Brexit Essentials

Brexit and insurers - two years on

28 June 2018

Immediately following the Brexit vote, the key question facing insurers with significant EEA business was whether they would need to carry out a Part VII transfer - or whether a deal would be done to make that unnecessary. Two years down the line there is still uncertainty both over the shape of any final deal and the length and nature of any transitional arrangements. It has also become apparent that there are many other complex questions for insurers arising out of the decision of the UK to leave the EU. In this article we consider some of the difficulties facing firms and what we have all learnt since June 2016.

Continuity of contracts

Despite ongoing lobbying, it is generally accepted that a future arrangement which preserves the ability of financial services firms to "passport" into the UK post-Brexit is unlikely. New business will therefore need to be written out of an EEA entity. Although not entirely straight forward, this is logistically comparatively simple to achieve. More difficult to resolve is how to deal with existing contracts written on a cross-border basis, as we discuss further below.

Would a simpler approach, however, be simply to grandfather all contracts which are already in place? This is what has been proposed by (among others) Insurance Europe, who commented in their March 2018 Brexit Key Messages document that:

> *"Grandfathering existing contracts would offer a permanent solution to ensure that customers can continue to benefit from the contracts they have lawfully entered into until those contracts run off, possible decades after Brexit"*

The UK government appears to have endorsed this approach – in a written statement to the House of Commons in December 2017 the Chancellor of the Exchequer confirmed that the UK would (if necessary) take a unilateral approach to business being written into the UK from the EEA to ensure continuity of financial services, possibly by introducing legislation to put in place a grandfathering regime. To date, however, there has been no suggestion from the EU negotiators that a reciprocal offer will be made. In view of the long-term nature of some policies - where payments could be made decades into the future - it is perhaps unlikely that even if some form of grandfathering is put in place that it will be sufficient to mean other steps need not be taken.

Where are you (actually) carrying on business?

The Solvency II Directive mandates that carrying on insurance business within an EU Member State by any undertaking with a head office outside of the EU must be subject to authorisation by the national competent

authority in that Member State, requiring the establishment of a branch. The Directive does not, however, specify what constitutes the carrying on of insurance business. Views differ between Member States.

In the UK – at least in a pre-Brexit environment – it is unlikely that the mere payment of claims in respect of existing contracts of insurance without a presence in the jurisdiction would be viewed by the regulators as requiring a UK authorisation. By contrast, BaFin has been very clear that this activity would require authorisation in Germany.

Potential issues include:

Issue	Comment
Unified books of business where policies have been sold both into the UK and the EU27	Post-Brexit the policies will need to be serviced in different jurisdictions but this is problematic as it involves splitting the book
Policyholders where the habitual residence is unclear, e.g. a policyholder who spends equal amounts of time resident in the UK and Spain	It may be unclear whether the policies should be serviced in the UK or EU after Brexit
Policyholders who move after purchasing a policy	This may mean that an entirely UK business could have policyholders in the EU27 even though it has not marketed any policies outside of the UK (and vice versa). This problem will continue after Brexit and makes it difficult to put in place a structure to address all eventualities

On the whole, insurers with material EU business are taking a cautious approach and arranging for transfers of relevant policies as best they can. UK firms with insignificant amounts of business in the EU are more likely to take a pragmatic approach to ongoing servicing of EU-based contracts rather than attempting a restructuring.

Outsourcing and reinsurance

Some firms may plan to outsource key functions, including underwriting decisions in respect of EU policyholders, back to the UK following a Part VII transfer. In its 2017 opinion on supervisory convergence in the light of Brexit, EIOPA expressed some concerns about this type of outsourcing – commenting, in particular, that outsourcing should not be allowed to deplete the corporate substance of the firm and that undertakings with complex risk profiles or a large scale of business should not be permitted to outsource a "significant part" of their key functions.

There is additionally a risk that EEA regulators may consider the outsourcing of underwriting decisions to the UK to involve carrying on insurance on a cross-border basis, particularly if the PRA requires a third country branch to be put in place. Whether or not a UK branch of an EEA insurer can benefit from the

passporting rights of the EEA entity remains uncertain – some EU regulators have expressed the view that it cannot but EIOPA has so far been silent on the point.

Firms may also wish to reinsure business back to the UK from a newly established EEA insurer. The EIOPA opinion suggests that there should be a minimum retention of 10% of business written, although there is no basis for this in the Solvency II Directive. For life business, where insurers are seeking to preserve the integrity of a with-profits or other fund, this approach is likely to cause significant problems. It is therefore hoped that regulators will take a pragmatic view in the application of the guidance.

Location of the risk or location of the policyholder?

For non-life business, the risk being insured may not be located in the same jurisdiction as the policyholder. It is therefore important to establish where the business is being carried on in these cases in order to ensure that a geographically-appropriate authorisation is in place. It may be necessary to have authorisation in both jurisdictions. Where one of these is the UK, questions may still arise regarding whether business is being conducted on a cross-border basis (see above). Particular problems are likely to arise where a customer – e.g. a multinational company - wishes to take out a single policy in respect of risks located in multiple jurisdictions. This might typically apply, for example, for group property insurance policies.

Policyholder protections

Loss of FSCS and FOS coverage

The Solvency II Directive provides for harmonised standards of prudential regulation of insurers across the EU. It does not, however, include a requirement for policyholder protection in the form of "insurance guarantee schemes" ("IGS") or similar arrangements. The European Commission published a white paper in 2010 which proposed introducing a Directive to ensure that all Member States had an IGS, meeting certain minimum requirements, but that proposal was not taken forward. A review undertaken for the Commission in 2007 identified that at that time only 13 of the then 27 EU Member States operated an IGS, of which only six covered both life and non-life insurance.

The lack of harmonised protection is a potential issue for UK insurers carrying out Brexit-related Part VII transfers. Although the Solvency II Directive requires mutual recognition of portfolio transfers carried out in other Member States, it does not (at least not explicitly) require Member States to sanction transfers of insurance portfolios on a cross-border basis. It has recently become clear that the UK regulators – in particular, the FCA – are far from comfortable about transfers which involve UK long-term insurance customers ceasing to benefit from the protections specifically afforded by the UK regulatory regime. These concerns have been expressed in both the recently finalised FCA guidance on its approach to the review of Part VII insurance business transfers (FG18/4) and in private communications with firms carrying out Brexit-related transfers. Key issues highlighted in FG18/4 and other communications include:

The FCA expects Applicants to aim to preserve access to the Financial Ombudsman Scheme as far as possible to avoid any loss of protections, in the context of Brexit at least until the point of policy renewal
The FCA expects the Independent Expert to consider the impact on policyholders of loss of access to the FSCS, including whether mitigations are in place. Although the capital position of the Transferee may be a relevant consideration, it expects that firms will need to provide evidence of

why it is unlikely that the Transferee will default before the time when policyholders have to claim on their policies
The FCA would like Brexit-related Schemes to include a commitment for the Transferee to comply with the requirements of the Dispute Resolution part of the FCA Handbook and other relevant standards, e.g. COBS 20, where local law does not have equivalent standards
The FCA would like a commitment that the UK regulators will be notified of proposed changes to the Scheme post-transfer, notwithstanding that the Transferee will not be a UK-regulated entity

In view of the harmonisation of prudential requirements provided by the Solvency II regime, there is an argument that the FCA's cautiousness over transfers of business out of the UK to other EU jurisdictions is unjustified. The EU has not to date chosen to make mandatory the provision of schemes fully equivalent to the UK FOS and FSCS but it has compelled all insurers to hold a minimum level of capital to support their policyholder liabilities.

EIOPA opinion on notifications to customers

Separately, it is worth noting that both the European Commission and EIOPA have published opinions on the need for firms to make appropriate notifications to their customers regarding the impact of Brexit on their contracts. As previously noted in our March newsletter, the European Commission's 8 February notice to stakeholders suggested that the Solvency II Directive requires firms to inform policyholders about the impact of Brexit on their rights and on the provision of services, although it is not clear that there is such an obligation under the directive. On 28 June EIOPA published an opinion on disclosure of information to customers regarding Brexit. EIOPA does not cite any specific provisions in support of its opinion but refers more generally to each of the Solvency II Directive, Insurance Mediation Directive and Insurance Distribution Directive.

In the opinion, EIOPA states that customers with existing contracts should be informed about how any relevant contingency measures taken by the insurer will impact their contractual relationship and services to them. Examples given include where there will be a change in counterparty or a change or loss of protection provided by an existing national compensation scheme following a transfer of business and tax implications where an entity is relocated to a different jurisdiction. Potential new customers should also be informed of the possible impacts of Brexit on their rights and the provision of services to them.

In practice where a Part VII transfer is being carried out the policyholder communications are likely to cover the information specified by EIOPA. In other circumstances it is less clear what the most appropriate way will be to communicate with customers.

HMT, PRA and FCA approaches to financial services legislation under the EUWA

The European Union (Withdrawal) Act (the **"EUWA"**) received royal assent on 27 June and on the same date HM Treasury published its approach to financial services legislation under the EUWA.

The EUWA gives ministers the power to prevent, remedy or mitigate any failure of retained EU law to operate effectively, or any other deficiency in retained EU law, through statutory instruments (SIs). The power is subject to a number of restrictions including a time limit of two years after exit day. In the approach

document HMT confirms that it intends to delegate some of these powers to the PRA and FCA to address (i) deficiencies in their rulebooks arising as a result of exit and (ii) deficiencies in the binding technical standards which will be part of the retained EU law. Exercise of these powers will be subject to HMT approval. The regulators will also be given powers to introduce transitional measures which will, in particular, give firms more time to make changes if no deal is reached with the EU.

HMT emphasises that firms can and should continue to plan on the assumption that there will be an implementation period in place from 29 March 2019 until December 2020 which will allow them to continue to do business on the same basis as now. It also confirms that it will prepare to introduce a temporary permissions regime to apply if no deal is reached (as previously announced in December 2017). In practice most firms are continuing to plan on a worst case scenario notwithstanding this and similar previous statements to the same effect.

HMT intends to begin publishing the financial services "onshoring" SIs in the near future, beginning with those dealing with the temporary permissions regime and the sub-delegation of powers to the PRA and FCA. Some other SIs will be published as drafts over the summer, with a view to being laid before Parliament in the autumn. It is not entirely clear the extent to which these will constitute consultations – HMT comments that the SIs will be published as drafts "to give stakeholders an opportunity to engage and familiarise themselves with the draft provisions".

The FCA and the Bank of England have also published statements on their role in preparing for Brexit. In its statement the FCA comments that it expects to consult on Brexit-related handbook changes in the autumn. The Bank has just said it will consult once HMT has published relevant SIs.

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