BREXIT: WHAT NEXT FOR THE UK INSURANCE SECTOR?

Following the UK's decision to leave the EU, what can the insurance sector do to protect its interests? This briefing provides a view on how you can contribute to the shape of the negotiations on the industry's future relationship with the European Union and focuses on some short term issues for UK insurers.

This briefing looks at how you might participate in the government's preparations for exit negotiations, and the short term risks for UK based insurers. Please also see our earlier analysis on the Brexit impact on the insurance sector which was published before the Referendum result.

Initial observations

No immediate change: The UK is still part of the EU and so insurers should continue to comply with applicable EU (and domestic) legislation.

UK formal withdrawal: The UK is expected to initiate the withdrawal process by formally serving an Article 50 notice, following which the UK will have two years to negotiate withdrawal before it ceases to be a member of the EU.

The timing of the withdrawal is a political decision and there is currently no clear indication as to exactly when the UK will serve an Article 50 notice on the European Council.

Model agreement: The longer term legal implications for UK insurers and EEA insurers wishing to do business in the UK are dependent on the final model agreed between the UK and the EU. At this point in time there is no certainty as to which type of model the UK wishes to pursue and which type of model the EU will agree to, but the UK will be required to negotiate a single deal with the remaining 27 EU Member States under the EU's common commercial policy.

Whilst it is still an EU Member State, the UK also cannot negotiate or conclude trade agreements with third countries on an individual basis. Easing this restriction ought to be a key point of exit negotiations.

Application of EU law: Whether or not the UK will continue to be bound by EU financial services law (including Solvency II) will depend on the trading model agreed. We refer to our client briefing on alternatives to membership which discusses the pros and cons of alternative models that the UK could adopt.

Some EU Member States have already said that negotiations will be concluded with the UK as a third country and will have to be based on a balance of rights and obligations. It is not clear what this means for negotiations but the UK may have to negotiate a bilateral agreement in the same way as other third countries seeking to trade with the EU.

Single Market access: It has been made apparent by the remaining Member States that they will not accept the UK "cherry-picking" rights to access the Single Market in goods, capital and services without free movement of people. The clear tension between the EU's position and the 'take back control' rhetoric of the Leave campaign will be difficult to reconcile for those negotiating the UK's exit.

Lobbying/Consultation

Government: We understand that the government does not intend to trigger exit negotiations until at least the autumn. In preparation for exit negotiations, the government has established an EU Referendum Unit within the Cabinet Office headed by Oliver Robbins (a Second Permanent Secretary at the Home Office with responsibility for immigration and free movement policy) and a business engagement inter-ministerial group chaired by the Business Secretary Sajid Javid. Oliver Robbins' appointment signals the importance that free movement of people will play in the exit negotiations.

Although there is a great deal of uncertainty about the trading model the UK will seek to negotiate, insurers need to identify their key business concerns and make them known to the government to help develop its Brexit negotiating position for financial services. To influence the negotiating position insurers will need to understand the options under consideration by the EU Referendum Unit and be able to articulate the key areas where insurers need protection and certainty, whilst considering where flexibility and even de-regulation could be achieved. The industry should attempt to agree on the critical longer term issues in order to have more influence in the negotiations.

It is likely the UK will seek equivalence under Solvency II as a third country, so most of Solvency II could remain applicable to UK insurers, although there are areas where change could be made without affecting equivalence criteria. Given the amount of cross-border business, transitional provisions for exit will be critical, ideally with permanent passporting for business already written until it runs-off.

Trade bodies and other insurers: The speed and complexity of negotiations will necessitate a high degree of co-ordination by the industry, even though individual insurers will need to make their own plans and have their own voice. Lloyd's has already made announcements signalling its position on access to the Single Market and that it has been in talks with the government on Brexit issues. Insurers should liaise with their trade bodies and others to promote their own negotiating positions.

FCA/PRA: The FCA and the PRA are shortly expected to organise internal transitional teams consisting of insurance policymakers and lawyers, supported by business analysts to help with the planning process. The teams are likely to report to a separate transitional board, with senior members including directors sitting at the board meetings.

The transitional teams will be focused on developing the regulatory environment on Brexit, and will then seek to oversee the necessary transition by putting in place the appropriate processes, for example grandfathering arrangements.

The PRA and FCA will be closely working with EIOPA and the Treasury on the UK's position post Brexit. Therefore, insurers who wish to influence the UK's policy development and implementation process should engage with their respective supervisory teams and/or PRA/FCA senior officials and set out clearly their views on their essential and non-essential legislative and regulatory requirements post Brexit.

Short term business specific issues

Post referendum, insurers are facing significant uncertainty, creating business critical risks that need managing.

Derivatives/collateral: Short term market volatility will affect derivatives and other collateralised obligations, including reinsurance contracts with collateral structures. Insurers should therefore review arrangements with counterparties to ensure that assets can still meet collateralised obligations.

Financial covenants: Given the recent market volatility, insurers and their counterparties should determine their ongoing ability to give financial covenants, including repeat covenants.

Exposures: The Bank of England has made £250 billion of extra funds available to ease market liquidity concerns which are more likely to affect the banking sector. However, insurers should still review their liquidity positions, credit lines and interest rates and understand exposures relating to these.

Capital requirements: Insurers are expected to be much better capitalised following the implementation of Solvency II. However, insurers should prudently monitor their asset (and liability) values given the resulting implications for their Solvency Capital Requirements (SCR).

Fund redemption: Given market volatility, insurers should check fund documentation to determine the availability of fund redemptions, which could include retail insurance funds, and should specifically determine whether there is any ability to restrict redemption. Standard Life, M&G and Aviva have announced suspension of property fund redemptions.

Communication: Given the current unpredictability of the markets and unfolding political events, insurers should keep communication lines open with policyholders, clients and counterparties. Insurers should also be ready to answer questions from the regulators in relation to their financial health and contingency planning.

Transferability of contracts: With the potential need to split business between UK and continuing EU business, existing contracts should be reviewed for ease of separation and/or transferability and new contracts drafted with potential division and/or transferability in mind; keeping contracts flexible will be critical given the current level of uncertainty.

Investment strategy: Whether there should be an immediate change to an insurer's investment strategy will depend on their current exposure to equity, credit downgrades, interest rates and foreign exchange mismatch, and on their capital position. Any insurer heavily invested in sterling may look to diversify their portfolios by investing in dollar assets or emerging debt. However, following Solvency II insurers should be better placed to withstand the recent financial volatility.

Other issues to consider

Potential regulatory change – there will be Brexit implications for the PRA and FCA, and implications of any divergence from the wider European supervisors/EIOPA.

Outsourcing: Arrangements will need to be reviewed to ensure they are workable following Brexit changes to UK legislation.

Distribution networks: We expect the FCA to implement the Insurance Distribution Directive (IDD) which it is required to do by 2018, but the extent of its transposition will impact both insurers (given the IDD's scope) and intermediaries.

Products: Policy terms including policyholders' residency will need to be reviewed. Administering contracts outside the UK may become difficult if passporting rights are lost.

Data protection: Much of this law is derived from EU legislation and so the UK's approach to this (i.e. whether it will look to equivalence) will need to be closely monitored.

Enforcement: The UK may need to negotiate new treaties on enforcement or potentially risk creating enforcement issues for English judgments in the EU.

Employees: We expect changes in employment in respect of the status of EU citizens employed in the UK and UK citizens employed in the EU.

Tax: There could be changes to withholding tax on dividends and interest and so insurers should consider the impacts on their business models.

Competition: Much of the law is derived from EU legislation so any changes could impact on insurer business structuring and product lines.

How we can help...

Clifford Chance has a dedicated Brexit team monitoring political developments closely and this team works closely with our leading insurance practice to help identify the specific Brexit risks for your insurance or reinsurance business.

We can assist you to manage your Brexit exposure and help in the preparation of a contingency plan.

We also have the experience to help you lobby for post-Brexit arrangements for your sector.

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