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The International Comparative Legal Guide to:

Insurance & Reinsurance 2017

6th Edition

A practical cross-border insight into insurance and reinsurance law

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Email: info@glgroup.co.uk
URL: www.glgroup.co.uk

GLG Cover Design
F&F Studio Design

GLG Cover Image Source
iStockphoto

Printed by
Ashford Colour Press Ltd.
February 2017

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ISBN 978-1-911367-37-6
ISSN 2048-6871

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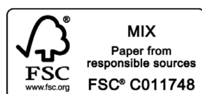

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The Implications of Brexit for the Insurance Industry

Matheson

Darren Maher

Introduction

In June 2016, the British electorate voted to leave the European Union (the "**EU**") by a margin of 52% to 48%. What followed amongst the political fall-out and recriminations was a turbulent market reaction with the Euro and the Pound Sterling falling to historic lows against the US Dollar and global stock markets losing approximately USD 2 trillion in the days immediately following the vote.

The global economy has stabilised in the interim period and the process of understanding what the implications of Brexit will be across various financial sectors has begun. Following recent announcements by the UK Government on the approach it intends to take in the upcoming Brexit negotiations, this article will explore the likely implications this will have on the UK insurance industry and the options available to UK insurers who wish to establish in Ireland to deal with the fall-out from Brexit.

UK Insurers and the EU

The City of London is the world's leading insurance centre. Many of the insurers based in London write business throughout the single market of the EU. The EU is a significant market, which accounts for 32% of the global insurance market with assets of almost EUR 9,800 billion invested on behalf of life and non-life insurance customers.

The single biggest challenge facing UK insurers in a post-Brexit environment is that they may no longer be able to directly access the European single market. UK authorised insurers currently access the single market by way of the financial services passport. This allows an insurance company authorised by one Member State of the European Economic Area (the "**EEA**") to carry on business across all EEA Member States. The continued ability of UK authorised insurers to access this market is uncertain as the UK will have to renegotiate its trading arrangements with the EU. Prime Minister Theresa May has stated that the UK is leaving the single market and therefore any future access to the European single market would have to be negotiated as part of a trade deal with the EU, which seems unlikely at this time.

The UK will remain a member of the EU until Article 50 is triggered, following which there will be a two-year period in which to negotiate an exit with the EU. It was initially expected that Article 50 would be invoked using the royal prerogative, however, the UK Supreme Court confirmed that the prior approval of Parliament was required to trigger Article 50. The European Union (Notification of Withdrawal) Bill (the "**Bill**") has begun its journey through the UK Houses of Parliament. The Bill passed through the Second Reading stage in the House of Commons on 1 February 2017 and will be subject to a final vote in the House of Commons and a vote in the House of Lords before becoming law. If the Bill is passed and becomes law, it will authorise Prime Minister May to trigger Article 50 when the Government chooses to do so, which is expected to be March 2017. Separately, the UK Government has also confirmed that the final Brexit deal would be put to a vote through both houses of Parliament.

Given the uncertainty in the interim, which will continue throughout the two-year negotiation period, many of our UK insurance clients are considering alternative options in order to retain their EU passporting rights and unrestricted access to the single market.

Options for UK Insurers

Following the Brexit vote, some UK insurers proposed to adopt a 'wait and see' approach. However, given the UK's new stated intention to leave the single market, it is increasingly clear that UK insurers who currently rely on the financial services passport cannot afford to wait any longer to address the uncertainty surrounding their current business model. The question which then arises for UK insurers is which EEA jurisdiction they choose to establish a presence and the form which that presence should take.

What makes Ireland an attractive jurisdiction?

Ireland is an attractive jurisdiction for UK-based insurers considering establishing an EEA subsidiary in order to retain their EU passporting rights. Ireland is an English-speaking common law jurisdiction with geographical proximity and ease of access to the UK. The two nations also have a long history of shared historical and cultural ties.

Ireland has one of the most educated workforces in the world, with 52% of 25–34 years olds holding a third-level qualification. Ireland has placed particular focus on practical education, often including work experience as part of this education, which has fostered the growth of a talented, innovative and highly educated workforce. Consequently, Ireland has become a place where enterprises can successfully compete on a global scale, evidenced by the fact that Ireland is currently ranked as the single most competitive country in the Eurozone. In 2016, Ireland also ranked number one globally for readily available financial skills according to the International Institute for Management and Development.

Insurers who establish in Ireland will enjoy one of the lowest corporate tax rates in the OECD, currently set at 12.5%. Despite

various economic factors, the stability of Ireland's corporate tax rate has been maintained over the past decade and the Irish Government remain committed to this figure remaining the same for the foreseeable future. Ireland has signed double taxation treaties with 70 countries. This wide (and growing) tax treaty network is a key attraction of Ireland for internationally-focused financial services institutions.

Ireland is also home to a highly developed and sophisticated financial services industry. Over half of the world's top 50 banks and nine out of the world's 10 leading technology companies are based in Ireland meaning finance and technological expertise are readily available to new entrants in the Irish market. Many of the world's leading insurers and reinsurers have long-established established bases in Ireland.

Ireland has an advanced telecommunications infrastructure with state-of-the-art optical networks and international connectivity. The Irish Government has spent in excess of €4.5 billion in recent years developing digital communications. Ireland's telecommunications system is considered to be one of the best in Europe with full fibre optic services and unlimited broadband connectivity to the US and Europe. Further investments have been made with the rollout of broadband DSL to regional locations and according to a recent OECD study, Ireland has the second lowest international leased line costs.

To cope with the expected influx of financial services companies, extensive construction has begun in the commercial office sector. It was estimated that an extra 1.5 million square foot came on-stream in 2016; three million square foot of space is under construction and due for completion between 2017 and 2019; and six million square foot of additional space can potentially be delivered, half of which either has planning permission or is going through the process.

The Central Bank of Ireland

The Central Bank of Ireland (the "**Central Bank**") is a respected European regulator. It has a proven reputation of being a robust but business-friendly regulator. Given Ireland's status as an existing hub of cross-border activity, the Central Bank has a wealth of experience in regulating such activities. As it is expected that Ireland will be seen as an attractive European base for companies from right across the financial services spectrum, the Central Bank has developed contingency plans to cater for any potential increase in the number of applications including increasing staffing levels. The Central Bank is committed to meeting the statutory requirement of processing all fully completed insurance applications within six months.

As a strong independent regulator, the Central Bank is open to growing the financial services industry in Ireland and is ready to handle any enquiries it receives, however, it is keen to note that it is not open to so-called 'brass plate' operations and that insurers seeking to establish a presence in Ireland will have to comply with the Central Bank's requirements. Gerry Cross, the Director of Policy and Risk in the Central Bank, noted in a speech that when it came to applications for authorisations in Ireland, the Central Bank stood ready to meet the challenges that might arise:

> "*We will do so on the basis of an active, open stance, ready to engage, but in line with our duty to protect consumers, and in keeping with EU rules, international standards and our published processes*."

We have set out below what this means for UK insurers seeking to establish a presence in Ireland post-Brexit, either by establishing an Irish subsidiary or a branch operation.

Establishment of a subsidiary

UK insurers considering setting up a subsidiary in Ireland will need to make an application to the Central Bank of Ireland for authorisation. Applicants must demonstrate to the Central Bank that the insurance company is sufficiently resourced to carry out its business in compliance with the applicable legal and regulatory requirements. Generally speaking, the application process, from the submission of the formal application to the Central Bank to the receipt of final authorisation, takes in the region of four to six months. The factors that tend to impact on the timing are: (i) the quality of the application submitted to the Central Bank; and (ii) the ability of the Applicant to respond promptly to any questions or requests for additional information received from the Central Bank.

One of the key concerns for the Central Bank when considering an application for authorisation by an insurance company is whether the senior management personnel responsible for making key strategic business decisions are based in Ireland. This is referred to by the Central Bank as the 'heart and mind' of the business. Whilst each insurance company will have its own specific requirements, the Central Bank will generally want to have a Chief Executive Officer and the Chief Financial Officer employed by the Irish entity and situated on a permanent basis in Ireland. In addition, the applicant must have appropriate officers to fill the mandatory control functions, being: (i) internal audit; (ii) risk management; (iii) compliance; and (iv) actuarial. The applicant will also be required to appoint a Chief Risk Officer with distinct responsibility for the risk management function to staff carrying out. Whilst there is no hard-and-fast rule in terms of where these central functions are located, and the Central Bank does permit reliance on group functions located in other jurisdictions, it would be a matter of negotiation between the applicant and the Central Bank as to what functions must be maintained in Ireland to demonstrate real substance.

Under the Solvency II regime, any functions of an insurance company may be outsourced to a third party provided that appropriate oversight and control is retained by the insurance company. It is open to an applicant therefore to outsource additional activities should it wish. Any outsourcing must not: (i) materially impair the undertaking's system of governance; (ii) cause an undue increase in operational risk; (iii) impair the supervisory monitoring of compliance with obligation; or (iv) undermine continuous and satisfactory service to policyholders. Whilst an insurer can outsource freely to an entity located in another EU/EEA Member State, the Central Bank has been reluctant in the past to authorise an undertaking which plans to outsource a large proportion of its activities to a third country. That being said, as the Central Bank is very familiar with the PRA, the Central Bank may be more willing to authorise an insurance undertaking which heavily relies on outsourced services provided from the UK, even after Brexit. The level of workforce on the ground shall be dependent on the nature, scale and complexity of the business that is proposed to be written through the Irish subsidiary.

The board of any new insurance subsidiary will be required to have a minimum of five directors. The majority of the board must be comprised of group directors, or, alternatively, a combination of group directors and independent non-executive directors ("**INEDs**"), provided always that the number of INEDs does not drop below two. The board must satisfy itself as to a particular INEDs independence prior to his or her appointment to the board. At least one of the INEDs will also be expected to be based in Ireland as the Central Bank view INEDs as their 'eyes and ears' within the company. All proposed directors and senior management will have to apply to the Central Bank for prior approval to act as part of the Central Bank's

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Fitness and Probity regime. This is to ensure that the undertaking has the necessary people, skills, processes and structures to successfully manage its insurance business. This includes, in particular, close scrutiny of the undertaking's management structures, board and senior management appointments, key committees and key statutory roles.

Further, the Central Bank is open to discussions with applicants on "dual hatting" or duplication in functions, once there are sufficient similarities between the functions to allow them to be performed by the same individual. In addition, the individual in question would need to be able to demonstrate that he/she has sufficient capacity to carry out more than one function.

Establishment of a branch

Post-Brexit, UK insurers who have not established an EEA-subsidiary but who wish to continue to access the single market may consider operating as a third-country insurance undertaking under Solvency II. It is important to note that a branch does not have passporting rights similar to a subsidiary, and therefore would only be able to write business in the jurisdiction in which it is established. A UK insurer seeking to establish a third-country insurance undertaking in Ireland would be required to establish a permanent presence in Ireland and comply with significant minimum capital requirements to be held within the state and deposited with the Courts as security.

The European Union (Insurance and Reinsurance) Regulations 2015 (the "**2015 Regulations**") (implementing the Solvency II Directive in Ireland) do not specifically provide for the treatment of a third-country branch of an Irish authorised insurer. However, the current regime requires the board of an Irish authorised insurer to comply with the prudent person principle when calculating the solvency capital of the insurer. The prudent person principle requires insurers to invest assets held for regulatory purposes so as to ensure the security, quality, liquidity and profitability of the portfolio as a whole, including diversification. In addition, insurers are also required to ensure that assets are localised to ensure their availability to meet policyholder claims.

It must be noted that there has been reluctance recently from the Central Bank and other EU regulators to accept third-country branch applications. Therefore whilst the Solvency II Directive provides for this model, in the absence of a regulatory appetite for such applications, the establishment of an EEA subsidiary may well be the better option for securing access to the European single market.

Solvency II Equivalence

There has been some media commentary suggesting that insurers based in the UK could continue to service their EU customers once the UK is deemed an 'equivalent' jurisdiction for Solvency II purposes.

The primary concern with equivalence is whether the EU would actually deem the UK's insurance regime equivalent. Clearly, being fully Solvency II compliant currently, there is a strong case to be made that it should be afforded such equivalence, however, if and when the EU authorities would actually be minded to make such determinations is unclear.

If the UK was to be deemed equivalent, the requirement to remain equivalent is ongoing. Therefore, it may be the case that the UK would have to continue to adopt measures promulgated at EU level into UK domestic law in order to retain their equivalence status. This raises obvious concerns from a political standpoint.

Third-country insurers (even those from an equivalent jurisdiction) seeking to carry on insurance business in the EU will still have to establish a third-country branch or an insurance subsidiary. Equivalence is a more useful classification for reinsurers. Solvency II provides that a reinsurance contract concluded with a third-country reinsurer must be treated in the same fashion as contracts entered into with an EU reinsurer where the third-country reinsurer is based in an equivalent jurisdiction. In spite of this, BaFin has recently announced that third-country insurance and reinsurance undertakings who wish to carry on insurance or reinsurance business in Germany must establish a German branch.

The treatment of equivalent jurisdictions under Solvency II and the approach regulators will take to such 'equivalent' status remains unclear. What is clear, however, is that being deemed equivalent is not the same as having passporting rights and it is not a credible alternative for UK insurers seeking to access the European single market on an ongoing basis post-Brexit.

Conclusion

Prime Minister May's announcement that the UK would not be seeking access to the single market has cast significant doubt over the ability of UK authorised insurers to access the single market post-Brexit. Whilst the UK may seek to maintain some form of access to the European single market for the financial services industry as part of any trade deal it may negotiate with the EU, certainty on this point seems further away than ever. UK insurers who currently access the European single market would be well advised to consider their options for continuing to access key EU markets post-Brexit.

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Matheson

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