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Solvency II – New Outsourcing Rules for (Re)Insurance Undertakings in Ireland

Solvency II introduces a number of detailed and prescriptive conditions in relation to outsourcing requirements for (re)insurance undertakings and it is incumbent on undertakings to take steps to ensure that their existing outsourcing arrangements are compliant with the new rules which came into effect on 1 January 2016.

Solvency II in the Irish Context - A New Prudential Supervisory Approach

The Irish State transposed into Irish law the Solvency II Directive (Directive 2009/138/EC) as amended by the Omnibus II Directive (Directive 2014/51/EC) by way of Statutory Instrument, namely the European Union (Insurance and Reinsurance) Regulations 2015 (the “2015 Regulations”) which came into effect on 1 January 2016.

The Solvency II regime represents a significant reform of European insurance legislation affecting life, non-life and reinsurance undertakings and will establish harmonised requirements across the EU.

In Ireland, the Solvency II regime will also be supplemented by more detailed technical Commission Level 2 measures and they in turn will be supplemented by Level 3 guidance for national supervisors developed and adopted by the European Insurance and Occupational Pensions Authority (EIOPA).

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Solvency II and Outsourcing Arrangements

Scope of the new rules – “critical or important functions”

The majority of the Solvency II rules relating to outsourcing apply to critical or important outsourcing functions such as actuarial, compliance or risk management functions. The rules specifically mandate that the outsourcing of critical or important operational functions or activities shall not be taken in such a way as to lead to any of the following:

- (a) materially impairing the quality of the system of governance of the undertaking concerned;
- (b) unduly increasing the operational risk;
- (c) impairing the ability of the Central Bank of Ireland (the “Central Bank”) to monitor the compliance of the undertaking with its obligations; or
- (d) undermining continuous and satisfactory service to policyholders.

Intra-group outsourcing

Intra-group outsourcing is not necessarily different from external outsourcing. Outsourcing to group members also falls within the scope of the Solvency II outsourcing rules. The new rules require that consideration should be given to the extent to which the undertaking controls or has the ability to influence the actions of the service provider and the nature of the outsourced functions. Although intra-group outsourcing may allow for a more flexible selection process, it should not be seen as automatically requiring less care and oversight than external outsourcing.

Obligation to notify the Central Bank

Notification in a timely manner to the Central Bank will be required under Solvency II before outsourcing any critical or important functions or activities or implementing any material developments or changes in relation to them.

Key features of outsourcing arrangements under Solvency II

Solvency II places a mandatory legal obligation on (re)insurance undertakings that outsource functions or (re)insurance activities to a service provider to establish a written outsourcing policy which takes into account the impact of outsourcing on its business and the reporting and monitoring arrangements to be implemented in cases of outsourcing.

Importantly, notwithstanding any outsourcing, (re)insurance undertakings will remain fully responsible for discharging all of their obligations under Solvency II.

Solvency II sets out clear and unambiguous obligations on (re)insurance undertakings who seek to outsource functions or activities to a service provider:

- (i) The undertaking must undertake due diligence to ensure that the preferred service provider has:
 - (a) the ability, capacity and any authorisation required by law to deliver the required functions or activities satisfactorily, taking into account the undertaking's objectives and needs;
 - (b) adopted all means to ensure that no explicit or potential conflict of interests jeopardise the fulfilment of the needs of the outsourcing undertaking;
 - (c) the necessary financial resources to perform the additional tasks in a proper and reliable way and that all staff of the service provider who will be involved in providing the outsourced functions or activities are sufficiently qualified and reliable; and
 - (d) adequate contingency plans in place to deal with emergency situations or business disruptions and periodically tests backup facilities where necessary, taking into account the outsourced functions and activities.

- (ii) A written agreement must be entered into with the service provider. The outsourcing agreement must include certain key provisions which include:
 - (a) clearly defining the respective rights and obligations of the insurance or reinsurance undertaking and the service provider;
 - (b) mandating the service provider to comply with all applicable laws, regulatory requirements and guidelines as well as policies approved by the insurance or reinsurance undertaking and to co-operate with the undertaking's supervisory authority with regard to the outsourced function or activity;
 - (c) obliging the service provider to disclose any development which may have a material impact on its ability to carry out the outsourced functions and activities effectively and in compliance with applicable laws and regulatory requirements;
 - (d) ensuring that where the service provider seeks to terminate the outsourcing agreement, the notice period for the termination of the contract by the service provider is long enough to enable the insurance or reinsurance undertaking to find an alternative solution;

- (e) ensuring that the insurance or reinsurance undertaking is able to terminate the arrangement for outsourcing where necessary without detriment to the continuity and quality of its provision of services to policyholders;
- (f) allowing the insurance or reinsurance undertaking to reserve the right to be informed about the outsourced functions and activities and their performance by the service provider as well as a right to issue general guidelines and individual instructions at the address of the service provider, as to what has to be taken into account when performing the outsourced functions or activities;
- (g) bestowing the insurance or reinsurance undertaking, its external auditor and the Central Bank effective access to all information relating to the outsourced functions and activities including carrying out on-site inspections of the business premises of the service provider;
- (h) allowing, where appropriate and necessary for the purposes of supervision, the Central Bank to address questions directly to the service provider to which the service provider shall reply;
- (i) and relating to the terms and conditions, where applicable, under which the service provider may sub-outsource any of the outsourced functions and activities while ensuring that the service provider remains fully responsible for the performance of its obligations under the agreement.

Fit and Proper Requirements

Solvency II also imposes additional “fit and proper” obligations on all persons who have been assigned certain key functions namely that their professional qualifications, knowledge and experience are adequate to enable sound and prudent management (fit) and they are of good repute and integrity (proper).

In October 2015, the Central Bank issued a policy notice on the fitness and probity regime for (re)insurance undertakings under the Solvency II rules. The Central Bank requires that where key functions are outsourced, the (re)insurance undertaking designates a current PCF holder within the undertaking with overall responsibility for the outsourced arrangement.

(Re)insurance undertakings that outsource key functions will therefore be required to notify the Central Bank of the PCF(s) within the undertaking responsible for the key function. The Central Bank has confirmed that this should be done through the supervisory notification of proposed outsourcing of key functions in a format to be prescribed by the Central Bank in line with the Solvency II outsourcing requirements.

From 1 January 2016 – Next Steps

(Re)insurance undertakings face a significant change in the regulatory framework governing outsourcing agreements. As a result, undertakings should now take steps to review all existing contractual outsourcing arrangements, policies and governance structures to ensure they are Solvency II compliant.

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