Regulatory and supervisory issues relating to outsourcing and third-party relationships

1. What do you consider the key challenges in identifying, managing and mitigating the risks relating to outsourcing and third-party relationships, including risks in sub-contractors and the broader supply chain?

Peruvian financial institutions (FIs) are using highly specialized third party services more intensively in the last years. In that environment, we identified the following challenges identifying, managing and mitigating third party related risks:

- FIs must be responsible for every third party service hired outcome as if it were their own; but, we can only access third parties information through the supervised FIs.
- FIs do not necessarily have enough capabilities or resources to comprehend the nature of third party services or to assess their compliance to regulatory requirements.
- Supply chain opacity that might include cross border services and "fourth" parties. That also limits systemic concentration risk estimation given the few specialized providers.
- Limited negotiation powers, especially small FIs, to demand compliance with regulatory requirements and inclusion of clauses to allow information access, as well as facilities for auditing and supervision activities.
- Exit barriers for FIs to terminate or modify contracts conditions with third parties, as they do not have resources of their own to assume outsourced services and the limited supply of specialized providers.
- Lack of supervisor's capabilities to assess highly specialized services and complexes supply chains.
- Lack of agreements with other supervisors to facilitate information access of cross boarding services.

We also identify some particular challenges regarding ML/FT risk:

- ML / FT Risk Management Regulation establishes that companies supervised by the SBS may use third parties to comply with the identification and / or information verification of clients, directors, managers, workers, counterparts or suppliers; to introduce and / or attract new businesses or to develop commercial activities; to develop and implement a monitoring system; among others. In that sense, FIs may hire third parties to develop their ML / TF monitoring system without the direct participation of the Compliance Officer or the third parties may not know the information needs or specific elements associated with the CDD, transactional client's profiles, which variables and criteria should be established, among others.

As for the third party's information provided for credit model risk purposes, we identify the following difficulties:

- Regulation does not define the scope and depth of the required assessment for credit model risk provided by third parties.
- FI's limitations to assess model risk services as if they were their own, given that data construction and sources access are key in credit model risk.
- Difficulties to clearly define the kind of third party relationship in order to identify information access requirements.

2. What are possible ways to address these challenges and mitigate related risks? Are there any concerns with potential approaches that might increase risks, complexity or costs?

We consider the best options to address the challenges regarding third party's risks is to update third party services regulatory and supervisory framework, as well as, third party risk management, cybersecurity and data protection; that might result in more expenses and complexity for the sake of better risk management. Among the aspects to be consider to update the regulation are:

- Establish differentiated requirements according to the criticality of the services provided by third parties, and even stablish requirements for specific services.

- Require detailed and viable exit plans for critical services provided by third parties.
- Reinforce clauses, considering a more efficient information access by the supervisor.
- Guarantee independence in the validation and / or monitoring of services provided by third parties.
- Require greater capacity building within FIs to understand the nature of the services provided by third parties.

The main risk of more demanding requirements is that this could mean an entry barrier, especially for small companies with less negotiation power with suppliers and, at the same time, with fewer resources to have specialized areas or resources on their own.

We also identify the following actions to address some of the challenges described in the previous question:

- Constantly train supervisors on issues related with third party services, contracting modalities and supply chains.
- Seek more MoU with supervisors to facilitate cross border suppliers information.

3. What are possible ways in which financial institutions, third-party service providers and supervisory authorities could collaborate to address these challenges on a cross-border basis?

- Best practices and requirements applicable in different jurisdictions to the services provided by third parties awareness.
- Common understanding between supervisors regarding expectations, definitions, concepts and scope to be considered for third party assessment.
- Access to evaluation's results and reviews carried out by international authorities, in order to be considered as antecedents.
- Access to cross boarder providers without creating unnecessary burdens, conflicts or duplications. This could be addressed by establishing cross-border supervisory cooperation and coordination mechanisms.
- Access or supervision over relevant activities provided by third parties, that is, requesting certain information directly from third parties (for example, DDC, suppliers, workers).
- MoU for information exchange between Supervisors from different jurisdictions.

4. What lessons have been learned from the COVID-19 pandemic regarding managing and mitigating risks relating to outsourcing and third-party relationships, including risks arising in sub-contractors and the broader supply chain?

The Covid-19 pandemic has accelerated the FI's digitization process, both for the digitization of internal processes and for the development of digital financial services. This has meant in most cases a greater technology and third party services dependence. Likewise, there has been a greater services demand and lower availability of personnel that have stressed FI's response capabilities.

In this sense, the main lessons regarding third parties risk are: i) the importance of having continuity plans in the event of the failure or unavailability of suppliers, which includes having alternate suppliers and / or internal resources to allow the most critical operations to operate; ii) have clear roles and responsibilities regarding third party services; and iii) have a succession plan of key contacts in place.