INSURANCE/REINSURANCE
BREXIT – FIVE UNANSWERED QUESTIONS

Some issues have been clarified but (re)insurance businesses urgently need answers to important questions on the future relationship with the EU.

Since the UK and the EU reached a provisional agreement on the three "divorce" issues in December 2017, talk has turned to the future trading relationship between the UK and the EU. Although a transition period has been mentioned, the two sides are yet to agree the length of this period or what it might mean in practice. With just over a year to go until the UK formally leaves the EU, agreement on the future relationship still seems a long way off, and many important questions remain unanswered.

Here we look at five of those questions, and the impact that the answers could have on businesses operating in the (re) insurance sector:

1. Will there be a transition period?

The short answer is that we still do not know anything of substance about the future relationship between the UK and the EU, and therefore do not know whether all of the effort that (re)insurance businesses are putting into preparing for Brexit will be needed before March 2019.

At the date of writing, the negotiating teams have not agreed that the relationship between the UK and the EU will fall away completely after 29 March 2019 (known as a "hard Brexit"), have not agreed an arrangement which allows the UK to retain some of the benefits of EU membership, such as access to the single market (known as a "soft Brexit"), and have not agreed to preserve the existing relationship for a short period of time (the transition period) while the future relationship is determined.

A transition period is increasingly being regarded as an absolute necessity, given how complex it will be to untangle a relationship which has lasted nearly 50 years and to agree a future relationship which may last even longer. However, in the absence of any other agreement, the default position is a "hard Brexit", so it is prudent to prepare on this basis.

2. Will "passporting" rights be retained?

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

If an agreement is not concluded between the UK and the EU which preserves passporting rights, (re)insurers and intermediaries would in principle no longer be able to passport from the UK into other EU member states, and vice versa, although reinsurers may still be able to write reinsurance 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, if required by the cedant's home state regulator, the UK maintained a Solvency II "equivalent" regime.

An alternative to passporting would be for the UK and the EU to agree a "mutual recognition" arrangement, under which businesses authorised in the UK would have this authorisation recognised in EU member states (and vice versa) despite there being different regulatory regimes in place. The EU-US covered agreement which was announced in September 2017 is an example of a similar arrangement but the fact that the covered agreement was 20 years in the making shows that a UK-EU "mutual recognition" agreement could not be agreed overnight. While a UK-EU deal would surely be much simpler than the EU-US deal, the current

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negotiating stances of the UK and the EU make such an agreement look unlikely.

In light of the uncertainty, (re)insurers and intermediaries should plan at an early stage how to continue their business without interruption in the event that passporting rights are not preserved and mutual recognition is not agreed.

3. If passporting rights are not retained, 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 likely loss of passporting rights, and the potential lack of mutual recognition. The most obvious post-Brexit strategies are for UK firms to establish a branch or subsidiary in an EU member 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 firms to bear in mind when considering these options are that:

- The EU currently requires a branch of a non-EU company (which the UK would be following Brexit) to hold capital in the EU in respect of the company’s EU 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 branch basis would need to establish a branch in each EU state in which it intended to do business, as branches of non-EU entities cannot passport from one EU state into another.

- By way of contrast, although obtaining authorisation for a subsidiary in one EU country would come with a high initial time and cost commitment due to the need to establish a local head-quarters 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 already be challenging for a (re)insurer or intermediary to complete an application for authorisation before 29 March 2019, so any (re)insurers or intermediaries which are considering this option should not delay any further.

- Any reinsurance arrangement between a UK (re)insurer and an authorised subsidiary 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 (re)insurers (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 entity. 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.

EU member state (re)insurers and intermediaries wishing to establish a branch or subsidiary in the UK are likely to face many of the same issues. A Prudential Regulation Authority (PRA) consultation issued in December 2017 proposes two additional factors which the PRA would consider before permitting a branch of an EU (re)insurer to conduct business in the UK following Brexit. The same consultation also proposed that any EU member state (re)insurer which has more than £200 million of liabilities which are protected by the Financial Services Compensation Scheme (FSCS) should apply for authorisation as a UK subsidiary, rather than applying to establish 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 (motor and employer liability) and life insurance.

4. After Brexit, will UK and EU (re)insurers be able to pay the claims of EU and UK policyholders respectively?

A major question which has arisen over the last year is whether, after Brexit, 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 under the passporting regime.

The UK government announced on 20 December 2017 that it would if necessary pass legislation to allow EEA firms to obtain temporary permissions to continue their activities in the UK for a limited period after Brexit, so that they could continue to pay claims. The PRA welcomed this announcement but warned firms to consider use of the temporary permissions regime only as a fall-back, and instead to prepare for authorisation as set out in section 3 above.

By way of contrast to the UK's position, EIOPA issued an Opinion in December 2017 stating that while contracts concluded before Brexit would in principle be valid, (re) insurers might not be authorised to carry out insurance activities with regard to these cross-border (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 after Brexit. EIOPA stated that supervisory authorities should ensure that undertakings develop contingency plans to ensure service continuity but warned that, similarly to the PRA's approach, such contingency plans should not rely on there being an arrangement between the UK and EU.

As a result, while it appears likely that the UK will put in place transitional measures to allow EEA firms to continue servicing contracts issued to UK policyholders prior to Brexit, both the PRA and EIOPA have warned against relying on this, and instead recommend firms proceed on the basis that no such arrangement will be in place following Brexit.

What does this mean for contracts written before Brexit?

In principle, UK (re)insurers will be required to complete insurance business transfers of their EEA business before Brexit to enable these existing contracts to be serviced after Brexit, and EU (re)insurers will need to do the same for their UK business. These transfers would need to be approved in the firm's home state under its applicable portfolio transfer regime. As things stand, a UK insurance business transfer (or "Part VII transfer") is likely to take at least a year to complete, leaving UK (re)insurers with very little time to complete a transfer before Brexit. The time required by EU re(insurers) to transfer their UK business to a UK authorised firm varies considerably from state to state; if the EU firm does not have a UK subsidiary to which to transfer the business of its UK branch, obtaining authorisation before Brexit will be a significant timing challenge.

Lloyd's has also been trying to grapple with how it can ensure that the Lloyd's market can continue to pay claims after Brexit. While completing a Part VII transfer before Brexit might be increasingly difficult for individual (re)insurers, it would be impossible for Lloyd's to complete the necessary transfers br March 2019 or even December 2020.

In searching for alternative solutions to this problem, the International Underwriting Association of London has produced an EU Contract Continuity Clause which was designed with the intention of allowing a transfer of a UK firm's (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 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 of Brexit, although for the reasons set out above it is unlikely

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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.

5. How might UK laws and regulations change?

The 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 but, if it decides largely to maintain the rules which implement Solvency II, the UK could apply to the EU to be deemed "equivalent" under Solvency II for group supervision, group solvency and reinsurance. Equivalence would mean that, following a technical assessment, the European Commission would accept that the regulatory and supervisory regime in the UK in these areas is equivalent to that of the EU. For UK companies and those domiciled in other EU member states, the UK maintaining equivalence under Solvency II would facilitate co-operation between regulators, thus reducing compliance costs for (re)insurance firms, and would also facilitate cross-border reinsurance.

However, there is a timing issue to be addressed – in the absence of other arrangements, the UK can apply for equivalence only once it has left EU. If the UK intends to retain much of Solvency II, it might seek to agree equivalence as part of the exit negotiations, but this remains to be seen.

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

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their respective regimes. Again, we hope that this topic forms a key part of the negotiations.

There may be some beneficial changes to UK law which do not affect the UK’s equivalence and 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, we do not think that significant amendment is likely in the short to medium term.

Summary

For UK (re)insurers and intermediaries operating in the EU, and EU (re)insurers and intermediaries operating in the UK, Brexit will inevitably bring significant challenges. The issues set out above are not exhaustive, and further issues can be found in our previous briefing[1] and our Dispute Resolution Brexit Considerations[2].

Brexit may also open up new opportunities but, in the meantime, businesses have to contend with the difficulty of devising company strategy with no certainty as to post-Brexit arrangements, and only a short time to go until the UK formally leaves the EU.

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 have already advised and are currently advising several UK and EU (re)insurance businesses on their strategic options.

Published: March 2018

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

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

For more information, please contact the authors:

RICHARD SPILLER
Partner, London
T +44 (0)20 7264 8770
E richard.spiller@hfw.com

WILLIAM REDDIE
Senior Associate, London
T +44 (0)20 7264 8758
E william.reddie@hfw.com

or any of the following:

PIERRE FRÜHLING
Partner, Brussels/Paris
T +32 (0)2643 3406/
+33 1 44 94 40 50
E pierre.fruhling@hfw.com

PAULINE ARROYO
Partner, Paris
T: +33 1 44 94 40 50
E: pauline.arroyo@hfw.com

SAM WAKERLEY
Partner, Dubai
T: +971 4 423 0530
E: sam.wakerley@hfw.com

MERT HIFZI
Partner, Singapore
T: +65 6411 5303
E: mert.hifzi@hfw.com

ROSIE NG
Consultant, Hong Kong
T: +852 3983 7792
E: rosie.ng@hfw.com

RICHARD JOWETT
Partner, Melbourne
T: +61 (0) 3 8601 4521
E: richard.jowett@hfw.com

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