



Banc Ceannais na hÉireann  
Central Bank of Ireland

Eurosystem

# Discussion Paper

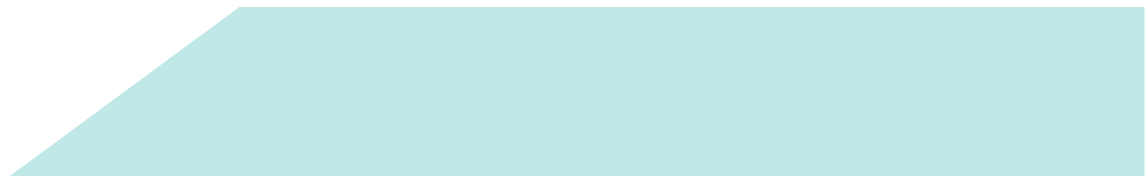
## Use of Services

### Companies in the

## Insurance Sector

# Contents

<b>1. Introduction.....</b>	<b>3</b>
<b>2. Background and Purpose of the Paper .....</b>	<b>5</b>
<b>3. Discussion Topics .....</b>	<b>8</b>
<b>4. Conclusion .....</b>	<b>16</b>



# 1. Introduction

The Central Bank of Ireland (hereinafter referred to as “the Bank”) is responsible for the provision of high quality financial regulation and supervision aimed at ensuring protection for consumers, promoting financial stability and facilitating a well-functioning financial system to support the economy. A core means by which the Bank meets that responsibility is via the use of risk-based supervision to assess and, where necessary, challenge the appropriateness of the governance structures implemented by financial services providers that it regulates.

The Bank has observed a practice within the Insurance Sector both over the longer term and more recently, arising from the Bank’s engagement with UK based firms seeking to establish here following the UK’s decision to leave the EU, whereby a number of insurance and reinsurance undertakings (“undertakings”) are seeking to enter arrangements for the use of separate legal entities for the provision of extensive (all or almost all) staffing to the undertaking (hereinafter referred to as “arrangements”). These entities, often referred to as service companies or service providers, are usually part of the same group as the undertaking.

It is the responsibility of the boards and senior management of undertakings to ensure that there are appropriate governance structures in place, including appropriate organisational and operational structures and risk management systems and, where this is not being achieved, to appropriately modify or eliminate relevant structures or arrangements. We believe that this is an area where further regulatory consideration is required and where Guidance may need to be developed.

In this context, we wish to increase our understanding of the kinds of arrangements mentioned above and described in more detail in Section 2 of this discussion paper. We want to seek stakeholder’s views on how undertakings who enter such arrangements adequately identify, assess and mitigate against all material risks that they introduce. How can undertakings ensure that appropriate control rests within the undertaking and that the arrangement does not undermine its ability, and inclination, to ensure appropriate protection of its policyholders at all times, particularly in stress scenarios.

Therefore, the Bank is seeking, via this discussion paper, to engage with undertakings and other interested stakeholders in order to further explore:

- exactly how boards and senior management of undertakings satisfy themselves that these arrangements are appropriate for their undertakings and provide for adequate and effective governance of same, and
- how undertakings ensure adequate identification and management of all material risks, including risks that would arise in stress scenarios for any of; the undertaking, the service provider or the group.

Responses to this Discussion Paper will help inform the Bank’s consideration of its policy position in relation to this practice within the Insurance Sector in Ireland and any enhanced regulatory or supervisory action that may be required.

The combination of staffing and other activity outsourcing within some arrangements adds additional complexity and the need for further risk management. Such hybrid arrangements are within the scope of this paper. As is the question of the boundary and difference between these two forms of third party reliance.

For the purposes of clarity, while there is both commonality and overlap between the issues addressed in this discussion paper and those being considered as part of the Banks more general work on outsourcing<sup>1</sup>, this is a distinct discussion, with a particular focus on arrangements observed within the Insurance Sector involving the extensive provision of staffing, and sometimes other services, by separate legal entities

Furthermore, this paper is not referring to, nor concerned with, the normal captive management arrangement between captive insurance or reinsurance undertakings and their respective captive management provider.

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<sup>1</sup> Discussion Paper on Outsourcing - Findings and Issues for discussion, published in November 2018 - sets out the Central Bank's main findings to date in the context of its outsourcing review across all financial services firms and discusses a number of key evolving risks across the outsourcing landscape

## 2. Background and Purpose of the Paper

### The Bank's observations

As outlined above, we have observed a number of undertakings seeking to enter arrangements with services companies for the provision of extensive staffing, and sometimes other services, to the undertaking. Proposing undertakings have cited various reasons for seeking to enter such arrangements, including:

- flexibility,
- costs and tax efficiencies,
- leveraging group expertise,
- following group practice,
- focusing the management of all HR and pension related issues in one company within the group,
- standard market practice.

While the precise nature of and rationale for each arrangement varies, the common feature or outcome is that, arising from the arrangement, the level of staff directly employed by the regulated undertaking is significantly reduced, i.e. often very few or no staff are directly employed by the undertaking.

The Bank understands that pursuing objectives such as cost savings, leveraging group expertise, facilitating increased flexibility, etc. is practical and may be beneficial for the undertaking and its wider group. However, we consider that this is likely to introduce new and increased risks for the undertaking, which need to be appropriately managed. Therefore, we would like to explore further how the board and senior management of undertakings identify and manage these risks and thereby ensure that undertakings uphold appropriate standards of governance, control and risk management when they enter such arrangements.

### Services provided under third party<sup>2</sup> arrangements

In general, services provided under third party arrangements fall in to two main categories:

- i. provision of various services or activities under outsourcing-type agreements, or,
- ii. provision of staffing (i.e. human resource) only under, for example, secondment-type agreements.

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<sup>2</sup> For clarity "third party" includes separate entities which are part of the same group of companies.

Under the first category, the service provider (SP) is providing extensive services to the undertaking in the form of processes, activities or services in relation to many of the undertaking's operations, functions or departments (sometimes referred to in this paper as "activity outsourcing arrangements"). This type of arrangement falls under the definition of "outsourcing" under the Solvency II Regulations<sup>3</sup> and all requirements relevant to outsourcing apply, including those related to the selection of the SP, notification to the Bank, the reporting and oversight of outsourcing arrangements and the appointment of a designated person(s) within the undertaking to oversee the outsourcing arrangement.

Under the second category, which is the main focus of this discussion paper, the SP is providing extensive staffing/human resource only to the undertaking for the undertaking to employ or allocate, as it considers appropriate. In this scenario, while the staff have their employment contract with the SP, which is responsible for all employment related obligations including relevant legal and tax obligations, the SP is not involved in or responsible for any decision making on behalf of the undertaking or any direction setting for the staff. Instead, all the work conducted by the staff is carried out under the direction of the undertaking and is viewed as being the activity of the undertaking. Where this is the nature of the arrangement, it may be argued that it does not fall under the definition of outsourcing under Solvency II and therefore, while all general governance requirements apply in respect of the arrangement, the requirements specific to outsourcing do not necessarily apply. These staffing arrangements are viewed as another way of employing people such that the relevant staff consider themselves, to all intents and purposes, as employees of the undertaking and hold their duty of fidelity and responsibility to the undertaking as opposed to the SP.

Arrangements of the kind this paper is concerned with may include a combination of both categories of service ("hybrid arrangements") for example, the SP is providing extensive staffing while also providing some additional services to the undertaking. As mentioned earlier, these hybrid arrangements introduce further complexity and the Bank is keen to seek stakeholder's views on how boards and senior management of undertakings address that additional complexity in ensuring that appropriate controls, oversight and risk management are in place.

### Question 1

Do you agree that there is a substantive difference between third party staff provision arrangements and activity outsourcing arrangements?

### Question 2

How do you define the difference? What are its implications?

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<sup>3</sup> Regulation 3 of SI 485 of 2015 – European Union (Insurance and Reinsurance) Regulations 2015 defines outsourcing as "an arrangement of any form between an insurance undertaking or reinsurance undertaking and a service provider, whether a supervised entity or not, by which that service provider performs *a process, a service or an activity*, whether directly or by sub outsourcing, which would otherwise be performed by the insurance undertaking or reinsurance undertaking itself"

## The Bank's questions

In considering proposals from undertakings seeking to enter the types of arrangements that this paper is concerned with (i.e. staffing only and hybrids), we seek to understand how the undertaking, via its board and senior management, assesses and concludes that the proposed arrangement is; (i) appropriate for its business, (ii) enables the undertaking to meet all its obligations to policyholders and other relevant beneficiaries and stakeholders, and (iii) enables the undertaking to continue to comply with all relevant rules and principles of good corporate governance.

As part of this, the Bank focuses in particular on issues such as:

- the appropriateness and adequacy of the initial and ongoing risk identification and management in relation to the arrangement;
- the adequacy of the protections provided for policyholders and other beneficiaries on an ongoing basis and in stress scenarios; and,
- the substance in the Irish undertaking.

This discussion paper seeks to explore these issues further and poses questions to interested stakeholders on how the boards and senior management of undertakings do or can satisfy themselves, and appropriately demonstrate, that the undertaking complies with relevant requirements, standards and supervisory expectations where arrangements of this kind are in place.

## 3. Discussion Topics

### Rationale for arrangements of this kind

As mentioned in section 2 of this paper, undertakings have stated various reasons for, and benefits to them and their groups from, entering these arrangements.

The Bank would like to understand more about the reasons for, and the perceived benefits to, undertakings (and the groups to which they belong) entering these type of arrangements taking account of the obligations that apply for those undertakings and the potential increase in risk that may arise as a direct result of such arrangements.

#### Question 3

What are the reasons for and benefits to undertakings and their groups from entering arrangements of the kind addressed in this paper?

#### Question 4

How do / can undertakings, via their boards and senior management, consider and weigh up the benefits of entering such arrangements, against the risks they introduce, to ensure that they do not impede the undertaking from meeting its obligations to policyholders and other relevant stakeholders?

### Compliance with general rules and principles of good corporate governance

It is the responsibility of each undertaking to identify the obligations that apply to it, taking account of the nature and specificity of its activities and its organisational and operational structures, and to ensure compliance with those obligations. Thereafter, it is for the Bank to assess whether it agrees with the undertaking's assessment of its compliance with relevant obligations.

The obligations that apply, arising from arrangements of this kind depend on the specific underlying elements, i.e. contractual conditions, of the arrangement. There are certain obligations that apply in respect of all such arrangements (e.g. general corporate governance, fitness and probity and risk management) and others that only apply in respect of some arrangements (e.g. outsourcing requirements, i.e. where the services provided include services that fall under the definition of "outsourcing", or, IDR<sup>4</sup> requirements i.e. where insurance distributions services are provided by the SP.

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<sup>4</sup> S.I. No. 229/2018 - European Union (Insurance Distribution) Regulations 2018



For the purposes of this discussion paper, we would like to focus in particular on the following topics:

## General Corporate Governance

The system of governance of any undertaking should provide for sound and prudent management of its business and should include at least:

- An adequate and transparent organisational structure,
- An effective system for transmission of information,
- Compliance with the governance requirements of Solvency II, and
- Reasonable steps to ensure continuity and regularity of the undertaking's activities.

Furthermore, in terms of the organisational and operational structures, undertakings should ensure that these support the strategic objectives of the undertaking. The Bank has concerns about how undertakings who enter these arrangements can meaningfully comply with the letter and the spirit of these requirements, in particular related to:

- The soundness and prudence of the management of the business in terms of the objectives and interests pursued and the protections provided as a result of the arrangement (e.g. depending on the arrangement and the resulting organisational structure; are the objectives that are actively pursued by the undertaking of greater benefit to the group or the undertaking itself? In addition, how has the board and senior management assessed and satisfied itself on this?),
- The adequacy, transparency and appropriateness of the organisational structure, for example in the case of a hybrid arrangement:
  - is it absolutely clear to all those who should know – both internally and externally – what is the exact nature of the arrangement and the services being provided?
  - who is employed by/works for what organisation?
  - how much time is being spent on the activities of the undertaking? is that sufficient? by whom, and what level of experience, are the activities being undertaken and is that appropriate for the undertaking to meet all its obligations?,
- Risk management (addressed in more detail below)
- Continuity of business and protection of policyholders (addressed below)

### Question 5

How do / can the boards and senior management of undertakings

satisfy themselves that, upon entering an arrangement of the kind outlined in this paper, there is sound and prudent management of the undertaking including:

- An adequate and transparent organisational structure
- Effective transmission of information
- Compliance with relevant governance requirements
- Appropriate steps to ensure continuity and regularity of activities

and, that the strategic objectives pursued by the undertaking are focused primarily on benefiting the undertaking and its policyholders as opposed to mainly benefiting other related parties.

## Fitness & Probity

*“Individuals who work in regulated firms must meet high standards of competence, integrity and honesty. To ensure this, the Fitness and Probity Regime was introduced by the Bank under the Central Bank Reform Act 2010. The Fitness and Probity Regime imposes significant obligations on firms, which must be followed, to ensure that senior and other key personnel comply with fitness and probity requirements”<sup>5</sup>.*

Undertakings, irrespective of their chosen organisational or operational structure, have the first line of responsibility under the Fitness and Probity Regime. Where arrangements with service providers are entered into for the provision of any control function, and notwithstanding any exclusions allowed under the F&P Standards<sup>6</sup>, the undertaking must ensure people subject to the regime are fit and proper. Further, this responsibility does not end following the hiring of staff; undertakings must ensure that their staff are fit and proper on an on-going basis.

### Question 6

Where undertakings enter arrangements of the kind outlined in this paper, how do/can they ensure that control function holders have, and continue to maintain, the appropriate skills and expertise to fulfil their responsibilities?

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<sup>5</sup> [extract from Dear CEO letter, issued April 2019](#)

<sup>6</sup> Section 1.5 of the Fitness and Probity Standards

## Risk Management

As part of their normal risk management framework, the Bank expects undertakings to conduct and document an appropriate risk assessment in relation to any arrangement of this kind prior to its commencement. That risk assessment is expected to include the identification and assessment of all material risks arising from the specific arrangement and should outline the undertaking's planned approach to the ongoing monitoring and management of those risks. While, in practice, a decision to enter these types of arrangements may arise based on an overall group strategy, we expect the risk assessment to primarily consider the perspective of the individual undertaking that we supervise, i.e. taking account of the obligations and risks that apply to that undertaking. Furthermore, we expect that the result of any chosen risk management action should provide for a level of protection that is comparable to a scenario where the staffing/services are employed/conducted directly by the undertaking.

While the types of risks to be considered as part of the risk assessment of any proposed arrangement will depend on the specific nature of that arrangement, below are some risks the Bank considers are likely to be relevant (some being more relevant in the case of a staffing only arrangement and others in the case of hybrid arrangements).

- Risk of conflict of interest
- Control risk / risk of undue group influence
- Risk related to staff and their duty of fidelity and responsibility
- Business continuity risk
- Resolvability risk
- Substance risk
- Legal risk
- Regulatory risk
- Complexity risk
- Supervisability risk

Of these risks, there are some that we consider more likely and more challenging for undertakings to appropriately manage than others. These are considered in more detail below. Recognising that the onus is on undertakings to appropriately manage the relevant risks and provide satisfactory evidence of same to the Bank, as needed, we are seeking the views of stakeholders on how undertakings are currently/can appropriately and demonstrably manage those particular risks.

### **Risk of conflict of interest**

One of the particular challenges that is likely to be associated with arrangements of this kind is the risk of conflict of interest, potentially for the undertaking itself but more so for the SP, where it is servicing more than one group company.

The types of conflicts will be different, depending on the services provided under the arrangement, but some examples include:

- Where a SP employee is seconded on a part time basis to the undertaking but also has responsibility for other group activities that potentially conflict with the activities they are conducting on behalf of the undertaking, and
- Where the SP has responsibility for multiple deliverables to multiple group companies at the same time, conflicts in prioritisation may arise.

The Bank expects undertakings to identify and appropriately manage any conflicts of interest that arise from arrangements such as these.

### Question 7

What conflicts of interest do stakeholders consider could arise where undertakings enter arrangements of this kind?

### Question 8

What measures do/can undertakings implement to ensure that the above mentioned conflicts, and other potential conflicts of interest, are appropriately managed at all times?

### Question 9

Are there any services or types of arrangement that should not be permitted in this context due to the potential conflict that may arise and the limitation in an undertaking's ability to adequately manage that conflict?

## Control risk / risk of undue influence

As mentioned in the introduction to this discussion paper, the Bank is concerned about the risks arising related to the level of control that the undertaking itself has over its operations and activities where arrangements of this kind are entered into. For example, in the case of a group SP, many of its policies, procedures, strategies, objectives, etc. will be defined from the group's perspective. Where this is the case, we are concerned that these may not always be fully reflective of or aligned with the objectives or requirements of the undertaking. Furthermore, SP staff may have group reporting lines, objectives, performance targets, etc. that do not reflect their obligations to the undertaking and therefore pose a control risk for the undertaking.

Given that ultimate responsibility for all activities of the undertaking rests with the undertaking itself, we expect that ultimate control for those activities also

rests with the undertaking and we expect to be able to see meaningful evidence of that at commencement of any such arrangement and on an ongoing basis. As such, we would like to explore further, how boards and senior management of undertakings address this control risk to ensure the appropriate level of control rests within the undertaking at all times.

#### **Question 10**

Where a group SP is providing extensive staffing/other services to an undertaking, how can the undertaking ensure that it has appropriate control over the SPs staff/activities to ensure that the activities and objectives pursued by the SP in relation to the undertaking are always fully aligned with the objectives and requirements of that undertaking?

*(as part of your response please provide examples of safeguards which might be implemented regarding the assignment, oversight, performance and re-deployment of SP staff focused on activities of the undertaking)*

#### **Question 11**

Are there some positions (e.g. PCF)/activities of the undertaking which should always be directly employed/conducted by the undertaking itself? If so, which ones and why?

#### **Question 12**

What, if any, benefits are there to having common directorships between the SP and the undertaking?

### **Risk related to staff duty of fidelity and responsibility**

Under a staffing only arrangement, it should be evident that the arrangement is simply a form of employing people and that the relevant staff genuinely owe their duty of fidelity and responsibility to the undertaking, as opposed to the SP, and act in the interests of the undertaking at all times. The Bank considers that this becomes more difficult to ensure and demonstrate when the relevant staff are working for several group companies at the same time. Where this is the case, we have a concern that such an arrangement could become, in substance, more like an activity outsourcing arrangement (i.e. the provision of a process/service/activity) than a staffing arrangement and, as such, different issues and requirements might need to be considered.

### Question 13

In the case of a staffing only arrangement, and in particular where the SP staff are contracted to more than one group company at the same time, what measures can be applied to ensure the staff's duty of fidelity and responsibility are in favour of the undertaking at all times, including in stress scenarios?

#### **Business continuity**

Undertakings are expected to provide for appropriate business continuity (i.e. continuity of critical services, activities, etc.) at all times.

Where an undertaking enters an arrangement of the kind dealt with in this paper, it becomes very reliant on the SP's resources and operations. Therefore, its business continuity planning should adequately consider and include appropriate measures related to the arrangement which are aimed at ensuring business continuity in all circumstances (e.g. appropriate termination clauses, adequate funding of the SP, etc.) including in the case of failure of the SP (e.g. alternative SPs, ability to transfer staff/activities back to the undertaking, etc.).

For the avoidance of doubt, the Bank expects undertakings to ensure that all business continuity measures provide a comparable level of protection to that which would exist if the staff/activity were directly employed/conducted by the undertaking.

### Question 14

What particular business continuity measures are/should be put in place, both within the undertaking and the SP, in respect of these arrangements to ensure an appropriate level of protection for the undertaking at all times?

#### **Resolvability risk**

Where undertakings have entered arrangements of this kind, the Bank is concerned about the level of protection that is in place for the undertaking and, by extension, its policyholders in the event of the failure of the undertaking or indeed the group. For example, measures aimed at ensuring an adequate continuity and standard of services to its policyholders and appropriate engagement with and reporting to the Bank on behalf of the undertaking throughout the resolution process (e.g. adequate pre-funding of the SP, or adequate support or commitment from group for both the undertaking and the

SP, to ensure continuity of service and an orderly wind-down of the undertaking's activities).

### Question 15

What measures are/could be put in place at both undertaking and group level to ensure an appropriate level of protection for the undertaking, its policyholders and other relevant parties in the event of the failure of the undertaking or the group?

### Substance risk

When considering entering these types of arrangements, we expect undertakings to have assessed and satisfied themselves that there would be sufficient substance in the Irish undertaking. Any such assessment should be guided by the Bank's general statement on substance in Irish firms as published on its website under "Brexit FAQ - Financial Services Firms"<sup>7</sup>.

### Question 16

How do/can undertakings, who propose to enter these types of arrangements, ensure adherence to the Bank's expectations of regulated financial service providers (RFSPs) in terms of adequate substance in the Irish undertaking?

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<sup>7</sup> [Brexit FAQ – Financial Services Firms](#)

## 4. Conclusion

The Bank is continuing its examination of this topic, against the background of an evolving financial services landscape with a view to determining whether and if so, what, further regulatory or supervisory action is needed. We encourage undertakings within the Insurance Sector and other interested stakeholders to share their views and provide feedback on the key risks associated with this practice within the Sector.

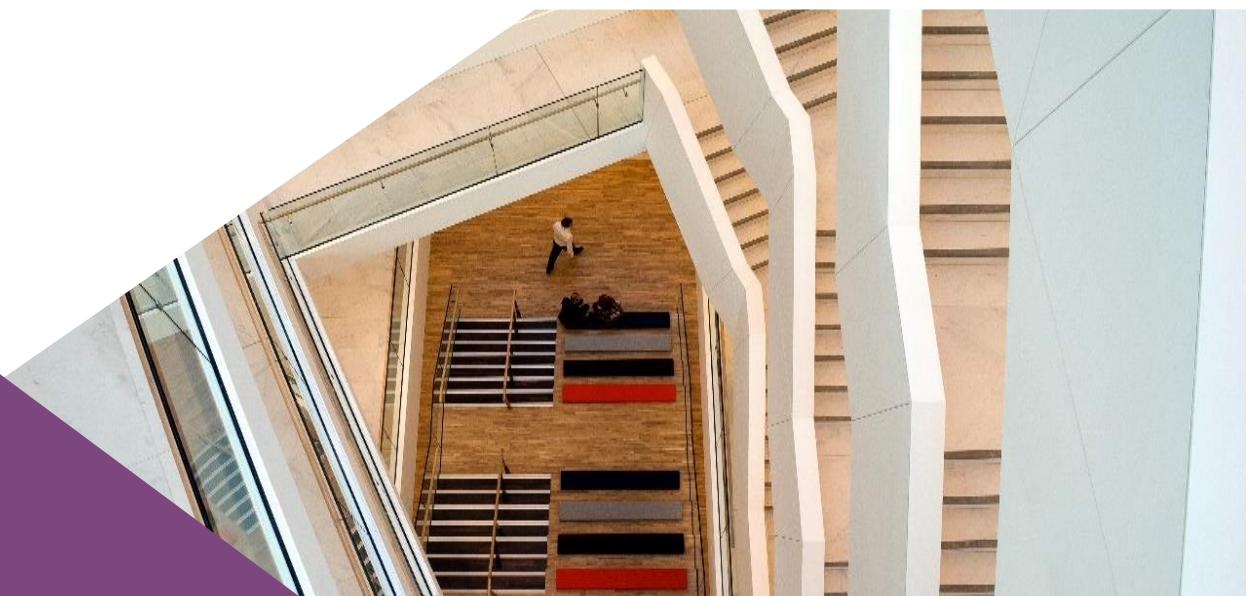
### Making your submission

Specific questions are listed in Parts 1 and 3 of this paper to stimulate your views. While these particular questions are posed for stakeholders to consider and respond on, we also welcome any other general comments, observations or evidence stakeholders may have in relation to this practice. It is important to note that although we would like to receive responses to all questions posed, where for some reason this is not possible for all respondents, partial responses are also welcome.

The Bank will make submissions received available on its website after the deadline for receiving submissions has passed. If commercially sensitive material is included, please highlight this clearly so that the Bank may take reasonable steps to avoid publishing that material. This may involve publishing submissions with sensitive material redacted. Despite the approach outlined, the Bank cannot guarantee that any information interested parties deem to be confidential will not be published. So be aware that unless any commercially sensitive information is identified, interested parties are making a submission on the basis that consent to publish-in-full is given.

This paper will be open for comment until 31 January 2020.

Submissions, entitled **“Response to Discussion Paper on Use of Service Companies in the Insurance Sector”**, should be made to [insurancepolicy@centralbank.ie](mailto:insurancepolicy@centralbank.ie).





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