelines, the ABS Guide supports the use of cloud by financial institutions and sets out useful guidance on how financial institutions may manage the unique risks associated with cloud services.

Key definitions – scope of the Guidelines

The Guidelines have added a number of new definitions, including "customer" (which is tailored to each different type of financial institution). Other definitions have been expanded and, in particular, "institution" now refers to all financial institutions in Singapore, which broadens the range of institutions required to consider the Guidelines when entering into and maintaining outsourcing arrangements. Previously, "institution" referred only to banks, finance companies, approved holding companies, approved exchanges, designated clearing houses, capital markets services licensees and insurance companies (each as regulated under applicable Singapore laws and regulations). The new Guidelines are, in addition, applicable to (amongst others) licensed money changes and remittance agents, trustees for collective investment schemes, holders of stored value facilities and issuers of credit cards and charge cards in Singapore.

Of particular relevance is the new definition of "material outsourcing arrangements", which is considerably broader than under the old guidelines. The definition now explicitly captures any outsourcing arrangement which involves customer information, if any unauthorised access or disclosure, loss or theft of customer information occurs, would have a material impact on the institution's customers. As pointed out in industry feedback, this potentially means that any outsourcing arrangement involving customer data should be deemed "material".

Similarly to the tone of the rest of the Guidelines, the definition of "material outsourcing arrangement" is not prescriptive, and MAS expects financial institutions to have their own frameworks in place to evaluate the materiality of outsourcing arrangements on a case-by-case basis. MAS has provided in Annex 2 of the Guidelines some guidance on factors that may affect materiality, although these are qualitative rather than quantitative, and should not replace a financial institution's own independent assessment of materiality. However, the list, which is an expansion of the list provided in the old guidelines, does provide welcome further clarity on factors that should be considered.

Engagement with MAS

Material outsourcing arrangements

In possibly the most practically impactful change, MAS has removed the expectation for financial institutions to notify it of material outsourcing arrangements prior to entering into them.

The pre-notification expectation has been replaced with an expectation to keep a register of all outsourcing arrangements (in the template provided by MAS, located in Annex 3 of Guidelines). Historically, MAS has required certain financial institutions to produce such registers periodically, although this has typically been required by way of private instructions to the relevant financial institution. This new register-keeping expectation will require financial institutions to maintain up-to-date registers, to be provided to the MAS at least annually, or upon MAS' request.

It is important to note that MAS expects the register to contain <u>all</u> outsourcing arrangements (external and intra-group; material and non-material). This is distinct from the expectation that financial institutions will keep a register of all material outsourcing arrangements for presentation to the board and senior management – this can be in a form determined by the financial institution, but should still contain (at a minimum) the information specified in Annex 3 of the Guidelines.

Adverse developments

The Guidelines clarify the expectation on financial institutions to notify MAS of adverse developments in their outsourcing arrangements. Under the old guidelines, a notification to MAS was expected whenever an adverse development could “significantly impact” the financial institution. MAS now expects financial institutions to notify it whenever an adverse development could “impact” them, and has clarified that the notification should be made “as soon as possible”. This both lowers the threshold for notifications to be made to MAS and reduces the scope for delaying a notification for any reason.

Furthermore, MAS has continued to decline to exhaustively prescribe circumstances which could constitute an adverse development, noting in its response to industry feedback that consequences of an event will differ depending on the nature and scope of each individual outsourcing arrangement. MAS has provided examples of adverse developments in the Guidelines, particularly events that could lead to service failures or security breaches, and breaches of confidential customer information. This is a different focus to the old guidelines, where the only example provided was events that could lead to a termination and early exit from the outsourcing arrangement.

Audit and inspection

MAS has slightly expanded its powers in relation to contractual rights to audit and inspect service providers, by providing explicitly that MAS should have the right to access reports produced by internal or external auditors of the service provider. Previously, the old guidelines set out that MAS should be able to exercise powers to access the service provider directly.

The expansion of this provision may be an acknowledgment by MAS that many cloud service providers do not typically grant direct audit rights to outsourcing counterparties, but will provide an independently produced audit report to such counterparties. MAS therefore expects that it will also have access to such reports, in the absence of contractual rights to directly access the service provider. However, MAS has also retained the expectation that it will be able to directly access a service provider where the outsourcing counterparty has been granted such a right.

Monitoring and review of outsourcing arrangements

Initial assessment

The Guidelines set out general risk evaluation and due diligence expectations that MAS will expect financial institutions to follow before entering into any outsourcing arrangement. These expectations cover the same broad areas as the old guidelines, but more detail has been added throughout.

Of particular importance is a new expectation on financial institutions to assess the hiring policies of the service provider to ensure that such policies are consistent with the equivalent policies of the outsourcing financial institution. MAS has clarified that this does not equate to a full fit-and-proper assessment of the service provider's employees, and does not require individual assessment of specific employees. However, it is a new factor to consider when conducting outsourcing due diligence as it will have timing implications, and will involve an allocation of appropriate resources to assess the service provider's policies. Furthermore, service providers will need to consider whether they should amend and improve their own hiring policies to meet the standards of the outsourcing financial institution, and data protection issues will have to be considered when sharing information on employees with the financial institution.

MAS clarified in its response to industry feedback that it always expects institutions in Singapore to play a part in the due diligence of a service provider, even if the final decision is made by a head office in another jurisdiction. If the practice of the financial institution is for the head office to appoint its service providers, MAS will still expect the Singapore branch to ensure that Singapore legal and regulatory requirements are met. This may involve the Singapore branch reviewing the current due diligence practices of its head office in respect of appointing outsourcing service providers, in order to ensure that such practices meet the standards set out in the Guidelines.

Ongoing assessment

Similarly to under the old guidelines, MAS expects financial institutions to conduct periodic risk evaluations and due diligence on all service providers. The appropriate level of ongoing monitoring is a risk-based decision to be taken by each financial institution on a case-by-case basis, although material outsourcing arrangements should be reviewed on at least an annual basis, which is a more explicit expectation than under the old guidelines.

Cloud computing

MAS has included in section 6 of the Guidelines new guidance on cloud-based services. This section clarifies that MAS views cloud-based services as a form of outsourcing. MAS is of the view that the types of risks associated with cloud-based services are not distinct from other forms of outsourcing arrangements, and therefore all of the expectations contained in the Guidelines should apply equally to cloud-based services. However, MAS recognises that cloud involves unique risks which financial institutions need to manage, including risks arising from the multi-tenancy nature of cloud services and that cloud services often involve the movement of data between data centres in different locations.

Subsequent to the issuance of the Guidelines, the ABS has published the ABS Guide. The ABS Guide contains industry-approved guidance developed with the input of MAS and applicable to both financial institutions and cloud-based service providers, concerning:

- classification of outsourcing (i.e. when an outsourcing should be deemed "material" in the cloud context);
- activities recommended as part of due diligence, prior to entering an outsourcing arrangement; and

- key controls for cloud-based service providers to have in place when dealing with financial institutions.

The ABS Guide usefully includes a number of practical recommendations for how financial institutions may use cloud services in compliance with the Guidelines and other MAS guidelines. For example, the ABS Guide suggests that financial institutions should:

- establish the precise locations of the data centres where their data will be stored and processed;
- ensure that they have the ability to access their data and a clear exit plan which allows them to retain data stored in the cloud service; and
- implement encryption and tokenisation to strengthen the security of data stored in the cloud service.

While the Guidelines indicate MAS' support for the use of cloud services by financial institutions as long as financial institutions have taken appropriate steps to manage the risks associated with use of cloud, the ABS Guide outlines how financial institutions may be able to manage those risks.

Status of the Notice on Outsourcing

When consulting on the Guidelines in 2014, MAS also proposed and consulted on a new Notice on Outsourcing (the "**Notice**"). The introduction of the Notice would be significant, as it would be legally binding (in contrast to the Guidelines which provide for "best practice" standards).

In its response to industry feedback on the Guidelines, MAS stated that the Notice would be issued "at a later date". Prior to issuance, MAS intends to engage the industry, where necessary. Whilst this does not commit MAS to further consultations, or a date for issuance, it is likely that the Notice will be issued later in 2016.

Impact on your business

The issuance of these new Guidelines fundamentally changes the nature of interactions with MAS on outsourcing arrangements, and brings welcome clarity to a number of existing expectations. Financial institutions in Singapore should proceed to evaluate all outsourcing arrangements to which they are a party in order to (a) ascertain which should be deemed “material outsourcing arrangements” and (b) populate their outsourcing register in the format prescribed by MAS. Financial institutions should also conduct an evaluation of risk management frameworks in order to ascertain that they are compliant. The Guidelines also clearly indicate MAS’ support of the use of cloud services by financial institutions and, along with the ABS Guide, set out helpful recommendations for managing the unique risks associated with cloud.

MAS has specified that it expects financial institutions to conduct self-assessments of all existing outsourcing arrangements against the Guidelines within 3 months of the issuance of the Guidelines (i.e. by 27 October 2016). If there are any deficiencies identified by such self-assessments, MAS expects financial institutions to address them within 12 months from the issuance of the Guidelines (i.e. by 27 July 2017).

Further information

If you would like to discuss the above, feel free to contact Peiying Chua or Adrian Fisher or any of your other Linklaters contacts.

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