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BREXIT: PASSPORTING AND EQUIVALENCE IMPLICATIONS FOR THE UK INSURANCE SECTOR

The implications of Brexit for EEA authorised insurers, reinsurers and intermediaries, including those currently authorised in the UK, will largely depend on the legal agreements governing the basis of the UK's future relationship with the EU. Although these are subject to negotiations, there are some certainties in the UK's favour: a respected regulatory system, the likelihood of securing Solvency II equivalence, and an environment of conservative capital management – all of which make the UK a stable and competitive participant in global insurance markets.

Access to the Single Market for UK authorised insurers, reinsurers, and intermediaries and to the UK market for those authorised in the rest of the EEA will continue until the lapse of the two year exit period following a notification under Article 50 of the Treaty on European Union (TEU) or at an earlier date agreed between the UK and the EU. Article 50 now looks unlikely to be triggered until at least the end of 2016.

Before exit and before the necessary legal agreements are agreed, uncertainty will remain. This briefing note sets out a preliminary view on the potential longer term position in the insurance sector and the factors for insurers to take into account in their contingency planning.

Please see our earlier analysis on the Brexit impact on the insurance sector which was published before the Referendum. Please also see our analysis of shorter term issues faced by insurers following the Brexit vote.

PASSPORTING

Given the size and opportunities in the EU insurance market, post-Brexit the majority of the insurance industry in the UK would ideally wish to keep the right of insurers and reinsurers to passport from the UK into the EEA (and vice versa) by exercise of the freedom to provide services and right of establishment provided by the Treaty of the Functioning of the European Union (TEFU).

However, the continuance of the right to passport would be likely to require participating in the Single Market either as a member of the EU or EEA, accepting the free movement of people and making budgetary contributions and it is unlikely that there would be a public appetite to accept this model even though there has been some discussion amongst EU leaders on permitting a seven year emergency brake on immigration. On this basis, we

believe that firms should assume that the most likely outcome is that there will be in due course some form of bi-lateral agreement between the EEA and the UK but not necessarily with rights akin to existing passporting rights. Insurers should therefore have contingency plans for a loss of these passporting rights and we set out below other possible scenarios for conducting (re)insurance business within the EEA.

THIRD COUNTRY BRANCHES

Solvency II requires undertakings headquartered outside the EU wanting to carry on insurance business (other than exclusively reinsurance business) in the EEA to obtain authorisation as a 'third country branch'. This will mean that if the UK is considered a 'third country' under Solvency II, insurers with a head office in the UK would need to apply for branch authorisation in one or more EEA states. Such undertakings, if they have branch authorisations in more than one member state, can apply for a number of advantages under Solvency II including calculating their SCR in relation to their entire EEA business by taking into account only the operations of branches in the EEA, having one EEA supervisor to monitor solvency and localising assets representing the MCR in one of the member states where they have a branch. Passporting from a single authorised branch is not however currently envisaged under Solvency II.

Should the above position become the default, then the UK will likely need to allow reciprocal access for EEA insurers much as currently is the case for non-EEA insurers.

UK/EEA BASE

On the loss of passporting rights, a UK insurer may wish to retain a UK base to allow access to UK business and, in particular, access to the existing market infrastructure, talent pool and industry expertise, particularly in London. But to benefit from passporting access within the EEA, an insurer will need to set up an EEA base.

Similarly, an insurance group with insurers in both the UK and another EEA country already may wish to duplicate its UK passport rights in the other EEA country in case the UK passport became ineffective.

It may not be possible for such an insurer to retain the present level of UK operations, as the EEA regulator may insist that sufficient management oversight, capital, support-staff and business is based at the EEA insurer. This could pose practical difficulties for firms and it is unlikely that the UK would push for a relaxation of these rules to smooth the transfer because it would likely require similar here for UK authorised business.

Depending on the extent and distribution of its current and anticipated business, an insurance group could (i) rely on reinsuring EEA fronting insurers from the UK; (ii) use the branch procedure in those member states it writes business in; or (iii) set-up an EEA authorised insurer to passport for its EEA business, using a separately authorised UK branch or a separately authorised insurer in the UK for its UK business. The latter two approaches will maintain passporting access to EEA markets but will inevitably represent an increase in the capital and regulatory burden although there are ways to mitigate some of the effects.

FAST-TRACK AUTHORISATIONS

The UK government could potentially push for a deal with the EU allowing

Solvency II passporting

The activity of providing insurance on a cross-border basis within the EEA is described as 'passporting' and, under Solvency II, a (re)insurance undertaking authorised in one member state can provide (re)insurance into another member state either by:

- providing services only (i.e. with no permanent physical presence in the EEA state) – a right provided by Article 56 TEFU;
- setting up an establishment there, usually described as a 'branch' – a right provided under Article 49 TEFU.

A (re)insurance undertaking that has 'passported' by one of the above means, will be supervised in respect of prudential matters by the member state in which it has its head office and is authorised. This is its 'home state' and the member state in which or in respect of which the undertaking exercises its passport is referred to as the 'host state'.

Under Solvency II, a passport is available to insurers carrying on direct insurance business only, or a combination of direct and reinsurance business. To take advantage of Solvency II passporting rights, insurers must comply with prescriptive notifications and rules for the 'general good' in host member states.

A passport is also available to 'pure reinsurers' (that is, reinsurers that only write reinsurance business). The Solvency II Directive does not specify prescriptive notifications for reinsurers who wish to passport under Solvency II, but reinsurers with a branch or who pursue business under the freedom to provide services are still expected to comply with legal provisions applicable to them in the host member state (if any – reinsurance is significantly more lightly regulated in the EEA than direct business).

fast-track authorisation (possibly on a two to three month turnaround depending on resource) throughout the EEA for UK or third-country insurers with PRA-regulated branches or entities in the UK.

The insurer would retain its PRA authorisation and would need to be authorised in an EEA state on a fast-track basis. Such an authorisation should be achievable, particularly if UK regulatory equivalence is accepted. Otherwise (and especially in the absence of any transitional/grandfathering provisions, which may be the more likely approach) EEA regulators could struggle to process a mass influx of requests for normal authorisation from a number of complex financial institutions previously based in the UK.

The UK would no doubt be required to agree a reciprocal arrangement for the fast-track authorisation of EEA insurers into the UK. Therefore, the fast track suggestion could work to the mutual benefit of UK based and EEA based insurers. The fast-track authorisations could potentially also allow for some element of home state supervision in a similar way as with passporting, currently, although this is likely to be more controversial.

The fast track suggestion is loosely based on the Swiss position agreed in a 1991 bilateral agreement (non-life business only) which allows EU insurers to set up a branch or agency in Switzerland (and vice versa, but with the Swiss insurer's application being made to the appropriate EU regulator). The application must detail how the insurer will meet the minimum solvency margin and the home state regulator must also certify that the insurer meets this requirement.

EQUIVALENCE

Should the UK become a 'third country' (i.e. fall completely outside the EU and not pay towards the EU's budget to acquire access to the Single Market) then, in respect of the insurance sector, the UK will wish at least for the Commission to agree UK equivalence under Solvency II.

Equivalence under Solvency II should be distinguished from equivalence under other directives in the financial sector since the effects vary across directives. Under Solvency II, equivalence is not a single determination in relation to a third country's regime and does not provide for passporting rights. Instead it is three separate decisions under the Solvency II Directive:

- Reinsurance (Article 172);
- Group solvency calculation (Article 227); and
- Group Supervision (Article 260).

Each equivalence provision has its own requirements and very specific effects – please refer to our briefing on Solvency II equivalence for further details.

A finding of equivalence would place reinsurance contracts issued by reinsurers in the UK on a similar footing to those issued by EEA reinsurers in terms of capital treatment. Whether a licence would be required to reinsure EEA risks from the UK depends on the relevant member state's rules but many states do permit such cover for reinsurance.

Commission decision

Each of the Solvency II equivalence provisions contains the wording "the Commission may adopt a decision…". In other words, third country access is a gift entirely within the control of the Commission.

The UK has been at the forefront of prudential regulation for insurance and, in some areas, is super-equivalent for Solvency II, e.g. the requirements of the Senior Insurance Managers Regime (SIMR), so it should be in a position to achieve Solvency II equivalence in the three areas mentioned above. Any relaxation which may be made to the UK regulatory regime post-Brexit needs not to impinge on the equivalence criteria in Solvency II.

Additionally, post-Brexit, the UK is unlikely to depart significantly from Solvency II. It is not expected to reduce insurance regulation given the PRA's commitment to robustly pursuing its 'safety and soundness' and policyholder protection objectives.

EXTENSION OF EQUIVALENCE

The UK could seek to extend the Solvency II Directive equivalence provisions to permit passporting access for third countries that are recognised as equivalent at least on a services basis and perhaps limited to institutional policyholders.

The UK, as a current member state, could lobby for this position as could the industry, including many insurers authorised in the other 27 member states. For an amendment to the Solvency II Directive, the European Commission would make a proposal to the European Parliament and the European Council following the Ordinary Legislative Procedure. Those bodies would then vote on the proposal. The Commission would conduct an Impact Assessment (IA) to identify the need to amend the Directive.

EIOPA would likely be heavily involved in advising the Commission during this process and therefore it will be necessary for the PRA (who would need to support this change) to engage with it at an early stage.

An IA may take around one month to complete once formally commenced, but a directive change could take anytime between a few months and several years; however the latter appears more likely given the reluctance by some member states to 'reward' the UK on Brexit.

REORGANISATIONS

Given the potential loss of passporting right, insurers should be planning now for any necessary group reorganisations albeit they would not necessarily wish to implement these until the position is clearer. Leaving the EU will impact on the legislation which currently enables cross-border restructuring of (re)insurance business through the insurance business transfer mechanism (under Part VII of the Financial Services and Markets Act 2000 in the UK), the EU cross-border merger mechanism and migration of companies through the European company (SE) regime.

The above methods are convenient because they are currently recognised throughout the EU. However, should this position change after an EU exit by the UK, then insurers could face complex regulatory issues (e.g. in respect of change in control applications, new authorisations) and longer delays to attain the necessary regulatory approvals. Insurers should lobby for the UK and the rest of the EU to seek to reach an agreement to permit the continuation of cross-border portfolio transfer between the UK and EEA (re)insurers or at least several years' transitional provisions to allow the continuation of cross-border restructuring mechanisms for a period after any UK exit, which would be in the interests of many member states.

FLEXIBILITY

Should the UK leave the EU and EEA (and subject to the desire to achieve equivalence under the three current Solvency II bases), then the government and the PRA will have the legal flexibility - since the UK will no longer be under the direct effect of EU treaties and delegated legislation or under a requirement to transpose directive provisions - to place the UK in a more competitively favourable position (as compared with remaining EU member states) and could speedily act to rectify some of the current difficulties with Solvency II and other EU legislation.

Whilst we would not expect the PRA to change Solvency II significantly, given the significant role of the UK regulator in the formation of the regime, and mindful of equivalence requirements, there are some areas the government or PRA may agree to change. Some examples are below:

Excessive volatility of the risk margin

The calculation of the risk margin under Solvency II is sensitive to current interest rates. This sensitivity has significant absolute and hedging costs for insurers, in particular where there are short term variations in the risk-free rate. On a UK exit, the PRA could be granted the power under UK legislation to modify the risk margin to deliver more stable outcomes and so to support the position of insurers as long term investors.

More tailored capital charges

The Commission has changed the treatment of infrastructure investments through infrastructure project companies under Solvency II and is expected to do this also in respect of infrastructure corporates. On a UK exit, the PRA will not be subject to the Commission's legislative timetable (which can be lengthy) and so could be empowered to impose charges (subject to the position for equivalency) to allow a more tailored treatment for long term investments for UK insurers and so to support economic investment in the UK.

Cumulative effects

The PRA could be empowered to unilaterally rectify balance sheet inconsistencies caused by the derivation of the Ultimate Forward Rate (UFR) under Solvency II. This will allow UK based insurers to benefit (and so to plan accordingly) from a balance sheet that is more reflective of economic reality.

Other areas where the UK may have gone further than the directive strictly requires could be revisited given the government's imperative to increase the competitiveness of the UK particularly in light of the challenges posed by Brexit. It might also be a good time to add a provision for the regulator to at least take into account the need to promote the UK when pursuing its regulatory objectives despite this suggestion having been previously rejected.

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