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Brexit: Implications for the Insurance and Reinsurance Industry

Following the so-called "Brexit" referendum held on 23 June 2016, the UK has narrowly voted to leave the European Union. This note briefly discusses the possible issues arising from the decision for the UK and EU insurance and reinsurance industry. Even in the scenario of a full exit, assuming relevant equivalency decisions are taken by EU authorities for the UK, cross-border reinsurance should generally remain unaffected. Direct insurance businesses should in principle be able to benefit from certain equivalency arrangements as regards group solvency calculations and group supervision requirements, but would not have access to customers in the single market unless they establish a local branch or subsidiary. Insurance sales, mediation and distribution have no third-country access or equivalence regimes, and so UK insurance sales firms will become subject to the national regimes of EU states when marketing there. Were the UK to remain in the EEA, all current passporting rights should be preserved. Insurance businesses in the UK and EU should consider the impact of Brexit and some of the potential structuring solutions discussed in this note.

Introduction

As a result of the 23 June 2016 referendum, the UK has indicated that it intends to trigger Article 50 of the Treaty on the European Union, which would commit the UK to a "Brexit". An in-depth analysis of this and other constitutional issues and the broader impact of Brexit can be found on the Shearman & Sterling Brexit webpage,[1] with our previous client notes on banking,[2] asset management,[3] CFO functions[4] and state aid rules.[5]

This note discusses how possible Brexit scenarios could affect the UK and EU insurance industry. Any Brexit scenario will only come into effect after the Article 50 negotiations are complete, or the two-year exit period expires, which is likely to be in mid-2018 at the earliest. Until then, the existing EU rules and regulations on insurance will continue to apply, including in the UK and for UK businesses accessing the rest of the EU. In this note, we examine the various equivalency regimes available for third-country insurance and reinsurance businesses, because this should set a baseline for worst-case scenarios after any exit and contingency planning. It is also possible that transitional or grandfathering provisions may be agreed which would extend

1 The Shearman & Sterling Brexit resource page is available at: http://www.shearman.com/en/services/key-issues/brexit-what-it-means-for-business.

2 Brexit: Issues for Financial Businesses, 24 June, 2016, available here.

3 UK Votes to Leave the European Union: What Does it Mean for Fund Managers?, 24 June 2016, available here and Brexit for Fund Managers: Time for Cool Heads, 5 July 2016, available here.

4 Brexit and Other Key Issues for CFOs and Corporate Treasurers, 7 July 2016, available here.

5 Brexit: State Aid Implications, 5 July 2016, available here.

many of the existing rules to beyond 2018, but that cannot be assumed. It is imperative that negotiations between the UK and EU are monitored by the insurance sector on an on-going basis to maintain an accurate impact assessment.

Legal Framework

Current EU Insurance and Reinsurance Regime

The EU regulatory regime for insurance and reinsurance is set out in Solvency II,[6] although a number of other European laws also apply or will apply. For instance, the revised and recast Insurance Mediation Directive ("IMD2")[7] covers insurance mediation and is essentially required to be implemented by February 2018, which should be before Brexit takes place.

Like other financial services sector directives and regulations, Solvency II establishes a passporting regime. This enables a regulated insurance or reinsurance entity in one EU Member State to provide insurance or reinsurance-related services into another EU Member State, without being subject to additional regulation in that other state.

Definition of Cross Border Insurance Activity

Solvency II

The definitions in Solvency II of whether a Member State is "hosting" a cross-border insurance or reinsurance service depend on where the risk is located and the type of insurance or reinsurance. For example, the "host" Member State can be: where a building is located for home insurance, the habitual residence of the policy-holder for life insurance, or the Member State where a vehicle or vessel is registered for insurance of the vehicle or vessel.

Insurance Mediation

For insurance and reinsurance mediation and distribution, the home Member State is the jurisdiction of the relevant firm's registered office. The host Member State is the state where the branch from which the services are being provided is located or, when services are being provided cross-border, it is where the services are seen as being provided to customers. The current Insurance Mediation Directive ("IMD1")[8] does not apply to risks or commitments located outside the EU and neither will IMD2.

Other Services

Services which are ancillary to insurance, reinsurance or insurance mediation and distribution may be caught under other legislation, such as the Markets in Financial Instruments Directive ("MiFID," or, from January 2018, MiFID II). Even though such legislation excludes insurance and reinsurance activities, non-insurance activities conducted by insurance or reinsurance affiliates (such as asset management) may be within scope. For more

6 Directive 2009/138/EC.

7 Directive 2016/97/EC.

8 Directive 2002/92/EC.

information on the impact of Brexit in this area of regulation, please see our client notes on issues for financial businesses and on the impact for fund managers.[9]

Post Brexit Access to the EU Insurance Market

There are three main options available for the UK in structuring its relationship with the EU if it ceases to be a Member State:

- New bespoke bilateral agreements that retain freedom of trade and/or establishment, without membership of an existing European bloc. This includes a free trade agreement under the World Trade Organisation framework, which would place the UK in a similar position to that of Canada in its current negotiations vis-a-vis the EU.
- Re-joining the European Economic Area (the "EEA") as an EEA treaty member and joining the European Free Trade Association ("EFTA") (i.e., the Norway, Liechtenstein and Iceland route).
- Joining EFTA and relinquishing membership of the EEA whilst gaining access to the European markets through bilateral agreements (i.e., the Swiss route).

These options are discussed further in our client note on issues for financial businesses.[10]

Scenario 1: Complete Exit from the EU

A departure by the UK from the EU without re-joining the EEA would mean that the UK would not be part of the EU / EEA single market. All EU legislation would cease to apply to the UK at EU level. As a result, the passports for insurance and reinsurance business would cease to be available automatically. Similarly, EU bodies, such as the European Commission and the European Insurance and Occupational Pensions Authority ("EIOPA"), would cease to have competence over UK matters. Instead cooperation arrangements between EIOPA and the UK regulators—Prudential Regulation Authority ("PRA") and Financial Conduct Authority ("FCA")—would need to be established. Any memorandum of understanding will need to consider the position of Lloyd's, which has important regulatory functions in the UK for its market.

Reinsurance

Solvency II provides an alternative access route for reinsurers based in "third countries." Where an equivalence determination is made for the reinsurance regime of a third country, reinsurance contracts entered into with reinsurers from that country are treated in the same manner as contracts entered into with reinsurers operating under Solvency II. A number of non-EU countries with diverse legal traditions and reinsurance legal frameworks have been declared fully or temporarily equivalent: Bermuda, Japan and Switzerland. In our client note on issues for financial businesses,[11] we discuss how the UK may adopt legislation continuing pre-existing EU legislation after a Brexit. It seems likely that all existing EU legislation would have to be grandfathered into UK national law, at least initially. This should lead to a situation where UK laws and EU laws in Solvency II are identical at the point of exit.

[9] Brexit: Issues for Financial Businesses, 24 June 2016, available here, UK Votes to Leave the European Union: What Does it Mean for Fund Managers?, 24 June 2016, available here and Brexit for Fund Managers: Time for Cool Heads, 5 July 2016, available here.

[10] Brexit: Issues for Financial Businesses, 24 June 2016, available here.

[11] Brexit: Issues for Financial Businesses, 24 June 2016, available here, at "Complete Exit from EU."

Given the existing equivalence precedents, it is hardly conceivable that the UK, with a regulatory regime that will at the point of Brexit be pretty much identical in material respects to the EU's, and whose regulators are already working together with their EU counterparts, would not be declared equivalent. Against the backdrop of the time frame for a Brexit and the possibility of granting equivalence on a temporary and provisional basis, equivalence should in principle be established by the time the UK's exit becomes effective.

Insurance

For direct insurance there is no similar equivalence regime for third-country entities. As a result, UK-based insurers would need to establish one or more locally-authorised branches or carriers within the EU to access the market there. As an alternative, the equivalence-based access available for reinsurance means that UK-based insurers should be able to access EU customers by establishing a "pass-through" EU vehicle, with relatively light capitalization and staff, that reinsures all of its risks back to head office.[12] There are also limited equivalence regimes for group supervision and group solvency, discussed below, which would support such a structure.

In terms of EU business into the UK, it is possible that, after Brexit, if there is a reversal of the application of Solvency II in the UK, insurers from EU (and indeed EEA) Member States could write UK risks cross-border without a place of business in the UK. Unlike Solvency II, UK financial regulation tends to be activity-based rather than focusing on the location of the risk being insured.

There are other options too. Some Member States, such as Germany, generally permit so called "home-foreign insurance," on the basis of reverse solicitation. Reverse solicitation occurs when a person based in an EEA Member State takes out insurance with a non-EEA insurer on their own initiative and without being induced by or on behalf of the insurer. The insurer is not regarded as conducting insurance business in the relevant Member State and does not need to establish a branch or obtain authorisation in that state. The "home-foreign insurance" concept may not be a viable business model for a meaningful retail business. However, it does allow some wholesale insurance business to be conducted by third-country insurers. Similar national perimeter rules would need to be assessed for each EU jurisdiction on a case-by-case basis.

Reinsurance and Insurance Groups

Where an EU insurance or reinsurance entity is part of a third-country group, an additional equivalence regime is available for two purposes:

I. Group supervision: Solvency II requires insurance and reinsurance entities that are part of the group to be supervised at group level. Where an equivalence decision determines that the prudential regime for the supervision of insurance or reinsurance entities in the relevant third country where the group's headquarters are located is equivalent to the Solvency II regime, Member States may rely on the supervisory powers of the third-country regulators. An EU insurance or reinsurance entity that is part of a group headquartered in the UK would be able to rely on the UK's group supervision if the UK regime is determined to be equivalent after Brexit. A similar situation arises under the Financial Conglomerates Directive for mixed insurance and other financial groups.

[12] It is possible for solvency purposes for risk exposures to be offset between insurance and reinsurance businesses within the same group.

In the absence of an equivalence determination, Member States would be permitted to apply many of the rules set out in Solvency II directly to a UK insurance or reinsurance entity that is subject to EU group supervision or to agree "other methods" so as to ensure appropriate supervision of the relevant entity within the group. These "other methods" could include agreeing to the establishment of a holding company in the EU. Group supervision for insurance and reinsurance undertakings under the Solvency II regime could then be carried out by cooperation between the regulator of the EU top level company and that of the third-country insurer or reinsurer.

II. Group solvency: for a group with an EU insurer or reinsurer as a parent of a third country insurer or reinsurer, the third country entity would be treated as an EU insurer or reinsurer for the purposes of group solvency under Solvency II. Where an equivalence determination is made for the UK, EU groups which include UK entities would be able to rely on local (UK) capital requirements rather than Solvency II rules in respect of the UK entities as part of group solvency calculations. Where an insurer establishes an EU pass-through vehicle (discussed above), we would expect the UK to establish similar rules to those available under Solvency II to allow for such structures.

Transitional arrangements are available for third countries interested in pursuing equivalence assessments for group solvency and supervision purposes. The regimes in Australia, Brazil, Canada, Japan, Mexico and the USA have already been accepted in whole or in part on this basis. Notably, Switzerland has already achieved full equivalence for group supervision and group solvency. Bermuda has full equivalence also, for insurance (not reinsurance), save for its rules on captives and special purpose insurers.

Supervisory Considerations and Branches

Solvency II further provides that, if establishing branches across multiple Member States, third-country insurers are able to satisfy certain requirements relating to the lodging of assets and holding of capital by complying with the requirements in any one member state, provided that the other relevant supervisory authorities in the EU agree.

Various agreements between EU and UK regulatory and governmental authorities may need to be in place prior to a branch being authorised or a reinsurer being permitted access to EU markets under an equivalence regime. This includes agreements on supervision arrangements and the exchange of information. Solvency II expressly provides for such bespoke bilateral arrangements between the EU and third countries for cross-border insurance and reinsurance regulation, subject to reciprocity conditions being met. This provides an opener for insurance and reinsurance to be part of any new deal that may be agreed between the UK and EU.

Insurance Intermediaries

IMD2 applies to all firms that provide insurance or reinsurance distribution services to third parties. By contrast, IMD1 only applies to insurance brokers and agents. Neither of these Directives covers third-country entities at all and there is no equivalence regime. Insurance and reinsurance sales and distribution by third-country entities is therefore subject to national laws. If the UK leaves the EU and cannot retain any passport for insurance mediation, then insurance sales and marketing firms (or teams) will need again to navigate national Member State laws on access, as was the case before IMD1.

Trade Agreements

Any future trade agreements made bilaterally between the UK and the EU could contain provisions ensuring that each Member State and the UK treat service suppliers and services provided from one another's jurisdiction as favourably as service suppliers and services provided in their own jurisdiction. Similar to the forthcoming trade agreement between the EU and Canada, such a broad obligation might be subject to exceptions whereby a jurisdiction may prescribe formal requirements or regulations (such as authorisation requirements) for the insurance industry, provided that those requirements are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination. Certain types of industry products may also potentially be excluded on a Member State-by-Member State basis. Any such trade agreement should not affect access under equivalence determinations.

Scenario Two: European Economic Area and European Free Trade Association

There are currently four non-EU countries in EFTA—Iceland, Norway, Liechtenstein and Switzerland (the "EFTA States"). Iceland, Norway and Liechtenstein are also members of the EEA (the "EEA EFTA States"). The EEA is made up of the EU member states and the three EEA EFTA States.

Upon exiting the EU, the UK could join EFTA and re-join the EEA as an EEA EFTA State. In terms of substance, most current EU law would continue to apply in a similar manner should the UK become an EEA EFTA State.

Solvency II, IMD1 and IMD2 are EU texts of EEA relevance, which means that they are intended to be implemented in EEA EFTA states. Insurance firms in EEA EFTA states also obtain all the passporting benefits of membership, provided that their state has implemented the relevant legislation into national laws. If the UK re-joined the EEA with the same rights as current EEA members and then adopted Solvency II and IMD2 (IMD1, which has been adopted as EEA text, would be repealed by that time), its insurers and insurance intermediaries would receive full cross-border passporting rights within the EEA as a whole (i.e., including the EU).

Scenario Three: Joining EFTA but Exiting the EEA: the Swiss Model

This would entail the UK becoming an EFTA State and leaving the EEA. Switzerland has opted to be an EFTA State only, and therefore only has partial access to the EU's internal market. Were the UK to adopt this option, it would need to negotiate bilateral agreements with EU Member States (or the EU acting for all Member States). A passport for insurers and reinsurers would not be available. Switzerland entered into an agreement with the (then) European Economic Community regarding non-life insurance in 1991 and, in 2015, its insurance regime was recognised as equivalent under all three Solvency II equivalency regimes.

Conclusion

Irrespective of the agreed model for the future relationship between the EU and the UK, it is likely that UK-based insurers, in particular reinsurers, should have some access to the EU (and EEA) markets and be able to continue to conduct business in Europe. Reinsurers may continue to operate on a cross-border basis if the UK obtains equivalence. In such a case, reciprocity from the UK to EU insurers can be expected. For direct insurance and insurance mediation, the position is more complex. The possibility of using locally established reinsured insurers and relying upon third-country equivalence for group solvency calculations and group supervision arrangements, as well as agreeing a single group supervisor for EEA and non-EEA carriers, means that the practical implications for insurance and reinsurance groups carrying out direct insurance may not be too

onerous. Market participants should closely monitor the negotiations between the UK and EU on an on-going basis to maintain an accurate impact assessment.

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