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Brexit and the insurance industry

It is possible that in less than two months' time the UK will have voted to leave the European Union. Brexit would have significant regulatory implications for insurance industry participants (whether based in the UK or elsewhere in the European Economic Area (**EEA**)) and result in a lengthy period of considerable uncertainty while negotiations were undertaken over the terms on which it would take place. It would also have potentially serious short and longer term consequences for industry participants (particularly but not exclusively those based in the UK), the nature and extent of which would depend considerably on the nature of post-Brexit UK access to EU markets (and *vice versa*).

In this note we examine these regulatory implications and consequences and comment on some associated risk management actions that industry participants could take, both in the run-up to the referendum on 23 June and in the event of a vote to leave.

But first, some general context.

What we know

Whatever views one might hold on the merits of "remain" or "leave", only two things are certain at this point if the UK votes to leave:

- If the Government gives notice of the UK's intention to withdraw from the EU immediately after the vote[1], the UK will automatically leave two years later (i.e. in summer 2018)[2] unless by the end of that period (i) an agreement on the terms of the withdrawal (**Withdrawal Agreement**) has been concluded or (ii) the other 27 member states have unanimously agreed to an extension of the period to negotiate the withdrawal; and
- In the meantime, the UK will continue to be an EU member with the full benefits and responsibilities of EU membership (except that it will not be entitled to participate on the EU side of the discussions and decisions about its withdrawal)

What we don't know

We can't be certain about anything else. If there is a vote to leave:

1. We cannot know whether it would be possible to conclude a Withdrawal Agreement within the two year 'automatic exit' period. The agreement would be negotiated by the European Commission and could only be concluded once approved by the European Parliament (by a simple majority of MEPs) and then by the European Council acting by a qualified majority (being at least 20 of the other 27 member states representing at least 65% of their population). But it's not as simple as that. A Withdrawal Agreement would deal only with the arrangements for the UK's withdrawal from the EU, not with their

1. The provision of the relevant Treaties that deals with withdrawal from the EU is Article 50. In his statement to Parliament on 22 February 2016 on EU reform and referendum, the Prime Minister said "An idea has been put forward that if the country votes to leave we could have a second renegotiation and perhaps another referendum…This is a straight democratic decision – staying in or leaving – and no government can ignore that. Having a second renegotiation followed by a second referendum is not on the ballot paper… the idea that other European countries would be ready to start a second negotiation is for the birds… I want to spell out this point very carefully. If the British people vote to leave there is only one way to bring that about – and that is to trigger Article 50 of the Treaties and begin the process of exit. And the British people would rightly expect that to start straight away"
2. Even this isn't certain; some experts believe that as a matter of law, we could change our mind and not leave after all, even though Article 50 does not provide for withdrawal of a notification of intention to leave

future relationship (although Article 50 refers to a Withdrawal Agreement as an agreement "taking account of the framework for its [i.e. the departing members state's] future relationship with the Union"). On the assumption that the UK would want at least a future trading relationship of some kind, it is distinctly possible that the agreement governing this future relationship (**Future Relationship Arrangement**) would itself require ratification by every one of the 27 remaining member states.

2. We cannot know whether an extension to the 'automatic exit' period would be forthcoming if a Withdrawal Agreement were not concluded within two years, since the agreement of every one of the 27 other member states to such an extension would be required.[3]
3. We cannot know what a Future Relationship Arrangement might look like or when it might commence.
   a. As to when it might commence, it must be quite likely that there would be a transition period of perhaps several years between the date of a Withdrawal Agreement (whether concluded within the two year period provided for by Article 50 or any extension to that period which may be agreed) and the date on which a Future Relationship Arrangement would come into force.
   b. As to what it might look like, the oft-cited models on which it might be based are:
      - EEA membership (or the 'Norwegian model') – membership of the European Free Trade Association (**EFTA**) and the EEA. This model provides its non- EU participants (currently Norway, Iceland and Lichtenstein) with access to the EU single market (including by way of free movement of services and people) in return for being subject to many EU laws and regulations (without being entitled to participate in their development and implementation) and making substantial contributions to the EU budget
      - The 'Swiss model' – membership of EFTA coupled with bilateral agreements with the EU for single market access in specific sectors. EU laws and regulations do not apply but in areas covered by the bilateral agreements, Swiss laws must be equivalent to corresponding EU laws. It is thought unlikely that the EU would be willing to replicate this model
      - Customs union (or the 'Turkish model') – tariff/quota-free EU/UK trade in goods but not services; obliged to comply with EU standards for goods exported to the EU; obliged to apply EU external tariffs (cannot conclude free trade agreements with non-EU countries without EU consent)
      - Free trade agreement (or the 'FTA model') – negotiation of a free trade agreement (**FTA**) with the EU[4]; obliged to comply with EU standards for goods exported to the EU; not bound by or able to benefit from EU FTAs with non-EU countries (so the UK would need to negotiate its own on a country-by-country basis)
      - The 'WTO model' – under this model the UK would trade with the EU on the basis of World Trade Organisation (WTO) rules, principally the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS). The UK would be obliged to comply with EU standards for goods exported to the EU; in the main, exports would be protected from punitive rates but tariffs would be applied. Regulatory barriers would be likely to constrain trade in financial services. The UK would not be bound by or able to benefit from EU FTAs with non-EU countries

[3] For this reason there must be a possibility that the Government would not give notice of intention to withdraw under Article 50 immediately after the referendum but first hold informal negotiations with the EU about withdrawal arrangements before giving an Article 50 notice

[4] FTAs typically relate to goods, not services. If the UK were to pursue the FTA model, an agreement relating to services - particularly financial services - as well as goods would presumably be a key objective. Historically, FTAs have tended not to cover financial services because of the need for the parties' financial services laws to be 'equivalent'; given the starting point for any FTA that the UK might seek to agree with the EU in the event of our exit (ie harmonisation of our financial services laws with those of the EU), this would presumably be less of a stumbling block than it has been with previous FTAs

Regulatory implications

Passporting

Insurers, reinsurers and insurance intermediaries throughout the EEA (including those owned by groups based outside it) currently benefit from the European insurance single market system under which a firm authorised in one EEA state (home state) may carry on business in any other EEA state (host state) on the basis of its home state authorisation, either through a branch in the host state or on a cross-border services basis (**passporting**).

For UK-incorporated-and-authorised insurance businesses (**UK firms**), the passporting system provides access to an EU market of 500 million people, from which Lloyd's estimates that the London insurance market writes more than £6bn of premium.

If the UK leaves the EU then, unless it continues with membership of the EEA (or concludes Future Relationship Arrangements to similar effect), passporting rights will cease to be available with the result that:

- UK firms with branches in EEA countries will need to either:
  - obtain local authorisations for those branches; or
  - establish (or acquire) a subsidiary in the EEA (with its own regulatory capital) in order to write EEA business on a passporting basis
- Similarly, insurance businesses incorporated and authorised in EEA countries that maintain branches in the UK will need to either:
  - obtain UK authorisation for them; or
  - establish a UK subsidiary with its own regulatory capital
- UK firms that currently write risks situated in an EEA country from the UK on a cross-border services basis will in many cases need to establish a locally-authorised branch or subsidiary (or a subsidiary incorporated and authorised in another EEA country which can write the risks on a passporting basis) in order to continue to write such risks

Prudential regulation and reporting

If the passporting system does not continue, an EEA branch of a UK firm will be a 'third country branch' for the purposes of Solvency II. The UK is likely to maintain a Solvency II-based system of prudential regulation (Solvency II itself being heavily based on the UK's previous risk-based regime). If this proves to be the case, the UK system is likely to be assessed by the EU as "equivalent" under Solvency II. (In the highly unlikely event of the UK system diverging from Solvency II, Europe-wide groups headquartered in the UK might become subject to 'double supervision' under both the UK regime and Solvency II.)

Transfers of business

A further likely consequence of a non-continuation of passporting rights for the UK would be the loss of automatic mutual recognition (as between the UK and the EEA) of insurance business transfers sanctioned by UK or EEA courts or regulators, potentially making the process of reorganising books of insurance business located in insurance companies and their branches in the UK and the EEA considerably more complex (through a need for multiple applications to courts or regulators) or perhaps, in some cases, impossible.

[5] The Bank of England has announced that it will hold additional liquidity auctions for banks in the weeks around the EU Referendum

Risk management actions

Despite (and to some extent because of) all the uncertainties, it makes sense for insurance businesses to engage now in an exercise of identifying issues and considering options related to a possible Brexit, and perhaps undertake some more detailed contingency planning in certain areas. However, with limited exceptions (such as the implementation of hedging arrangements and, possibly, the pursuit of an M&A transaction that could have Brexit-related benefits where there are good non Brexit-related strategic or financial reasons for the deal), any contingency plans drawn up in the relatively near future should almost certainly not be acted on until matters become considerably clearer.

The following matters could be considered:

- Volatility in the foreign exchange, equity and loan markets[5], its possible effects on insurers' liquidity, investments and solvency positions (and credit ratings) and how those possible effects might be mitigated (market volatility may also make it difficult for additional capital to be raised)
- The possibility of additional information being required by the UK regulators, coupled with a likelihood that overall demands on the regulators themselves would increase significantly and might impact on their speed of response to such things as requests for approvals (eg to changes in control) and requests for rule waivers/modifications
- Provisions in existing key commercial contracts (including distribution, outsourcing, IP licensing, IT and financing agreements, and standard terms and conditions) that deal with the following matters could be examined to assess how Brexit might affect the rights and obligations imposed by the provisions and whether amendments may be necessary or desirable (if they are possible):
  - Territorial scope (including with respect to distribution obligations and non-competition clauses, for example)
  - References to European laws or legal concepts rooted in European legislation
  - Regulatory reporting and compliance with other regulatory obligations
  - Data protection
  - Financial condition
  - Termination (including any material adverse change clauses)
  - Force majeure
  - Law and jurisdiction
- Whether any existing key commercial contracts are so dependent on European legal provisions or concepts that they might become wholly or partly impossible to perform (or be performed by a counterparty)
- New key commercial contracts:
  - the possibility of including Brexit-related termination rights or excluding Brexit from any material adverse change or force majeure clauses
  - how the possibility of Brexit might impact the drafting of other provisions (including those mentioned above in respect of existing key commercial contracts)
- How terms and conditions for product wordings may need to be altered and how Brexit might affect product pricing
- Concerning data protection, how cross-border data flows might need to change (depending on the approaches the UK might take to data protection regulation in the event of Brexit)
- Concerning staff:

5. The Bank of England has announced that it will hold additional liquidity auctions for banks in the weeks around the EU Referendum

- how any changes to the work permit system and other employment laws might affect the ability of UK citizens to work elsewhere in Europe, or of persons from elsewhere in Europe to work in the UK, or result in increased employment costs
- how any structural changes to secure ongoing access to markets (see below) might affect the location of senior management and other staff

- The steps that could be taken in order to secure ongoing access to EEA markets (in the case of a UK firm or group) or the UK market (in the case of a non-UK firm or group) if a Future Relationship Arrangement did not provide for the continuation of passporting, including for example:
  - in the case of a UK insurer (or a group containing only a UK insurer) that currently passports across the EEA, establishment (or acquisition) of an EEA insurer
  - in the case of a group containing both UK and EEA insurers, switching passports from the UK insurer to the EEA insurer,

and the steps that could be taken in order to implement any associated group reorganisation.

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