

Defining “critical or important functions or activities” when outsourcing

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With the recent increase in regulatory focus on outsourcing, (re)insurers need to ensure that their system of governance, risk management and monitoring of outsourcing arrangements all satisfy the expectations of the regulator.

Under Solvency II, the requirements (re)insurance companies must fulfil are most onerous for the outsourcing of “critical or important operational functions or activities”. It is clearly vital for (re)insurers to identify all such instances of outsourcing. However, the Solvency II directive does not specify how a company should determine if an instance of outsourcing is critical or important.

In this briefing note, we explore what a “critical or important function or activity” means for a (re)insurance entity. We focus on the Irish market where the Central Bank of Ireland has given additional guidance on their requirements.

Central Bank of Ireland Feedback

The “Outsourcing—Findings and Issues for Discussion” paper issued by the Central Bank of Ireland (“CBI”) in November 2018 stated there are “general inconsistencies noted in how regulated firms are determining criticality or importance of outsourcing arrangements”.

“In terms of the criteria used to determine criticality or importance, there was largely a consensus across the banking sector in the use of the CEBS guidelines. However, a number of approaches were reported as being used in both the asset management firm sector and insurance sector to determine criticality or importance. While some regulated firms used either MiFID guidance or EIOPA guidance respectively, this was not consistently applied.”

The note also highlights that there were many instances where regulated firms failed to designate certain outsourcing arrangements appropriately. The CBI said this is likely to be an “area of focus”, and there may be a further review on this aspect at some time in the future.” The average number of critical or important arrangements per firm was 15 for the insurance sector according to the survey the CBI conducted.

The CBI also highlighted the need to review and revisit the classifications on a regular basis. The majority of regulated firms

surveyed by the CBI did this at least on an annual basis, however some only did this every three years. Although no definitive comment was provided, it appears that a period of three years between such reviews was not viewed in a positive light. The minimum regulatory expectation is that this classification will be “assessed on an on-going basis”

Regulatory Definitions

SOLVENCY II GUIDANCE

While the Solvency II directive and the Delegated Regulations lay out the requirements which must be fulfilled when outsourcing a critical or important function, they do not define what is a “critical or important” function.

In fact, it is up to the company itself to decide if an outsourced function or activity is critical or important. Guideline 60 of the EIOPA Guidelines on system of governance¹ states the following:

“The undertaking should determine and document whether the outsourced function or activity is a critical or important function or activity on the basis of whether this function or activity is essential to the operation of the undertaking as it would be unable to deliver its services to policyholders without the function or activity.”

While the company must determine for itself if an outsourced activity should be classified as critical or important, Guideline 63 of the EIOPA guidelines on system of governance states that the process for determining whether a function or activity is critical or important must be included in the company’s outsourcing policy.

CENTRAL BANK OF IRELAND NOTIFICATION PROCESS

For certain functions, there is no ambiguity over whether they are critical or important. In the CBI’s “Notification Process for (Re)Insurance Undertakings when Outsourcing Critical or Important Functions or Activities under Solvency II” document², they state that:

“The 4 key functions of the system of governance are considered to be critical or important functions.”

This point is also made in the introduction (point 1.4) of the EIOPA Guidelines on system of governance. So, there is no doubt that the risk management function, the actuarial function,

¹ EIOPA Guidelines on system of governance

² Notification Process for (Re)Insurance Undertakings when Outsourcing Critical or Important

the internal audit function and the compliance function are also considered to be critical or important.

CENTRAL BANK OF IRELAND DISCUSSION PAPER

In the November 2018 discussion paper, the CBI explicitly called out the minimum regulatory expectation that:

“Regulated firms have a ‘criticality and importance of service’ methodology that can be applied consistently across all outsourcing decisions and is in line with relevant sectoral regulations and guidance.”

A clear definition was not provided here, but the discussion paper did give some further colour on how to approach the definitions:

“Regulated firms may consider the meaning of criticality or importance relative to the size, scale and complexity of the activity being outsourced, if appropriate.”

The CBI stated that in the discussion paper they are using the term “critical or important” in line with the Markets in Financial Instruments Directive (“MiFID II”), the Payment Services Directive (“PSD2”) and the EBA Draft Guidelines on Outsourcing Arrangements. We will look at each of these in turn.

MIFID II

The MiFID II Delegated Regulations³ define an operational function as critical or important where:

“a defect or failure in its performance would materially impair the continuing compliance of an investment firm with the conditions and obligations of its authorisation or its other obligations under Directive 2014/65/EU, or its financial performance, or the soundness or the continuity of its investment services and activities.”

While the MiFID II definition may not be directly applicable to the activities of all companies, it is useful to see the definition underpinning “critical or important” in the CBI’s discussion paper and used by other financial services firms. If you were to replace the word “investment” with “insurance” and the reference to MiFID with the Solvency II Directive, then the above definition may allow you to assess if you are defining critical or important activities in line with the CBI’s expectations.

EBA DRAFT GUIDELINES ON OUTSOURCING ARRANGEMENTS

Section 4 of the EBA Draft Guidelines on Outsourcing Arrangements⁴ sets out criteria for identifying critical or important functions. Although the EBA guidelines do not apply to (re)insurance companies, they provide a further insight into what regulators are expecting banks to consider and are more detailed than any currently existing Solvency II guidance.

The guidelines state that banks must always consider a function to be critical or important where:

- “a) a defect or failure in its performance would materially impair:*
- i. their continuing compliance with the conditions of their authorisation or its other obligations under Directive 2013/36/EU, Regulation (EU) No 575/2013, Directive 2014/65/EU, Directive (EU) 2015/2366 and Directive 2009/110/EC and their regulatory obligations;*
 - ii. their financial performance; or*
 - iii. the soundness or continuity of their banking and payment services and activities;”*

This echoes the MiFID II definition given above, but the EBA criteria go on to say that a function must be considered as critical or important when:

- “b) operational tasks of internal control functions are outsourced, unless the assessment establishes that a failure to provide the outsourced function or the inappropriate provision of the outsourced function would not have an adverse impact on the effectiveness of the internal control function;*
- c) they intend to outsource functions of banking activities or payment services to an extent that would require authorisation by a competent authority”*

The EBA specification of internal control functions as critical or important is similar to that in the CBI Notification Process. In an insurance context, point c) states that if insurance activities are outsourced, where the performance of those activities requires authorisation by the regulator, then that outsourcing arrangement must be considered critical or important.

The EBA guidelines also state that:

“particular attention should be given to the assessment of the criticality or importance of functions if the outsourcing concerns functions related to core business lines and critical functions as defined in Article 2(1)(35) and 2(1)(36) of Directive 2014/59/EU³⁶ and identified by institutions using the criteria set out in Articles 6 and 7 of Commission Delegated Regulation (EU) 2016/778.”

The definitions and criteria for critical functions above refer to the systemic risk of the function in that its discontinuance would likely lead to:

“disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross-border activities of an institution or group, with

³ Commission Delegated Regulation (EU) 2017/565

⁴ EBA Draft Guidelines on Outsourcing Arrangements

particular regard to the substitutability of those activities, services or operations.”

This indicates that the EBA do not consider the definition of critical or important to be solely based on the internal workings of a firm, but that it is also defined by how the failure of a function could impact the wider financial system.

The EBA Guidelines provide a list of factors which institutions must consider when determining the criticality or importance of a function. While some of these are banking specific, many could equally apply to an insurance company:

- a. *whether the outsourcing arrangement is directly connected to the provision of banking activities or payment services for which they are authorised;*
- b. *the potential impact of any disruption to the outsourced function or failure of the service provider to provide the service at the agreed service levels on a continuous basis on their:*
 - i. *short- and long-term financial resilience and viability, including, if applicable, its assets, capital, costs, funding, liquidity, profits and losses;*
 - ii. *business continuity and operational resilience;*
 - iii. *operational risk, including conduct, information and communication technology (ICT) and legal risks;*
 - iv. *reputational risks;*
 - v. *where applicable, recovery and resolution planning, resolvability and operational continuity in an early intervention, recovery or resolution situation;*
- c. *the potential impact of the outsourcing arrangement on their ability to:*
 - i. *identify, monitor and manage all risks;*
 - ii. *comply with all legal and regulatory requirements;*
 - iii. *conduct appropriate audits regarding the outsourced function;*
- d. *the potential impact on the services provided to its clients;*
- e. *all outsourcing arrangements, the institution's or payment institution's aggregated exposure to the same service provider and the potential cumulative impact of outsourcing arrangements in the same business area;*
- f. *the size and complexity of any business area affected;*
- g. *the possibility that the proposed outsourcing arrangement might be scaled up without replacing or revising the underlying agreement;*
- h. *the ability to transfer the proposed outsourcing arrangement to another service provider, if necessary or desirable, both contractually and in practice, including*

the estimated risks, impediments to business continuity, costs and time frame for doing so ('substitutability');

- i. *the ability to reintegrate the outsourced function into the institution or payment institution, if necessary or desirable;*
- j. *the protection of data and the potential impact of a confidentiality breach or failure to ensure data availability and integrity on the institution or payment institution and its clients, including but not limited to compliance with Regulation (EU) 2016/679.”*

As noted above, Guideline 63 of EIOPA's Guidelines on system of governance requires firms to document their process for determining if an outsourced function is critical or important in their outsourcing policy. This list of factors might provide a good starting point for the development of such a process.

Another useful point to note is the EBA Guidelines say that institutions should keep an updated register of information on all outsourcing arrangements and distinguishing between the outsourcing of critical or important functions and other outsourcing arrangements. The CBI have also commented on the need for such a register for institutions in Ireland.

Conclusion

At present, responsibility and flexibility on how to define what is “critical or important” in relation to outsourcing activities and functions remains with (re)insurance entities. Little formal regulation or guidance has been issued on this topic for (re)insurers specifically, although there is some commentary from regulators which provides some insight.

The process of defining this category is more advanced for some other areas of financial regulation, and it seems that regulators are looking to this as the benchmark going forward. Therefore, it would seem wise to at least consider these sources when constructing and documenting your own firm's definition.

The definition is important because of the extent of governance and oversight required for “critical or important” outsourced activities or functions. A balance is required to meet the need for enough oversight and governance while also ensuring the process isn't unwieldy for minor instances of outsourcing.

How Milliman can help

We will be working with our clients to help them improve their processes and policies to better manage outsourcing arrangements.

Milliman has developed an Outsourcing Compliance Tool which provides a simple and cost-effective way to help (re)insurance companies stay on top of their outsourcing arrangements, and to evidence this to key stakeholders including auditors and regulators.

If you are interested in discussing this, or any aspect of your risk management and governance please contact the authors below or your usual Milliman consultant.

The screenshot shows a dashboard titled "Outsourced Providers" with various filters and tabs. The main table displays compliance data for several questions under the heading "3. MONITORING & RESPONSIBILITY".

		91%	6%	10%
3. MONITORING & RESPONSIBILITY				
<input type="checkbox"/>	70%	60%	100%	
<input type="checkbox"/>	67%	Partial	Partial	Yes
<input type="checkbox"/>	83%	3 -	2 -	3 -
<input type="checkbox"/>	83%	3 -	2 -	3 -
<input type="checkbox"/>	67%	2 -	2 -	3 -
<input type="checkbox"/>	83%	Partial	Yes	Yes

Fig1: Sample dashboard from Outsourcing Compliance Tool



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