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Insurance industry must ensure its interests are heard in Brexit negotiations

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Insurers have too much to lose from the UK leaving the EU not to take an active role in discussions

Historians will mark June 23, 2016, the day the UK voted to leave the EU, as a turning point – for some it is the “Great Escape”, for others “buyer’s remorse” and for many in the UK insurance sector it is a major concern as they contemplate the possible loss of EU benefits, notably passporting rights.

What does the single market in re/insurance mean today and what can firms expect and need to plan for in a very uncertain future?

First, the single market in insurance. In the 50 years the market has been in the making (the first directive dates back to 1964) the European legislator’s primary objective has been the protection of policyholders. The legislator has also liberalised insurance and harmonised many rules, helping to ensure a competitive level playing field for various operators in the market. Many insurers that were domestic carriers have developed pan-European strategies and Europe is now home to many world-class players.

Second, EU law has created other benefits. The main one is “mutual recognition”: through the harmonisation of rules, EU states recognise each other’s supervision of re/insurers, resulting in a “single licence” enabling a re/insurer to operate on a direct freedom of services basis across the entire EU or via local branches – the “EU passport” – without having to set up a fully capitalised and authorised subsidiary in the target market. Intermediaries enjoy comparable rights.

In practice, many EU market players have grown through acquisitions. Here again, single market principles have facilitated integration by prohibiting discrimination on grounds of nationality: subject to prudential safeguards, an insurer in any EU state is free to buy an insurer in any other.

Another benefit is the introduction (as long ago as 1973) of the portfolio transfer, a mechanism which facilitates the reorganisation and disposal between insurers of portfolios of policies without the need to obtain individual policyholder consents.

The apogee of this legislative effort has been Solvency II – an ambitious (if imperfect) attempt by all EU states to modernise supervision of the sector. The UK has throughout been a key participant.

Insurers also benefit from other, cross-sector legislation: for example, EU insurers can constitute themselves as a single European company, the Societas Europaea; and they merge, reorganise and redomesticate cross-border thanks to EU company law, including with non-discriminatory tax relief. Many insurers have used EU law to optimise their capital base and governance arrangements. Insurers also benefit from the clarity of a common framework regarding jurisdictional and choice of law rules (the Brussels and Rome Regulations).

Brexit risks excluding the UK insurance sector from 50 years of legislative creativity and co-operation. It raises the question of the nature of the future regulatory landscape and how EU and UK firms can continue to prosper. The UK government should (and we expect will) strive to retain the harmonised prudential and regulatory regime which benefits the industry, the City and in turn the UK and, ultimately, the rest of the EU.

The UK will continue to be heard in international insurance negotiations, but will likely speak for itself rather than being part of the EU's unified team in such negotiations. The UK will rightly emphasise the international role of the London market and its ability, in particular for large and specialty risks, to attract international business from beyond the EU.

Brexit could break the thread of regulatory dialogue and convergence which EU states have developed over the years – most recently through the creation of European supervisory authorities, such as the European Insurance and Occupational Pensions Authority. After Brexit, legal instruments might change in the UK (no more implementing regulations, regulatory technical standards and so on), but the regulatory concerns and objectives will remain.

Supervisors will continue to seek a balance in regulation which has been either relatively light touch (pre-financial crisis) or relatively prescriptive (post-crisis). To date, the UK has enjoyed significant regulatory influence inside the EU over complex texts, such as MiFID II, PRIIPs and, most recently, IDD. In other words, Brexit seems unlikely to change how the UK regulates conduct of business.

At the operational level, firms have serious grounds for concern. First, uncertainty itself is a major risk factor: what arrangements will be negotiated is unclear. Second, unless the UK obtains a satisfactory deal from the remaining EU, it will have the status of a "third country". In terms of access to the EU direct and reinsurance markets, the UK would in this case be vulnerable to protectionist or discriminatory pressures from the EU or its member states such as collateral requirements in reinsurance. Fortunately, some access for large risks (marine, aviation and transport) and reinsurance should continue.

Without a deal that preserves single market principles, such as mutual recognition and passport rights, UK outwards firms seeking opportunities in continental markets would have to establish a fully capitalised and locally authorised branch or, more onerous, to incorporate and apply for authorisation of a local subsidiary (or to buy one).

UK-outwards firms have not been subject to such requirements for nearly 25 years. UK branches of incoming European Economic Area (EEA) insurers are not subject to prudential supervision by the Prudential Regulation Authority at present with attendant solvency requirements and so on. After Brexit, if there is no deal, they could become subject to UK prudential requirements in addition to their home ones. Likewise, equivalent jurisdictions might cease to enjoy the benefits of that status in relation to their operations on the UK market (it seems unlikely the UK would exclude access altogether).

It is helpful that the existing regime will remain in place for at least two years (while the Brexit negotiations take place), but contingency planning and restructuring do take time. Incoming and outwards firms therefore need to consider how to mitigate the effects of third-country status on each side of the Channel, in particular to minimise capital inefficiencies. Choices include whether to enter or withdraw from a market, earmark capital for a branch, incorporate a subsidiary and so on. They will also need to be attentive to local conduct of business rules which, over time, may no longer be harmonised.

In principle, arrangements can be put in place to enable continued free trade in re/insurance after Brexit, whether through the EEA, a Swiss model or an equivalent status. Two other international hubs, Switzerland and Bermuda, have already obtained equivalent status for Solvency II and the UK may be able to follow, but that would be time-consuming and would rely on EU goodwill which cannot be assumed.

Although solutions for the industry concerns can in principle be achieved, the industry will be only one of many affected and it is unclear how well the wider negotiations will protect its interests. Firms' contingency planning needs to bear this reality in mind.

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