FIDC

Finance Industry Development Council

(A body incorporated as a Self Regulatory Organisation for Registered NBFCs – AFCs)

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May 08, 2015

The Chief General Manager,
Department of Non-Banking Regulation,
Reserve Bank of India,
Central Office, 2nd Floor,
Centre-1, World Trade Centre, Cuffe Parade,
Colaba, Mumbai 400005.

Re: Comments / Views on the draft guidelines on Managing Risks and Code of conduct in outsourcing of financial services by NBFCs

Sir,

On 10th April, 2015, RBI had released draft Guidelines on "Managing Risks and Code of Conduct in Outsourcing of Financial Services by NBFC". The guideline lays down a framework for outsourcing for NBFCs so that necessary safeguards can be built for addressing the risks inherent in such outsourcing.

There are some provisions in the guidelines which need to be revisited considering the practicality and hardship in implementing the same. They are highlighted in following paragraphs:

1. **Restriction on outsourcing Internal Audit functions:** While Internal Audit is a core management function, many NBFCs are conducting their internal audit through big firms where the services are far more superior and they provide an independent and objective assurance to add value and improve the company's operations.

   In view of above, it is required to remove the restriction for outsourcing of Internal Audit function in such cases. Alternatively a panel of firms, selected on pre-defined criteria, may be formed which can provide internal audit services to NBFCs.

2. **Outsourcing of business process to a single large vendor vs. multiple small vendors**: The draft guidelines **do not differentiate** between outsourcing to large and small vendors. All the controls prescribed in the guidelines over large no. of small vendors, like DSAs, DMAs, and Recovery Agents who provide limited service of sourcing customers or only repossession services, would not be practical and are difficult to implement. There are number of controls in the draft guidelines which would be impractical in case of such small vendors, such as:

   - Service Provider (SP) to develop and establish a robust framework for documenting, maintaining and testing business continuity and recovery procedures

   - SP periodically tests the Business Continuity & Recovery / Contingency Plan and occasional joint testing & recovery exercises with SP

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- To review and monitor the security practices and control processes of the SP on a regular basis and require the SP to disclose security breaches

- To review the financial and operational condition of the SP to assess its ability to continue to meet its outsourcing obligations

- To publicize in the event of termination of the agreement with SP, for any reason, so as to ensure that the customers do not continue to entertain the service provider

- To include a clause in the outsourcing agreement to allow RBI to cause an inspection and access to NBFC's documents, records of transaction and other information available with Service Provider (SP)

The guideline should differentiate between large and small vendors and clarify as to which paras of the guidelines apply to large vendors. The guidelines may be made applicable on large vendors to whom the whole of business process is outsourced like entire collection and remittance process and not to small individual vendors like DSA, DMA, and Recovery Agents who provide transaction specific services.

3. **Separate Audit:** The draft guidelines require **regular audits by either the internal auditors or external auditors** to assess the adequacy of the risk management practices adopted in overseeing and managing the outsourcing arrangement, the compliance with its risk management framework and the requirements of these guidelines.

   In this regard, the guidelines should provide a **framework for evaluating** the adequacy of risk management practices adopted by NBFCs for outsourcing agreements. This is critical since the external auditors would require a framework and guidance before certifying the same.

4. **Service Provider should not be a related party:** The service provider, if not a subsidiary of the company, cannot be an entity 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. Since there is large no. of individual vendors, it would be difficult to comply with such requirements specially to identify if the vendor is related to any officer /employee or their relatives. Also there should be relaxation in cases where the outsourcing transaction is on arm's length basis and also the bar may be applied only to senior employees and not all employees

5. **Existing outsource agreements:** As per the draft guidelines, for existing outsourcing agreements, NBFCs may conduct a self-assessment to bring them in line with the guidelines by way of time bound plan.

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The guidelines should not be made applicable to all the existing agreements. On the contrary, it should be made applicable to outsourcing agreements with large vendors only and with prospective effect.

a. **Board and senior management to have the ultimate responsibility:** The draft guidelines provide that Board and senior management, would have the ultimate responsibility for the outsourced activity without any exception, e.g., the customer has paid money to an agent without a money receipt for which the management should not be held responsible.

6. **Size of NBFCs for applicability of Outsourcing Guidelines:** It is ironical that the guidelines have been made applicable to all the NBFCs irrespective of their size of operations. It may be recalled that NBFCs are of heterogeneous sizes and a negligible number only hold minuscule amount of public deposits. The business model of NBFCs is to reduce the cost of transactions and every activity of the companies cannot be taken up in-house like a commercial bank. We suggest that even if there is a need for stipulating outsourcing guidelines for NBFCs, these can be considered only for the NBFCs which have balance sheet size of Rs. 25000 crore and above and have 100 branches and above, in order to balance the purpose of risk management and viability of the NBFCs.

We hereby request you to kindly give us an appointment at an early date so as to enable us to present our views that need urgent consideration, in detail and in person.

We look forward to an **immediate positive response** and are confident that we are in the process of a long and beneficial relationship.

Thanking you,

Yours sincerely,

FOR FINANCE INDUSTRY DEVELOPMENT COUNCIL

MAHESH THAKKAR
Director General