

The following text has been elaborated by the CAA for information purposes. The French version of this Circular letter is the only authentic version.

Circular letter 22/16 on the outsourcing of critical or important operational functions and activities

Article 81 of the law of 7 December 2015 on the insurance sector as amended (hereinafter the "LSA") provides that Luxembourg insurance and reinsurance undertakings shall, in advance and in a timely manner, notify the Commissariat aux Assurances (the CAA) of their intention to outsource any activities or important operational functions or the compliance, internal audit or actuarial functions (deemed critical) as well as of any subsequent material developments with respect to those functions or activities.

In this context, the purpose of this circular letter is to clarify the CAA's requirements regarding the outsourcing of critical or important operational functions and activities and their notification to the CAA. In addition, in view of the increasing use of outsourcing and in order to facilitate monitoring, the CAA provides undertakings with a digital form that can be downloaded from the CAA website. This form should be filled in and sent to the CAA.

1. Definitions

For the purposes of this circular letter, the following definitions apply:

- outsourcing agreement: an arrangement of any form, between a natural or legal person within the insurance sector 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 a third party, which would otherwise be performed by the person itself.
- service provider : a third party, which is a legal or natural person other than the legal entity of the insurance or reinsurance undertaking, performing under an outsourcing agreement the entire or a part of a process, a service or an activity.

2. Legal basis

This circular letter is based mainly on the following texts:

- Articles 32 (paragraph 21), 43 (paragraph 19), 65, 71, 81 and 300 of the LSA,
- Article 274 of the Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) ((hereinafter the « Delegated Regulation»),
- Circular Letter 15/13 of the CAA on further guidelines from EIOPA on the 'Solvency 2' regime,

- Orientations 14, 60, 61, 62, 63 and 64 of the EIOPA guidelines on system of governance (see EIOPA-BOS-14/253),
- Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation).

3. Pre-outsourcing analysis

Before entering into an agreement to outsource an insurance or reinsurance activity or function to a service provider, the insurance or reinsurance undertaking shall:

- a) assess the risks related to the outsourcing agreement;
- b) verify that the conditions specified in Article 65 of the law of 7 December 2015 on the insurance sector as amended are fulfilled;
- c) take into account the extent to which it controls the service provider or the influence it may have to influence its actions, where the provider is a member of the same group;
- d) assess whether the outsourcing agreement concerns an important or critical operational function or activity, in accordance with point 4 of this circular letter, and if so, verify that the conditions stipulated in Article 81(2) of the LSA are met.

In any case, it is the responsibility of the insurance or reinsurance undertaking to ensure that the outsourcing complies with all related laws and regulations.

4. Assessment of critical or important operational functions and activities

Before entering into an outsourcing agreement, the insurance or reinsurance undertaking shall assess and document whether and to what extent the outsourcing agreement relates to a critical or important operational function or activity. In completing this assessment and documentation, the insurance or reinsurance undertaking shall consider whether the activity or function in question is expected to become important or critical in the future.

Where an outsourcing agreement with a service provider covers multiple activities or operational functions, the undertaking should consider all aspects of the agreement in its assessment.

The determination of whether the outsourced function or activity is critical or important remains the responsibility of the undertaking. When assessing, the undertaking should consider whether it would be unable to deliver its services to policyholders without the outsourced function or activity. Other useful factors to consider in the assessment are:

Impact on business plan

- a) outsourcing of a key function or a main activity;
- b) the size, nature, importance and complexity of the activity, functions or services provided by the outsourcing agreement;
- c) the contribution of the outsourced activity or function to revenues and profits;
- d) the cost of outsourcing in comparison with the general expenses of the insurance or reinsurance undertaking;
- e) the continuation of the business and the operational resilience of the insurance or reinsurance undertaking;

Impact on control and supervision

- f) the right to issue general guidelines and specific instructions to the service provider regarding the elements to be considered when performing the outsourced functions or activities;

- g) the extent of control and supervision carried out by the insurance and reinsurance undertaking;
- h) the global exposure of the insurance or reinsurance undertaking (and/or the group where appropriate) to a single service provider;

Impact on brand and public perception

- i) the reputational risks of the insurance or reinsurance undertaking;
- j) the protection of personal and non-personal data and the possible impact on the insurance or reinsurance undertaking, policyholders or other persons affected by a breach of the rules of professional secrecy as well as a violation of confidentiality or a failure to ensure the availability and integrity of data, based in particular on Regulation (EU) 2016/679¹.

The undertaking should also reassess the important or critical nature of any previously outsourced activity or operational function if there is a significant change in the nature, scale or complexity of the risks inherent to the agreement.

The key functions as defined in the Solvency 2 Directive are always considered as critical and important functions.

The above-mentioned assessments shall be properly documented.

5. Insurance secrecy

In the context of an undertaking subject to the rules of Article 300 of the LSA and whose outsourcing to service providers includes personal data of the policy stakeholders (policyholder(s), insured(s), beneficiary(ies)) or allowing the identification of the policy stakeholders, it is the responsibility of the undertaking to:

- a) carry out a legal analysis to determine whether it is necessary for the policyholder to accept the outsourcing in accordance with the terms described in Article 300(2a) LSA²;
- b) document and regularly update the analysis described under a) according to the evolution/expansion of the activities or the general and specific terms and conditions as well as the applicable jurisprudence;
- c) ensure that staff working for the service provider or its subcontractors may under no circumstances access the personal data of the policy stakeholders without the prior explicit consent of the undertaking and without a monitoring mechanism being provided to the undertaking to control the accesses carried out; such accesses must remain exceptional;
- d) ensure that the service provider's access is restricted and supervised by preventive and detection measures in line with good practice and reviewed at least annually;
- e) ensure that sufficient safeguards are in place to prohibit unauthorised access to their systems. In particular, the undertaking should ensure that telecommunications are encrypted or protected by other available technical means to ensure the security of communications.

6. Scope of outsourcing agreements to be notified

Insurance and reinsurance undertakings incorporated under Luxembourg law shall notify the CAA of:

¹ Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation) (JO L 119 of 4.5.2016, p. 1.)

² In the absence of case law on the form of consent, it is not excluded that some parties to the contract may challenge the validity of their consent in court.

- Outsourcing of activities considered as critical or important by the undertaking;
- Outsourcing of a key function as defined by Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (hereafter the "Solvency 2 Directive");
- Any subsequent material development in these functions or activities;
- Any outsourced activity that leads to a major change in the business plan.

In general, core activities of an insurance or reinsurance undertaking that are fully outsourced have to be considered as important or critical. Simple rights of control, effective controls, communication of general guidelines or individual instructions to the service provider do not justify the absence of full outsourcing in accordance with the above.

Outsourcing of operational tasks of a key function entrusted to a third party other than the legal entity concerned, should be notified, unless the assessment establishes that not providing the outsourced function or providing it inappropriately would not have a negative impact on the effectiveness of the key function.

Where an IT outsourcing or an outsourcing chain, consisting exclusively of IT outsourcing, is based on a cloud computing infrastructure as defined in Circular Letter 21/15, the terms of this Circular Letter do not apply. In such cases, the insurance or reinsurance undertaking must comply with the requirements of Circular Letter 21/15.

Excluded from the notification provided for in this circular letter is the outsourcing to a professional of the insurance sector (hereinafter "PSA") as provided for by the provisions of Title III, Chapter 1 of the LSA:

- of the day-to-day management or;
- of a key function as defined in the Solvency 2 Directive;

by a reinsurance or insurance undertaking the purpose of which is to provide (re)insurance cover for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which it is a member.

Also excluded from this circular letter is the use of intermediaries for the distribution of insurance or reinsurance products, which must be done in compliance with the applicable legal and regulatory provisions.

The underwriting of policies or the claims settlement by an insurance intermediary who is not an employee of the insurance undertaking is however to be considered as outsourcing activity, if this activity is considered critical or important.

7. Principle of written notification to the CAA

The written notification requirements referred to in Article 81(3) of the LSA and specified by the EIOPA guidelines on system of governance shall apply to any outsourcing of important or critical operational functions and activities. The notification shall also cover any subsequent material developments to those functions or activities. Subsequent material developments include:

- a change of service provider;
- an addition of a significant activity to an existing contract;
- a significant reduction in the undertaking's staff;
- a change of costs by more than 20% (up or down) on an annual basis;
- an intra-group counterparty which becomes extra-group.

Furthermore, if an outsourced activity or operational function previously classified as unimportant or non-critical becomes important or critical, the undertaking must notify the CAA.

Conversely, if an outsourced activity or operational function previously classified as important or critical becomes unimportant or non-critical, the undertaking must also inform the CAA by official letter.

A written notification regarding the outsourcing of a critical or important activity or operational function must be made prior to the conclusion of the outsourcing agreement by using the Excel notification form which can be downloaded from the CAA website to be completed.

The notification must be provided at least one month before the intended outsourcing takes effect.

The CAA will send, diligently and in any case within ten working days following the receipt of the notification, a written acknowledgement of receipt to the undertaking. This acknowledgement is without prejudice to subsequent measures in the context of an on-site inspection if it appears that the outsourcing does not comply with all applicable laws and regulations.

If the notified outsourcing agreement is not concluded or signed, the undertaking must inform the CAA as soon as possible.

For each notified outsourcing of a critical or important activity or function, the compliance key function holder must assess and confirm in writing to the CAA, within two months of the signing of the outsourcing agreement, that:

- the outsourcing does not entail the breaching of any law in particular with regard to rules on data protection;
- the outsourcing agreement includes the clauses as defined in Article 274(4) of the Delegated Regulation (EU) 2015/35;
- due diligence on the service provider has been carried out in accordance with section D01.X.0040 of the notification form;
- regular monitoring of the service provider's performance and results is put in place.

8. Notification form

Each form has six sections which are related to:

1. D01.X.0010 - the insurance or reinsurance undertaking;
2. D01.X.0020 - the outsourced activity or function;
3. D01.X.0030 - the service provider (general information);
4. D01.X.0040 - the service provider (due diligence);
5. D01.X.0050 - the service provider (outsourcing agreement), and
6. D01.X.0060 - control and management of the outsourcing.

In case of an outsourcing agreement covering several critical or important activities or functions (e.g. a framework contract), it is requested to notify them using a notification form per critical or important activity or function.

When filling in the forms the following details should be considered.

- D01.X.0020 (R0010) : Type of activity or function

- The « product distribution » activity

All outsourcing activities relating to the European PRIIPs Regulation are to be reported under this point. The use of intermediaries for the distribution of insurance or reinsurance products, which must be done in compliance with the applicable legal and regulatory provisions, is to be excluded.

- The « operational tasks of the Solvency II key functions »

Operational tasks performed within the context of Solvency II key functions that are outsourced to a third party other than the legal entity concerned, insurance or reinsurance undertaking. The person responsible for the key function under Article 42(2) of the Solvency 2 Directive is not affected. The question is to know whether there are service providers who

perform the tasks and work on behalf of the person responsible for the key function.

- D01.X.0020 (R0030) : Intra- or extra-group outsourcing

The outsourcing of a procedure, service or activity to a undertaking in the same group as the insurance or reinsurance undertaking should be reported as intra-group outsourcing.

- D01.X.0030 (R0250) : Information on sub-outsourcing

If the service provider indicates in line R0250 (D01.X.0030) of the notification form to sub-outsource 100% of the activities or functions contractually agreed in the outsourcing agreement with the insurance or reinsurance undertaking, the service provider(s) involved in this sub-outsourcing must be indicated.

- D01.X.0050 (R0030-R0170) : Compliance of the outsourcing agreement with the requirements of Article 274 of the Delegated Regulation.

The insurance or reinsurance undertaking must draw up a correlation table relating to the compliance of the outsourcing agreement provisions with the requirements of Article 274(4) of the Delegated Regulation. This correlation table should be available at the undertaking's premises.

- D01.X.0050 (R0220) : The governing law of the outsourcing agreement

The jurisdiction and law applicable to the outsourcing agreement (preferably the law and jurisdiction of the Grand Duchy of Luxembourg) must be specified under this point.

- D01.X.0050 (R0240) : The type of cost (fees or commission)

It is requested to specify whether the outsourcing cost is invoiced via fees or commissions.

- D01.X.0060: Person in charge of the outsourced activity or function at the undertaking level

This is the key function holder when the outsourcing concerns operational tasks carried out in the context of one of the key functions defined by the Solvency 2 Directive. In other cases, it is the person responsible for the supervision and quality of the services provided by the service provider.

9. Documentation requirements

As part of its governance and risk management system, the insurance or reinsurance undertaking should keep a record of its outsourcing agreements, for example in the form of a specific register that is updated over time.

Where critical or important operational functions and activities are outsourced, the insurance or reinsurance undertaking must document all the following information:

- a) the name of the subcontractors including the countries where the subcontractors are registered;
- b) the results and date of the assessment of the criticality or importance of the function or activity;
- c) the results of the assessment of the substitutability (e.g. easy, difficult or impossible) of the service provider;
- d) signed outsourcing agreements;
- e) the date of approval of the administrative, management or supervisory body of the insurance or reinsurance undertaking which approved the outsourcing agreement;
- f) the results of the service provider's performance evaluations;
- g) assessment of the competence and reputation of the service provider to carry out an

outsourced key activity or function;

- h) verification that the service provider has adequate contingency plans in place to deal with emergencies situations or business interruption;
- i) a list of persons at the service provider responsible for critical or important functions and activities that have been outsourced to them.

In the case of outsourcing of non-material or non-critical operational activities or functions, the insurance or reinsurance undertaking should define the information to be recorded according to the nature, extent and complexity of the risks inherent to the services provided by the service provider.

The insurance or reinsurance undertaking should make available to the CAA, upon request, all information necessary to enable it to monitor the outsourcing, including a copy of the outsourcing agreement as well as the outsourcing policy in accordance with guideline 63 of the EIOPA's guidelines on system of governance.

The undertaking should carry out a self-assessment, including a correlation table, on the compliance of the outsourcing agreement with this circular letter, Article 274 of the Delegated Regulation and EIOPA's guidelines on system of governance.

Final provisions

This circular letter applies as from November 1st 2022 to all outsourcing agreements concluded or amended from that date.

The Executive Board