Linklaters

Leaving the European Union

Implications for insurance companies

November 2016

Macro effects

> In the immediate aftermath of the Brexit vote in June 2016, the impact observed was economic and financial rather than legal, eg volatility in stock exchange indices, exchange rate movements and credit rating downgrades. This situation remains fluid, although the share prices of UK listed insurers have largely recovered.

> The key immediate effects appear to be the devaluation of sterling and the effect of UK Bank of England fiscal action, including the lowering of the Bank of England interest rate. This may result in cost cutting, changes to product design and more aggressively yield-driven investment strategies.

> Lower asset valuations, if they become locked in, could erode capital buffers over time.

> It is anticipated that the effects of Brexit will need to be reflected in internal model and ORSA reviews.

> However, UK insurers are currently considered to be well capitalised.

> Low interest rates may also increase capital requirements because they reduce the discount rate to be used for future liabilities.

> Economic slowdown (which is predicted) is typically associated with a reduction in premiums received and an increase in claims frequency.

Effect on key legislation

> The UK Government has signalled that initial legislation on the UK leaving the EU (expected to occur early 2019) will enact existing EU legislation, including Solvency II in its entirety. This should make it easier to obtain an "equivalence" ruling. However, references to and reliance upon EU institutions would require review and further consideration and there are increasing calls to question whether the "price" of equivalence (at least exact equivalence) is worth paying.

> Government could review possible changes at a national level, eg regarding risk margin (thereby reducing capital requirements) or matching adjustment (thereby increasing capital requirements). A Parliamentary Committee is reviewing the operation of Solvency II against the backdrop of Brexit and there are overtures in relation to re-visiting key unpopular concepts. However, the scope for deviation whilst maintaining equivalence and the prevailing attitudes of UK regulators toward regulation will be a limiting factor.

> Solvency II Directive was implemented in the UK by:

  > Solvency II Regulations, which were made through powers conferred by ECA 1972 – specific saving provision required

  > changes to PRA and FCA rulebooks under FSMA – which will survive repeal of ECA 1972, but consequential changes may be required

> In addition, some EU supporting measures have direct effect, for example, Delegated Regulation (level 2 rules) and Regulatory Technical Standards, guidance. These will need to be specifically preserved by new domestic legislation.

Passporting

> Leaving the EU will result in loss of passport rights for insurers. It is currently impossible to say what agreement will be reached on access to the single market for financial services (including insurance).

> This would potentially cause issues for UK insurers operating across the EEA on a freedom of services basis as well as those operating from branches established in other EEA jurisdictions. Issues could arise from the run off of existing business as well as for the sale and administration of new business, depending on exactly what activities are undertaken and what local law regards as a regulated activity in the relevant jurisdiction.

> If the UK becomes a member of EFTA, it would re-join the EEA and retain financial services passporting rights. Current political dialogue makes this a less likely outcome. Other trade agreement models have not, historically, permitted passporting for financial institutions.

> Grandfathering of existing passported business is possible as part of the negotiations and is being raised by the industry as an area requiring early engagement. However, until Article 50 is triggered, it seems unlikely that there will be any practical engagement on transitional relief. It is more likely to be the case that some form of transitional relief be agreed to allow the run off of existing in-force business or claims arising from business written under passports, whether this is branch or freedom of services business.

> Otherwise, UK firms would have to apply for branch authorisation in each jurisdiction where they have branches and in each separate EEA jurisdiction where they conduct regulated activities under a passport. Alternatively, (more likely) it would need to establish an EEA regulated insurance subsidiary, which would benefit from passporting rights into remaining EEA member states. Equally, fresh authorisations may be required by EEA firms that currently passport into UK.

> UK-headed international groups operating both inside and outside the EU may need to establish a second carrier for its EEA group, particularly for reinsurance which is, in practice, done more on a cross-border basis, unless local law exemptions apply.

> For reinsurance businesses, some EEA states allow business to be conducted in their jurisdictions by reinsurers based in a jurisdiction which is equivalent for Solvency II purposes. (NB this is purely a matter of local law: The Solvency II effect of equivalence is explained in the "Equivalence section").

> UK carriers which currently rely upon passporting rights are developing contingency plans now given the two year exit period under Article 50 and the likely timescales for achieving an effective restructuring.

Equivalence

> If the UK is no longer part of the EU and does not join the EEA, insurers would likely want the UK to be "equivalent" under Solvency II, although it is recognised that the cost of equivalence needs to be weighed against other advantages of relaxing Solvency II. Three areas of equivalence exist:

1. Treatment of reinsurance by an EU cedant (Article 172);
2. Group solvency assessment (Article 227); and
3. Group supervision (Article 260).

> Logically, the UK should be considered equivalent if it preserves Solvency II rules post-exit, but obtaining a decision on equivalence from the Commission (following technical assessment by EIOPA) could well be slow and is, ultimately, a political process.

> Groups with a UK headquartered parent would either become supervised at group level by an EU regulator or would seek a waiver and be subject to additional reporting and other conditions. There is scope for EU regulators to require a new EU holding company to be established (if one does not exist) for the purposes of group supervision.

Transfers of insurance business

> A key restructuring tool for insurers in the EU is the use of an insurance business transfer regime based upon EU directives (now Solvency II). Processes vary from state to state but allow insurance business to be transferred without the need for individual consent.

> Mutual recognition of insurance business transfers would cease following exit, absent EFTA membership or contrary agreement with the EU. Several applications to different courts or regulators may be required where insurance has been written on a cross-border basis.

> However, a view may be taken to treat EEA countries similarly to countries such as Australia, ie formal local consent is not always sought, depending on policyholder numbers – each case would need to be analysed on its own facts.

> Given potential additional EEA complexity after exit, insurers may seek to complete portfolio transfers before the "one-stop-shop" mechanism of Part VII falls away.

> UK regulators' workload may cap the number of transfers that can take place in practice in this period.

Other legislation

> Cross-border Mergers Regulations will cease to be available in relation to UK private limited companies following exit, absent contrary agreement with the EU. If the mechanism ceases to be available, the likely approach would be traditional asset sales under relevant local laws, followed by winding up. Similarly, the ability to form or migrate a European Company (Societas Europaea) is likely to cease following exit.

> Other legislation may lapse or be disapplied, eg the UK Government may decide to change the Equality Act back so that insurers may price by reference to gender (after it had been changed to prohibit pricing by reference to gender following the Test-Achats case relating to the Gender Directive).

Further aspects

> Data protection: the UK may seek a finding that it provides "adequate protection", allowing transfer of personal data to the UK as a non-EEA country. It is likely that the UK will continue to implement the new General Data Protection Regulation making adequacy easy to find. However, this approach and a finding of adequacy is not certain.

> Contracts: insurers may need to review standard form contracts/boilerplate clauses/key commercial contracts (eg change of law/regulation amendment/termination rights) for any changes, eg to territorial definitions or references to European laws or regulation and consider these clauses carefully in updating these forms and negotiating new contracts.

> Freedom of movement: restrictions on mobility of personnel could cause difficulties in recruitment and retention.

> Employment and incentives: employers are likely to be faced with employees seeking assurances on job security, which will require employers to adopt a clear communications strategy to avoid entering into legally binding commitments in an uncertain environment. Incentives arrangements are likely to be impacted by share price fluctuations, prompting employers to consider how best to incentivise and retain employees under existing market conditions. It is expected that existing EU remuneration regulations, including those under Solvency II (and CRD IV, where relevant), will continue to apply in the UK, post-exit.

> The UK will need to put in place alternatives to bodies such as EIOPA.

> A second referendum on Scottish independence is possible. Consultation in relation to this step has been commenced by the Scottish Parliament – many of the issues that apply to UK leaving the EU would also apply to Scotland leaving the UK, plus the possible adoption of the euro and introduction of border controls. A referendum on the unification of Ireland is a further, less likely, possibility.

> Lloyd's of London may be negatively affected since its business relies on it offering direct access to EEA markets through passporting rights.

> Brokers are also potentially impacted by passporting issues and would need to follow any geographical relocation of insurance business such as the reinsurance market and analyse their structures in the context of the passporting of insurance mediation permissions.

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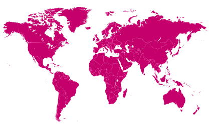

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