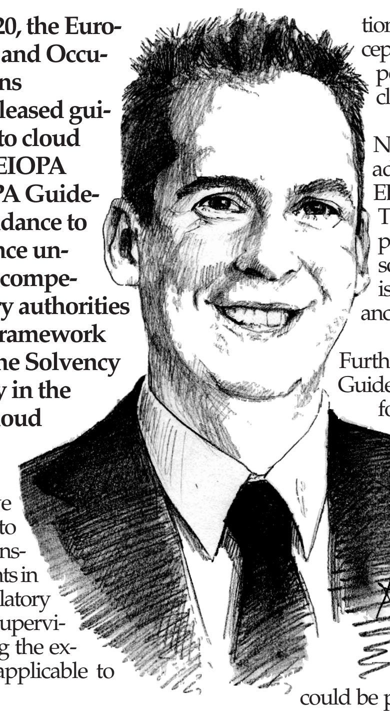
EIOPA Guidelines on outsourcing to cloud service providers by insurance and reinsurance undertakings

On 31 January 2020, the European Insurance and Occupational Pensions Authority («EIOPA») released guidelines on outsourcing to cloud service providers («the EIOPA Guidelines»). The EIOPA Guidelines aim to provide guidance to insurance and reinsurance undertakings as well as to competent national supervisory authorities on how the regulatory framework for outsourcing under the Solvency II regime[1] should apply in the case of outsourcing to cloud service providers.



The EIOPA Guidelines have two overarching goals: (a) to provide clarification and transparency to market participants in order to avoid potential regulatory arbitrage and (b) to foster supervisory convergence regarding the expectations and processes applicable to cloud outsourcing.

Scope of the EIOPA Guidelines : all types of outsourcing with a cloud component

The EIOPA Guidelines apply not only when an undertaking outsources directly to a cloud service provider but also when an undertaking outsources operational functions or activities to service providers that do not qualify as cloud service providers but rely significantly on cloud infrastructure to deliver their services. This could be the case, for instance, when an insurance undertaking outsources certain HR functions to a payroll service provider, which relies significantly on cloud infrastructures to deliver its services. As soon as a cloud service provider forms part of the outsourcing chain, the EIOPA Guidelines appear to apply.

Although the EIOPA Guidelines were inspired by the Guidelines on Outsourcing Agreements issued by the European Banking Authority on 25 February 2019 («the EBA Guidelines»), it should be noted that the scope of the EBA Guidelines is broader and extends to all types of outsourcing arrangements, not only cloud outsourcing, while the EIOPA Guidelines focus specifically on cloud outsourcing (albeit the clarification of certain general outsourcing concepts in the EIOPA Guidelines would appear to extend their impact beyond cloud outsourcing arrangements).

Nevertheless, the EIOPA Guidelines adopt key concepts analogous to the EBA's and impose similar requirements. This approach is very welcome and appropriate considering that cloud outsourcing gives rise to similar risks and issues in both the financial and insurance sectors.

Furthermore and in line with the EBA Guidelines, the EIOPA Guidelines provide for more concrete criteria to assess whether an arrangement with a cloud service provider falls under the definition of «outsourcing» pursuant to the Solvency II Directive. In this regard, consideration should be given to (i) whether the outsourced function or activity is performed on a recurring or an ongoing basis and (ii) whether the function or activity could be performed by the undertaking in the ordinary course of business, even if the undertaking has not performed the function or activity in the past. Moreover, if cloud-based outsourcing takes place via another entity in the group, the EIOPA Guidelines on System of Governance may also apply.

Specific requirements for the various phases of cloud-based outsourcing

The EIPOA Guidelines set out concrete requirements for the outsourcing by insurance and/or reinsurance undertakings of an operational function or activity. These extensive requirements can be grouped into five categories, which correspond to the five chronological steps in an outsourcing process, namely (1) governance, (2) the outsourcing policy, (3) a pre-outsourcing analysis, (4) contractual requirements and (5) audit and monitoring.

For the cloud-based outsourcing of critical or important functions, the requirements are quite prescriptive, whilst greater flexibility is allowed for the outsourcing of non-critical activities. The EIOPA Guidelines moreover provide more and welcome guidance on when an outsourced activity must be considered critical and/or important.

In terms of **governance**, it is required that any decision to outsource operational functions or activities to a cloud service provider be based on a risk assessment proportionate to the nature, scale and complexity of the risks inherent in the service(s) to be outsourced. Specific criteria are indicated, which should be taken into account when critical or important operational functions are outsourced. Furthermore, the EIPOA Guidelines specify certain information to be included in the written notification to the supervisory authority when critical or important operational functions or activities are outsourced and require the undertaking to keep a record of past and present cloud outsourcing arrangements, including certain required information in the event of a critical outsourcing. On the other hand, for non-critical outsourcing, undertakings have more flexibility to define the information to be included in the record, based on the nature, scale and complexity of the risks inherent in the outsourced services.

With regard to the **outsourcing policy**, the EIOPA Guidelines require an update of the policy as well as other relevant internal policies, for example the information security policy, in order to take into account cloud outsourcing specificities in certain areas, such as the processing and reporting procedures required for the approval, implementation and monitoring of critical cloud outsourcing arrangements.

Undertakings should furthermore conduct a **pre-outsourcing analysis** before entering into any arrangement with a cloud service provider. The analysis should include: (i) an assessment of whether the outsourcing concerns a critical or important operational function, (ii) a risk assessment, (iii) appropriate due diligence on the prospective cloud service provider, and (iv) an assessment of conflicts of interests the outsourcing could cause. The EIOPA Guidelines provide concrete guidance to undertakings on the conduct of these assessments, with the exception of the latter.

The **contractual requirements** contain a list of compulsory clauses to be included in any critical or important cloud-based outsourcing arrangement, such as a clear description of the outsourced function, the start and end date of the agreement and applicable notice periods, the governing law and jurisdiction, the parties' financial obligations, detailed service levels, reporting obligations, monitoring rights, exit strategy clauses, provisions to ensure accessibility, availability, integrity, confidentiality, privacy and safety of data, whether sub-outsourcing of a critical or important function or activity is permitted and at which conditions, etc.

As for the **monitoring requirements**, undertakings should monitor on a regular basis the performance and security measures of their cloud service providers. In order to ensure adequate oversight, undertakings should allocate sufficient resources, skills and knowledge to the monitoring of services outsourced to the cloud. Furthermore, the administrative, management or supervisory body (AMSB) should be periodically updated on the risks identified in the cloud outsourcing of critical or important operational functions or activities. Finally, in terms of audit requirements, it should be noted that the EIOPA Guidelines allow for reliance on a pooled audit, meaning several undertakings can cooperate to jointly audit the same provider and third-party certifications and, under certain conditions, internal audit reports made available by the provider.

Timeline for implementation

Insurance and reinsurance undertakings must ensure compliance with the EIOPA Guidelines, which could require a significant update of their outsourcing contracts in order to include an extensive list of compulsory clauses, by (i) 1 January 2021 for any outsourcing arrangement entered into or amended on or after this date or (ii) 31 December 2022 for existing outsourcing arrangements.

The EIOPA Guidelines form part of the EIOPA's Final Report on public consultation No. 19/270 on Guidelines on outsourcing to cloud service providers.

At the national level, we expect the Luxembourg insurance and reinsurance regulator, the *Commissariat aux Assurances* (CAA), to formally adopt the EIOPA Guidelines by way of a circular letter.

Vincent WELLENS (picture),
IP & Tech Law Partner, NautaDutilh
vincent.wellens@nautadutilh.com

Miryam LASALLE,
Head of Insurance & Reinsurance Practice, Counsel, NautaDutilh
miryam.lassalle@nautadutilh.com

Sigrid HEIRBRANT,
IP & Tech Law Associate, NautaDutilh
sigrid.heirbrant@nautadutilh.com

1) Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) and the amended Delegated Regulation (EU) 2015/35.

Pan-European Personal Pension:

The solution to Europe's pension problems?

By Chrystelle VEECKMANS, Partner, KPMG Luxembourg

An interview with Christian LEMAIRE, Global Head of Retirement Solutions at Amundi

In light of the recent publication of the Pan-European Personal Pension (PEPP) Regulation and the EIOPA consultation specifying the pension product's features, we decided to take a moment to examine the PEPP's implications. Chrystelle Veeckmans, Chairman of the Association of Luxembourg Pension Funds and of the KPMG Luxembourg Pension scheme, sat down with Christian Lemaire, Global Head of Retirement Solutions at Amundi Asset Management, to help shed some light on the product's status and outlook.

Chrystelle Veeckmans (CV): Christian, five years after writing my first blog post on PEPP, where are we in the implementation process of the Pan-European Personal Pension product? When are the first PEPPs expected to be launched and by whom?

Christian Lemaire (CL): The final PEPP regulation text was published in the Official Journal of the EU on 25 July 2019. EIOPA has been mandated by the European Commission to develop so-called Level 2 delegated acts on various topics and it launched a public consultation that closed on 2 March 2020. The PEPP will only be available one year after those Level 2 delegated acts are approved by the European Commission, probably at the end of 2020. Considering the time it usually takes to develop technical standards, we don't expect to see the first PEPPs before 2022. They will most likely first be launched by large local players who know their market well. The legislation allows for bankers, asset managers and even some Institutions for Occupational Retirement to provide PEPPs. However, the objective of the obligatory basic investment option to offer capital protection after inflation may prove difficult for capital guaranteed products in the current low interest rate environment. Banks are more likely to act as distributors of the product and asset managers on the structuration side, through life cycle strategies in particular.

CV: Who is PEPP for and what are the objectives that led to its creation?

CL: The objective of the Commission in developing the PEPP is twofold: help address the demographic challenges caused by the aging population and the pension gap it creates, while channeling more savings into long-term investments that contribute to the development of the capital markets union and European growth. Turning to the product itself, the PEPP is a voluntary personal pension scheme that will be available to all EU citizens. It is not an alternative to state pension (pillar 1) or to occupational pension (pillar 2) but comes as an additional option to personally save more for retirement (pillar 3).

CV: What makes this product innovative, and what elements are necessary for its success in helping savers?

CL: The PEPP is designed to be a simple, flexible, modern and cost-effective product with strong investor protection. Portability is one of its key features, allowing individuals to continue saving in the same product via sub-accounts in different countries. So, when people change residence across EU borders, they can rely on a product that supports the rising trend of worker mobility in Europe. In terms of investment possibilities, the product could offer up to six investment options, one of which should be a safe product representing the default option, called the Basic PEPP. After five years, savers have the possibility to change the chosen option or switch PEPP providers.

Although the PEPP offers interesting features, its success among savers highly depends on its fiscal treatment, an area that may not be regulated. The Commission might only strongly recommend that each member state treats the PEPP like other national pension products from a fiscal point of view. If this does not happen, savers might not show any interest in the PEPP.

CV: What came out of the EIOPA consultation that makes the product unworkable?

CL: In the providers' eyes, the product's success will largely depend on the detailed requirements that will be set by technical standards. At this stage, potential PEPP providers remain skeptical and are waiting to learn more about the content of the Level 2 to further assess if the product will be workable.

Let's take two examples of potential requirements that make the PEPP unattractive:

EIOPA proposed using its Ultimate Forward Rate (UFR), which is 3.75 percent in 2020, as proxy for the risk-free rate over the long term. This is far higher than current and, most probably, future financial market conditions for risk-free rates! Risk premia per asset classes would be added to the UFR to communicate a benchmark for the expected performance. This benchmark is not only unachievable but would also be confusing and discouraging for savers. It would be more appropriate to communicate on the long-term expected returns (over a minimum of 20 years) of each PEPP based on stochastic models.

The one-percent Fee Cap on the accumulated capital per year applicable to the Basic PEPP is another example. EIOPA proposes excluding from the Fee Cap costs linked to any provided capital guarantee or biometric cover, as well as switching costs, but includes the cost of advice.

The factors to consider when opening a PEPP are clearly defined: the person's knowledge and experience in the investment field relevant to the PEPP; the person's financial situation, including ability to bear losses; his or her investment objectives, including risk tolerance; and his or her accrued individual retirement entitlements. In addition, providers will have to check if the PEPP is the most appropriate savings product (suitability). As the contributions will be blocked until retirement, providers will also have to check affordability. Therefore, providers will need to give complete, detailed and personalized advice before initiating a personal pension plan. This implies significant time and cost. Several market studies show that including these advice costs in the one-percent Fee Cap will not be economically viable.

CV: Do you think PEPP will be digital and low cost?

CL: The PEPP opens up the possibility of fully digitalized distribution via the use of robo-advisors. However, robo-advisors have experienced limited success in the past years and most of them have ceased operations, recognizing that they were unable to attract a sufficient number of investors.

As mentioned, choosing a pension product presents a critical decision for savers, who will likely require detailed and highly personalized advice. Quality advice hinges on competent advisors and comes at a cost. This takes us back to the one-percent Fee Cap of the basic PEPP.

CV: Will we see the first PEPP in Luxembourg?

CL: Luxembourg, a cross-border domicile of investment products, is ideally positioned to become the main future hub for personal pension products in Europe.

CV: So, Christian, in a nutshell, PEPP is an excellent idea for solving Europe's pension problems, but its practical implementation still raises many questions. It is essential that the regulator makes room for feasibility and that member states ensure adequate national tax incentives to allow the product to exist.