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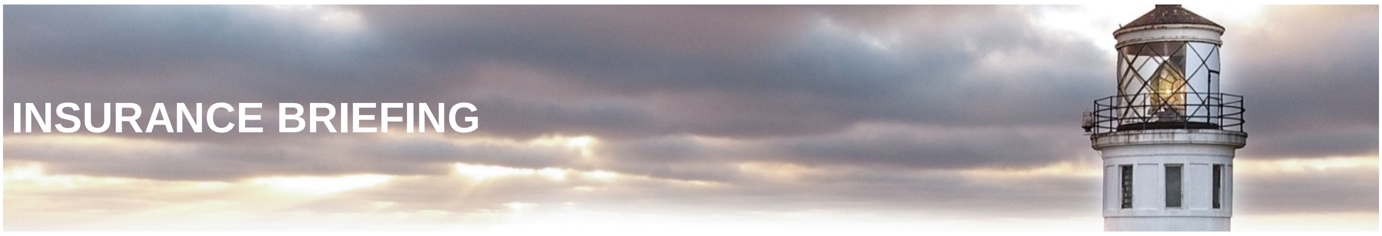

"ACCESS TO THE SINGLE MARKET" – AN EXPLANATION FOR THE (RE)INSURANCE SECTOR

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Introduction

The UK has voted to leave the European Union ("EU"). Since the result became known, there has been much discussion of the wish to preserve "access to the single market" so far as possible. This briefing seeks to explain the issues which arise in this context for the insurance and reinsurance sector and suggests some issues to be brought to the attention of those negotiating the terms of the UK exit. For this purpose, the briefing assumes that the UK does not join the European Economic Area ("EEA") on exit or negotiate a bespoke form of access to EEA insurance markets (the "EEA Market") in a manner that substantially replicates that which it has today.

Withdrawal from the EU does not of itself mean that UK insurers and reinsurers will not be able to do business in EEA states. What it does mean is that they will not be able to carry on insurance activities on an EEA-wide basis as a matter of right (albeit subject to the necessary formalities), flowing from the UK's membership of the EU. Instead, how they are able to access the EEA Market will depend in part on rules contained in the Solvency II Directive ("Solvency II"). To the extent not addressed under Solvency II, it will be up to individual EEA states to determine the conditions on which access is given to UK insurers and reinsurers.

This note does not cover the position under national law in individual EEA states. That must form the subject of legal due diligence performed by financial services specialists in the relevant national law.

The loss of passporting rights will be equally relevant to the cross-border activities of insurers and reinsurers coming from the EEA into the UK. It is more difficult to advise EEA firms on their position in this regard because this will depend on the regime that the UK decides to introduce in place of Solvency II rules. In practice, it is inconceivable that EEA firms will be prevented from doing business in the UK, but the precise terms on which they will be able to conduct crossborder activities are likely to depend on the exit negotiations and on requirements for reciprocity agreed between the UK and the EU in that context.

We will be issuing a further client briefing in due course which considers the issues for this type of firm. That briefing will also look at issues raised by the UK's exit from the EU for non-EEA headquartered groups that currently passport into the EEA through a UK subsidiary.

We will also issue a separate client briefing on the legal issues raised by Brexit for the cross-border activities of intermediaries.

For any business to determine the impact of losing its right to access the EEA Market on withdrawal of the UK from the EU, it will need to ask the following questions:

(a) What activities are carried on prior to exit in the EEA and can those activities continue to be carried on as a matter of the national law of each relevant state?

(b) If not, can those activities be carried on under third country access provisions of the specific EU law regulating the conduct of those activities within the EEA?

(c) If so:

   i. How likely is it that the firm will be able to make use of such third country access provisions, taking into account the taxation, capital and other costs of doing so (i.e. how 'achievable' are they)?

   ii. Is there some aspect of national law in the relevant EEA state that negates the effect of the third country access in that EEA state?

For insurance companies, Solvency II rules on third country access are the starting point for determining how UK insurers might continue to access the EEA Market once withdrawal has taken place.

In this note, the terms "insurers" and "insurance companies" should be read as including both insurance and reinsurance companies, unless otherwise specified. The term "pure reinsurer" refers to a firm that only carries on reinsurance business.

Solvency II - Background

Solvency II establishes a framework for the prudential regulation of insurers and the corporate groups of which they are members. The new regime has applied throughout the EEA since 1 January 2016. As with the predecessor EU legislation, one of the cornerstones of Solvency II is the insurance "passport". Provided certain formalities, involving the giving of notice to use the passport to the home state regulator, are followed, insurance companies which have their head office in the EEA are able to carry on business throughout the EEA on the basis of a single home state authorisation. Such cross-border business can be carried on in one of two ways:

(a) through an establishment in the host EEA state; or
(b) on a services basis without having a presence in the host EEA state

Once the UK leaves the EU (and, as envisaged above, on the assumption it neither joins the EEA nor succeeds in entering into bespoke arrangements which preserve the passport), the passport will no longer apply to cross-border activities between the UK and remaining member states of the EEA. The UK becomes a non-EEA state, or "third country", for Solvency II purposes.

A secondary focus of the Solvency II regime is on firms whose head office is outside the EEA, but which carry on business in the EEA. Solvency II provides for the authorisation of branches of non-EEA insurers that meet certain specified requirements. As will be shown below, however, the rights of such companies to conduct business within the EEA fall significantly short of passporting rights afforded to insurers which have their head office within the EEA.

Carrying on cross-border business post-"Brexit"

Third country insurer establishing EEA branch

A separate set of rules apply under Solvency II (beginning at Article 162) to EEA branches of third country insurers (but not to pure reinsurers).

The starting point for conducting business through a branch is that a third country insurer must obtain authorisation in the EEA state in which the branch is located. EEA states may grant an authorisation where the relevant insurer meets certain specified conditions, which include:

(a) being entitled to carry on insurance business under its national law;

(b) keeping at the place of management of the branch (i) accounts specific to the business pursued there; and (ii) all the records related to the business transacted;

(c) possessing assets up to a certain value in the EEA state in which authorisation is sought;

(d) undertaking to meet the Solvency Capital Requirement ("SCR") and Minimum Capital Requirement ("MCR") in respect of business carried on through the branch;

(e) submitting a scheme of operations that meets specified requirements; and

(f) fulfilling Solvency II governance requirements.

Where a third country insurer has more than one branch in the EEA, with the approval of the supervisory authorities in all the states concerned, the required assets may be localised in just one of the EEA jurisdictions and the SCR may be calculated in relation to the entirety of its EEA business.

Once authorisation has been obtained for a branch, rules to which it must be made subject include requirements to:

(a) establish adequate technical provisions in respect of business written through the branch, applying Solvency II rules;

(b) establish eligible own funds in accordance with Solvency II rules;

(c) calculate the SCR and MCR in accordance with Solvency II rules, but only in respect of the business of the branch; and

(d) maintain assets representing the SCR within the EEA state in which the branch is established up to the amount of the MCR and the excess either within that state or elsewhere within the EEA.

There appears to be no obligation for the EEA state to grant authorisation to an insurer that meets these requirements, which would suggest that more onerous obligations could be imposed at individual EEA state level.

If the UK wishes to achieve a different outcome for UK insurers than that set out above, it may seek to use Article 171, Solvency II. Article 171 allows the EU to conclude agreements with third countries that deviate from the requirements described above. The purpose of such an agreement must, however, be to ensure "under conditions of reciprocity" that EEA policyholders are properly protected. The circumstances in which this provision might be used are not clear and we are not aware of any guidance on its application. EIOPA guidelines on the supervision of branches of third-country insurance undertakings contain extensive guidance on the application of Articles 162-170, Solvency II but do not discuss the possible use of Article 171.

Third country pure reinsurer establishing EEA branch

The provisions described above do not apply to pure reinsurers. Article 174, Solvency II simply requires that rules in an EEA state applying to branches of third country pure reinsurers should not result in the third country reinsurer being treated more favourably than home state reinsurers. Other than that, the EEA state is free to do as it wishes in relation to third country pure reinsurers wishing to set up a branch within its jurisdiction.

Article 175, Solvency II applies in a similar way to Article 171 (discussed above). It allows the EU Commission to submit proposals to the Council of the EU for the negotiation of agreements with a third country regarding the supervision of:

(a) third country pure reinsurers which conduct reinsurance business in the EEA; and
(b) EEA pure reinsurers which conduct reinsurance business in the relevant third country.

The purpose of such an agreement would be to secure effective market access for both types of reinsurer on the basis of mutual recognition of the respective parties' supervisory regimes. Recital (89), Solvency II refers to the international nature of reinsurance markets and calls for the use of a "flexible" approach to determining the prudential equivalence of third countries "so as to improve liberalisation of reinsurance services in third countries". It seems likely that Article 175 has been included with a view to ensuring, so far as is possible, that EEA reinsurers can access important overseas markets

Third country reinsurer providing services into the EEA

The position for third country insurers wishing to provide insurance into the EEA on a services basis (i.e. without having a presence in that EEA state) is less clear.

Solvency II is silent on how cross-border services business (often referred to as "non-admitted" insurance) from outside the EEA should be treated and there is no consistent approach to this issue. In some EEA states, the prudential regime may be triggered when a non-EEA firm covers risks located in the state in question but has no other presence there. In others, an on-going presence is required before any regulatory authorisation becomes necessary.

For example, the UK has historically taken the view that authorisation is only needed by e.g. US insurers if they are actually carrying on insurance business here (i.e. effecting or carrying out contracts of insurance "in the UK" under the Financial Services and Markets Act 2000). This requires some form of physical presence either of the firm itself or at least of an authorised agent. There are signs of a movement towards heavier regulation of non-admitted business in some EEA states, including Germany.

It may be for this reason that the EU Commission ("Commission") has recently expressed[1] the view that "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". This is the Commission's view of the effect of Article 162, Solvency II which is grandfathered almost word for word from Solvency I. However, the Commission's view runs contrary to UK interpretation of the Directive rules. If the Commission's view is adopted by EEA states, it will affect UK insurers' ability to write new business in EEA states after Brexit takes effect.

Perhaps unsurprisingly, given that the possibility of a country leaving the EU has not hitherto been seen as something for which extensive provision needs to be made in European legislation (and the concept of a policy which was once "admitted" insurance ceasing to be so is also unlikely to have been extensively considered in the domestic legislation of most EEA states), there must be uncertainty over the continued ability of UK firms to continue to service existing business written before the passport was withdrawn. The associated risk to policyholders of being unable to claim under policies written pre-Brexit on a services basis from the UK and to firms of suddenly finding themselves needing to establish a branch merely to service existing business in a manner compliant with local law makes the treatment of existing business (at least) an important issue to resolve in the lead-up to the UK's exit.

Equivalence under Solvency II as a substitute for the insurance passport?

"Equivalence" means different things in different contexts in EU financial services legislation. At the broadest level, having a regime in the UK that is broadly aligned with that applying throughout the EU may make it easier to negotiate a more beneficial deal for the UK on exit.

In the context of Solvency II, "equivalence" has a more technical meaning. It applies a test of "equivalence" to the regulatory regimes of jurisdictions outside the EEA in three contexts:

(a) **Article 172 - Reinsurance provided by a non-EEA reinsurer**: Contracts between an EEA cedant and a non-EEA reinsurer which is located in a jurisdiction whose solvency regime is assessed to be "equivalent" for the purpose of this Article must be treated in the same manner as if that contract were concluded with an EEA reinsurer.

(b) **Article 227 – Group solvency - related companies located in a non-EEA jurisdiction**: Where a Solvency II group contains a non-EEA insurer which is located in a jurisdiction whose solvency regime is assessed to be "equivalent" for the purpose of this Article, the group may apply to use local rules in capital calculations carried out under the deduction and aggregation method. Such an application may or may not be granted.

(c) **Article 260 – Group supervision**: Where a Solvency II group is headquartered in a non-EEA jurisdiction which is assessed as having a system of group supervision that is "equivalent" to that operated under Solvency II, EEA supervisors must rely on supervision of that group by the national supervisor in that jurisdiction.

[1] See minutes of meeting of the "Expert Group on Banking, Payments and Insurance", July 2015. For comment by Geoffrey Maddock on the Commission's view, click here.

It is clear from this list that determination that the post-Brexit UK regulatory regime is "equivalent" under any of these heads does not mean that UK insurers would "retain access" to the EEA Market. The benefits UK insurers would gain from a finding of equivalence in each case fall considerably short of offsetting the loss of the passport that would result from a UK Brexit. This is in contrast to the position under some other financial services directives, where a finding of equivalence would be considerably more meaningful in maintaining UK access to the EEA single market.

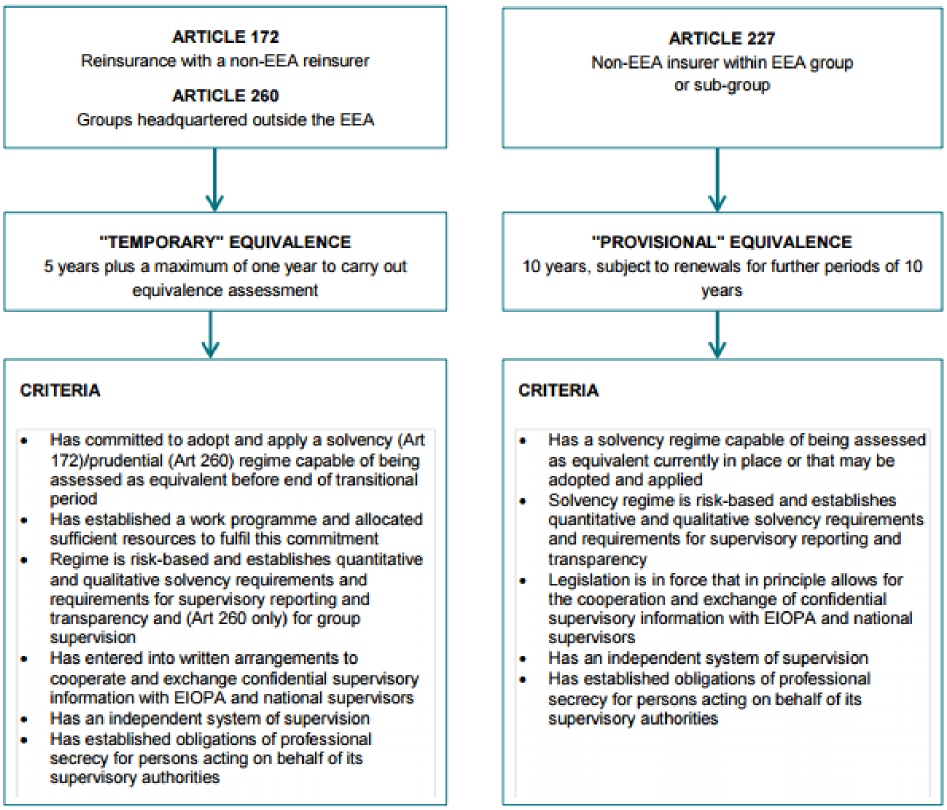
Should the UK seek equivalence status?

Despite the shortcomings attaching to equivalence under Solvency II, it seems likely that the UK would seek to be assessed as being equivalent under all three heads described above. As an alternative to seeking full equivalence status from the start (which would take some time to be given), the UK may prefer to seek temporary or provisional equivalence status:

(a) Countries may be afforded "temporary" equivalence status for a period ending in December 2020 for the purposes of Articles 172 and Article 260 if they satisfy certain specified criteria (see below for details). These include making a commitment to put in place a regime that can be assessed as equivalent before the end of the transitional period.

(b) Countries may be granted "provisional" equivalence status for ten years for the purposes of Article 227. This is seemingly capable of renewal any number of times (for a further ten years in each case). Again, specified criteria must be met (see below for details). Significantly, however, the country concerned need not have made any commitment to put in place an equivalent regime by the end of the transitional period, or at all.

"Temporary" and "Provisional" Equivalence



As Solvency II is drafted (and consistent with the point made earlier that the legislation makes no provision for a country leaving the EU), the UK cannot initiate a formal application for equivalence status (whether on a full, temporary or provisional basis) until after it leaves the EU. Even then, there would inevitably be some delay whilst the assessment process was carried out, however self-evident it might be that the UK regime was still the same as the pre-Brexit Solvency II-compliant regime (if this is the position which the UK adopts – the possibility of some differences being proposed by the PRA cannot be ruled out). This would be unhelpful for UK insurers and groups because, for a short time at least:

(a) reinsurance taken out by EEA insurers with a UK reinsurer may not be given full recognition, which may make UK reinsurers less attractive as providers of reinsurance to EEA cedants;

(b) groups headed by a UK-headquartered entity with an EEA insurance subsidiary would be subject to EEA group supervision unless "other methods" could be agreed with the relevant group supervisor under Article 262, Solvency II; and

(c) UK subsidiaries within groups headed by a EEA-headquartered entity would need to be brought into account for group capital purposes on a Solvency II basis instead of under local, UK rules (although it is doubtful whether this would have much significance while the UK regime is heavily based on Solvency II standards).

Insurers may wish to lobby for "equivalence" status to be granted to the UK immediately on exit, rather than having to wait for the formal process to be initiated once its withdrawal from the EU is complete. Without such a concession, it seems that a gap is inevitable.

Of course, any negotiations over expediting equivalence decisions needs to be seen in the context of reciprocal arrangements that the UK may grant to EEA supervisory regimes. This raises a number of interesting dynamics. For example, reinsurers that have their head office in the EEA will wish to preserve their competitive position when it comes to providing protection to the UK insurance market. This position is likely to be undermined if their home state supervisory regimes are not given the same recognition by the UK that they have under the current regime.

Finally, this is, of course, the first time that a Member State has left the EU at a time when its domestic regime is, effectively, fully equivalent. Given this, there may be some merit in exploring whether, if the UK adopts the Solvency II regime in full on exit, it could achieve something more than just equivalence status, perhaps through use of Article 171, Solvency II (see discussion above). This may improve the position for both EEA and UK insurers in terms of retaining the access to insurance markets across the EEA that they currently hold.

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