

Changes ahead for Insurance Undertakings Using Service Companies for Staffing

On 5 August 2021 the Central Bank of Ireland (the “**Central Bank**”) published a consultation paper seeking views on proposed Guidance on the Use of Service Companies for Staffing Purposes in the Insurance Sector (the “**Guidance**”). This consultation follows on from Discussion Paper 9 Use of Service Companies in the Insurance Sector published in November 2019.

Why is there a need for Guidance?

The Central Bank is introducing this Guidance as, in its view, these types of staffing arrangements used by the (re)insurance industry, have potential, if not effectively managed, to threaten the operational resilience of (re)insurers. Such arrangements include the use of separate legal entities known as service companies for the provision of staffing or hybrid arrangements, which involve a combination of the provision of staff and other outsourced activities.

Which firms are in scope?

This Guidance applies to (re)insurers (“**Undertakings**”) authorised by the Central Bank. It does not, however, apply to arrangements entered into between captive (re)insurance undertakings and captive management companies for the provision of extensive captive management services.

The Guidance

The Guidance notes that the Central Bank’s key expectations of Undertakings using such arrangements are that the arrangement should not ***“impair the quality of the system of governance, unduly increase operational risk, impair the ability of the Central Bank to monitor compliance or undermine service to policyholders.”***

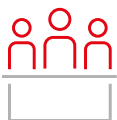
The following is a note of the specific elements set out in the Guidance, which Undertakings need to have regard to:



The role of the undertaking

The Central Bank expects Undertakings to:

- have robust governance arrangements in place which take the staffing arrangement into account;
 - integrate the staffing arrangement appropriately into the risk management system (including, the Own Risk and Solvency Assessment (“**ORSA**”) process) and internal control framework;
 - be able to demonstrate how the board has reviewed, considered and become comfortable with the specific arrangement and to provide details on their deliberation and decision upon request;
 - be able to demonstrate compliance with all relevant requirements, legislation, and other supervisory expectations; and
 - ensure that the arrangement does not create impediments to the supervision and resolvability of the undertaking.
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The role of the board

The Central Bank expects decisions to enter such arrangements and approval of the underlying staffing arrangement to be made at board level. Boards must satisfy themselves that:

- the overall governance framework appropriately integrates the staffing arrangement;
- the risk management system adequately identifies, assesses, manages, monitors and reports on the risks associated with the arrangement at the outset and on an ongoing basis;
- the protections provided for policyholders and other beneficiaries are not adversely affected by the arrangement;
- there are appropriate oversight mechanisms in place that provide for board review and consideration at regular intervals and times of material change;
- sufficient substance is maintained in the insurer at all times i.e. that it does not become an ‘empty shell’; and
- the arrangement does not impede the insurer’s ability to meet its conditions of authorisation.

Undertakings must be able to demonstrate how the board has considered and addressed these points upon request.



Basis of the staffing arrangement

In respect of the basis of the staffing arrangement, the Central Bank expects the following:

- a formal legally binding written agreement;
- clearly set out the basis of the staffing arrangement including structure, roles and responsibilities of both parties;
- include clauses requiring prior notice to the undertaking of any new activities assumed by the service provider that might be understood to potentially affect its service delivery to the undertaking; and
- include clauses which address issues of prioritisation and commitment to the undertaking in times of stress.

In addition, the Central Bank expects that the written agreement should, at minimum include:

- a clear outline of the roles and responsibilities of both parties;
- the management of conflicts of interest;
- fit and proper (“**F&P**”) procedures for assessment of persons employed via the service provider;
- the roles and responsibilities of Pre-approval Controlled Functions (“**PCFs**”) / Controlled Functions (“**CFs**”), particularly where such roles are shared across more than one entity;
- appropriate business continuity provisions including termination clauses, funding and transition to a new service provider.
- compliance requirements under relevant applicable legislation.



Risk management

The Central Bank expects Undertakings to conduct and document an appropriate risk assessment in relation to a staffing arrangement prior to its commencement.

The Central Bank advises that the the risk assessment is expected to include:

- the identification and assessment of all material risks likely to arise from the specific arrangement proposed;
- outline the undertaking’s planned approach to the management and ongoing monitoring of those risks; and
- consider the perspective of the undertaking, and the chosen risk management responses should provide for a level of protection that is comparable to a scenario where the staff are employed directly by the Undertaking.



Compliance risk

Undertakings and the service provider must identify the specific legal and regulatory obligations that apply to them, taking account of the nature and specificity of their activities and their organisational and operational structures, and ensure compliance with those obligations.



Due diligence

The Central Bank expects Undertakings to conduct appropriate and proportionate due diligence in respect of a prospective staffing arrangement. In addition to normal due diligence, Undertakings must consider:

- the extent of control or influence that may be exercised;
- the appropriateness of group policies and procedures in the context of the individual undertaking;
- potential conflicts of interest;
- the capabilities of the service provider and whether it holds the appropriate authorisations;
- F&P;
- the ability of the service provider to meet its requirements and contractual obligations in both normal and stressed circumstances; and
- data protection laws.



Conflicts of interest

The Central Bank expects Undertakings to appropriately address potential conflicts in its written conflicts of interest policy and in the written agreement.

In particular:

- it must be evident that relevant staff hold a duty of fidelity or responsibility to the Undertaking and that they act in the interests of the insurer at the appropriate times;
- where staff are shared across multiple entities, this does not compromise the staff's ability to properly carry out their responsibilities for the Undertaking;
- where the arrangement is a hybrid arrangement and a material element of that relates to other activity outsourcing, the responsibility for overseeing the delivery of that other activity by the services company, as required by Solvency II, is assigned to a person directly employed by the Undertaking; and
- an undertaking to implement appropriate measures to mitigate risk of conflict of interest, such as,
 - appropriate segregation of duties; and
 - oversight and reporting, designed to prevent undue influence; or
 - inappropriate combinations of activities and to ensure disclosure and mitigation of conflicts where identified.

Undertakings are expected to be able to demonstrate how they have considered and addressed these points if requested.

NB: If staffing arrangements do not align with the above expectations the Central Bank expects them to be avoided.



Control risk / Risk of undue influence

In the case of a staffing arrangement with a group service company, the Central Bank expects an insurer to ensure that the staffing arrangement is appropriately aligned to its strategy and objectives and use specific and relevant controls to manage this risk.

Undertakings must ensure they exert appropriate influence over the staffing arrangement in terms of the underlying selection and recruitment of staff, performance management, day-to-day operations, and reporting.



Operational resilience

In relation to operational resilience, the Central Bank expects Undertakings to:

- understand whether the staffing arrangement contributes to the delivery of any critical or important business service(s) and ensure that it can remain within its impact tolerance(s);
- have sufficient controls and procedures in place to identify in a timely manner, vulnerabilities or threats to the operational resilience of the insurer posed by the staffing arrangement;
- regularly assess the effectiveness of these controls and procedures;
- ensure that the staffing arrangement is adequately incorporated into the overall operational resilience framework of the undertaking; and
- have processes to identify, analyse and report on operational risk events related to the staffing arrangement.



Business continuity planning

The Central Bank expects an undertaking to ensure that the business continuity measures provide for a comparable level of protection to that which would exist if the staff were directly employed by the undertaking. When designing and implementing Disaster Recovery and Business Continuity Plans (“BCP”), the Central Bank expects Undertakings to:

- regularly review the appropriateness of, and adjust as necessary, the Disaster Recovery/BCP in respect of the staffing arrangement;
- explicitly consider the staffing arrangement when carrying out stress and scenario testing; and
- ensure that the staffing arrangement is considered in the context of, and integrated within, the Undertakings recovery planning.



Resolvability

The Central Bank expects Undertakings to:

- have appropriate plans and measures in place in order to disentangle arrangements and provide continuity of service to policyholders in a stressed scenario, e.g. adequate pre-funding (equivalent to six months' worth of working capital being ring-fenced within the service company) and contractual obligations that ensure continued service for a reasonable period of time; and
- have contracts, which include the staffing arrangement, that provide for events of resolution and/or failure of the undertaking to be managed in an orderly manner by the relevant authority and/or third party.



Fitness and Probity

Where a staffing arrangement includes the provision of staff to perform a PCF and/or CFs, Undertakings must ensure they comply with the relevant F&P requirements.

In circumstances where the service provider is itself a Regulated Financial Services Provider and the exemptions permitted under Section 1.5 of the Central Bank's F&P Standards apply, the service provider must ensure relevant staff comply with applicable F&P requirements.



Internal Reporting

The Central Bank expects Undertakings to have the necessary structures and mechanisms in place to ensure timely and appropriate management information for the board to facilitate necessary deliberations.



Regulatory reporting

The Central Bank expects Undertakings to provide appropriate information on a staffing arrangement at both commencement and whenever there is a material change to the arrangement.

If a staffing arrangement is being entered into at authorisation stage, information is expected to be included in the insurer's business plan, or, if the arrangement is entered into at a later stage, relevant information is expected to be provided as part of the next narrative Regular Supervisory Report following commencement of the arrangement.

Next steps

The Consultation remains open for submissions until 6 November 2021. As ever, Undertakings which are impacted by the Guidance are encouraged to make submissions on any element of the Guidance. The Central Bank will, following receipt of submissions, issue a feedback statement and confirm the final text of the Guidance.

The draft Guidance sets out clearly what the Central Bank's expectations are of Undertakings in terms of next steps once the Guidance is finalised. These are set out below. While acknowledging that the Guidance maybe subject to change, Undertakings would be advised to consider those next steps and begin to identify gaps in documentation, processes and procedures in order that they are in a position to deliver on the Central Bank's expectations within 12 months after implementation of the Guidance.

Next steps identified by the Central Bank include:

- review the Guidance;
- ensure that any staffing arrangements falling into the categories above are reviewed in light of the Guidance;
- update and augment any existing arrangements, if necessary, to align with the expectations set out in the Guidance;
- carry out this work within 12 months of the implementation of the Guidance;
- be able to demonstrate **how** they have carried out this work;
- be able to demonstrate the **rationale** for their approach; and
- be able to **provide evidence** that the Guidance has been considered and approved by the board.

Should you require further information in relation to the material contained in this article, please get in touch with a member of the team or your usual Matheson contact. Full details of Matheson's Financial Institutions Group together with further updates, articles and briefing notes written by members of the team, can be accessed at www.matheson.com.

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