

# Legal and Regulatory Implications of Brexit for the Insurance Industry

Presentation to AIDA

13 April 2018

Steven McEwan, Hogan Lovells

# Introduction

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- Summary of current status of legal developments on Brexit
- Key risks and uncertainties
- Opportunities
- Impact on different types of insurers and intermediaries
- Q&A and discussion

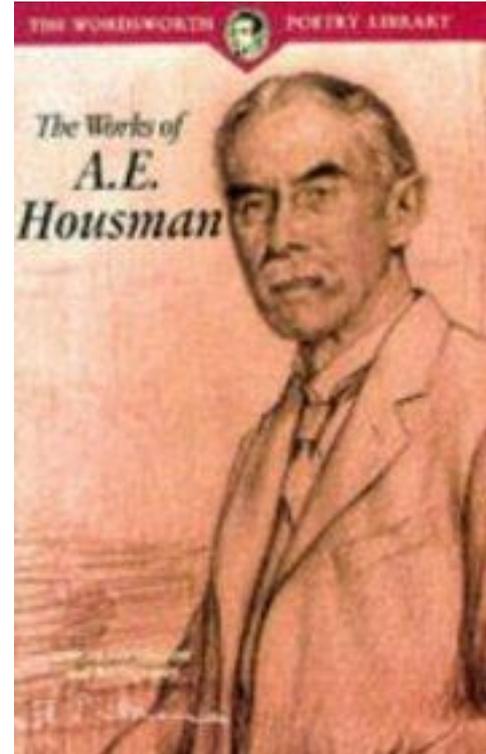
# Brexit poetry ?

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A.E. Housman, *A Shropshire Lad*, 1896

INTO my heart an air that kills  
From yon far country blows:  
What are those blue remembered hills,  
What spires, what farms are those?

That is the land of lost content,  
I see it shining plain,  
The happy highways where I went  
And cannot come again



# Brexit poetry ?

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Robert Burns, *Ae Fond Kiss*, 1791

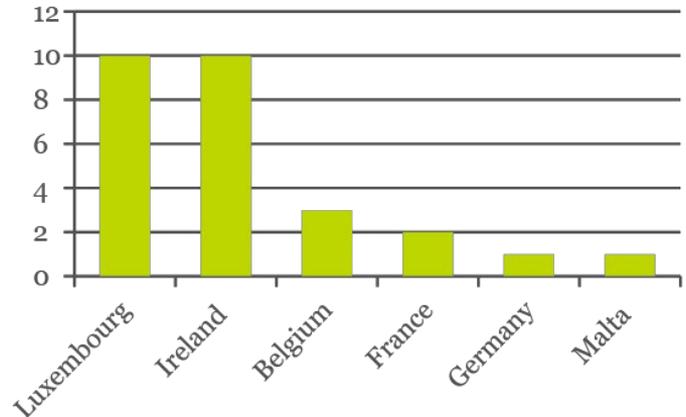
AE FOND KISS, and then we sever;  
Ae fareweel, alas, for ever!  
Deep in heart-wrung tears I'll pledge thee,  
Warring sighs and groans I'll wage thee.  
Who shall say that Fortune grieves him,  
While the star of hope she leaves him?  
Me, nae cheerful twinkle lights me;  
Dark despair around benights me.



# Some statistics

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- Recent London Market Group reports stated that
  - £8 billion of premium is brought annually to the London Insurance Market by brokers on behalf of EU customers
  - £6 billion of international business is written in London by firms with a parent company or principal base located elsewhere in the EU
  - A total of US\$432 billion of non-life GWP (21% of worldwide non-life GWP) was written in the EEA (other than the UK) in 2015
- 27 insurance groups have announced plans to establish subsidiaries elsewhere in the EEA as a result of Brexit:



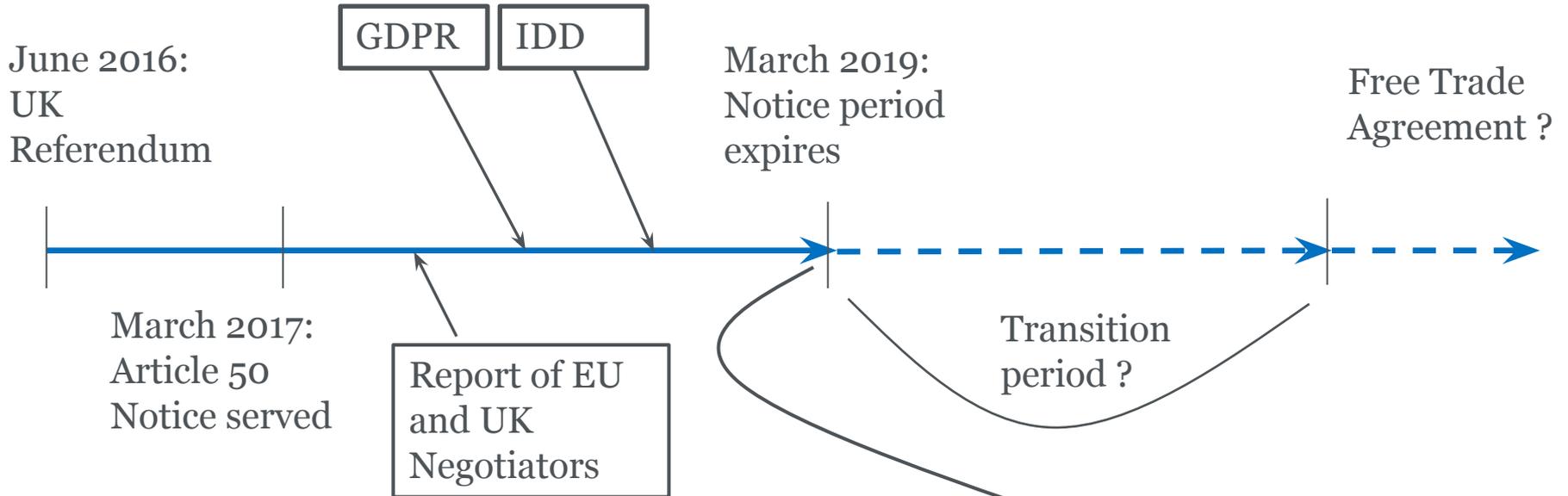
Source: Hogan Lovells research of publicly available information

# Some key areas of uncertainty

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- Will it be legal to pay out claims on a contract that was entered into before Brexit ?
- What about communications with the policyholder, and amendments ?
- Will a new authorisation be required following Brexit ?
- Will it be sufficient to have an existing branch authorised, or will it be necessary to set up a new subsidiary ?
- If it's a new subsidiary, what happens to the old business ?
- Will the UK be "equivalent" under Solvency II following Brexit ?
- Will there be a Free Trade Agreement covering insurance ? If so, what might it say ?
- What will happen to community co-insurance ?

# Status



"agreed by the UK on the condition of an overall agreement under Article 50 on the UK's withdrawal, taking into account the framework for the future relationship, including an agreement as early as possible in 2018 on transitional arrangements"

European Union (Withdrawal) Act takes effect

# Article 50 Notice

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- **Treaty on the European Union**

## Article 50

1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.

2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.

3. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.

4. For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it.

A qualified majority shall be defined in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.

5. If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article 49.

# Article 127 Notice ?

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- **EEA Agreement**

## **Article 127**

Each Contracting Party may withdraw from this Agreement provided it gives at least twelve months' notice in writing to the other Contracting Parties.

Immediately after the notification of the intended withdrawal, the other Contracting Parties shall convene a diplomatic conference in order to envisage the necessary modifications to bring to the Agreement.

- The UK is a Contracting Party in its own right

# Gibraltar

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- **Treaty on Functioning of European Union**

**Article 355(3)**

The provisions of the Treaties shall apply to the European territories for whose external relations a Member State is responsible.

**Declaration 55. Declaration by the Kingdom of Spain and the United Kingdom of Great Britain and Northern Ireland**

The Treaties apply to Gibraltar as a European territory for whose external relations a Member State is responsible. This shall not imply changes in the respective positions of the Member States concerned.

- See also decision of CJEU of 13 June 2017, deciding that activities between Gibraltar and the UK were within a single EU member state

# European Union (Withdrawal) Bill

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- **Clause 1:** Repeal European Communities Act 1972
- **Clause 2:** UK laws that are EU-derived apply after exit day
- **Clause 3:** Most forms of directly applicable EU law are automatically incorporated as UK law on exit day (to extent "in force" and "applying")
- **Clause 4:** Preserve the effect in UK law of existing rights, powers, liabilities etc. notwithstanding change to legal basis
- **Clause 5:** EU law still relevant to interpretation of laws passed or made before exit day
- **Clause 6:** No further references by UK courts to CJEU

# European Union (Withdrawal) Bill

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- **Clause 7:** Power to make regulations the Minister considers appropriate to deal with "deficiencies" in retained EU law, within 2 years of exit day

Nationalising  
the "acquis"

House of Lords wants to  
change this to "necessary"

- **Clause 8:** Regulations to comply with international obligations
- **Clause 9:** Power to make regulations the Minister considers appropriate for purposes of implementing the withdrawal agreement, but only before exit day  
Government defeated  
on Wednesday

- **Clause 17:** Power to make regulations the Minister considers appropriate to make transitional provisions

# Amendments to the Bill (1)

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## 7 Dealing with deficiencies arising from withdrawal

7 (2) Deficiencies in retained EU law ~~are include (but are not limited to)~~ where the Minister considers that retained EU law— ...

7 (3) There is also a deficiency in retained EU law where the Minister considers that there is—

(a) anything in retained EU law which is of a similar kind to any deficiency which falls within subsection (2), or

(b) a deficiency in retained EU law of a kind described, or provided for, in regulations made by a Minister of the Crown.

# Amendments to the Bill (2)

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## 9 Implementing the withdrawal agreement

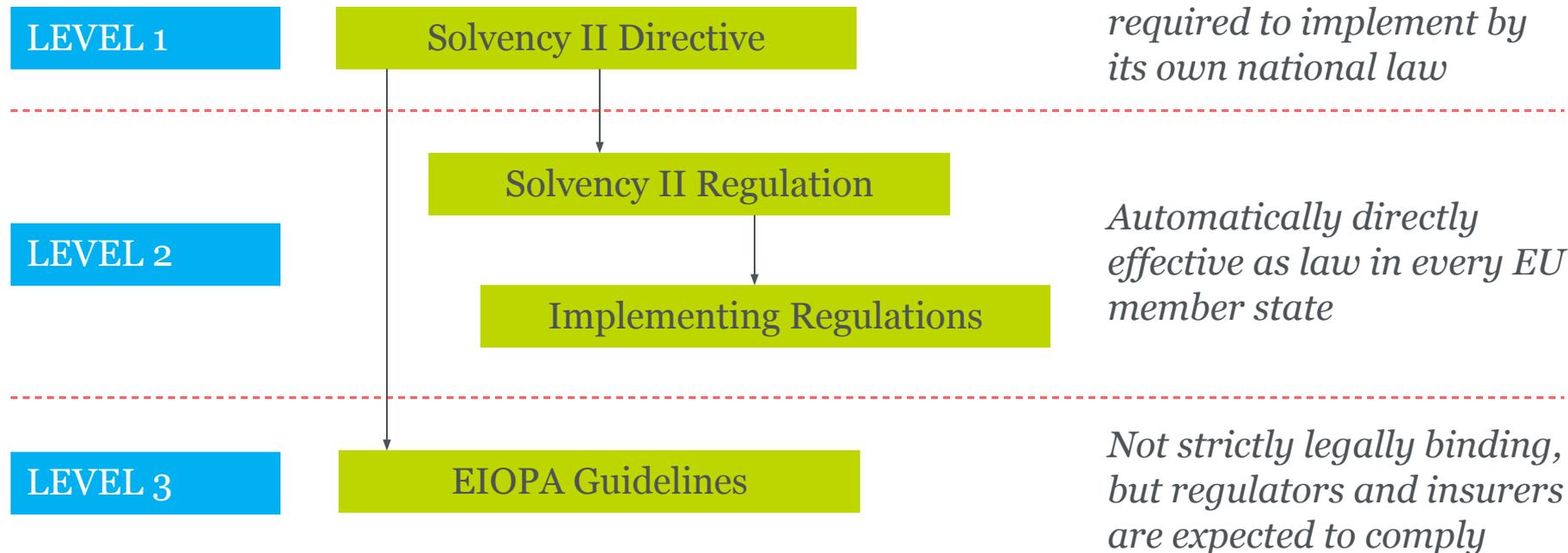
(1) A Minister of the Crown may by regulations make such provision as the Minister considers appropriate for the purposes of implementing the withdrawal agreement if the Minister considers that such provision should be in force on or before exit day, subject to the prior enactment of a statute by Parliament approving the final terms of withdrawal of the United Kingdom from the European Union.

## 14 Interpretation

“exit day” means ~~such day as a Minister of the Crown may by regulations~~ Appoint 29 March 2019 at 11.00 p.m. (and see subsection subsections (2) to (5));

# Solvency II regulatory framework

- EU insurance regulatory framework



# Passporting

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- Two forms of passporting
  - Freedom of establishment: Article 49 of Treaty on Functioning of European Union
  - Freedom of services: Article 56 of Treaty on Functioning of European Union
- These provisions apply to "nationals" of a Member State of the EU
- Article 54 of the Treaty on Functioning of European Union extends these provisions to "**companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union**"
- Similar provisions in the EEA Agreement extend to the EEA countries (Iceland, Norway and Liechtenstein)
- Incorporated into Solvency II, Insurance Mediation Directive and Insurance Distribution Directive, with further procedural provisions
- But they do **not** apply to branches of third country insurers / reinsurers / intermediaries, even if the third country is "equivalent"

# "Third" countries

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- Third country undertaking: Solvency

**Solvency II**, Article 13(3):

"third-country insurance undertaking" means an undertaking which would require authorisation as an insurance undertaking in accordance with Article 14 if its head office were situated in the Community

- Following implementation of Brexit, and in the absence of other agreement:
  - The UK will be a "third country" with respect to the countries of the EEA
  - Each country of the EEA will be a "third country" with respect to the UK

**Or might the UK regard the EEA as a whole as a third country?**

# Authorisation under Solvency II

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- **Article 1:**

This Directive lays down rules concerning ... the **taking-up** and **pursuit**, within the Community, of the self-employed activities of direct insurance and reinsurance; ...

- **Article 2:**

1. This Directive shall apply to direct life and non-life insurance undertakings which are established in the territory of a Member State or which wish to become established there.

It shall also apply to reinsurance undertakings which conduct only reinsurance activities and which are established in the territory of a Member State or which wish to become established there with the exception of Title IV.

- **Article 14:**

1. The **taking-up** of the business of direct insurance or reinsurance covered by the Directive shall be subject to prior authorisation.



**What about  
run-off only ?**

- **Article 162:**

1. Member States shall make **access to the business** referred to in the first subparagraph of Article 2(1) [**direct insurance business**] by any undertaking with a head office outside the Community subject to an authorisation.

2. A Member State may grant an authorisation where the undertaking fulfils at least the following conditions:

- (a) it is entitled to pursue insurance business under its national law;
- (b) it **establishes a branch** in the territory of the Member State in which authorisation is sought; ...

# Authorisation under Solvency II

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“a third country insurance undertaking may only insure risks located in a member state through a branch authorised by the competent supervisory authority of that member state”;

**European Commission:** minutes of meeting on the “Expert Group on Banking, Payments and Insurance”, July 2015 (commenting on Article 162)

This view is disputed:

- It is not the UK interpretation, which permits direct insurance by third country insurers provided they do not "carry on insurance business" in the UK ("**activity based**" approach)
- Other EU countries (eg France and Spain) apply it more literally and only permit direct insurance by third country insurers if they have a branch authorised in that country ("**location of risk**" approach)

# What does this mean for insurers after Brexit ?

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Assuming the UK incorporates Solvency II rules unchanged and treats EEA countries as "third countries" and EEA countries treat the UK as a "third country":

- If EEA insurers wish to "carry on insurance business" in the UK, they will need to establish a branch and have it authorised in the UK
- The same will apply to EEA pure reinsurers: although Article 162 of Solvency II is silent on pure reinsurers, the PRA has applied the same rules to branches of pure reinsurers (see rule 15.1 of "Third Country Branches", PRA Rulebook)
- However, if they do not "carry on insurance business" in the UK, they will not require an authorisation – see next slide
- UK insurers which wish to provide insurance to policyholders in EEA countries which adopt the "location of risk" interpretation of Article 162 will need to establish a branch in the relevant country
- Since third country branches cannot passport under Solvency II, a separate branch and a separate authorisation will be needed in each such country

# "Carrying on insurance business" in the UK

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- Under the Financial Services and Markets Act 2000 (Regulated Activities Order) 2001, the relevant regulated activities are:
  - Effecting contracts of insurance
  - Carrying out contracts of insurance
- Applies irrespective of the location of the policyholder
- Various cases have interpreted quite widely:
  - *Stewart v Oriental Fire and Marine Insurance Co Ltd.*
  - *Re Great Western Assurance Co SA and ors.*
  - *DR Insurance Co v Seguros America Banamex.*
- Includes sourcing business, selecting opportunities for consideration, negotiating terms, binding risks, paying claims and amending contracts.
- But not mere representative office in the UK, and not activities outside the UK.



**So an insurer operating within the UK would be caught even if all its policyholders were outside the UK**

# Authorisation under IDD

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## Article 1

1. This Directive lays down rules concerning the taking-up and pursuit of the activities of insurance and reinsurance distribution in the Union.

2. This Directive applies to any natural or legal person who is established in a Member State or who wishes to be established there in order to take up and pursue the distribution of insurance and reinsurance products.

6. This Directive shall not apply to insurance and reinsurance distribution activities in relation to risks and commitments located outside the Union.

This Directive shall not affect a Member State's law in respect of insurance and reinsurance distribution activities pursued by insurance and reinsurance undertakings or intermediaries established in a third country and operating on its territory under the principle of freedom to provide services, provided that equal treatment is guaranteed to all persons carrying out or authorised to carry out insurance and reinsurance distribution activities on that market.

This Directive shall not regulate insurance or reinsurance distribution activities carried out in third countries.

**So each member state can make its own rules concerning third country intermediaries operating on its territory**

# What does this mean for intermediaries after Brexit ?

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Assuming the UK keeps the IDD rules unchanged and treats EEA countries as "third countries" and EEA countries treat the UK as a "third country":

- If EEA intermediaries wish to carry on insurance distribution in the UK, they will need to establish a branch and have it authorised in the UK
- The same will apply to EEA reinsurance intermediaries
- However, if they do not "carry on insurance distribution" in the UK, they will not require an authorisation – see next slide
- UK intermediaries which wish to be "established" in another EEA country will need to establish a branch and obtain authorisation under IDD
- Since third country intermediaries cannot passport under IDD, a separate branch and a separate authorisation will be needed in each EEA country where the intermediary wishes to be established
- UK insurers which wish to operate in other EEA countries without establishing a branch will need to comply with the laws of each relevant country

# "Carrying on insurance distribution" in the UK

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- An EEA intermediary will require authorisation in the UK if it carries on insurance distribution in the UK
- UK law will copy the IDD definition of "insurance distribution":
  - the activities of advising on, proposing, or carrying out other work preparatory to the conclusion of contracts of insurance, of concluding such contracts, or of assisting in the administration and performance of such contracts, in particular in the event of a claim, including the provision of information concerning one or more insurance contracts in accordance with criteria selected by customers through a website or other media and the compilation of an insurance product ranking list, including price and product comparison, or a discount on the price of an insurance contract, when the customer is able to directly or indirectly conclude an insurance contract using a website or other media

# Consequences of not being authorised

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- It is a criminal offence under section 19 of FSMA to carry on a regulated activity in the UK without being an authorised person or an exempt person (the "**general prohibition**")
- If it is the insurer who is not authorised then contracts entered into in breach of the general prohibition are unenforceable by the insurer under section 26
- If it is the intermediary who is not authorised (but the insurer is authorised) then the contract is unenforceable by the insurer under section 27

**Illegality is no defence**

- In either case the policyholder is able:
  - to enforce the contract against the insurer; or
  - recover any money or property paid under the contract and compensation for having parted with it

**UK insurers need to check that any intermediaries who are currently passporting obtain authorisation**

# Options for EEA (re)insurers currently operating in the UK

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- Option 1: Obtain authorisation for an existing UK branch into which the (re)insurer is currently passporting
- Option 2: Establish a new UK branch, and have that authorised
- Option 3: Establish a new UK subsidiary, and have that authorised, then transfer the existing UK business into it under an insurance business transfer scheme
- Option 4: Stop writing new business in the UK and transfer all existing UK business to another insurer which is already authorised in the UK
- Option 5: Stop writing new business in the UK and conduct the run-off of the business from outside the UK (questionable)

# Options for UK (re)insurers currently operating in the EEA

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- Option 1: Obtain authorisation for each existing EEA branch into which the (re)insurer is currently passporting
- Option 2: Establish a new branch in each EEA country into which the (re)insurer is currently passporting, and have each branch authorised
- Option 3: Establish a new subsidiary in one EEA country, and have that authorised, then transfer the existing EEA business into it under an insurance business transfer scheme:
  - the new subsidiary can then passport into each other EEA country under Solvency II, without needing additional branches
- Option 4: Stop writing new business in the other EEA countries and use an insurance business transfer scheme to transfer all existing EEA business to another insurer which is already authorised in the EEA
- Option 5: Stop writing new business in the EEA and conduct the run-off of the business in compliance with law (questionable)

# Options for UK (re)insurers currently operating in the EEA

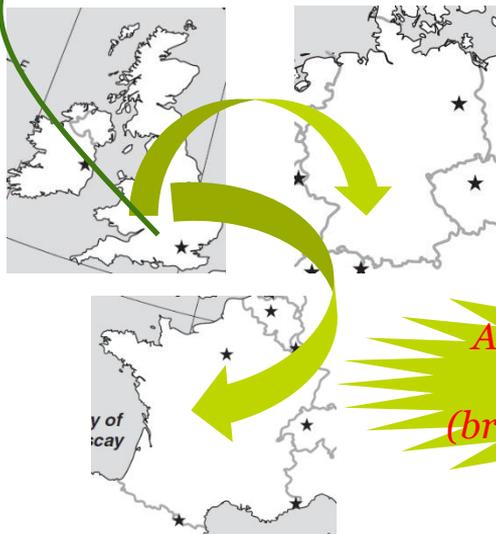
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- Option 6: Convert the UK company to a plc then use an SE merger to change the registered office of the company to another EEA country, then establish a UK branch of that company and have it authorised
  - the company can then passport into each other EEA country under Solvency II, without needing additional authorisations
  - only the SE merger process is needed, without an insurance business transfer scheme
  - company must have had a subsidiary somewhere in the EEA for at least two years

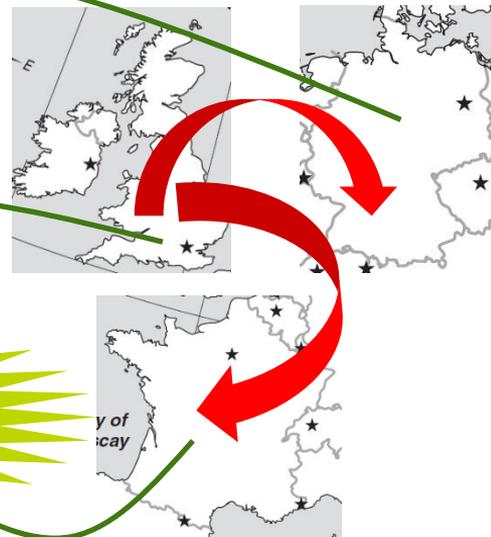
# Passporting

*Authorisation and prudential regulation only in UK*

UK still in the EEA



UK out of EEA



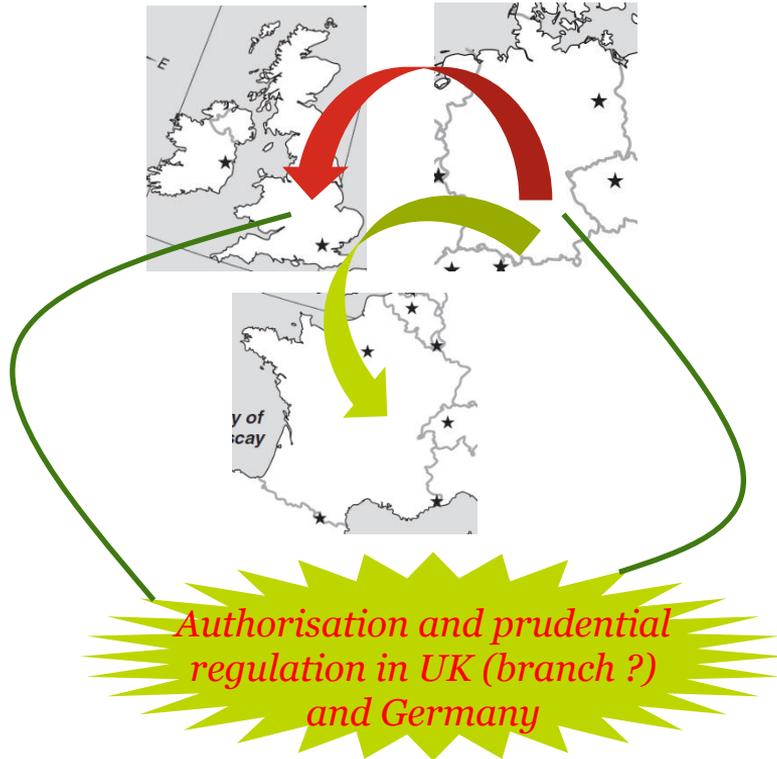
*Authorisation and prudential regulation in UK, France (branch) and Germany (branch)*

UK insurer passports into France and Germany though local branches German branch; authorisation and prudential regulation all by the UK regulator

Each branch requires authorisation by the local regulator as a branch of a third country insurer

# Restructuring to facilitate passporting

## Possible restructuring



Establish German insurer which passports into Germany under Solvency II, and establishes a UK branch under UK rules governing establishment branches of third country insurers

What about existing business ?

- Reinsurance
- Transfer of business to German insurer under Part VII
- Convert insurer to Societas Europaea (SE) and transfer registered office

# Community co-insurance

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- Article 190 of Solvency II allows a pool of EEA insurers to act together as co-insurers of "large risks"
- Provided the conditions are satisfied, only the lead insurer needs to following the passporting process into the host jurisdictions
- Following insurers do not need to passport or obtain authorisation

## After Brexit:

- Where a UK insurer is a following insurer, it will no longer be able to rely on Article 190, and would have to be authorised in the host jurisdiction
- Where the UK insurer is the lead insurer, none of the following insurers would be able to benefit from Article 190

# Financial promotions

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- Laws also restrict the making of financial promotions in various countries
- These rules are **not** harmonised across the EEA, so the position has to be understood in each jurisdiction
- Exemptions apply for authorised insurers and intermediaries (both UK and those passporting under IMD / IDD)
- The rules seem to provide an exemption for financial promotion of general insurance products by non-EEA insurers and intermediaries, which seems illogical

See "A Critique of the Territoriality Rules apply to UK Insurance Regulation: Part I", Jonathan Goodliffe, BILA Journal No. 130, October 2017

- This may be a "deficiency" that the government will correct as part of Brexit



**Will the exemption apply to an EEA intermediary following Brexit ?**

# Equivalence

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- "Equivalence" for third country regimes under Solvency II
  - Article 172: Reinsurance solvency
  - Article 211 (of Solvency II Regulation): ISPV supervision
  - Article 227: Group solvency calculation (for deduction and aggregation method)
  - Article 260: Group supervision
- No corresponding "equivalence" provisions apply under IDD
- Equivalence does not give rise to passporting rights for third country firms

# Equivalence decisions made under Solvency II

Jurisdiction	Art 172 (Reinsurance)	Art 227 (Group solvency)	Art 260 (Group supervision)
Switzerland	Yes	Yes	Yes
Bermuda *	Yes	Yes	Yes
Japan	Temporary (5 years)	Provisional (10 years)	
USA		Provisional (10 years)	
Australia		Provisional (10 years)	
Brazil		Provisional (10 years)	
Canada		Provisional (10 years)	
Mexico		Provisional (10 years)	

\* Apart from captives and SPVs

**Will the UK be equivalent ?**

# What might change

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- Depends on model – see next slide
- Key areas of interest:
  - Passporting
  - Equivalence
  - Group supervision
  - Risk margin
  - Matching Adjustment
  - Internal model approvals
  - Standard formula
  - Authorisation of insurers
  - Authorisation of branches of third country insurers, including of EU insurers



*These are areas where extra flexibility might be welcomed by the UK, but where using that flexibility might prejudice the chances of passporting or equivalence*

# What might the UK agree?

Regime	Passporting	Influence over EU legislation	Comment
EEA (Norway Model)	Yes	Consultation rights – no veto	Retains access to EEA Market Requires free movement of persons Potentially quickest to implement
Co-operation Agreements (Swiss Model)	Depends on what is negotiated	No	Passporting conditional on free movement of persons?
Comprehensive Free Trade Agreement	Depends on what is negotiated	No	Time consuming to negotiate Passporting conditional on free movement of persons? Impact on Most Favoured Nations clauses in existing free trade agreements
Reliance on WTO rules	No	No	

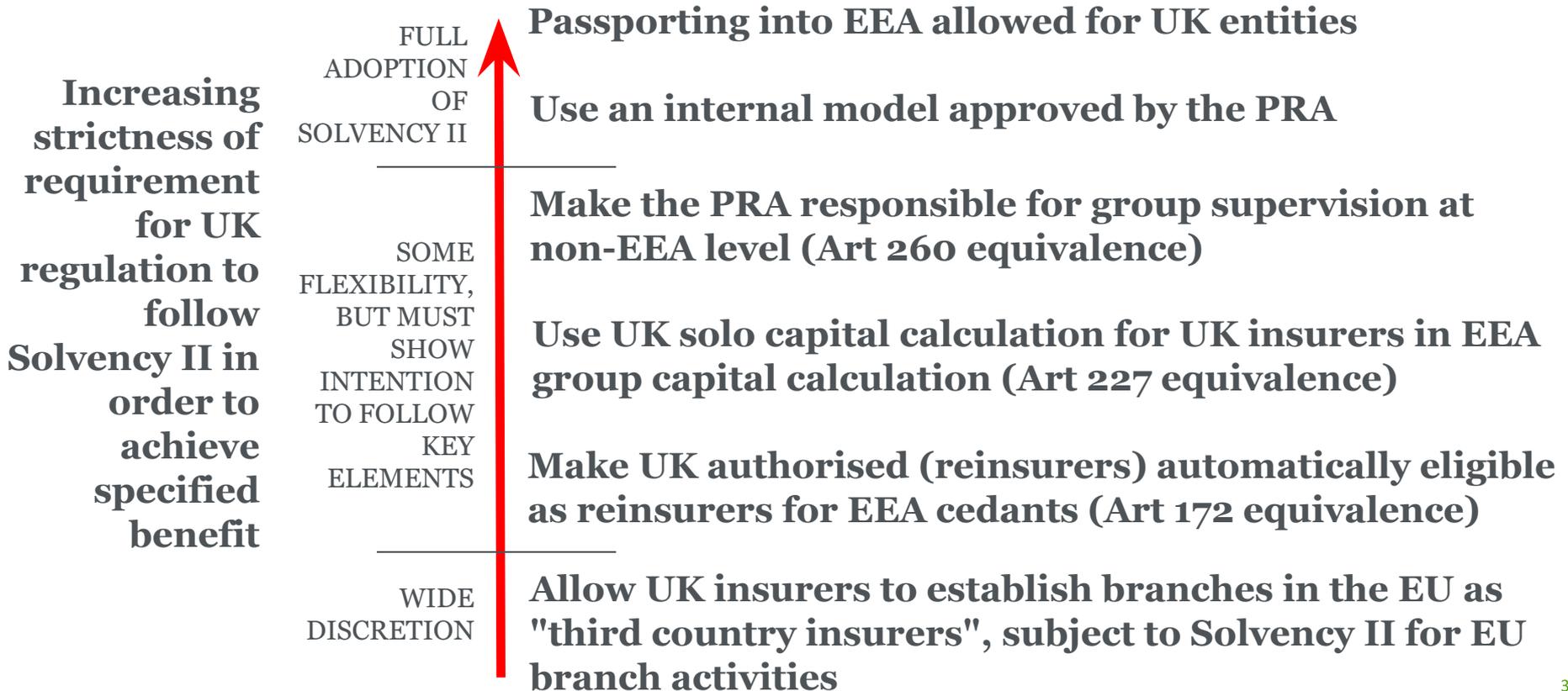
# Risk margin

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"The calculation of the risk margin in Solvency II is sensitive to current interest rates. This sensitivity is likely to have significant absolute and hedging costs for firms when there are short term variations in the risk-free rate. Such a degree of volatility is likely to be undesirable from a microprudential and macroprudential point of view, because it promotes procyclical investment behaviour."

Bank of England Response to the European Commission  
Call for Evidence on the EU Regulatory  
Framework for Financial Services, January 2016

# Brexit – What might change



# Continuity of contracts

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- ABI and Treasury Select Committee have emphasised the need for legislation to make clear that:
  - UK (re)insurers operating in EEA countries under existing passporting arrangements
  - EEA (re)insurers operating in the UK under existing passporting arrangements

may pay out under existing policies following Brexit without thereby acting unlawfully

**Basic minimum  
approach**

# Towards a Free Trade Agreement

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- London Market Group
  - *"Proposals for a future trading relationship between the EU and the UK"*, November 2017
  - *"A Brexit Roadmap for the UK Specialty Commercial Insurance Sector"*, November 2017
- International Regulatory Strategy Group:
  - *"The EU's Third Country Regimes and Alternatives to Passporting"*, January 2017
  - *"Mutual Recognition – A Basis for Market Access after Brexit"*, April 2017
  - *"A New Basis for Access to EU/UK Financial Services post-Brexit"*, September 2017
- UK Finance
  - *"Supporting Europe's Economies and Citizens: A modern approach to financial services in an EU-UK Trade Agreement"*, September 2017

**Keep as much as  
we can approach**

# Update (1)

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- Treasury written statement (20 December 2017)

The government will, if necessary, bring forward legislation:

- which will enable EEA firms and funds operating in the UK to obtain a “temporary permission” to continue their activities in the UK for a limited period after withdrawal; and
  - alongside the temporary permissions regime, the government will legislate, if necessary, to ensure that contractual obligations, such as insurance contracts, which are not covered by the regime, can continue to be met.
- PRA Consultation Paper regarding its approach to supervision of international insurers (20 December 2017)
    - EEA firms with more than **£200m** of FSCS-protected liabilities would have to establish an authorised subsidiary, while others with FSCS-protected liabilities below that level would be allowed to have an authorised branch (subject to certain other factors that the PRA has said it would take into account regarding the significance of the branch to the wider insurance market).
    - Applications may be submitted from as early as January 2018

**Now increased to £500m  
in SS 2/18 (April 2018)**

# Update (2)

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- PRA "Dear CEO" Letter (20 December 2017)
  - Summarising proposals
- FCA Statement on EU Withdrawal (20 December 2017)
  - For firms and funds that are solely regulated in the UK by the FCA they would need to notify the FCA before exit day of their desire to benefit from the regime but this notification for temporary permission will not require the submission of an application for authorisation. We will set out further details of our approach in the New Year.
  - Firms based in the UK servicing clients in the EEA should continue to prepare for a range of scenarios and should discuss these arrangements and the implications of an implementation period with the relevant EU regulator. The FCA will keep these expectations under review as negotiations on an implementation period progress and communicate to firms accordingly.
- Letter from Economic Secretary to the Treasury (published on 19 December 2017)
  - explaining how government will use powers under the European Union (Withdrawal) Bill

# Contact for questions

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