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Legal Update
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Brexit: What does it mean for the insurance industry?

As we have discussed in our prior communications over the last two weeks[1], the majority vote in favour of the UK's departure from the European Union ("**EU**") means that businesses operating in the UK now face a period of uncertainty, no more so than in the insurance industry. The UK insurance industry is the largest in Europe and the third largest globally, contributing over £25 billion annually to the UK GDP. The decision to leave the EU will have specific effects on the insurance industry depending upon the terms of exit to be negotiated with the EU. Insurers have been and continue to be engaged in formulating contingency plans, with Lloyd's of London (**"Lloyd's"**) already publically restating its commitment to plan for a post-Brexit scenario. In addition to contingency planning, insurance industry participants need to protect their interests by having their voices heard in discussions with politicians and policy makers ahead of, and during, the upcoming negotiations with the EU. In this Legal Update we seek to identify the challenges, risks and opportunities for the insurance industry.

The impact on the insurance industry

The impact on underwriting

The impact that leaving the EU will have on the insurance industry will vary depending on the type of insurance business underwritten and, crucially, the method of distributing the product to market. General insurers, who have a large retail customer base, are likely to rely more heavily on the EU passport for cross-border transactions, and continued access to the EU insurance market will be one of their main concerns. The reverse is equally true for European Economic Area ("**EEA**") insurers wishing to access the UK market. The loss of easy access to the EEA market may also make investment in such UK based insurance firms less attractive, though a weaker sterling may go some way to offset that sentiment.

Alongside losing access to five hundred million potential customers in the EU, if UK insurers lost the ability to use the passporting system, such as the Solvency II passport, they may have to make changes to their group structure to provide for a presence in both the EEA and the UK. Insurers based in the UK may need to set up a subsidiary in the EEA and insurers based in the EEA may have to set up a subsidiary in the UK to perform cross-border transactions. Many of the larger pan-European businesses already have authorised carriers in places such as Dublin (which as a jurisdiction, sees the post-Brexit world as an opportunity, quite understandably) and those that don't are probably making plans.

For other more specialist insurance businesses, the UK's withdrawal from the EU will likely be less significant. Lloyd's has released a statement stating that only 4% of its global gross written premium ("**GWP**") is at risk with the UK outside the EU single market. The EEA only accounts for 11% of Lloyd's total GWP and almost half of this is reinsurance. The loss of the EU passport will likely not significantly impact pure reinsurance business. Generally, the insurance sector is far less reliant on EU passporting than other financial services, relying more on trading with non-EEA countries. To that extent, it is often claimed that the specialist insurance industry is truly global and London remains at the heart of the market. The challenge is to maintain that position going forward. The UK insurance industry carries out a large proportion of its cross border transactions with Canada, the United States (which together account for 47% of Lloyd's total GWP) and Bermuda. Losing the EU passport will likely have no direct effect on this business.

1 See the Mayer Brown Brexit web page at https://www.mayerbrown.com/experience/Brexit-The-UK-and-the-EU/

However, even (re)insurers with little exposure to the EU can be affected by Brexit. The value of the pound against the dollar and euro has fallen and this may impact claims exposures denominated in foreign currencies and capital denominated in pounds. Additionally, S&P has cut the UK's credit rating from AAA to AA, citing that the referendum could lead to a drop in economic performance. Moody's has downgraded the credit rating of some UK insurers due to market uncertainty and the effect of the referendum on capitalisation.

The impact on investments

Insurers are major investors and market participants (one major insurer announced that it was expected to generate 37% of its revenues from global market investment in 2016 prior to the vote) and market uncertainty and volatility following the referendum may have a significant impact on returns on these investments. Moreover, with interest rates now forecast to stay at record low levels, bond yields are at rock bottom and likely to languish there.

Since the announcement of the referendum result early on 24 June, the severe volatility across all markets, including fixed income, equities and currencies has the potential to impact solvency capital ratios and has already attracted the attention of rating agencies, particularly with respect to the life sector. The UK's Prudential Regulation Authority ("**PRA**") has sensibly adopted rules recently to ease compliance with Solvency II capital ratios as a transitional matter to relieve the immediate pressure on insurance companies to sell investment assets at a time when market values are depressed.

Investment activities are also subject to EU legislation such as the European Market Infrastructure Regulation ("**EMIR**"), the Markets in Financial Instruments Directive II ("**MiFID II**") and the Market Abuse Regulation ("**MAR**"). Even firms that are not reliant on an EU passport for their (re)insurance business may find that they rely on the passport to conduct their investment business.

The impact of Brexit on financial services for those insurers who rely on EU passports

The process of leaving the EU

The formal process of leaving the EU is set out in Article 50 Treaty on European Union ("**TEU**"). Once triggered, Article 50 provides a two year window to negotiate an exit from the EU. When this period expires, the UK will leave the EU, whether or not the parties have reached an agreement. The remaining twenty seven Member States can extend this period, but only with unanimous agreement.

Article 50, however, only provides for the negotiation of a withdrawal arrangement and not a deal on the future relationship between the UK and the EU. It would make sense (from the UK's perspective) for the UK to not trigger Article 50 until there is some clarity as to the future relationship with the EU, or for the two sets of negotiations to take place side-by-side. There is a degree of uncertainty over how to progress the negotiations given that there is no precedent for triggering Article 50. There is also a strong indication from EU officials that there can be no negotiations pre-trigger. Prime Minister David Cameron, having resigned his position, has stated that he will not trigger Article 50, allowing the new Prime Minister (to be announced on 9 September 2016) to decide how and when this should be done. Additionally the UK will want to negotiate new relationships with non-EEA countries it currently has trade relationships with by virtue of being a member of the EU.

The short-term legal impact

Despite the referendum result, legally nothing has changed and it is business as usual. The UK is still a member of the EU and subject to its laws and this will be the case until the Article 50 negotiation period has expired. This is unlikely to happen for at least two and a half years given the UK governments reluctance to trigger Article 50. The Financial Conduct Authority ("**FCA**") has released a statement stating that current UK laws are still applicable, including those derived from EU law and that firms should continue to implement plans for EU legislation that is yet to come into force. This means UK firms are, for the time being, able to benefit from the passporting system which allows firms authorised in the UK to access the markets of the other thirty states within the EEA without having to set up a subsidiary or obtain further licences.

The potential UK-EU relationship in the medium to longer term

From a legal point of view there are three realistic potential relationships between the UK and EU post-withdrawal. As we state above, the relevance or impact of each option on the insurance industry will to a large extent vary depending on the type of (re) insurance firm in question.

1. **The Norwegian model (EEA membership)**

   The Norwegian model provides for full access to the single market as a member of the EEA. Norway is obliged to implement all single market rules, but has no influence over them. Norway is required to accept the free movement of persons and are also required to contribute towards the EU budget. In our view, this model provides few advantages for the UK. EU legislation would bind the UK, but the UK would have no influence over it. This option is, however, the only one which gives financial services firms such as insurers the passport providing them with access to the single market.

2. **The Swiss model (bilateral agreements)**

   Switzerland currently has around one hundred bilateral agreements with the EU that give access to the single market for goods but not most services. Switzerland makes contributions to the EU budget and is subject to the free movement of persons. The functioning and structure of these agreements is complex and it would seem unlikely that the EU would establish a similar relationship with another state. If the UK adopted this model, it would not automatically have to implement new EU legislation, with agreements negotiated case-by-case. Swiss financial institutions do not benefit from the EU passport, but the EU often regards Swiss legislation on financial services as "equivalent" to that of the EU because their legislation is so similar as a result of the bilateral agreements.

3. **Free trade area arrangement (e.g. Canada and South Korea)**

   This option provides for a single bilateral free trade agreement. The EU would not require the UK to implement all EU rules, pay into the EU budget or accept the free movement of persons, but a single bilateral agreement would not give financial services firms the benefit of the EU passport. The negotiation process is historically lengthy (the EU-Canada trade arrangement has taken seven years to negotiate and has not yet been approved by the Council of the European Union or the European Parliament) and would create a period of extended market uncertainty.

A transitional period post withdrawal?

The loss of the EU passport may not be the end of cross-border financial services from the UK, but it will raise questions about how to undertake them. The EU and UK could agree to preserve existing passports immediately post-withdrawal. For example, when Greenland withdrew from the European Economic Community ("**EEC**") they agreed transitional provisions which preserved certain rights during the transitional period. This may work along the lines of the granting of provisional equivalence decisions in respect of Solvency II.

Outside the scope of (re)insurance activities, but still of relevance to a (re)insurer's investment activities, some EU legislation has adopted the concept of third-country (or non-EEA) passports. For example, the Alternative Investment Fund Managers Directive ("**AIFMD**") incorporated such an option, subject to the recommendation of the European Securities and Market Authority ("**ESMA**"). Although ESMA has recommended that the EU Commission not extend the passport to a non-EEA state until the conclusion of further assessment, it has given positive feedback on three countries (Guernsey, Jersey and Switzerland) and the option to extend the passport remains. The effects for non-EEA managers looking to benefit from the passport would be that they become subject to substantially all of the obligations of the AIFMD and in return they get easier access to the EEA. Other legislation such as MiFID II also contains the option of a third party quasi passport. The UK may be able to benefit from these third-country passports, but there is no guarantee and their application is uncertain.

The EU provides a mechanism which gives financial services institutions established in non-EEA Member States certain rights within the EEA. This process is known as "equivalence". The parties agree which rights apply on a case-by-case basis and these vary between individual pieces of legislation but are in no way commensurate to a passport.

There is no specified process for granting equivalence; however the guiding principle is that the non-EEA legislative regime is equivalent to that in the EEA. The US has struggled to obtain equivalence in what have been highly politicised discussions, even where they implement the same international standards as the EU, and have only been granted provisional equivalence under Solvency II. Bermuda has, however, been granted full Solvency II equivalence. Given the political nature of the early discussions between the UK and EU it is possible that any discussion relating to equivalence would be difficult, however it is important to note that current UK legislation is **not** equivalent, but identical, to that of the EU. On this basis it would be difficult for the EU to justify a decision that UK legislation is not equivalent. Accordingly, and leaving aside political manoeuvrings, it seems to us that the UK would have a very strong case to be deemed fully equivalent as regards Solvency II in a post-Brexit world.

Given that the UK and London in particular is a global financial centre, the insurance industry recognises that its domestic financial services legislation is some of the most sophisticated in the world. In fact, UK financial services legislation has heavily influenced EU legislation. For example, the Bank of England and the PRA had significant involvement in negotiating, and influence over the outcome of, Solvency II. It is therefore highly unlikely the UK will have a dramatic policy shift.

What should firms be doing now?

- reviewing their crossborder strategies in the light of developing negotiations – to what extent does the passport affect their (re)insurance and/or investment activities;
- checking the impact of Brexit on their capital adequacy, their liquidity and their access to funding, particularly given a risk of capital flight and the current market volatility;
- checking whether their key financial contracts will be affected;
- continuing to work on the implementation of current and forthcoming EU directives and compliance with directly applicable EU regulations as they will be law for at least the next two years and may continue to be so for some time after;
- making sure that systems and controls are in place to address the current market volatility and report any activity in the market that they suspect does not meet proper standards of market conduct; and
- actively lobbying the regulators and the UK government to ensure that the concerns of the insurance industry, which is such a major contributor to UK GDP, are put to the fore.

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