Defining the scope of "Outsourcing"

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Governance of Outsourcing

Governance, risk management and monitoring of outsourcing arrangements are getting a lot of focus from regulators and companies of late. There is an industrywide push to improve policies, processes and procedures.

One key aspect is causing some confusion though – how exactly should "outsourcing" be defined? This definition will set the scope for what activities or arrangements should fall within the boundaries of these governance and monitoring exercises.

In this briefing note we explore the definition of outsourcing and give some food for thought when setting your company's definition.

Regulatory Definitions

Solvency II Directive

The Solvency II directive defines outsourcing in the recitals (paragraph 28) 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, a service or an activity, whether directly or by sub-outsourcing, which would otherwise be performed by the insurance or reinsurance undertaking itself;"*

The definition includes service providers that perform a process, a service or an activity which would otherwise be performed by the insurance or reinsurance undertaking itself. To define the scope of outsourcing then, the Company needs to have a clear understanding of what processes, services or activities it would perform itself.

Level 3 Guidance

The guidelines on the systems of governance don't define outsourcing, however the Final Report on Public Consultation No. 14/017 on Guidelines on system of governance do contain some useful context. In paragraphs 2.287 to 2.289 there are a number of relevant paragraphs:

> *"the arrangement is likely to be an outsourcing unless the policyholder has a direct contractual relationship with the third party for the delivery of those services".*

One-off exercises and use of specialists are not considered as constituting outsourcing:

> *"Hiring a specialist consultant, for example, to provide one-off technical advice or one-off support for an undertaking's compliance, internal audit, accounting, risk management or actuarial functions does not normally constitute outsourcing."*

However, if this turns into ongoing support, the arrangement may then be considered as outsourcing;

> *"However, it may become outsourcing if an undertaking subsequently relies on that consultant to manage an internal function or service, e.g. when it is installed or becomes fully operational."*

The discussion also recognises that setting the scope is complicated and requires judgement. It indicates:

> *"While it is not possible to determine a bright line it can be expected that, in broad terms, the more substantial or frequent the advice or service provided by a third party for an undertaking is, the more likely it is to fall within the definition of outsourcing."*

Therefore, it seems wise to consider the frequency and scale of the activity when deciding how to classify an arrangement.

Central Bank of Ireland Communications

The Central bank of Ireland ("CBI") has placed an increased focus on outsourcing since the thematic inspection conducted over 2017. The lack of clarity in defining outsourcing by companies is one item called out as a weakness in the "Outsourcing–Findings and Issues for Discussion Paper" that the CBI issued in November 2018:

> *"Supervisory engagements have identified another area of concern in relation to classification of outsourcing arrangements whereby, in some instances, regulated firms have not identified certain arrangements as 'Outsourcing' and hence have not applied the appropriate risk management controls to these arrangements."*

The discussion paper goes on to mirror the points raised in the Final Report on the consultation on the Guidelines on system of governance:

> *"It should be noted that not every provision of a function or service to a regulated financial service provider by a service provider will fall within the definition of outsourcing. Hiring a specialist OSP for example, to provide one-off technical advice or one-off support on compliance, internal audit, accounting, risk management or actuarial functions does not normally constitute outsourcing. However, it may become outsourcing if the regulated financial service provider*

subsequently relies on that OSP to manage an internal function or service when it is installed or becomes fully operational.

Another point raised in the discussion paper is to consider whether 'Strategic Partnerships' or 'Collaborative Strategies' are a form of outsourcing. The comment was made in relation to regulated firms partnering with fintech companies, but the point could be equally applied more widely.

European Banking Authority

The European Banking Authority has also been focusing on outsourcing and has published updated guidelines in this respect. In the guidelines, the following definition is provided:

"Outsourcing means an arrangement of any form between an institution, a payment institution or an electronic money institution and a service provider by which that service provider performs a process, a service or an activity that would otherwise be undertaken by the institution, the payment institution or the electronic money institution itself."

This definition is in line with that contained in the Solvency II Directive. The other pieces of guidance are consistent with the other sources listed above, perhaps with a bit more focus on the frequency of the services;

"Consideration should be given to whether the function (or a part thereof) that is outsourced to a service provider is performed on a recurrent or an ongoing basis by the service provider and whether this function (or part thereof) would normally fall within the scope of functions that would or could realistically be performed by institutions or payment institutions ,even if the institution or payment institution has not performed this function in the past itself."

The definition provided was a point of contention raised in the consultation process in drafting these guidelines – with some arguing the definition was too broad and calling for a definitive list.

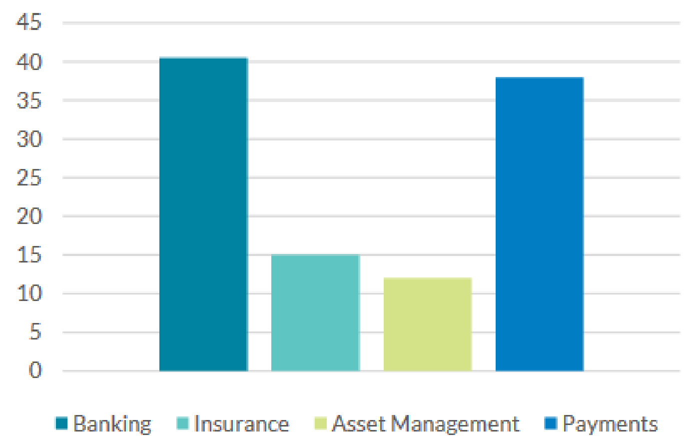
Practical Application

Outsourcing should be defined within the company's outsourcing policy and one sensible approach is to also define the scope of activities the company would perform itself within the outsourcing policy of the company. This could link back to memorandums and articles of association if required and reference general industry practice and the strategy of the company.

Defining the scope of activities sets the universe of processes, services or activities that could fall under outsourcing. From here, the company can apply consistent criteria based on the scale and frequency of the arrangement to decide whether an activity is outsourcing or a one-off arrangement.

A second item to address is to create guidelines on what constitutes one-off technical advice or one-off support and when this is classified as a more frequent/permanent outsourcing arrangement.

Chart 1: Median number of outsourcing arrangements per regulated firm



[1] Source: Central Bank of Ireland

Out of Scope

Taking an example in which banks provide a service to an insurance company by facilitating the operation of current accounts and financial transactions. This is something that an insurance company wouldn't perform itself so the services provided by banks doesn't equate to outsourcing.

Likewise, an insurance company is not typically in the business of electricity generation or the provision of phone or internet services. Suppliers of these items are not considered as outsourced providers.

These services are critical to the operation of the company, and risk related to their provision must be managed and monitored, however it wouldn't fall under the scope of the above outsourcing definition.

Hiring a consultant to review something or conduct a one-off piece of work would also not constitute outsourcing.

In Scope

If an insurance company uses a third party administrator to handle the administration of policies, this is an activity the company could perform itself and therefore is outsourcing.

If a consultancy was employed to provide ongoing support for a quarterly valuation process, even if the entire function is not

[1] "Outsourcing–Findings and Issues for Discussion Paper" that the CBI issued in November 2018

outsourced, then this would most likely be considered as outsourcing.

It is for areas in the middle-ground that the definition becomes somewhat grey, but the wording of the Solvency II recital text gives some assistance on how to interpret and define such arrangements. For instance, is selling via a bancassurance network outsourcing? The specifics of the company would need to be considered, as perhaps selling directly is not an option for all insurers.

Generally for larger, more important arrangements companies are able to decide reasonably well whether to classify these arrangements as outsourcing or not. The areas where there is uncertainty are often the more minor items. For instance, is the provision of catering services to a medium sized insurer a service that the company could perform itself? It could be, but at the same time this service probably isn't critical for the operation of the company and it doesn't have a direct impact on customers, so risk managers are best off making a practical assessment and focusing their attention on the more important areas.

Records

In practice, the Company should maintain a list of all instances of outsourcing. This list must be kept up to date (as well as any assessments conducted).

One practical way to satisfy this need is to consider every new supplier when it is engaged and whether it is an instance of outsourcing. In addition to this, regular reviews of existing suppliers should be conducted to see if any of the previous classifications need to be updated (e.g. a supplier may no longer be a one-off service provider). Educating staff and ensuring there is a robust process in place will also encourage front line managers to add providers to the list proactively.

It might also be useful to document the list of suppliers that are not considered as "outsourcing" and why this decision was made and when the assessment was conducted and last reviewed.

How Milliman can help?

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

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

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

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