Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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Report on Thematic Outsourcing Inspections in Credit Unions

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Contents

1. Introduction

While credit unions are permitted to outsource activities they must ensure that such activities are compliant with section 76J of the Credit Union Act, 1997 (as amended) ("the Act"). Additionally the Credit Union Handbook provides guidance in this area with a specific chapter on Outsourcing. This guidance covers such areas as: exercising due skill, care and diligence; outsourcing agreements; outsourcing policy; business continuity planning; supervision of outsourced activities; notifications required by the Central Bank; and review by the board of directors.

In order to assess the implementation of the outsourcing regime across the sector, the Central Bank conducted thematic inspections in a sample of credit unions. The Bank sought to establish a deeper understanding of the level of compliance with the outsourcing requirements and the level of understanding of these within the sector. These thematic inspections were carried out during the period June - October 2016 across a sample of 16 credit unions and focused on 3 specific areas of outsourcing, namely:

- Selection of Provider;
- Reporting; and
- Oversight and Review of Performance.

This report sets out the findings from these inspection; some key observations; and the expectations of the Central Bank in relation to compliance by credit unions in relation to the three areas set out above. The report also looks at patterns of behaviour within different strata of credit unions and examines for correlation between size and compliance.

2. Overview of Outsourcing within the Credit Union Sector

Credit unions outsource many activities, however, a large number of these have been excluded from the thematic review on the basis of immateriality (Appendix I sets out a full list of outsourced activities as per the 2015 credit union annual return). For the purposes of this review, focus was concentrated on IT (software and hardware), internal audit, risk and compliance outsourcing.

In order to get an overview of the level of outsourcing activity undertaken within the sector, the 2015 annual returns were examined. Within the annual return, credit unions are required to detail the activities they outsource. Of the 309 credit unions that submitted their annual return, 10 stated that they do not outsource any activities. An examination of the annual returns shows that of the 299 credit unions who stated that they outsource activity, 254 (85%) outsource their internal audit, 94 (31%) outsource compliance and 92 (30%) outsource their risk function. All credit unions outsource IT.

The Annual Compliance Statement (Statements) also provides information on outsourcing within the sector. A study of the 2015[1] Statements highlights that 20 credit unions, with a total of 24 breaches, stated they were not in compliance with the relevant section of the Act. All these breaches are reported as immaterial. The table below summarises the areas of non-compliance reported by credit unions.

Reason	Weak or no Policy	Review failures	Lack of Notifications	Weak Due Diligence	SLA not in place	BCP	Lack of Controls	Conflict of interest
Number	6	6	3	3	3	1	1	1

[1] While all 2016 returns have not been submitted, on the basis of 90% of the population being available 15 credit unions are reporting breaches in Outsourcing

3. Methodology

As mentioned in the introduction, a sample of 16 credit unions were visited for the purpose of this thematic review. The sample was chosen to represent the diversity of the credit unions sector and therefore it included credit unions from: both rural and urban areas; industrial and community based; and based on different asset sizes. The largest credit union in the sample had assets in excess of €300 million and the smallest had less than €10 million. The average asset size was €113.2 million with a combined total asset base of €1.81 billion. Four of the sixteen in the sample were industrial credit unions (all Dublin based) with the remaining 12 being community based, of which 9 were rural and 3 were situated in urban areas.

Each credit union was visited as part of the PRISM series of engagements. In order to ensure consistency of approach, each supervisory team used a set questionnaire during interviews with officers of the credit union. This questionnaire, combined with specific requested documentation, provided the supervisors with the necessary information to form a view on the outsourcing arrangements within each credit union.

In addition, the supervisors applied a pre-defined scoring matrix to classify the level of compliance of each credit union. The scoring system, a copy of which can be found at Appendix II, was based on a four point scale with 1 representing Ineffective, 2 Weak, 3 Reasonable and 4 Strong. Guidance was provided to the supervisors as indicative traits for each of the four categories.

4. Findings

This section sets out the main findings arising from the thematic inspections of outsourcing arrangements within credit unions;

- Under section 76J (9) of the Act, "credit unions remain legally responsible for compliance with requirements imposed under financial services legislation in respect of those activities". However, the inspection uncovered a number of instances where board involvement in the selection, overview and review of the arrangements was inconsistent, and in some cases, non-existent.

- A number of credit union boards did not formally respond in writing to internal audit, risk or compliance reports produced by outsource providers. This coupled with the lack of discussion seen on outsourcing at board level meant these credit unions were unable to demonstrate any engagement with their various outsource providers.

- Regarding selection of an outsource provider, the directors tended to have more involvement in this area and it would appear that generally the decision on which provider was made by the board.

- There were a number of occasions that appointments were made on an informal basis with an overreliance on word of mouth. Half (8) of the sample credit unions did not, or were unable to show evidence of, undertaking proper due diligence.

- Half of the credit unions in the sample were unable to show any critical analysis of the outsourcing contracts they had entered into with service providers. Most of these stated there was an informal review and "push back" on the agreements but they were unable to produce evidence that this had occurred.

- Only four of the boards sampled received planned, regular reports on the performance of the outsource providers. In general, ongoing oversight and review of outsourcing arrangements tends to be done on an informal basis. Reporting to the board on outsourcing was done on an ad hoc basis, and was normally as a result of an issue arising. As a result, the credit unions in question are reactive to issues resulting in a lack of preparedness should an event requiring a contingency occur.

- During the term of the outsourcing agreement, a lack of engagement by boards with the outsource providers was witnessed. This lack of engagement was most notable in the failure of the board to meet with the outsource providers as part of an ongoing review.

- In one case, the credit union did not have, or were unable to source, signed copies of relevant service level agreements ("SLAs").

- In contravention of section 76J (11), one credit union in the sample had failed to notify the Bank of their outsourced activities.

Analysis of Ranking

Of the 16 credit unions included in the thematic review, 3 were ranked as 4 "Strong", 6 ranked as 3 "Reasonable", 5 were "Weak" and 2 were ranked as "Ineffective". This equates to a simple average score of 2.6 across the sector suggesting that the processes and controls around outsourcing in the overall sample of credit unions are between weak and reasonable.

We further considered the rankings to examine if there was a link between the size of the credit union (based on total assets) and the strength of the ranking. The average asset size of the credit unions in each sector are set out in the table below.

Ranking	Number	Average size
4 Strong	3	€197 million
3 Reasonable	6	€121 million
2 Weak	5	€91 million
1 Ineffective	2	€14 million

It should be noted however that the average size for the cohort ranked as strong is skewed somewhat by the presence of an individual credit union whose asset size is significantly higher (+ €154 million) than the next largest. Controlling for this outlier the average of the other 2 in the strong ranking reduces to €101 million.

For comparison purposes, the table below illustrates the difference in the credit unions in the sample over and under €100 million in asset size.

Size	Number in sample	Average ranking
>€100 million +	6	3.17
<€100 million -	10	2.30

Based on the data, as set out above, the difference in the average ranking of 0.87 suggests that there may be a link between asset size and compliance with outsourcing requirements (given the small sample size it is not possible to extrapolate this to the full population). Only one credit union over €100 million (ML) received a ranking of 2. All but 3 of the credit unions in the under €100 million cohort ranked 1 or 2.

There was one notable exception to the overall trend. This credit union which was ranked as a 4, has an asset size of <€30 million and was the fourth smallest credit union within the selected sample. This credit union received this ranking as:

- The CEO demonstrated a good level of understanding of what is required from an outsourced provider;
- The credit union has a strong outsourcing policy;
- The credit union displayed a good awareness of the outsourcing framework;
- There was evidence of discussion of outsourcing at Board level;

- There was evidence that the credit union challenged the providers in the appropriate areas; and
- The credit union undertakes an annual review of all service providers.

As none of the above are predicated on size or the availability of resources, it confirms that all credit unions, should be able to operate at the expected standard.

5. Analysis of Findings Across Sample

A summary of the main findings, across the key areas in the sample, is set out below;

5.1 Selection

The selection process includes the identification of the need for the service, the consideration of alternatives, identification and due diligence of potential providers and the negotiation of agreements. Out of the sample of sixteen credit unions, seven were found to have weaknesses within their selection process. These weaknesses included:

- Failure to consider the alternative to outsourcing which is the development of these services inhouse.
- No cost benefit analysis done to ensure that outsourcing is financially effective.
- No formal selection process undertaken, with selection based primarily on word of mouth.
- Little or no due diligence carried out by the credit union on potential providers. This sometimes included a reluctance to ask for relevant information.
- No assessment of alternative suppliers undertaken which in addition to limiting the possibilities of the credit union has the effect of making them price takers.
- No critical analysis of, or negotiation around the draft Service Level Agreements (SLAs). In more technical aspects of agreements, the credit union may feel they do not possess the expertise to challenge.

5.2 Reporting

All service providers executing critical activities on behalf of a credit union are required to report regularly to the board. To ensure this happens, a formal process should be in place whereby the reports are furnished, reviewed by the board and any observations or questions fed back to the outsource provider. In the absence of this review, it is very difficult for the board to satisfy itself that it is in compliance with section 76J (9) of the Act.

Within the sample, nine credit union processes in this area were found to require improvement. The reasons included:

- Boards only informed by way of verbal general updates with nothing documented or captured on the minutes.
- No actual reports on critical activities being made to boards.
- Ad hoc reporting typically only occurring as a result of an issue arising.
- No evidence of any discussion by boards on outsourcing.
- No written reply to reports furnished to boards.
- The reports received by credit unions are not assessed for quality or for relevance to their business activities.
- No consistent approach taken across various material outsourced activities within individual credit unions.

5.3 Oversight and Review

During the term of an agreement with a service provider, credit unions must monitor the performance of the arrangement on an ongoing basis. This would include critically analysing any reports that are being provided to ensure that the credit union's needs and the terms of the agreement are being met. Additionally, at periodic intervals and as part of a formal process captured within the outsourcing policy, each service arrangement should be reviewed. Ten of the sample were found to be below the expected standard in the above areas for a variety of reasons;

- Some Outsourcing Policies, where they existed, were poor or just templates.
- No documented review process.
- Inconsistent approach to the critical analysis of service providers.
- Reviews only occur when problems are presented or when the terms of agreements have concluded.
- No mechanism for escalating difficulties.

6. Good Practices

During our inspections of the credit unions, the following were examples of good practice observed;

- Outsourcing Framework in place that dictates all stages in an outsourced activity i.e. identify business need - inhouse or outsource - cost benefit analysis - identification of potential providers - selection process - due diligence - negotiated agreement - performance monitoring - Review. This framework is proportionate to the activity in question. For example, IT has a more involved framework than document shredding.

- The written agreement setting out the terms and conditions is the output from a negotiated process. Prior to negotiations, the credit union identified its requirements and expectations from the arrangement and the final agreement should have a degree of risk sharing. Price is only one aspect of the negotiations, service levels, response times, resources to be applied, business continuity, access to the provider and break clauses are all aspects that were considered and discussed as part of the agreement. The credit union retain the necessary expertise to be able to negotiate from a position of knowledge.

- Generally those credit union boards who understand that the transfer of operations did not result in a transfer of responsibility, took a greater interest in the performance of outsourced providers.

- Review of all suppliers at set times. One credit union in the sample identified 50 different suppliers of services. A set number of these were reviewed each month meaning they were all subject to at least an annual review. If a contract is for 3 years, the time to review the performance of the service provider is not at the end of the term but during it. This will allow time for an easier migration to another supplier should it be deemed necessary at the contract's end.

- A subcommittee of the board is used for monitoring and review. This could be the audit and risk committee, as outsourcing activities and outsourcing itself should feature on the risk register of the credit union. The monitoring and review is assisted by persons with suitable knowledge and expertise in the relevant area.

- Regular formatted management information is provided to the Board. This MI is easy to follow, not too detailed and succinct. It sets out if the provider is meeting performance goals, reasons if they are not and suggested remedies to be considered by the board.

- The board engage fully with the service providers. This includes evidence of discussion at board meetings on the reports and other outputs, meetings with the service provider and written responses, with follow up, to the reports issued. It includes critical analysis of the suitability and format of the output, adds value, is clear with a suitable length and detail.

- Review and oversight of the more important outsourced activities have a business owner. This person(s) is responsible for co-ordinating reviews, following up on action points and acting as a liaison with the provider. They do not have to be a member of the management team and there is no reason why a board member cannot do it, thus ensuring that the particular service remains in the focus of the board.

- Contingency plans are in place for providers of material activities. This would constitute identifying alternative providers and setting out procedures to be followed in the event that one supplier is no longer able or no longer considered suitable to provide the service. With IT, business continuity planning is key.

- The whole area of outsourcing is governed by a regularly reviewed and updated outsourcing policy. The policy captures the proportionality of outsourced arrangements and reflects the framework in place. This is underpinned by robust procedures and processes within the credit union.

7. Conclusion

There were some examples of good practices observed during the thematic inspection of outsourcing arrangements. However, a large number of adverse findings were identified and these have been set out in this report. While there are a number of reasons for the adverse findings, the root cause can generally be traced back to a lack of board involvement in, and oversight of, outsourced activities. This is manifested in the low level of general engagement with the outsourcing processes and in the lack of ongoing formal reporting and challenge in this area.

Increasingly, credit unions are developing their business models to consider outsourcing material business activities to third party service providers. It is important for credit unions to exercise due care, skill and diligence when considering outsourcing and give careful consideration to the legal, technical, operational, transactional, strategic and reputational risks which can be a feature of outsourcing. It is also important for credit unions to ensure service providers have the financial, technical and organisational resources to assure service continuity and performance to regulatory expectations and standards.

As a result, credit union boards need to be aware of the legislative requirements and guidance provided around material outsourcing as well as be more cognisant of the importance of and risks arising from outsourcing. This would require boards to become more involved in the selection, monitoring and review of outsourced providers. This would result in better and more formal management information being presented to boards thus allowing for greater oversight on an ongoing basis. To achieve this desired state, credit unions need to establish proper outsourcing frameworks that are underpinned by a robust and regularly reviewed outsourcing policy. This policy will dictate the procedures and processes required to ensure that the risks arising from outsourcing are understood, monitored and managed. Taking these actions will result in maximising the benefits that accrue from successful outsourcing.

Appendix 1: Outsourced activities undertaken by credit unions

- Information Technology (Hardware and Software)
- Internal Audit
- Risk Management
- Compliance
- Document shredding
- Telephony
- Investment Advice
- Debt Collection
- Credit Control
- Waste
- Legal
- Payroll
- Human Resources
- Cleaning
- Cash Collection & Delivery
- Payments
- Electronic Funds Transfer
- Summons Server
- Mailing
- Alarms
- Security
- CCTV
- AML
- ATM Maintenance
- Printing
- Tracing agents
- Foreign Exchange
- Website upkeep

Appendix 2: Ranking system

Guidance on the Scoring Rating for the Outsourced Inspections		
Score	**Rating**	**Features within each rating**
1	**Ineffective**	• Credit Union fail to notify RCU of the outsourcing of critical business activities • No alternatives considered in selection process • No evidence of business needs analysis prior to entering into agreement • No periodic review of agreements • No monitoring of performance
2	**Weak**	• No consistent process applied • Due diligence not carried out on all service providers • Elements of keeping "Regulator happy" seen • No consideration of a tailored approach for the credit union • Meaningful review of performance not happening • Records partially maintained • No discussion on materiality
3	**Reasonable**	• Some tailoring of agreements to reflect credit union needs and size • Evidence of discussion around inhouse v outsourced debate • Board engage with outsourcing process and providers • Due diligence carried out on potential service providers • Engage with user groups where appropriate • Retain ability either inhouse or contracted third party to critically analyse agreements and performance • Regular reviews of arrangements for business needs purpose • Conflicts of interest considered • Evidence of outsourced framework and process that is consistently followed • Withdrawal of service contingencies considered
4	**Strong**	• In depth due diligence carried out on all potential providers • Alternative providers properly considered • Agreements reflect the credit union's own needs and circumstances with a reduced amount of boilerplate and an increased amount of risk sharing • Management and/ or board sub committees, with necessary skills and experience, actively engage with service providers and report to board periodically • Real and perceived conflicts of interest considered • Established framework utilised that reflects the differing criticalities of each outsourced service • Withdrawal of service contingencies tested

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