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C H A N C E

Briefing note

March 2016

Brexit – Insurance Sector Analysis

The upcoming referendum on the UK's membership of the EU is likely to have a major impact on financial services. With many insurers heavily reliant on the EU passport regime and several global insurers choosing to locate their head office within the UK, there are likely to be serious economic and regulatory consequences for the insurance industry if a Brexit occurs. This note considers some of those consequences and suggests what could be considered as part of insurers' and brokers' contingency plans.

The consequences of a vote to remain in the EU are likely to be minimal (although a narrow yes vote could also lead to uncertainty). In contrast, a vote to leave may result in several scenarios all of which present uncertain consequences[1]. This uncertainty will likely continue for several years after the referendum, as a leave vote will not result in an immediate exit from the EU but it will instead trigger at least two years (most likely more) of further negotiations.

Given the potential short term and medium term impact of a leave vote, insurers and brokers may wish, as part of their existing risk management framework, to start contingency planning for both the immediate and (at a high level) long-term risks of a Brexit and to identify the consequences and how they might be mitigated. These include:

1. immediate consequences upon a leave vote, such as market disruption, a depression of Sterling and the Euro (and consequently on investments and capital positions) and the impact of the resulting uncertainty on regulators, customers and counterparties; and
2. the longer term consequences of loss of market access to the EU and potential regulatory change following a Brexit.

DAY 1 PLANNING

Although a leave vote will not immediately trigger a Brexit, there may be severe implications for insurers in the immediate aftermath of such a vote. Even if the regulator has not required specific contingency planning, insurers should consider prior to the referendum, as part of their risk management framework the immediate risks of a leave vote and prepare appropriate plans to mitigate those risks. Immediate implications are likely to include:

- market turmoil, including a depressed Sterling and Euro and possible credit ratings downgrades for insurers and their counterparties. Insurers should consider the potential impact of market volatility on their investments, capital position, liquidity[2], continuing regulatory compliance and customer sentiment, and identify where it may be possible to implement strategies for mitigating this risk, such as hedging[3];
- impact on M&A and other material transactions. Insurers should ensure that the impact of Brexit is considered as part of due diligence and that the effect of contractual provisions such as MAC clauses, termination triggers and illegality provisions in a Brexit scenario are understood;
- lapse risk and policyholder concerns. Insurers should develop a communications strategy for policyholders who may have concerns about the consequences of a Brexit to mitigate immediate lapse and surrender risk. Communications

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[1] We have set out an in depth critical analysis of the possible outcome of a vote to leave in our Britain and Europe thought leadership page

[2] The Bank of England announced on 7 March that it will offer three additional Indexed Long-Term Repo (ILTR) operations in the weeks around the EU Referendum to assist banks with liquidity which may alleviate some of the risk to liquidity within the financial service industry

[3] Note that the regulator has raised concerns about hedging around the Brexit risk and this should be considered

may also need to extend to material counterparties, such as distributors and reinsurers;

- impact on the regulator. A vote to leave would require the PRA and FCA to focus significant attention on the implications for UK insurance regulation possibly at the expense of their business as usual activities. This may delay or inhibit obtaining approvals for material transactions whether or not Brexit related; and
- withdrawal of investment capacity. Whilst insurers may need additional capital to respond to volatile market conditions such conditions will make it difficult to raise capital. In particular, foreign investment is likely to reduce pending clarity of the position of UK outside the EU.

Planning for Medium to Long Term Impacts

Since the exact impact of a leave vote is as yet unclear it is probably too soon for insurers to be making detailed plans. However it would be appropriate to identify the key aspects of the business which may be affected by the UK being outside the EU and the material risks which will need to be addressed in more detail as the likely relationship with the EU after a Brexit becomes clearer. The key longer term consequences of an exit from the EU for insurers and brokers are likely to include:

- future legal and regulatory changes affecting the risks underwritten and/or the conduct of insurance business; and
- how their existing business and corporate structures may need to be adapted in order to maintain access to relevant markets.

In relation to regulatory changes, we do not expect a Brexit to result in an overall reduction of insurance regulation in the UK. Although the "Leave" campaign frequently highlights the cost and time involved in implementing EU laws as a reason for a Brexit, much of the recent financial services regulation, such as Solvency II, results from or is consistent with PRA initiatives. The UK is also likely to want to achieve "equivalence" under Solvency II (to benefit UK reinsurers of EU risks and UK headquartered groups) and therefore will need to maintain the Solvency II regime. Further, should the PRA wish to be more stringent than Solvency II it would be able to do so once the UK is outside EU.

In relation to maintaining market access across Europe, insurance groups should test their group structures and operations against a scenario where there are no passporting rights for insurers or intermediaries. For example:

- UK insurers and brokers, including UK subsidiaries of third country insurers and brokers, currently passporting throughout the EEA will not be able to underwrite risks from the UK into the vast majority of EEA states as local law often states that a local risk can only be underwritten by an EEA authorised insurer or with the benefit of an EU passport. Writing business through local branches would require local authorisation and capital being deposited to support the branch in some cases.
- EU insurers, for example a French insurer, could write UK risks without a passport provided they do not do so actually in the UK as the UK rules are activity based. If they establish or retain a local branch in UK it would need to be licenced as is currently the case for UK branches of non EU companies; and
- the UK would no longer benefit from treaties between the EU and third countries and so insurers might face new barriers when providing services outside of the EU.

Suggested steps for insurers and brokers when reviewing their structures are set out below:

1. identify where and by which group entity regulated activities are conducted in each of the relevant countries (considering the different jurisdictional approaches to providing regulated services);
2. consider how best to align legal entities with the regulated activities conducted. For example:
   - a UK insurer passporting throughout the EEA may wish to retain its UK insurer for UK business but set up a new European insurer and passport from that into the EEA; and
   - an insurance group with insurers in both the UK and another EEA country (e.g. Ireland) which passports into the EEA out of the UK may decide to set up its passports out of the other EEA country (e.g. Ireland) as well, in order to hedge against the UK passports becoming ineffective after a Brexit.
3. consider the impact of any group changes on where senior

management will need to be based and who the group supervisor would be. Such group changes might also affect other areas such as capital requirements and internal model approvals; and

4. consider methods to achieve any necessary group reorganisation including:
   - the EU cross-border merger mechanism, which broadly speaking, allows recognition of a merger across the EU; and
   - the insurance business transfer mechanism (i.e. under Part VII of the Financial Services and Markets Act 2000 in the UK) which allows EU wide recognition of insurance business transfers,

   these mechanisms, which are convenient because of their recognition throughout the EU, are themselves based on or rely on EU regulations and may no longer be available in the event of a Brexit. Insurers may therefore wish to have plans in place as soon as possible before the potential loss of the relevant mechanisms. In addition such re-organisations will require significant regulatory involvement (whether via change of control applications, applications for the establishment of new entities, informally in cross border mergers, or formally through the Part VII mechanism). Post-referendum, there may well be a queue for approvals which will come at a time when the PRA and FCA are likely to be focused more on the legislative changes needed to maintain Solvency II without being able to rely on EU Regulations which currently have direct effect and would no longer do so after a Brexit; and

5. identify possible alternatives to continue to write business on a cross-border basis, such as making use of the Lloyd's market if Lloyd's is able to secure market wide licencing in lieu of the EU current passport.

These issues will likely be faced most acutely by direct insurers. The consequences for reinsurers may be less severe if they can continue to rely on GATS and equivalence to continue providing services into the EU or from the EU into UK.

Other Brexit Publications by Clifford Chance

We are at the forefront of developments regarding Brexit and are continuously providing commentary and insight, examples of which can be accessed here:

Brexit – assessing the first draft of David Cameron's European Union deal

Brexit: The UK Referendum on EU Membership

OTHER ISSUES TO CONSIDER

- Products – policy terms may become problematic, policyholders' residency will need to be reviewed and the underwriting approach might change. Administering long term contracts outside UK may become difficult if the passport falls away
- Distribution networks - whether or not the UK implements the Insurance Distribution Directive it will lose the benefit of passporting for intermediaries
- Counterparties – effect on material contracts of the changed status of the counterparty and/or the UK party
- Data Protection – UK may choose to implement a less stringent data protection regime, which may be less onerous for the insurance industry but there may be benefits in maintaining the EU approach to avoid impairment of data flow into the UK from the EEA
- Enforcement of judgements – the UK may need to negotiate new treaties on enforcement or potentially risk creating enforcement issues for English judgments in the EU
- Outsourcing arrangements and other material contracts may become unworkable (for example due to EU data privacy laws) and will need to be reviewed including with respect to termination rights
- Employees – uncertainty about status of EU citizens employed in UK and UK citizens employed in EU and possible changes in employment law
- Consequences for Gibraltar whose access to EU is dependent on the U.K and for Scotland which may try to stay in EU

Contacts:

Katherine Coates
Partner

T: +44 20 7006 1203
E: Katherine.coates@cliffordchance.com

Hilary Evenett
Partner

T: +44 20 7006 1424
E: Hilary.evenett@cliffordchance.com

Alex Erasmus
Partner

T: +44 20 7006 1344
E: Alex.erasmus@cliffordchance.com

Ashley Prebble
Partner

T: +44 20 7006 3058
E: Ashley.prebble@cliffordchance.com

Narind Singh
Partner

T: +44 20 7006 4481
E: Narind.singh@cliffordchance.com

Clare Swirski
Partner

T: +44 20 7006 2689
E: Clare.swirski@cliffordchance.com

Cheng Li Yow
Senior Associate

T: +44 20 7006 8940
E: ChengLi.yow@cliffordchance.com