INSURANCE/REINSURANCE
BREXIT – SOME BREATHING SPACE, BUT FOUR IMPORTANT QUESTIONS REMAIN UNANSWERED

Following the second phase of negotiations on the withdrawal agreement in March 2018, while progress has been made in clarifying the position in some respects, (re)insurance businesses are still waiting for answers to important questions on the future relationship between the UK and the EU.

Here we look at four of those questions in light of what we know about the transition period and the impact the answers could have on businesses operating in the (re)insurance sector.

1. The transition agreement and temporary permissions

We now know that, subject to the successful completion of negotiations on the withdrawal agreement, the UK and EU have agreed in principle to a transition period (also known as an "implementation" period) from 29 March 2019 until 31 December 2020, during which time EU laws will continue to apply to the UK. Most new EU laws with an implementation date before 1 January 2021 will also need to be implemented by the UK.

The European Commission has published the draft agreement on withdrawal from the EU[1] showing the agreed terms and those under negotiation. Importantly, the freedom of movement for people, goods, capital, and services, including the passporting regime for (re)insurance businesses, will continue during the transition period.

EU leaders have approved guidelines[2] for the next stage of Brexit negotiations on trade, security and other issues which are now underway. As yet there is no agreement in principle on the trade framework nor over Northern Ireland, judicial co-operation and data protection issues. Failure to agree these matters by October 2018 could scupper the withdrawal agreement and the transition agreement contained in it.

Although we now know the terms of the transition period, little of substance is known about what the future relationship between the UK and the EU will look like from 1 January 2021. The UK government has made it clear that the UK will leave both the single market and the customs union. There is no legal certainty, including over the transition period, until the whole of the withdrawal agreement is agreed and ratified by all of the EU member states.

On 20 December 2017, HM Treasury stated[3] that the UK government will if necessary pass legislation to allow EEA firms to obtain temporary permissions to continue their activities in the UK for a limited period after the date of Brexit. However, the length of the temporary permissions period is not known. In a letter of 28 March 2018 to EEA firms with UK branches[4], the CEO of the Prudential Regulatory Authority (PRA), Sam Woods, welcomed this announcement and stated "that in the unlikely event the withdrawal agreement is not ratified, this provides confidence that a back-stop will be available". He goes on to state that "firms may plan on the assumption that PRA authorisation will only be needed by the end of the implementation (transition) period."

1 https://ec.europa.eu/commission/sites/beta-political/files/draft_agreement_coloured.pdf

2 http://www.consilium.europa.eu/media/33458/23-euco-art50-guidelines.pdf

3 https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2017-12-20/HCWS382/

4 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2018/firms-preparations-for-the-uk-withdrawal-from-the-eu-update-march-2018.pdf?la=en&hash=FD310274EDB28E2A0440228F3DD928E4BB725457

“The UK government will legislate to ensure that contractual obligations, including payment of claims under (re)insurance contracts between EEA (re)insurers and UK policyholders can continue to be met”

On 9 March 2018, the FCA launched a survey[5] to collect information from EEA firms and funds who would like to obtain temporary permissions. The FCA encourages firms to take part in the survey, which closes on 29 June 2018. On 28 March 2018, the FCA stated that, subject to the UK government’s legislation setting up the temporary permissions regime, it expects that firms and funds which are solo regulated by the FCA would need to notify the FCA of their desire to benefit from the regime prior to the date of Brexit. Notification will not require submission of an application for authorisation. Further details of the FCA’s proposals on temporary permissions are expected later this year.

The temporary permissions regime was proposed as an alternative to the continuation of passporting into the UK should there be no transition period. Presumably the government could legislate for a temporary permissions regime to commence following the end of the transition period if the EU and the UK are unable to reach agreement on the cross-border authorisation of firms. We await clarification from the UK government and the regulators in this regard.

2. Will (re)insurers be able to service cross-border policies after Brexit?

The transition period will give the UK and the EU time to legislate so as to provide regulatory certainty on the payment of cross-border claims from January 2021. However, a major question has arisen whether, after the date of Brexit or the end of the transition period, UK (re)insurers will be able to pay claims made by EEA policyholders, and whether EEA (re)-insurers will be able to pay claims made by UK policyholders, under policies which were written before Brexit or the end of the transition period under the passporting regime.

On 20 December 2017, HM Treasury stated[3] that the UK government will legislate to ensure that contractual obligations, including payment of claims under (re)insurance contracts between EEA (re)insurers and UK policyholders can continue to be met. However, neither the Treasury statement of December 2017 nor the PRA letter of 28 March 2018 clarified the position on servicing contracts after the transition or temporary permissions period.

In contrast to the UK’s position, the most recent European Insurance and Occupational Pensions Authority (EIOPA) opinion on this topic issued in December 2017 states that while contracts concluded before the date of Brexit would in principle be valid, UK (re)insurers might not be authorised to carry out such (re)insurance contracts. If the EU maintains this position, it would leave UK (re)insurers with what Nicky Morgan MP, chair of the House of Commons Treasury Select Committee, referred to as the choice of UK firms to “break the contract or break the law” when deciding whether to pay claims of EU policyholders. EIOPA stated that supervisory authorities should ensure that UK firms develop contingency plans to ensure service continuity but warned that such contingency plans should not rely on there being an arrangement between the UK and EU.

What are the practical implications for contracts written by UK and EEA (re)insurers before the end of the transition period?

Unless they obtain branch authorisation (see question 4 below), UK and EEA (re)insurers will need to undertake insurance business transfers (also known as “portfolio transfers”) to an authorised EEA or UK firm respectively. These transfers would need to be approved in the firm’s home state under its applicable insurance business transfer regime.

UK (re)insurers will be required to complete insurance business transfers of their EEA business to an EEA authorised (re)insurer before January 2021 (assuming the withdrawal agreement is ratified) to ensure that these existing contracts can be serviced in the future. As things stand, a UK insurance business transfer (or “Part VII transfer”) is likely to take at least a year to complete.

If the UK government does not legislate to permit servicing of contacts after the end of the transition or temporary permissions period, EEA (re)insurers will need to complete insurance business transfers of their UK business to a UK authorised (re)insurer or UK branch of the EEA firm. The time required by EEA (re)insurers to transfer their UK business to a UK authorised firm varies considerably from state to state; if the EEA firm does not have a UK subsidiary to which to transfer the business of its UK branch, the clock is ticking for it to obtain authorisation before the end of December 2020.

Lloyd’s has also been trying to grapple with how it can ensure that the Lloyd’s market can continue to service policies after the end of the transition period. While completing a Part VII transfer before the end of 2020 may pose a challenge to individual UK (re)insurers, it would be practically impossible for Lloyd’s to complete the necessary transfers to its Brussels subsidiary within this time period.

In searching for alternative solutions to this problem, the Aviation Insurance Clauses Group has produced an EU Contract Continuity Clause which was designed with the intention of allowing a transfer of a UK (re)insurer’s participation in a policy where Brexit prevents the (re)insurer continuing to participate in the policy. However, this clause is not without issues, such as whether the transfer of the (re)insurer’s participation would in any event be caught by the Part VII transfer regime, which would require the relevant (re)insurer to transfer its participation by way of a Part VII transfer.

Another market clause which might be relevant is the Lloyd’s Market Association’s (LMA) Euro Contract Continuity Clause, which was issued in 2012 in response to fears of “Grexit”. The clause provides for the relevant contract to continue in the event of a country withdrawing from the Euro or the EU itself. Seven years on, the clause might be useful for parties seeking to ensure that their contract does not terminate as a result

5 https://www.fca.org.uk/eu-withdrawal/survey-eea-inbound-passported-firms

of Brexit, although for the reasons set out above it is unlikely to assist a party to enforce obligations under the contract if performance is unlawful. The LMA updated the clause in April 2017, and the new clause recognises that performance cannot be enforced where it is unlawful.

3. What will replace "passporting" rights?

Many (re)insurers and intermediaries currently have a "passport" which enables them to provide regulated insurance services on a cross-border basis from one EEA member state into others, or to establish a branch in other EEA member states.

The UK government has recognised that passporting rights between the UK and the EU will not be retained beyond the end of the transition period. If the withdrawal agreement is not agreed, passporting will cease on 29 March 2019.

If an agreement is not concluded between the UK and the EU which contains mutual trading rights in another form, (re)insurers and intermediaries will in principle no longer be able to carry out cross-border business between the UK and EEA states. However, certain business classes (such as MAT) may be exempted by EEA states and (re)insurers may still be able to write MAT business and (re)insurance across the UK-EU border on a services basis under the World Trade Organisation's General Agreement on Trade in Services (GATS), so long as these classes are within the (re)insurer's home state's GATS Specific Commitments and any requirements of its regulator are met, such as the UK maintaining a Solvency II "equivalent" regime.

It has been said that an alternative to passporting could be for UK (re)insurers to be granted "equivalence" under the EU's established third country equivalence regime. Under the current regime, the EU determines whether the insurance regulatory regime of a non-EU country is equivalent to Solvency II for the purposes of group solvency calculation, group supervision and reinsurance. The Australian, Bermudian, Japanese, Swiss and U.S. prudential regimes have all been granted equivalence status with regard to one or more of these three elements. However, Philip Hammond has said that an equivalence regime would be "wholly inadequate for the scale and complexity of UK-EU financial services trade." The fact that the EU under the current regime can unilaterally withdraw a non-EEA country's equivalence status also makes this an unattractive option on which to base a future trading relationship.

Another option is for the UK and the EU to maintain access to each other's insurance markets without passporting by agreeing mutually binding prudential insurance standards. Under a "mutual recognition" arrangement, businesses authorised in the UK would have their authorisation recognised in EU member states (and vice versa) despite there being potentially different regulatory regimes in place. The EU-US reinsurance covered agreement, which was announced in September 2017, is an example of a trade agreement in relation to reinsurance. A UK-EU mutual recognition deal would be much simpler to negotiate than the EU-US deal because the markets are already deeply interconnected and regulatory frameworks aligned.

However, it is unlikely that the EU will agree to a mutual recognition arrangement unless there are effective mechanisms in place to survey and manage any future divergence, which would require extensive negotiation. The EU has also shown itself in the most recent round of negotiations to be deeply reluctant to allow the UK to continue to enjoy the benefits of the single market and EU membership without being part of it. In light of this uncertainty, (re)insurers and intermediaries should plan how to continue their business without interruption on the assumption that mutual recognition is not agreed.

4. If mutual recognition is not agreed, how difficult will it be for (re)insurance businesses to trade across the UK-EU border?

(Re)insurers and intermediaries, which intend to maintain a presence in both the UK and the EU, need to consider ways to tackle the loss of passporting rights and the potential lack of mutual recognition. The most obvious strategies are for UK firms to establish a subsidiary in an EEA state and obtain authorisation there. For EEA firms, establishing a UK branch or subsidiary, and obtaining authorisation for it, are the most obvious options.

Factors for UK (re)insurers to bear in mind when considering these options are that:

- The EU currently requires a third country branch (which the UK would be following Brexit) to hold capital in the EEA in respect of the company's EEA business. For (re)insurers, the amount of capital required must be calculated on a Solvency II basis.
- For UK firms providing insurance in several EEA states, branch authorisation is not likely to be a practical solution. A UK (re)insurer or intermediary seeking to trade on a services or branch basis would need to establish a branch in each EEA state in which it intended to do business, as branches of non-EEA entities cannot passport from one EEA state into another.
- By contrast, although obtaining authorisation for a subsidiary in one EEA state would come with a high initial time and cost commitment due to the need to establish a local headquarters function, the subsidiary would be able to passport across the EEA once authorised.
- The process of obtaining authorisation for a subsidiary will likely be costly and time-consuming (depending on the state selected), so will need to be commenced well in advance of the formal split. It will be challenging for a (re)insurer or intermediary to obtain authorisation before 29 March 2019 (if the withdrawal agreement is not ratified) and potentially even before the end of the transition period, so any (re)insurers or intermediaries which are considering this option should not delay preparing their applications for authorisation.
- Any reinsurance arrangement between a UK (re)insurer and a subsidiary authorised in the EU will need to take into account an EIOPA opinion of July 2017 which has recommended that EU supervisory authorities scrutinise the governance arrangements of undertakings seeking authorisation in the EU and their reinsurance arrangements with UK reinsurers (either intra-group or to third parties). EIOPA has recommended that a minimum retention of risks by the EU undertaking should be required, and has suggested a 10% lower limit.

The EIOPA opinion of July 2017 also warned EU regulators against permitting extensive outsourcing by EU entities, particularly to entities located outside the EU. This significantly reduces the potential for UK (re)insurers and intermediaries to establish an authorised entity in the EU and outsource significant parts of the business operations to the UK parent. This opinion was designed to level the playing field between EU states with a softer, more flexible approach to headquarters functions and those which took a more rigorous approach. In May 2018, EIOPA published an Opinion on the solvency position of (re)insurance undertakings in light of Brexit[6]. The Opinion sets out 14 changes to the determination of technical provisions, own funds and capital requirements of (re)insurance undertakings in the EU that may result from Brexit. The Opinion assumes that (i) there is no transitional period, (ii) the EU does not regard the UK as having a Solvency II "equivalent" regime, and (iii) there is no agreement between the UK and EU on trade terms allowing continuing market access for (re)insurance.

EEA (re)insurers and intermediaries wishing to establish a branch or subsidiary in the UK are likely to face many of the same issues. The PRA stated in a supervisory statement published on 28 March 2018[7] that it will consider two additional factors before authorising a branch of an EU (re)insurer to conduct business in the UK following Brexit, namely the scale of the branch's activities which are covered by the Financial Services Compensation Scheme (FSCS), and the impact of the failure of the firm on the wider insurance market and financial system. Any EEA (re)insurer which has more than £500 million of FSCS-protected liabilities should apply for authorisation as a UK subsidiary, rather than applying to authorise a branch in the UK. The FSCS protects policies held by individuals and micro-businesses (with a turnover up to £1 million), as well as all insureds under compulsory insurance (principally motor and employer liability) and life insurance.

5. How might UK laws and regulations change after Brexit?

The UK Treasury Committee recently undertook an inquiry into Solvency II to consider (amongst other issues) the options for the UK insurance industry in light of the decision to leave the EU. The Committee's main conclusion was that there are several practical difficulties arising out of Solvency II, and that the PRA should discuss these issues with the insurance industry to see what changes could be made to the UK regime. The PRA has not yet indicated how it will proceed.

Another area of uncertainty is the extent to which the UK will retain legislation, such as the Part VII transfer regime, which derives from EU legislation. Retaining this legislation is only half of the problem, as the UK and the EU would also need to agree to recognise post-Brexit transfers undertaken under their respective regimes. Again, this topic should form a key part of the negotiations.

There may be some beneficial changes to English law which do not present serious issues of recognition. For example, we would not be surprised to see some "gold-plating" of UK rules which implement maximum harmonising Directives, such as Solvency II.

One question we can answer is whether the upcoming Insurance Distribution Directive (the IDD) will apply to UK intermediaries after Brexit. The simple answer is that it will, as the date by which UK intermediaries must comply with the FCA's rules which implement the IDD (recently postponed to 1 October 2018) falls before Brexit. Unless after Brexit the UK repeals these rules, intermediaries will need to continue complying. As the IDD requires relatively little change to UK law and regulation, and will have been implemented for intermediaries for two years before the end of the transition period, we do not think that significant amendment is likely in the short to medium term.

Conclusion

For UK (re)insurers and intermediaries operating in the EU, and EU (re)insurers and intermediaries operating in the UK, Brexit may open up new opportunities but, in the meantime, businesses continue to have to devise company strategy without certainty as to post-Brexit arrangements. The issues set out above are not exhaustive, and further issues can be found in our previous briefing[8] and our Dispute Resolution Brexit Considerations[9].

What is clear is that (re)insurance businesses should not treat the agreement of a transition period as more than a breathing space, particularly in light of the fact that the transition period is not a certainty until the withdrawal agreement itself is ratified. Regulators have emphasised that businesses need to continue to prepare to make authorisation applications and begin insurance business transfer processes as soon as possible.

HFW is equipped to help you to overcome these challenges, to navigate the new legal landscape as it begins to take shape and to take advantage of the new opportunities which may arise. We are currently advising several UK and EU (re)insurance businesses on their strategic options.

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8 http://www.hfw.com/Preparing-for-Brexit-seven-things-that-re-insurance-businesses-can-do-now-July-2016

9 http://www.hfw.com/Dispute-resolution-Brexit-considerations