Client Update
Brexit for Re/Insurers: One Month On

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INTRODUCTION

Five weeks after the United Kingdom's Brexit referendum, the initial shock of the result has passed and the dust has somewhat settled. In this client update, we reflect on what we now know and take stock of the likely medium- to long-term impacts on the European insurance industry and more widely. We anticipate that it will take several years for the terms of the UK's withdrawal from the European Union to become clear. We outline here the current knowns and unknowns, the effects of the aftermath of the Brexit vote and the key risks to insurers, and suggest planning and practical steps that can be taken now.

We have published a number of client updates on Brexit, including our initial reaction following the referendum and an explanation of the next steps in the withdrawal process. A recording of our seminar discussing the issues as they relate to insurance is also available.

THE KNOWNS AND THE UNKNOWNS

Politically, the key individuals in the UK who will take the process forward have now emerged. The new Prime Minister, Theresa May, had supported, though not vocally, the campaign for the UK to remain in the EU before the referendum. Now insisting that "Brexit means Brexit" and having appointed pro-Brexit ministers in key international roles in the UK government, it appears that the Prime Minister will drive forward the UK's withdrawal from the EU. Nevertheless, the UK is not yet in a position to give notice of its intent to withdraw and does not intend to rush into negotiations by triggering the two-year exit process prescribed by Article 50 of the Lisbon Treaty, which the Prime Minister has announced will not begin in 2016.

As much as financial markets and insurers dislike uncertainty and value predictability, it is impossible to predict what the UK's post-Brexit relationship with the EU will look like. We can be sure that reaching a deal with the EU is likely to take several years. Industry participants hope that pragmatism and mutual interest will rule, leading the UK and EU to agree to an arrangement which allows the UK to retain its full access to the single market. The EU's political motivations (particularly around the importance and indivisibility of the four freedoms, including freedom of movement, and discouraging other would-be leaver nations) could drive the Brexit process to the other end of the spectrum, however, with the UK forced to rely on World Trade Organisation rules and no special arrangements regarding access to the EU.

The exit of a large economy from the EU is unprecedented and, at this stage, it remains unclear when the likely drawn-out withdrawal process will begin, let alone what the outcome will be. Add to this the risk of potential regulatory backlogs for insurers who may look to relocate and/or expand existing EU-licensed entities, and the "wait and see" approach is unappealing to many companies. If not in place already, firms should develop contingency plans for a worst-case scenario; we anticipate several companies will begin implementing such plans before the final outcome is known.

THE AFTERMATH

Market volatility, low interest rates and the decline of the British pound to its lowest level against the U.S. dollar in 31 years have all followed the announcement of the referendum result, although the initial fallout so far has not been as dramatic as some observers predicted before the Brexit referendum. Potential beneficiaries in such circumstances could include buyers of European insurance firms, given the assets expected to be sold in connection with re-evaluated global strategies, though M&A activity generally is likely to stall in the face of uncertainty. UK insurers who make most of their earnings outside the UK in Euros and/or U.S. dollars could also stand to have their share prices benefit without any actual increase in underlying operating performance.

On the other hand, UK-based firms with EU-based subsidiaries and operations will be exposed to significantly more currency risk and market disruption to bond portfolios and fluctuating currencies, causing asset and liability valuations to shift. General market uncertainty and continued low interest rates are likely to cause insurers' liquidity, investment returns and solvency to suffer.

European financial centres are already aggressively lobbying to take back financial services and challenge London's status as a global insurance hub: Ireland, Frankfurt and Paris are among those playing on current fears to actively put themselves forward as a viable alternative.

RISKS TO INSURERS

In addition to the immediate market aftershocks of the Brexit referendum, the UK's withdrawal from the EU could bring about significant long-term changes for re/insurers.

Passporting

All EEA member states currently benefit from passporting rights contained in the EU's single–market directives, which include Solvency II. The most significant risk is that these passporting rights could be lost (either directly or indirectly) following a UK exit. If this is the case, UK insurers would lose their ability to underwrite business in EEA states with only the supervision of their home regulator and without the need to localise funds or to report to local regulators. As these are reciprocal rights, the same would apply to insurers in EEA states accessing the UK market. The loss of passporting rights would also affect those global insurers relying on a single hub to write all their European business—access to the UK or to the other EEA states could disappear unless steps are taken to preserve access, as discussed below. For insurance services firms, including brokers and those providing outsourced services, the loss of passporting could also cause regulatory, supervision and operational difficulties.

Although approximately 1,000 insurers use passporting to sell into Europe from the UK or vice versa, the negative practical effect of losing passporting rights may not be as widespread among insurers as some commentators have initially suggested. The vast majority of UK and European top- and mid-tier insurers currently have both UK- and EEA-authorised entities within their groups. While some expansion of permissions, personnel, capabilities and capacity of such entities may be needed, additional local licensing requirements are unlikely to be a significant issue for such firms. A key issue will be reviewing local permissions to check that they are wide enough to cover all business that could now be written through those entities. In addition to costs required to expand any limited licences that will be used, firms should consider the costs and practicalities of expanding, relocating personnel and localising funds. The need to allocate capital across several jurisdictions, rather than concentrating it in a single hub, will also introduce inefficiencies into a firm's solvency capital requirements. Smaller firms are most likely to be affected by any loss of passporting, as they may lack an existing network of locally authorised subsidiaries that can be adapted in this way.

Equivalence

While a "Bermuda model" of equivalence for the UK has been put forward as an alternative on the basis that the UK's regulatory regime is today effectively equivalent for Solvency II purposes, this is not a complete solution to the passporting issue as, while it would allow UK insurers to continue their group supervision and capital structure model they currently have in place (as well as provide reinsurance on an equivalent basis to EU insurers), it does not provide the full right of establishment and other benefits passporting brings. In any event, the process for gaining equivalence is unpredictable and the date it is granted may not match the eventual date of the UK's exit. The London Market Group recently advised the UK government to start the process for the grant of equivalence now, so that it can be awarded concurrently with any Brexit and accompanying loss of passporting rights.

Regulatory Divergence

Another long-term change that could affect re/insurers following the UK's exit from the EU would be any regulatory divergence of the UK and EU regimes. This is certainly unlikely, at least until any equivalence decision is made. While the UK's PRA has been a key player in formulating Solvency II, which came into effect at the beginning of 2016 and harmonises insurance regulations across EU member states, there could be scope to move to a more bespoke regime and to relax some more stringent aspects. While this could be of benefit to UK re/insurers and enhance their competitive position *vis-à-vis* their European counterparts, it could also give rise to "double supervision" under UK insurance regulations and Solvency II. The Chief Executive of the UK's Financial Conduct Authority has recently said that there will be "no great bonfire of regulation" following Brexit, indicating that no sudden deregulation is planned or anticipated.

Other Considerations

Alongside these structural and regulatory considerations, a wide range of commercial and contractual terms could be impacted, including:

- policy terms (for example relating to policyholder residences or long-term administration), which could become problematic;
- territorial scope in licensing, distribution, bancassurance and noncompetition arrangements, which could change;
- termination, MAC provisions and renegotiation rights in all relevant agreements, which could be triggered (for example by changes in capital requirements—a key concern for reinsurance participants); and
- contractual references to European laws and regulations, which may be affected.

Further issues that may need to be addressed include:

- data protection and the terms on which customer data may be transferred in and out of the EEA;
- regulatory reporting and compliance obligations; and
- employee considerations, such as increased compliance costs if visas are required and transfer costs in connection with any restructurings.

WHAT NOW? PLANNING AND PRACTICALITIES

For those firms that would be affected by the loss of passporting, a certain degree of restructuring may be required—the question is whether to wait and see or to take steps now to obtain local authorisation on the basis of a worst case scenario. Whatever the ultimate timeline for a Brexit, there are some practical and planning steps that the prudent re/insurer could be taking immediately, which we outline below.

- Policyholder, counterparty and regulator relationships: Communication with these parties through uncertain times will be crucial. In particular, regulators are likely to require reassurance that suitable contingency plans are in place.
- Capital requirements: Given the effects of market volatility as discussed above, asset and liability valuations will need to be monitored and the knock-on effect on solvency capital requirements assessed.
- Collateralised obligations: Derivatives and collateralised obligations, like reinsurance contracts with collateral structures, could also be impacted by market volatility. Firms should check that assets can still meet such obligations.
- Restrictions on fund redemptions: Firms should review fund documents to assess whether redemptions are available or able to be restricted. A number of asset managers have suspended property fund redemptions in the wake of market volatility.
- Investments: Insurers may seek to diversify their portfolios and review their strategy, given their current exposures. Note that Solvency II should have had a mitigating effect on the most severe effects of financial volatility.
- Transfer of contracts to restructure: For firms considering significant restructuring to retain access to both the UK and the other EEA states, contracts should be analysed for separation issues and transferability.
- Outsourcing and data protection: There is potential for change to the UK's legislation in these areas. Monitoring such developments and adapting where required will be key to operational continuity.

CONCLUSION

By voting to leave the EU, the UK entered unchartered territory; what does appear certain is that the process will take a great deal of time to unfold. Ideally, pragmatism will prevail on all sides and as the shock and posturing dissipate, the EU and the UK will move to agree on a broad and mutually beneficial trade relationship. For the insurance industry, the hope is that this will preserve many of the existing benefits, including, critically, the passporting regime.

Years of uncertainty are likely to drive insurers and intermediaries to take decisions long before the details of any trade deals are hammered out. Even prior to making "worst case scenario" contingency plans, firms can start work on the practical aspects outlined above, including reviewing key commercial contracts and considering the need to negotiate amendments, waivers or modifications.

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Please do not hesitate to contact us with any questions.