Brexit: implications and options for life and pensions firms

Minds made for shaping financial services

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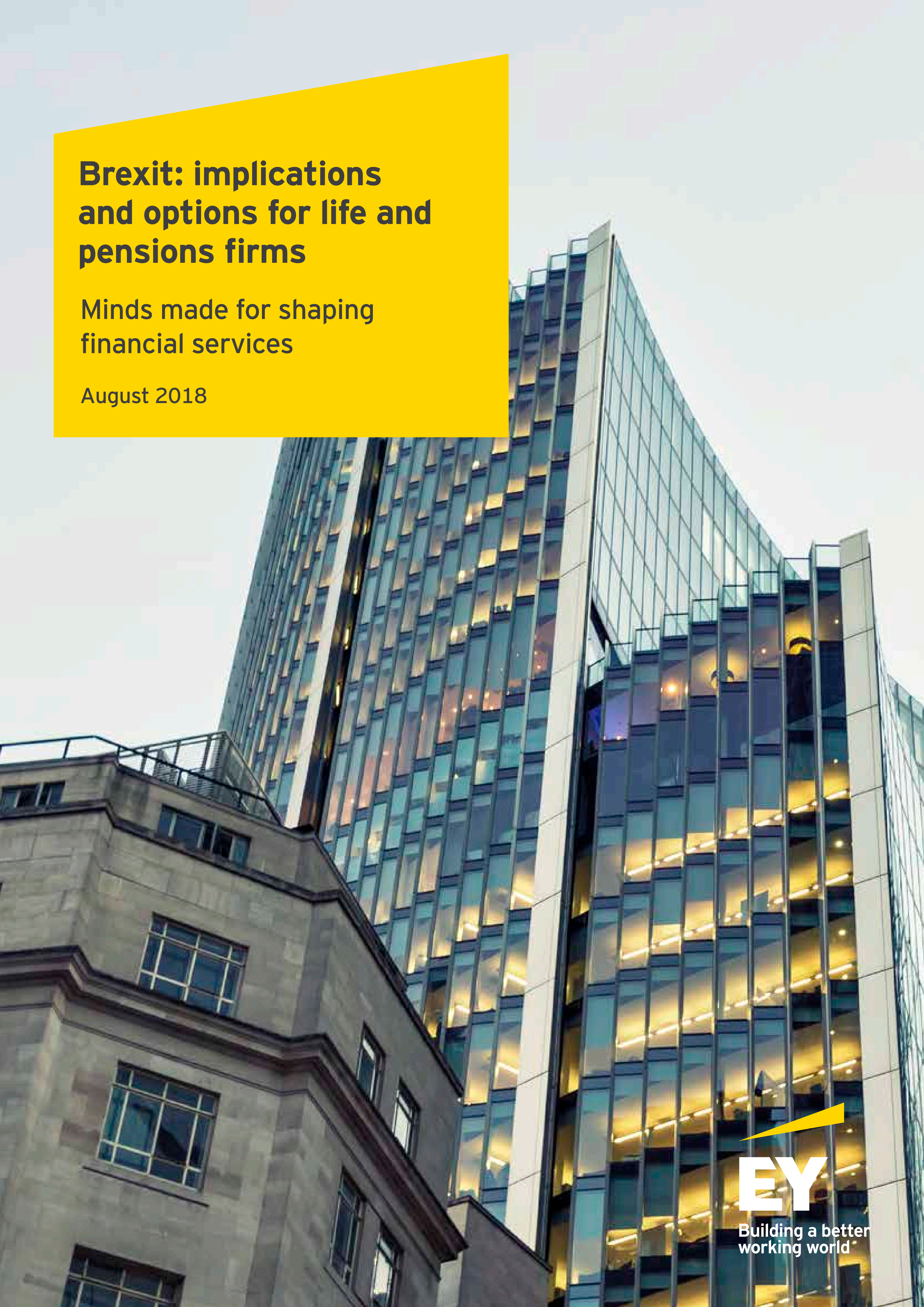

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Executive summary

There are now less than eight months before the UK formally leaves the EU. Brexit poses unique challenges for life and pensions (L&P) firms.

Are you ready to tackle them?

There is still considerable uncertainty about what Brexit will mean in practice for UK insurers. Many L&P firms have undertaken contingency planning and are focusing on implementation. However, some firms have yet to start.

Have you got a plan in place?

There are three key areas L&P firms need to focus on: the extent of existing passporting; migratory policyholders; and financial market exposures. This is laid against uncertain timelines, including the extent of any transition arrangements.

How will you manage the potential disruption to your business?

There are a number of potential options that will enable life insurers to continue to service EU policies, including using an EU subsidiary as a hub, setting up a cell in a Maltese Protected Cell Company and selling the exposed business.

Do you know which contingency plan would best suit your needs?

Each option will have different tax, regulatory and people implications that will vary from company to company.

Do you understand all the tax, regulatory and people issues?

Since the triggering of Article 50, businesses of all kinds have been grappling with political and regulatory uncertainty. Whilst plans are being developed for the insurance and investment management industries to continue to operate in post-Brexit conditions, timescales are short and implementation will be complex.

A number of insurance firms, mainly non-life, are at an advanced stage of their contingency planning and have started implementation. For the L&P sector, the status of contingency plans tends to depend on the firms' business perspective in Europe. On the one hand, some L&P firms with 'open' overseas business, conducted either by branches and/or freedom of services and which they want to continue writing, have been quick to mobilise plans and are at an advanced stage. On the other hand, most L&P firms with legacy books and/or migratory policyholder issues have been only recently mobilising.

With limited time left before the UK formally leaves the EU in March 2019, ahead of a planned, but not yet agreed, 21-month transition period, Brexit poses unique challenges for L&P firms due to the long-term nature of the business, the mobility of people, uncertainty over key regulatory concepts and the changes to the geographical perimeter of the single market.

In this paper, we outline the key areas of concern for L&P firms and discuss some of the options that may be available, depending on their circumstances; and the capital, tax, people and regulatory issues they need to bear in mind when considering these solutions.

Areas of uncertainty

Once the UK is no longer subject to European law, the ability of UK insurers to passport, i.e., to conduct business via freedom of establishment or freedom of services, into other European Economic Area (EEA) states will be lost.

What that actually means in practice for UK insurers depends on national interpretation of matters on which European Directives are vague or silent. It is possible that, in the absence of an agreement to the contrary, UK L&P firms with policyholders in the EU will lose the legal right to continue to service them once the UK has withdrawn from the EU if they have not taken appropriate actions beforehand. What is certain is that without appropriate contingency measures in place, UK firms will be unable to conduct new business in the EU27.

Responding to Brexit involves making assumptions on key areas of uncertainty, as the post UK withdrawal trading environment has yet to be determined. However, with now less than eight months remaining until the UK's formal withdrawal, and doubt lingering over whether the planned transition period will be agreed, L&P firms cannot afford to wait and see. Implementation timelines are measured in months, and waiting may mean it is too late to put a solution in place.

The impact of Brexit on L&P firms will vary. However, as part of contingency planning, L&P firms should understand the implications and the scale of the problem and then identify possible solutions, including any dependencies upon a political resolution to the legacy business issue. Therefore, as a first step, L&P firms should assess the scale and nature of the business that is exposed by the withdrawal of the UK, determine if contingency measures are possible and decide how to communicate the impact of Brexit to customers.

When developing contingency plans, as part of the strategy, the following should be considered.

1. The nature of any free trade agreement

The UK Government has accepted that financial services 'passporting' in its current form will no longer exist after Brexit and the insurance industry has been planning for some time on this basis. The UK Government has expressed a wish for a deep and comprehensive trading relationship including financial services; however the details are elusive so far, and EU negotiators have emphasised that financial services cannot be cherry-picked for special access.

2. The implementation period

The EU Council has agreed, in principle, to an implementation period for 21 months from 29 March 2019, whereby the UK will remain part of the EU's legal and regulatory framework, thereby providing additional time for insurance firms to prepare for the new post withdrawal trading environment. However, as this implementation period is still subject to further negotiations and forms part of the withdrawal agreement, it has yet to be agreed, providing extremely limited time to implement contingency measures if in fact no such period is agreed.

In view of this, many insurers, including life companies with 'open' European business, are proceeding with their contingency plans on the assumption that the UK will leave the EU without an agreement or implementation period, on 29 March 2019.

3. Continuity of service

Many insurance contracts will 'cross over' the date of Brexit and there are several ways in which life, pensions and investments contracts could create cross-border issues after this date.

Life insurance poses particular challenges when the geographical perimeter of the market changes, because of the long-term nature of the business and the mobility of people. Passporting has conveniently obscured local legal frameworks, but these must now be taken into account. In particular, UK L&P firms must look to local law to define key concepts, including what brings an insurer within the scope of regulation.

There may still be an agreement between the UK and the EU27 whereby firms can continue to uphold the rights and obligations of insurance contracts until the end of the contract without the need for authorisation in the relevant EU27. Regulators have asked firms to plan on the basis that authorisation in the EU27 will be required. The UK has taken unilateral action with a commitment to a 'Temporary Permissions' regime (whereby EEA firms currently operating in the UK under passporting can continue to do so for a time-limited period after the UK has left the EU). The EU27, on the other hand, have not provided the same assurance for UK-based insurers who conduct EEA business, and has no blanket mechanism for doing so. It is possible for an EEA state to take action along similar lines to the UK Government on a 'Temporary Permission' regime but none has done so to date.

4. EIOPA opinion on disclosure of information to customers

In June 2018, EIOPA released an opinion calling on national supervisory authorities (NSAs) to remind insurers and intermediaries about their duty to inform policyholders and beneficiaries of the possible impact on their contracts of the withdrawal of the UK from the EU and the contingency measures being taken or planned. Following the issue of the opinion, NSAs may increase their focus on the customer communications of L&P firms. National provisions such as the UK's requirements for treating customers fairly also impose duties to communicate information.

Specific considerations for life insurance

Brexit affects L&P firms differently compared with the rest of the insurance industry and investment management sector. Due to the nature of the business, in particular its sensitivity to matters such as insurance contract law, social security frameworks and tax systems, markets remain predominantly national, meaning business is mostly regulated in the country where it is written. L&P groups tend to operate through subsidiaries within the EU, resulting in less cross-border trade compared with general insurance.

However, there are a number of L&P firms with 'open' business through overseas branches or via freedom of services and others for whom a portion of their legacy policies were written in other jurisdictions through passporting. For these firms, contract continuity is a significant issue.

Many L&P firms also have policyholders who originally bought a policy in the UK and then subsequently moved to another EU country, the regulatory consequences of which could be open to different interpretation in different countries.

Firms could choose to wait until a final agreement has been announced. However, if there is no agreement in place at Brexit, they risk being unable to service their policyholders. Where the EU country in question considers that the UK firm is carrying on insurance activity, without authorisation, the company and directors may be exposed to penalties and the contract may be unenforceable locally. Equally L&P firms may be exposed to reputational damage. This could be a particular challenge for L&P firms dependent upon a political resolution to the legacy business issue.

There are three key Brexit implications that can affect L&P firms and should be considered when developing contingency measures.

1. Policies originally written by a UK insurer in an EU27 territory

Some L&P firms will have a portion of their business that is conducted via passporting, either originally written in another EU country through a branch or by freedom of services, or acquired from another insurer in a transaction. In the event there is no political agreement on existing contracts, even where no current business is written, UK insurers are likely to need to be authorised to continue to service these policies (e.g., premiums, switches, assignments or claims) in the EU27 countries concerned. An alternative is to dispose of these books of business by transfer to an EEA insurer with the appropriate authorisation, prior to Brexit, though separating the policies out in a fair manner can be difficult if policyholders participate in shared with-profits funds. In some cases, the establishment of a third-country branch may be feasible, but these are rare for life insurance.

When formulating a strategy, L&P firms should first assess the scale and nature of the business that is exposed by the withdrawal of the UK. The firm will also need to consider how important it sees this portion of the business as part of its overall strategy, to help narrow down the contingency plans that it wishes to consider. Firms that wish to continue conducting business in the EU27 will be required to have appropriate contingency measures in place before Brexit.

2. Migrating policyholders

The mobility of individuals presents a particular problem. Unless an agreed solution is negotiated, and applied consistently by EU27 countries, UK L&P firms may be unable to service policies that were originally purchased by someone living in the UK but who has subsequently moved to an EU27 country. The views of national and European regulators will be crucial in these cases.

Firms that do not have contingency plans in place and are not authorised to conduct business in the country the policyholder has moved to may — depending on interpretation of the national law — be breaching the law if they continue servicing policyholders who have moved to the EU27. It is illustrative of the complexity and sensitivity of the issue that many thousands of EU27 residents must already have life and pensions insurance contracts from third countries, taken out before they moved to the EU27. So far, such cases have attracted little regulatory attention, perhaps because of the inherent difficulty in imposing regulation on existing

insurers of policyholders who move their habitual residence from country to country, and do not always notify their insurers when they do so.

If no agreement is made on behalf of the EU27 as a whole, individual countries may take different stances. So firms should consider quantifying their risk by assessing the number of policies exposed, their geographical locations and the approach of local regulators. Firms can then decide whether to accept the risk or develop and implement contingency plans.

Portfolio transfer of the policies to an EU insurer would avoid this difficulty, at least for policyholders that have already migrated. However, the problem will continue for policyholders that move after Brexit, unless a routine solution can be established. Furthermore, in view of the lead time for portfolio transfer, the practicability of this solution now depends on agreement on a transition period, or availability of an existing portfolio transfer process which is already under way.

3. Reinsurance

Once the UK leaves the EU, reinsurance, including intra-group reinsurance, whereby the business is written by one part of the group and then, for capital efficiencies, reinsured within the group, will be affected. L&P firms should be aware that:

- Any structure involving domestication of the business and reinsurance back needs to demonstrate substance to the home state regulator of the cedant whilst meeting commercial needs, in terms of both retained risk and business operations. EIOPA has set a minimum retention of 10%, to guard against the establishment of 'empty shells' to access EU business.
- Where profit-sharing funds have policyholders in both the UK and EU27 countries, there can be significant operational and financial management issues with the process of splitting these policyholders and potential prejudice to policyholders for smaller overseas blocks. There is therefore a desire/need to reinsure 100% of the risk of these policyholders back to the original fund to remove this complication. This then needs to be balanced with the substance requirement mentioned above. Companies can consider retaining non-profit business to ensure both requirements are met.
- Solvency II prescribes little in respect of third-country reinsurers, requiring only that local supervisors do not treat third-country reinsurers more favourably than domestic ones. Regulators could require collateralisation for the transferring policyholders, in which case the impact on transferring and non-transferring policyholders will have to be considered.
- When conducting reinsurance business, firms will need to comply with the local country rules. L&P firms that intend to have an EU entity to continue carry on new business in the EU and plan to reinsure to the UK parent company will need to consider that, in some EU jurisdictions, this could be considered as the parent entity conducting reinsurance business in that territory and therefore need to ensure local regulatory compliance.
- Any delay in granting Solvency II equivalence to the UK for reinsurance could affect the ability of cedants to take credit for reinsurance with a UK firm, or the treatment of such reinsurance in the SCR calculation.

4. Outsourcing

Many L&P firms use outsource providers to administer customer facing services. Any structural solution that relies upon outsourcing will need to address the expectations of the relevant regulators.

Potential structures

L&P firms have a number of potential options to consider to ensure EU policyholders and/or UK migrating policyholders are serviced. The implications of the UK withdrawal from the EU will vary for each firm, and each option will need to be assessed to ensure suitability. Whichever approach is chosen, it is important to engage in regulatory dialogue early in the process, in the affected countries. It is also important to recognise that in order for the structures to be effective and enable continuity of service post-Brexit, the chosen structure needs to be in place and any portfolio transfer completed prior to March 2019, unless a transition period is agreed.

1. Use an existing EU subsidiary (or establish a new one)

An authorised EU-domicile company can continue servicing all policyholders located in the EU by using passporting rights across the EU. In addition, the solution is still effective if a policyholder subsequently moves again within the EU.

Existing customers' policies will need to be transferred to the new company, normally by way of a portfolio transfer under Part VII FSMA, the UK legislation governing cross-border insurance business transfers, before the UK officially withdraws from the EU. It may be possible to draft the scope of such portfolio transfers to include policyholders who have already moved but only notify the insurance provider at a later date.

Separating business into a new company, which needs to be capitalised to a level satisfying the local regulator, has potential for capital inefficiency due to loss of diversification benefit, though this may be mitigated by use of reinsurance. A further consideration for internal model groups is that a new company would need to apply separately for approval to use the group model, as UK PRA approvals of group models will cease to have currency for EEA subsidiaries, after Brexit.

Some life businesses already have insurance subsidiaries within the EU, providing an alternative to a new authorised company established for the purpose.

2. Set up a cell in a Maltese Protected Cell Company (PCC)

This is a refinement on the EU subsidiary option, whereby the transfer is to a cell of an existing, authorised PCC that is professionally managed. Malta is the only EEA country that has such corporate forms. An application process would be required for the PCC to host the cell, as well as a portfolio transfer of the exposed contracts. However, overall, the process would save the expense and infrastructure of a subsidiary whilst retaining passporting access to the EU27 market. One PCC could host cells owned by several UK insurers with portfolios needing to be managed in the EEA.

In terms of capital requirements, a PCC owner would require the company to fully capitalise its own cell(s), by way of subordinated debt or subscription for shares in the cell. This represents own funds for the cell, which can only be used for that cell. Cell surplus over the notional cell SCR is not counted for the overall solvency of the PCC.

3. Sale

L&P firms could consider selling the affected business to an EU authorised company. This will remove the exposure to EU policies. However, as only a part of the business is being sold, a portfolio transfer is still required.

There remains the challenge of identifying all affected policies and the potential for new migrating policies to arise over time. Furthermore, although selling the business would result in removing any remaining capital requirements for the EU business, the UK company as a whole would see a loss of diversification. There could also be a potential need for a Major Model Change process, for internal model firms, if there is a material change in the risk profile.

4. Other potential options

There are other alternative options that L&P firms can consider, but they might have practical limitations:

- Surrender/buyout — a firm could offer to policyholders to withdraw from their policies on favourable terms before Brexit. An insurer seeking to buy out policies in this way would need to have regard to its conduct risk, as encouraging a policyholder to withdraw from a long-term insurance contract could be considered as not in the policyholder's interest, no matter how much it is in the insurer's. Some countries require insurers to offer withdrawal as a condition of consenting to a portfolio transfer. Clearly, it will be difficult to obtain 100% acceptance of any such offer.
- Seek authorisation as a third country branch in the EEA country where policyholders are resident — a limitation is that a third-country branch can only operate in that country and cannot passport to other European jurisdictions, so multiple country branches would be necessary. This option could be a solution for L&P firms that have a material amount of business in a particular country. However, a third-country branch must be capitalised, and there could be a loss of capital efficiency at the level of the company, if the host country requires capital to be ring-fenced to the branch resulting in loss of diversification benefit. In addition, few countries allow third-country branches, and life branches are very rare. Therefore, this solution may not be available in most EU countries.

Tax considerations

The UK's withdrawal from the EU, and any restructuring measures undertaken as part of a contingency plan, may have tax implications where there is any movement or transfer of policies, assets, liabilities, capital and people. Tax considerations can arise from the nature of the business that is relocated, the location the business is transferred to, and the process taken (i.e., third party transaction, group transfer or Part VII portfolio transfer). Each option will have different tax implications that will vary from company to company.

An L&P firm that opts to transfer the business to a new or existing entity should consider whether there may be exit tax implications, and any available reliefs or mitigants, for the transferring entity across all taxes (e.g., corporate tax, VAT, Stamp Duty or other transaction taxes) and all impacted geographies (e.g., if branches in one or more EU27 territories are being transferred, there will be considerations in each branch territory as well as that of the transferor entity). The firm will also need to consider whether there are any personal tax implications for transferring policyholders.

The future tax profile of the new operating company and its parent may not be the same as that of previous local branch(es) and thus needs to be evaluated. Further, the group should consider whether the new target operating model presents any tax residence or Permanent Establishment risks in the UK or in other countries which may be providing support and services to the new operating entities. Ongoing transactions within the group (e.g., intragroup reinsurances and administrative support arrangements) will have tax implications (such as transfer pricing and VAT)

Firms should also be aware of ongoing customer tax reporting, withholding and other compliance obligations as well as employment tax issues and compliance.

The availability of tax relief for the costs incurred in developing and implementing Brexit options will also need to be considered; how and where such costs are charged may impact the availability of relief.

Other considerations

Financial Services Compensation Scheme (FSCS)

Transferring the policy to a new entity in the EU would result in the loss of FSCS cover, with no guarantee of equivalent cover in the new country. L&P firms must keep regulators and customers close for effective communication

Other business

Life groups tend to do more than life business. Plans need to be integrated with group strategies and contingency plans for fund management and pensions business.

How EY can help

EY can offer flexible support to clients across the broad spectrum of the four phases of Brexit planning, covering regulatory, legal and tax issues, capital, operations, financial reporting, processes and people. Working collaboratively with EY clients' in-house teams, the different levels of our assistance range from a review and challenge of companies' Brexit preparations to their involvement in full implementation of the plan. Moreover, we have an integrated model across Europe, which enables us to connect our clients to the appropriate professionals in the different jurisdictions.

Next steps

Contact a member of the EY team to discuss how they can support you with your Brexit challenges.

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