LLOYD'S MARKET ASSOCIATION

OUTSOURCING

APPLICATION OF FSA AND SOLVENCY II REQUIREMENTS TO MARKET AGREEMENTS

LMA Solvency II Committee
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Contents

1. Executive Summary

The majority of FSA Rules concerning outsourcing only apply to Lloyd's managing agents as Guidance. Solvency II will impose far more stringent requirements on managing agents and, to a large extent, the current FSA Guidance will effectively become Rules.

Model agreements relating to subscription market underwriting arrangements, delegated underwriting, claims management and business arrangements with brokers, together with standard market agreements with Xchanging for premiums and claims processing, have been reviewed to determine:

(i) whether such arrangements and agreements constitute outsourcing; and, if so,

(ii) whether such outsourcing is 'critical'; and

(iii) the extent to which the agreements meet the proposed Solvency II requirements.

Main findings

All model agreements reviewed would usually constitute outsourcing. The General Underwriters Agreement (GUA) and the North Atlantic Claims Handling Agreement (relating to aviation market claims handling) are not considered to be outsourcing of a critical function, and are therefore not subject to the detailed requirements of the FSA (in so far as these constitute relevant Guidance) or detailed Solvency II requirements. The other model agreements reviewed could constitute the outsourcing of a critical function, although this would depend on the exact circumstances and extent of the delegation.

The model agreements reviewed, which could constitute the outsourcing of critical functions, are considered to be compliant with the proposed Solvency II outsourcing requirements. Regarding the market agreements with Xchanging, gaps in the Xchanging Ins-sure (XIS) contract are being addressed. The Xchanging Claims Services (XCS) contract and Insurers' Market Repository agreement have been reviewed and are considered to be compliant with the Solvency II outsourcing requirements.

A summary of findings is provided in the table below.

Agreement	Outsourcing	Critical	SOLVENCY II compliant	Gaps & next actions
GUA	Yes	No	Yes	N/A
Lineslips	Yes	Dependent on materiality(*)	Yes	N/A
Coverholders/ service companies - Model LMA binding authority agreements	Yes	Dependent on materiality (*)	No	Gaps relate to the written contracts and have been addressed by the LMA Binding Authorities Wording Sub-Group. Coverholder arrangements will be compliant following adoption of the revised wording, due for publication in Q1 2013.
Model Third Party Administrators	Yes	Yes	Yes	N/A
North Atlantic Claims Handling Agreement	Yes	No	Yes	N/A
Model broker terms of business agreements	Yes	Dependent on materiality (^)	Yes (subject to FSA CASS review)	N/A

Agreement	Outsourcing	Critical	SOLVENCY II compliant	Gaps & next actions
XChanging Ins-sure services	Yes	Yes	Not fully	Gaps relate to the written contract and are known to the Xchanging Review Board (XRB). The XIS arrangement will be compliant following finalisation of the amended contract which is expected to be published later in 2013.
XChanging Claims Service	Yes	Yes	Yes	N/A
Market Repository agreement	Yes	Yes	Yes	N/A

(*) see Section 4.1.2 for description of materiality in relation to delegated underwriting
(^) see Section 4.1.4 for description of materiality in relation to risk transfer

2. Purpose

This paper is intended to:

- Provide a comparison between current FSA outsourcing rules and guidance, and those proposed under Solvency II;
- Summarise whether the following Lloyd's market model and standard agreements constitute outsourcing and, if so, whether they meet the definition of 'critical' outsourcing; and the extent to which they meet the proposed Solvency II requirements:

    - Model General Underwriting Agreement between leader and followers (GUA)
    - Model LMA binding authority agreements
    - Model Third Party Administrator Agreement (TPA) for claims handling
    - Model North Atlantic Claims Handling Agreement (NACHA)
    - Model terms of business agreements between managing agents and Lloyd's brokers, non risk transfer 2011 version (NRT TOBA) and risk transfer 2005 version with model 2011 endorsement (RT TOBA)
    - Standard Agreement between managing agents and LPSO Limited and schedules (XIS Agreement)
    - Standard Agreement between managing agents and Xchanging Claims Services Limited and schedules (XCS Agreement).
    - Standard Agreement between managing agents and Xchanging Ins-sure Services Limited and schedules, in relation to the market repository (IMR Agreement)

This paper considers the above model and standard agreements used in the market. It does not consider particular arrangements which managing agents may put in place in relation to the operation of these agreements or surrounding market practice; nor does it consider other functions which managing agents might outsource, e.g. investment management.

Managing agents are responsible for maintaining a written outsourcing policy and associated procedures, in order to manage outsourcing effectively.

3. Current FSA requirements and Solvency II proposals

Current FSA requirements concerning outsourcing are contained within the Systems and Controls (SYSC) chapter of the FSA Handbook, under sections 3.2, 8.1 and 13.9. These are reproduced at Appendix I.

Although SYSC 8.1 provides detailed rules for MiFID firms, the Handbook states that all the rules contained therein should be read across to all non-MiFID firms as guidance. Section 13.9 provides

specific guidance for insurers. Again, although SYSC 13.9 does not apply directly to managing agents, the requirements should be considered as good guidance.

SYSC 3.2.3 applies to all firms and states that firms cannot contract out of their regulatory obligations. It also states that outsourcing arrangements, systems and controls should include:

- Appropriate safeguards;
- The provider should be assessed for suitability;
- Extents and limits of the delegations;
- Arrangements for monitoring and supervision;
- Appropriate follow-up arrangements should cause for concern arise; and
- An assessment of the impact of outsourcing on its systems and controls.

The current Solvency II proposals concerning outsourcing are contained within the Level 1 Directive, Level 2 consultation papers, draft Level 3 guidance and the consolidated draft of Level 2 implementing measures, dated 31 October 2011. These are reproduced at Appendix II.

To meet the fundamental requirements of the Solvency II proposals, any agreement which would constitute outsourcing must satisfy the conditions set out in article 38 of the Directive, namely:

- The service provider must co-operate with the supervisory authority;
- There should be effective access to data for the managing agent, its auditors and the supervisory authority; and
- There should beeffective access to the business premises of the service provider for the supervisory authority.

3.1 Critical functions

SYSC 8.1 defines a function as critical or important, *"if a defect or failure in its performance would materially impair the continuing compliance of the firm with the conditions and obligations of its authorisation or its other obligations under the regulatory system, or its financial performance, or the soundness or the continuity of its relevant services and activities."*

EIOPA (formerly CEIOPS) DOC29/09 defines critical/important functions as the key functions of an undertaking's system of governance and all functions within the undertaking that are fundamental to carry out its core business. The guidance does not provide a definitive list of critical functions but does cite the design and pricing of insurance products and claims handling as examples.

In addition, regarding the outsourcing of critical functions, agreements must also satisfy the requirements of Article 49 of the Directive, namely:

- Agreements must not unduly increase operational risk, undermine continuous and satisfactory service to policyholders, or impair the ability of the supervisory authority to monitor compliance of the undertaking with its obligations.

3.2 Comparison of current FSA guidance and Solvency II

The following table provides a comparison of the current FSA rules and guidance, and Solvency II proposals. L2 refers to Article 264 SG12 of the consolidated Level 2 text.

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Area	Solvency II	FSA
Written policy	L1 Art 41 - requirement.	No requirement under SYSC 8 or 13
Intra-group	L2 - when outsourcing critical functions, take into account extent of control and influence over service provider.	SYSC 8.1.10 - take into account the extent of control and/or influence over the service provider. SYSC 13.9.3A - No assumption that intra-group outsourcing necessarily implies a reduction in operational risk.
Due diligence	L2 - Board has responsibility for outsourcing and approval of critical contracts.	No requirement under SYSC 8 or 13.
	L2 - ability, capacity and any authorisation required by law	SYSC 8.1.8 (1)a - Ability, capacity and any authorisation required by law
	L2 - adopt all means to manage conflicts of interest	No requirement under SYSC 8 or 13.
	L2 - adherence to Data Protection and other laws.	No requirement under SYSC 8 or 13.
	L2 - safety and confidentiality of information relating to firm and policyholders	SYSC 8.1.8 (1) f - protection of any confidential information relating to the firm and its clients. SYSC 13.9.5 (3) - confidentiality agreements to protect client and other information.
	L2 - financial resources and qualifications of staff	SYSC 8.1.8 (1) a - ability, capacity and any authorisation required by law. SYSC 13.9.4 (3) - the service provider's financial stability and expertise.
	L2 - adequate contingency plans for business interruption with periodic testing.	SYSC 8.1.8 (2) c - implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities. SYSC 13.9.5 (6) - the extent of provision of business continuity for outsourced operations.
Written agreement	L2 - written agreement required; setting out respective rights and obligations	SYSC 8.1.9 - ensure respective rights and obligations are clearly allocated and set out in a written agreement.
Agreement terms	L2 - duties and responsibilities.	SYSC 8.1.9 - ensure respective rights and obligations are clearly allocated and set out in a written agreement.
	L2 - commitment to comply with all applicable laws and regulations.	No requirement under SYSC 8 or 13.
	L2 - obligation to advise of any development which may materially affect the ability to perform the function	No requirement under SYSC 8 or 13.

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Area	Solvency II	FSA
Agreement terms	L2 - termination by service provider, only with sufficient notice period.	SYSC 13.9.5 (8) - conditions under which the service provider can terminate the contract.
	L2 - ability to terminate the arrangement without detriment	SYSC 8.1.8 (2) c - ability to terminate the arrangement without detriment. SYSC 13.9.5 (8) - conditions under which the firm can terminate the contract.
	L2 - reporting of service provider performance.	SYSC 8.1.8 (1) b - methods for assessing service provider performance.
	L2 - right to issue general guidelines and individual instructions.	SYSC 13.9.5 (5) - extent to which the service provider must comply with the firm's policies and procedures.
	L2 - protection of confidential information	SYSC 8.1.8 (1)f - protection of any confidential information relating to the firm and its clients. SYSC 13.9.5 (3) - confidentiality agreements to protect client and other information.
	Art 38 - Firm, auditors and the supervisory authority have effective access to information and business premises and can address questions directly to service provider.	SYSC 13.9.5 (2) - sufficient access available to auditors and the FSA. SYSC 8.1.8 (1) e - cooperate with the FSA and any other competent authority.
	L2 - terms and conditions of any sub-outsourcing and that duties and responsibilities remain unaffected.	No requirement under SYSC 8 or 13.
Risk Management	L2 - ensure relevant aspects of the service provider's risk management and internal control system are adequate.	No requirement under SYSC 8 or 13.
	L2- take account of the outsourced activities in its risk management and internal control system.	SYSC 13.9.4 (1) - analyse how the arrangement will fit with organisation and reporting structure, business strategy, risk profile and ability to meet regulatory obligations. SYSC 8.1.1 (2) - not undertake outsourcing of critical functions in such a way as to impair materially the quality of its internal control.
Notification to supervisor	L1 Art 49 - notify the supervisory authorities prior to the outsourcing of critical or important functions.	SYSC 8.1.12 - firms should notify the FSA when intending to outsource critical functions. SYSC 13.9.2 - firms should notify the FSA when it intends to enter into a critical outsourcing arrangement.

As can be seen from the table, the Solvency II requirements are similar to those of SYSC 13.9 and SYSC 8.1. Indeed, in some instances, wording identical to SYSC 8.1 is used. For managing agents, under Solvency II, these two sections of SYSC effectively become rules.

The Solvency II requirements which are supplementary to the current FSA guidance are:

- The need for a written policy on outsourcing
- That the Board assumes responsibility for due diligence and the general terms of the outsourced contract
- Appropriate means to manage any conflicts of interest
- Controls around sub-outsourcing
- Formal assessment of the service provider's risk management and internal control framework

Those Solvency II requirements not exactly mirrored in SYSC are either self-evident or would normally be included in any services agreement (for example, setting out the duties and obligations of both parties, the need to comply with applicable laws).

4. Lloyd's market model and standard agreements

Certain Lloyd's market model and standard agreements are considered below to determine to what extent they constitute outsourcing and the impact, if any, of the Solvency II outsourcing proposed requirements.

4.1 Model agreements

4.1.1 Subscription agreements between leader and following underwriters - General Underwriters Agreement (GUA)

The GUA is an agreement between the subscribing underwriters on a particular insurance contract relating to the level of delegated authority to the Slip Leader and/or Agreement Parties in respect of post placement alterations. The main benefit of the GUA is a clear, codified agreement process with a unified approach to contract alterations.

Although the delegations described above, could be considered outsourcing, in so far as they relate to underwriting decisions, they would not be considered critical since material amendments are reserved to all subscribing underwriters. The GUA sets out such delegations in three schedules – those that can be agreed by the Slip Leader alone; those that can be agreed by the Slip Leader in conjunction with the Agreement Parties; and those which require the agreement of all subscribing underwriters.

SCHEDULE 1 (agreement by Slip Leader alone): includes typographical errors, non-material changes to name of insured(s), minor extensions to payments dates.

SCHEDULE 2 (agreement of all subscribing underwriters): includes amendments to limits which increase underwriters' liability by more than 10% of their signed line, waivers or amendments to express or implied warranties, backdating of the policy period and cancellation of the policy.

SCHEDULE 3 (agreement by Slip Leader in conjunction with the Agreement Parties): includes all matters not dealt with in Schedules 1 and 2.

This grading of delegation according to materiality ensures that important/critical decisions are reserved to each subscribing underwriter.

4.1.2 Delegated underwriting

As stated in the EIOPA draftLevel 3 guidance published in 2010, underwriting is a critical activity and material delegation of underwriting authority could therefore constitute critical outsourcing. Where a managing agency considers such delegation to be material, it should be treated as critical outsourcing. Materiality would depend on the nature of the arrangement and considered in the light of the overall underwriting authority delegation arrangements by the managing agent, rather than on a contract, by contract, basis.

Lloyd's requires all managing agents to comply with Lloyd's code of practice – *delegated underwriting*. The code of practice defines the following as minimum standards:

- The managing agent has a clear strategy for writing and managing delegated underwriting as part of its overall business plan – this includes the requirement to have written procedures, agreed at board level, for managing delegated underwriting contracts.
- The managing agent carries out thorough due diligence of coverholders to which it proposes to delegate authority.
- The managing agent ensures that it has binding authorities in place with each coverholder to which it delegates authority clearly defining the conditions, scope and limits of that authority and which comply with Contract Certainty requirements, including the requirement to demonstrate regularly that insurance documents have been issued within required timescales.
- The managing agent proactively manages delegated underwriting contracts once incepted to ensure compliance with contract conditions.

In March 2011, a gap analysis of the delegated underwriting code of practice against Solvency II proposals was performed by Lloyd's. Gaps have been addressed through the revision of the LMA Model Binding Authority Agreements, as described below.

Lineslips

Lineslips are agreements where a managing agent delegates underwriting authority to another managing agent or authorised insurance company in respect of business introduced by a Lloyd's broker, named in the agreement.

Lineslips are also subject to the Lloyd's code of practice – *delegated underwriting*. Lloyd's requires each lineslip to be reviewed and authorised by appropriate personnel within the managing agent prior to inception and renewal, and for the facility to be monitored carefully thereafter, with lineslip processes and performance reporting included in internal audit plans.

The code of practice also expects following managing agents to ensure that the contract is constructed so as to provide them with all necessary information, including reports, appropriate for the class of business concerned.

As lineslips delegate underwriting to other authorised and regulated entities, the supervisory authorities (the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA)) are again ensured effective access to data and premises.

LMA Model Binding Authority Agreements

The LMA Binding Authorities Wordings Sub-Group [is preparing] has prepared amendments to the model binding authority wordings, the terms of which are designed to meet the Solvency II requirements. These amended wordings are expected to be issued in Q1 2013.

If a binding authority is agreed on the basis of the new model LMA Model Binding Authority Agreement, the agreement together with adherence to the code of practice and FCA supervision will satisfy the current Solvency II proposals.

Managing agents should remember that the model agreement is designed to act as a template to assist in compliance and does not guarantee compliance in itself. Managing agents should ensure that all the individual terms of the agreement meet their operational requirements.

Coverholders

Coverholders operate under binding authorities from underwriters. Lloyd's supervises coverholders as part of its statutory role in supervising the Lloyd's market. This supervision is carried out through the approval process and then through Lloyd's ongoing supervision of all approved coverholders.

Additionally, UK coverholders will be authorised and regulated by the UK FCA, thus ensuring effective access to data and premises for the supervisory authority.

Lloyd's requires all managing agents to maintain written contracts with coverholders which meet Lloyd's requirements under the Intermediaries Byelaw. This requirement is satisfied by the use of the LMA Model Binding Authority Agreements.

Service companies

A service company is an approved coverholder which is a wholly owned subsidiary of either a managing agent or of a managing agent's holding company and which is normally only authorised to enter into contracts of insurance for members of its associated syndicate and/or associated insurance companies.

As such, all requirements for coverholders detailed above, apply equally to service companies. Lloyd's also maintains a code of practice for service companies.

4.1.3 Third party agreements with claims handlers

Third Party Administrator agreements (TPA)

TPA agreements are contracts between managing agents and claims handling companies, where the claims handling company is appointed to manage claims under a binding authority agreement.

The Lloyd's Intermediaries Byelaw sets out which entities may be appointed as TPAs and in particular sets out the registration requirements for TPAs appointed under binding authorities. In addition the Lloyd's minimum standards mandate the need for clear and appropriate responsibilities and duties, and ongoing monitoring and auditing of the TPA.

The LMA model TPA agreement has been reviewed and has been assessed as being compliant with the proposed Solvency II requirements in respect of outsourced contracts.

As with the LMA Model Binding Authority agreement, the TPA agreement is a model agreement and managing agents should ensure that all the actual terms of the agreement meet their operational requirements, particularly in respect to notice of termination periods.

North Atlantic Claims Handling Agreement (NACHA)

The NACHA is used in aviation insurance where Lloyd's managing agents might follow on a risk led by a US insurer. The NACHA promotes efficient and economical investigation, administration, and adjustment of claims, by delegating certain claims handling authorities to the lead insurer.

The NACHA, like the GUA, splits claim types into three categories, as follows:

CATEGORY 1: routine claims with a value <£250,000. When notified of such claims, the lead insurer assumes complete authority to investigate, adjust, defend and/or settle. Such claims are notified to following insurers by monthly bordereau.

CATEGORY 2: claims with value >£250,000, <£1,000,000 will be notified to following insurers with a summary of details. The lead insurer will negotiate, defend and/or settle unless a following insurer provides a written objection within 14 days of notification.

CATEGORY 3: claims with a value >£1,000,000 or catastrophic in nature (involving death or serious injury) are notified to following insurers within 30 days with a detailed report of known facts and circumstances. Further reports will be provided to followers at least every 90 days. The lead insurer is required to obtain consent from each following insurer, prior to determination of liability, adjustment or settlement.

The NACHA contains a section on Inspection and Audit which provides for following insurers to have full and complete access to all relevant materials for auditors, investigators and other representatives of their choosing.

The NACHA also contains provisions for the replacement of the lead in the claims handling process, should the lead be unable to perform its duties appropriately.

As is the case with the GUA, the delegations as described above could be considered outsourcing, in so far as they relate to claims handling; however, again, they would not be considered critical as the NACHA provides a gradation of delegation according to materiality, such that important / critical claims decisions are reserved to each participating firm.

Claims management agreements similar to the NACHA in their gradation of delegation would also not be considered critical outsourced agreements.

4.1.4 Broker terms of business agreements (TOBA)

A TOBA is an agreement between a managing agent and a broker, governing the conduct of insurance business, including the holding of premiums, return premiums and claims monies (monies-in-transit).

There are two model TOBAs published jointly by the LMA, IUA and LIIBA - the non-risk transfer TOBA (NRT TOBA 2011) and the risk transfer TOBA (RT TOBA 2005), used with or without the 2011 endorsement (RT TOBA endorsement).

Regarding monies-in-transit, the NRT TOBA 2011 stipulates that the broker holds such monies as agent of the insured and must therefore do so in accordance with the FSA client money rules (CASS). The RT TOBA 2005 stipulates that the broker holds monies-in-transit as agent of the managing agent, but must still pay monies into a trust account in compliance with the CASS rules.

Therefore, in using the RT TOBA 2005, a managing agent outsources the collection and holding of monies-in-transit to the broker. Whether such outsourcing is critical, would depend on whether the amount of money held by the broker was material in relation to the managing agent's business. Therefore use of the RT TOBA 2005 with large brokers is more likely to constitute the outsourcing of a critical function than its use with a smaller provincial broker.

The RT TOBA 2005 has been reviewed by the LMA and the terms of the agreement reflect the SII requirements for critical outsourced contracts, save an express requirement for the broker to provide adequate access (documents, persons and premises) to the managing agent's regulatory body. However, such access follows naturally from the requirement contained in paragraph 3.1 of the agreement ("Regulatory Status"); that the broker must be FSA authorised.

The FSA has recently consulted on the client money/CASS rules to which the LMA responded on 25 October 2012. The consultation includes proposals relating to the reconciliations of trust accounts

and provision of audit reports to the FSA. The FSA intends to publish its feedback statement in Q2 2013.

Subject to introducing the detailed proposals, supervision by the future FCA should give confidence that brokers are meeting adequate standards in relation to the holding of syndicate funds. However, it should be noted that managing agents do not have a right of inspection and audit of trust accounts under the RT TOBA.

Therefore, subject to implementation of the FSA proposals, we believe the RT TOBA 2005 meets the Solvency II requirements of critical outsourced contracts.

4.2 Standard form agreements between managing agents and Xchanging (or its subsidiaries), for premiums and claims processing

A summary of Xchanging contracts[1] can be found on the LMA website

4.2.1 Premium processing - Xchanging Ins-sure services (XIS)

XIS is responsible for the provision of policy preparation and checking services, premium settlement, and regulatory and fiscal reporting for the Lloyd's market. These are critical functions and the XIS contract therefore constitutes a critical outsourcing arrangement.

XIS is a joint venture between Xchanging, which has 50% share ownership, and Lloyd's and the International Underwriting Association, each with 25% share ownership.

Lloyd's currently mandates the use of XIS and provides oversight of their services for the market. Additionally, KPMG produce an annual ISAE3402 (previously SAS70[2]).

The LMA Xchanging Review Board (XRB) is the nominated committee for oversight of the XIS contract agreement. The XRB has performed a gap analysis of the agreement and actions to ensure its compliance with the Solvency II requirements for critical outsourced contracts are due to be completed during 2013.

4.2.2 Xchanging Claims Services (XCS)

As previously noted, EIOPA (formerly CEIOPS) DOC29/09 cites *claims handling* as an example of a critical function.

Under the 2006 Lloyd's Claims Scheme, the lead insurer on a subscription risk would normally lead the claims handling process. Followers on the risk would use XCS for the provision of claims management and technical processing services. As such, following insurers would outsource the critical function of claims handling to XCS.

However, through implementation of the 2010 Lloyd's Combined Claims Scheme, responsibilities for claims handling become dependent on the complexity of the claim. 'Standard' claims will continue to be led by the leading insurer, whereas 'complex' claims will be led by the leading and second insurers. In both cases, XCS only provide processing services and not claims handling services. Therefore, under the 2010 Lloyd's Combined Claims Scheme, following insurers do not outsource the critical function of claims handling.

XCS is a joint venture between Xchanging and Lloyd's, which maintain equal share ownership.

[1] Login to the LMA website is required to view the contracts summary
[2] Statement of Auditing Standards No 70

Lloyd's currently mandates the use of XCS and provides oversight of their services for the market. Additionally, KPMG produce an annual ISAE3402.

The LMA Claims Services Review Board (CSRB) is the nominated committee for oversight of the XCS contract agreement. The CSRB has performed a gap analysis of the agreement and the XCS contract and found it to be compliant with the Solvency II requirements of critical outsourced contracts.

4.2.3 Insurers' Market Repository Agreement

The Insurers' Market Repository (IMR) supports the electronic processing of premiums, policies and claims through the Accounting and Settlement (A&S) and Electronic Claims File (ECF) solutions. The IMR enables its users to create, maintain and submit premium, policy and claims documentation direct to Xchanging and share documents with their trading partners, eliminating paper and increasing processing speeds.

The IMR contract is between managing agents and XIS. While not party to the IMR contract, brokers and company carriers also have the ability to contract with XIS to use the IMR.

The IMR contract outsources operation of the repository to XIS, including loading, storing, viewing and handling premium and claims documents/reports. As the IMR is a key piece of infrastructure for the London Insurance Market, its operation is a critical function.

The IMR contract has been reviewed by the LMA and found to be compliant with the Solvency II requirements for critical outsourced contracts.

Appendix I - Current FSA outsourcing requirements

1 SYSC 3.2 - general guidance for all firms

(3.2.3)

(1) A firm's governing body is likely to delegate many functions and tasks for the purpose of carrying out its business. When functions or tasks are delegated, either to employees or to appointed representatives or, where applicable, its tied agents, appropriate safeguards should be put in place.
(2) When there is delegation, a firm should assess whether the recipient is suitable to carry out the delegated function or task, taking into account the degree of responsibility involved.
(3) The extent and limits of any delegation should be made clear to those concerned.
(4) There should be arrangements to supervise delegation, and to monitor the discharge of delegated functions or tasks.
(5) If cause for concern arises through supervision and monitoring or otherwise, there should be appropriate follow-up action at an appropriate level of seniority within the firm.

(3.2.4)

(1) The guidance relevant to delegation within the firm is also relevant to external delegation ('outsourcing'). A firm cannot contract out its regulatory obligations. So, for example, under Principle 3 a firm should take reasonable care to supervise the discharge of outsourced functions by its contractor.
(2) A firm should take steps to obtain sufficient information from its contractor to enable it to assess the impact of outsourcing on its systems and controls.

2 SYSC 8.1 - requirements for MiFID firms (guidance for insurers)

(8.1.1) A firm should:

(1) when relying on a third party for the performance of operational functions which are critical for the performance of regulated activities, listed activities or ancillary services (in this chapter "relevant services and activities") on a continuous and satisfactory basis, ensure that it takes reasonable steps to avoid undue additional operational risk;
(2) not undertake the outsourcing of important operational functions in such a way as to impair materially:

> (a) the quality of its internal control; and
> (b) the ability of the FSA to monitor the firm's compliance with all obligations under the regulatory system.

(8.1.4) An operational function is regarded as critical or important if a defect or failure in its performance would materially impair the continuing compliance of the firm with the conditions and obligations of its authorisation or its other obligations under the regulatory system, or its financial erformance, or the soundness or the continuity of its relevant services and activities.

(8.1.5) The following functions are not considered as critical or important:

> (1) provision of advisory services, and other services which do not form part of the relevant services and activities of the firm, including legal advice training of personnel, billing services and the security of the firm's premises and personnel;
> (2) the purchase of standardised services, including market information services and the provision of price feeds

(8.1.3) where a firm relies on a third party for the performance of non-critical/important operational functions, other than those listed in (8.1.5), it should take into account, in a manner that is

proportionate given the nature, scale and complexity of the outsourcing, the rules in this section in complying with that requirement.

(8.1.7) A firm should exercise due skill and care and diligence when entering into, managing or terminating any arrangement for the outsourcing to a service provider of critical or important operational functions or of any relevant services and activities.

(8.1.8) A firm should, in particular, take the necessary steps to ensure that the following conditions are satisfied:

(1) the service provider should

(a) have the ability, capacity, and any authorisation required by law to perform the outsourced functions, services or activities reliably and professionally;
(b) carry out the outsourced services effectively, and to this end the firm should establish methods for assessing the standard of performance of the service provider;
(c) properly supervise the carrying out of the outsourced functions, and adequately manage the risks associated with the outsourcing;
(d) disclose to the firm any development that may have a material impact on its ability to carry out the outsourced functions effectively and in compliance with applicable laws and regulatory requirements;
(e) co-operate with the FSA and any other relevant competent authority in connection with the outsourced activities;
(f) protect any confidential information relating to the firm and its clients;

The firm should:

(g) retain the necessary expertise to supervise the outsourced functions effectively and to manage the risks associated with the outsourcing, and must supervise those functions and manage those risks;
(h) be able to terminate the arrangement for the outsourcing where necessary without detriment to the continuity and quality of its provision of services to clients;
(i) with the service provider, establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities where that is necessary having regard to the function, service or activity that has been outsourced;
(j) take appropriate action if it appears that the service provider may not be carrying out the functions effectively and in compliance with applicable laws and regulatory requirements;

The firm, its auditors, the FSA and any other relevant competent authority should have effective access to data related to the outsourced activities, as well as to the business premises of the service provider; and the FSA and any other relevant competent authority should be able to exercise those rights of access;

(8.1.9) A firm should ensure that the respective rights and obligations of the firm and of the service provider are clearly allocated and set out in a written agreement.

(8.1.10) If the firm and the service provider are members of the same group, the firm may, for the purpose of complying with these rules, take into account the extent to which the firm controls the service provider or has the ability to influence its actions.

(8.1.11) A firm should make available on request to the FSA and any other relevant competent authority all information necessary to enable the FSA and any other relevant competent authority to supervise the compliance of the performance of the outsourced activities with the requirements of the regulatory system.

(8.1.12) A firm should notify the FSA when it intends to rely on a third party for the performance of operational functions which are critical or important for the performance of relevant services and activities on a continuous and satisfactory basis.

3 SYSC 13.9 – requirements for insurers

(13.9.1) A firm cannot contract out its regulatory obligations and should take reasonable care to supervise outsourced functions. This section provides additional guidance on managing outsourcing arrangements (and will be relevant, to some extent, to other forms of third party dependency) in relation to operational risk.

(13.9.2) Firms should take particular care to manage material outsourcing arrangements and a firm should notify the FSA when it intends to enter into a material outsourcing arrangement.

(13.9.3) A firm should not assume that because a service provider is either a regulated firm or an intra-group entity an outsourcing arrangement with that provider will, in itself, necessarily imply a reduction in operational risk.

(13.9.4) Before entering into, or significantly changing, an outsourcing arrangement, a firm should:

(1) analyse how the arrangement will fit with its organisation and reporting structure; business strategy; overall risk profile; and ability to meet its regulatory obligations;
(2) consider whether the agreements establishing the arrangement will allow it to monitor and control its operational risk exposure relating to the outsourcing;
(3) conduct appropriate due diligence of the service provider's financial stability and expertise;
(4) consider how it will ensure a smooth transition of its operations from its current arrangements to a new or changed outsourcing arrangement (including what will happen on the termination of the contract); and
(5) consider any concentration risk implications such as the business continuity implications that may arise if a single service provider is used by several firms.

(13.9.5) In negotiating its contract with a service provider, a firm should have regard to:

(1) reporting or notification requirements it may wish to impose;
(2) whether sufficient access will be available to its internal auditors, external auditors or actuaries and to the FSA (see SUP 2.3.5 R (Access to premises) and SUP 2.3.7 R (Suppliers under material outsourcing arrangements);
(3) information ownership rights, confidentiality agreements and Chinese walls to protect client and other information (including arrangements at the termination of the contract);
(4) the adequacy of any guarantees and indemnities;
(5) the extent to which the service provider must comply with the firm's policies and procedures (covering, for example, information security);
(6) the extent to which a service provider will provide business continuity for outsourced operations, and whether exclusive access to its resources is agreed;
(7) the need for continued availability of software following difficulty at a third party supplier;
(8) the processes for making changes to the outsourcing arrangement (for example, changes in processing volumes, activities and other contractual terms) and the conditions under which the firm or service provider can choose to change or terminate the outsourcing arrangement, such as where there is:

(a) a change of ownership or control (including insolvency or receivership) of the service provider or firm; or
(b) significant change in the business operations (including sub-contracting) of the service provider or firm; or
(c) inadequate provision of services that may lead to the firm being unable to meet its regulatory obligations.

(13.9.6) In implementing a relationship management framework, and drafting the service level agreement with the service provider, a firm should have regard to:

(1) the identification of qualitative and quantitative performance targets to assess the adequacy of service provision, to both the firm and its clients, where appropriate;
(2) the evaluation of performance through service delivery reports and periodic self certification or independent review by internal or external auditors; and
(3) remedial action and escalation processes for dealing with inadequate performance.

(13.9.8) A firm should ensure that it has appropriate contingency arrangements to allow business continuity in the event of a significant loss of services from the service provider. Particular issues to consider include a significant loss of resources at, or financial failure of, the service provider, and unexpected termination of the outsourcing arrangement.

Appendix II -proposed Solvency II requirements

1 Level 1

The original Solvency II Directive was published by the European Parliament on 25 November 2009. Article 13 of the Directive defines outsourcing as *"an arrangement of any form between an insurance or reinsurance undertaking and a service provider, whether a supervised entity or not, by which that service provider performs a process, service or activity, whether directly or by sub-outsourcing, which would otherwise be performed by the (re)insurance undertaking itself."*

The Directive details the outsourcing requirements in Articles 49, 38, and 41.

Article 49

Article 49 states that firms remain fully responsible for discharging all of their obligations under the Directive when outsourcing functions. (I.e. firms cannot contract out their obligations.)

It further states that outsourcing of critical/important functions shall not be undertaken in such a way as to lead to:

- Materially impairing the quality of the firm's system of governance;
- Unduly increasing operational risk;
- Impairing the ability of the supervisor to monitor compliance of the firm with its obligations;
- Undermining continuous and satisfactory service to policyholders.

Article 49 also states the requirement for firms to notify the supervisor prior to the commencement of the outsourcing of any critical/important function, as well as any material development in such activities.

Article 38

Article 38 concerns rights of access for the supervisor and the safeguarding of its ability to effectively monitor compliance with the requirements of the Directive. Article 38 states that:

- Service providers must cooperate with the firm's supervisors;
- Firms, their auditors and their supervisors must have effective access to data related to the outsourced activity;
- The supervisor must have effective access to the business premises of the service provider and be able to exercise those rights.

Article 41

Article 41 mandates firms' maintenance of certain written policies including outsourcing.

2 Level 2

EIOPA (formerly CEIOPS) DOC29/09 on System of Governance states that undertakings must consider the effect of outsourcing on their business, and monitoring and reporting requirements. Additionally, undertakings must ensure that the outsourced activities are adequately included in their own internal control system.

The guidance provides details of due diligence undertakings should perform, on the service provider, prior to entering into an outsourced agreement, including the service provider's:

- Financial soundness;
- Ability and capacity to deliver the required functions or activities satisfactorily;

- Adequacy of risk management system;
- Conflicts of interest controls and management;
- Adherence to data protection regulation and any other law; and
- Arrangements around client confidentiality.

The guidance states that an undertaking must enter into a written agreement with the service provider which clearly allocates the respective rights and obligations and that the general terms and conditions of the outsourcing agreement are authorised and understood by the undertaking's Board.

The required terms of the written agreement for the outsourcing of a critical/important function include:

- The duties and responsibilities of both parties involved;
- The service provider's commitment to comply with all applicable laws, regulatory requirements and guidelines;
- The service provider's commitment to cooperate with the undertaking's supervisors;
- The service provider discloses any developments that may have a material impact on its ability to carry out the outsourcing;
- Protective termination arrangements which providing for sufficient notice by the service provider and allow timely termination by the undertaking;
- The undertaking's rights in respect of performance and other information regarding outsourced activities as well as the undertaking's right to issue guidelines and individual instructions;
- Protection of confidential information relating to the undertaking and its clients, as well as intellectual property ownership;
- Effective access for the undertaking, its auditors and supervisors, to all data concerning the outsourced activities, as well as the business premises of the service provider;
- The supervisor's right to directly address questions to the service provider.

The guidance recognises the internal outsourcing of functions and clarifies that the outsourcing requirements apply, albeit to a proportional extent, dependent on the undertaking's control over the provider. The guidance also provides information around sub-outsourcing.

3 Other guidance

In December 2010, EIOPA published a draft proposal for Level 3 guidelines on the system of governance. The draft proposal provided some clarification on what would constitute a critical function. In providing examples of non-critical functions, EIOPA used the same examples and indeed wording as provided by the FSA in SYSC 8.1.

Perhaps most importantly, the draft proposal provides clarity in respect of EIOPA's expectations in relation to the treatment of the delegation of underwriting. The draft proposal states that underwriting, as a key insurance activity, must be considered a critical function and any delegation of underwriting to intermediaries therefore constitutes outsourcing of a critical function. It should be noted that the draft proposal specifically references delegation of underwriting to intermediaries, subject to the Insurance Mediation Directive (IMD). It does not discuss delegation to other undertakings of underwriting or ancillary services.