

The background of the entire page is a close-up, slightly blurred image of the Union Jack (United Kingdom flag) and the European Union flag. The Union Jack is on the left, showing its characteristic red, white, and blue stripes. The European Union flag is on the right, showing its blue field with twelve yellow stars. The two flags overlap, with the Union Jack partially covering the EU flag.

BREXIT AND THE INSURANCE SECTOR

Towards 2020 and beyond

Kennedys

Foreword

I am delighted to introduce this report as part of Kennedys' ongoing commitment to providing key business insights on Brexit and how it is likely to impact on the UK's insurance sector.

The insurance sector is a vital part of the UK economy employing over 300,000 people; it is also a huge global success story generating over £20bn annually in export earnings for the UK and paying nearly £12bn in taxes to the Government. This international exposure makes the sector particularly sensitive to the impact of Brexit: policymakers ignore the sector at their peril.

This report comes at a critical stage in the UK's path towards exiting the European Union. Having moved beyond the first phase, the so-called 'divorce settlement', which addresses the immediate issues arising from the UK's exit, attention is now rapidly turning towards the future relationship between the UK and the EU. The outcome of this debate is vital for the long-term health and success of UK insurers, as well as international insurers doing business in the UK.

This report builds on the findings of our previous report – *The Insurers Speak* – which we published in the weeks before the Brexit referendum on 23 June 2016. While insurance companies did not have a vote in that referendum, they must now have an important voice in shaping what kind of Brexit will best serve the UK's long-term economic interests.

As we predicted in 2016, the UK is now devoting huge energy and resource to reframing its trading relationships with the EU. Eventually, this process will need to be replicated with all of the UK's trading partners as the country looks to recast its place in the global economy. In pursuing that agenda, it is crucial that politicians of all persuasions remain pragmatic and open-minded. A sustainable Brexit needs to be highly sensitive to the global competitiveness of the UK's insurance sector. As the world's leading financial centre, the City of London has built a global reputation for its skills and expertise in insurance and ancillary financial and professional services.

UK politicians must remain mindful of the need to continue to put in place ongoing trading arrangements that can provide reassurance to the market. In doing so, they will protect the UK's strength in acting as a vital gateway between Europe and the rest of the world, which contains many of the fastest growing markets in places like Latin America, Asia and the Middle East.

Our report in 2016 revealed there to be broad-based insurance industry support for remaining in the EU with a range of legitimate concerns if the UK did indeed vote to leave.

Two years on, with the UK now well down the road to exiting the EU, many of those concerns remain on the corporate risk agenda. Part 2 of this report identifies the key strategic issues, including the potential 'red lines' for the insurance industry, arising from the 2016 referendum vote to leave the European Union.

The various options for a new trading relationship between the UK and EU are outlined in Part 3 of this report. Given the ongoing political uncertainty around the exit negotiations, we look in Part 4 at the contingency planning issues for firms.

Key among these concerns include the ongoing need to attract the brightest and best talent from across the European Union, as well as from the global talent market. This is imperative to ensuring the future health of the UK insurance sector. Such access is particularly vital for the London market, which currently employs around 50,000 highly-trained professionals that service an increasingly global client base, and collectively ensure the vibrant and diverse marketplace that currently exists in our domestic insurance sector. Access to talent not only underlines the insurance sectors current success, but it also determines its future success through continued innovation. The potential threats to future innovation are highlighted in Part 5 of this report.

While our research illustrates continued widespread support for EU membership among insurance industry leaders, this report does not mark an attempt to reopen old battles. The people have spoken, and that democratic mandate must be respected. The challenge we seek to address within this report is to fully explore the subtle nuances involved in making Brexit a reality, by providing a comprehensive and objective review of the threats and opportunities when viewed from the prism of one of UK's most important economic sectors.



Nick Thomas
Senior partner

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Executive Summary

What will Brexit mean for the UK's insurance sector?

This report provides a snapshot of opinions from within the UK insurance industry as the UK undertakes the somewhat tortuous road towards Brexit. As part of this process we have undertaken in-depth interviews with 20 senior insurance executives and policymakers. The interviews were conducted between February and April 2018.

The immediate backdrop for these interviews was provided by the political agreements reached on the phase one Brexit 'divorce' issues (workers' rights, the divorce settlement and the Irish border) in December 2017, as well as the agreement on a two-year transition period reached in March 2018 which extends the UK's membership of the Single Market and the Customs Union to the end of December 2020. Both these important milestones contributed towards a more positive mood within the insurance sector, supporting the view that the UK would be able to negotiate a stable exit from the EU. But there is also perhaps a growing sense of realisation that a deal securing significant market access for financial services and insurance (broadly aligned with the current passporting arrangements) is highly unlikely to emerge. The Government's White Paper, published in July, appears to have taken mutual recognition off the negotiating table, confirming market fears about the loss of access to EU insurance markets.

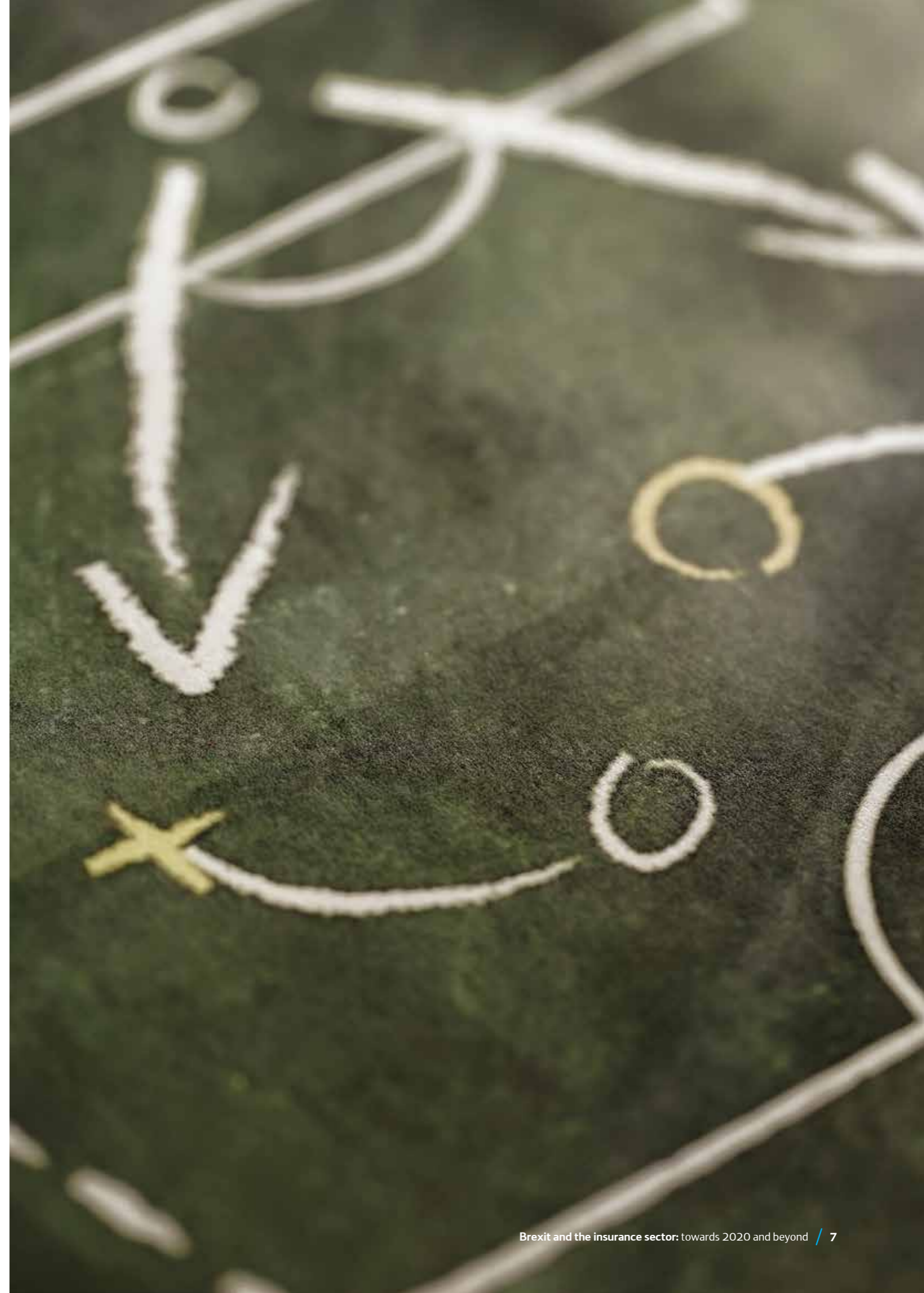
From the viewpoint of insurers, the UK Government needs to recognise that there are certain aspects of business continuity, notably the continuity of insurance contracts, which should form a serious consideration alongside any political issues.

KEY RECOMMENDATIONS

1. Resolve the uncertainty surrounding the terms of the UK's exit

- The UK needs to secure a new relationship with the EU and it needs to achieve clarity on this quickly. Respondents noted a trend of politicians 'kicking the can down the road' and waiting until the eleventh hour to reach political agreements. Such 'eleventh hour' agreements may be sufficient for averting constitutional crises, however, legal certainty requires more planning: businesses cannot plan based on political agreements reached late in the day.
- The proposed transition covering the period between the UK formally leaving the EU in March 2019 and the end of 2020 is welcomed in the market. However, it is only of value for business contingency purposes if it becomes legally binding during the summer of 2018. This means the UK and EU formally adopting legislation (which will need to be agreed with all national parliaments across the EU) covering the UK's terms of exit and the transition period. If the legal status of that transition is only assured in early 2019 (as now looks highly likely) then firms will be forced to make contingencies based on a hard Brexit or a no-deal outcome. Forcing firms to adopt a 'Plan B' based on the worst-case scenario will result in deeper economic impacts being felt across the UK insurance sector. The UK Government has indicated that a deal is '80% completed' and can be concluded by October 2018. It is crucial that the politicians endeavour to meet this timetable.

Forcing firms to adopt a 'Plan B' based on the worst-case scenario will result in deeper economic impacts being felt across the UK insurance sector.





2. The UK should aim for flexibility around the exit

- The timescale for leaving the EU should be flexible and pragmatic. The UK should not commit to a hard deadline of December 2020 if more time is required to agree a bilateral relationship. Some even felt that the UK should ask for more time to conclude the initial discussions, effectively extending the Article 50 process beyond March 2019.
- From the viewpoint of insurers, the UK Government needs to recognise that there are certain aspects of business continuity, notably the continuity of insurance contracts, which should form a serious consideration alongside any political issues. Transferring those contracts across jurisdictions can take over two years. Legal certainty on how these contracts will be enforced post-Brexit is needed without any further delay.
- The open-ended approach supported by industry respondents is most akin to the current backstop option for customs union membership, which is preferred to the alternatives (Maximum Facilitation or Customs Partnership). Underlying this view is a belief that the UK Government should take the necessary time to secure the best alternative to the current Single Market and Customs Union membership. The UK should only move away from the current market access arrangement once it becomes clear that a workable alternative can be agreed and implemented in a timely manner. Whatever the new arrangement looks like, any transition period needs to be long enough to enable firms to make the necessary adaptations to their current business models. Politicians should resist attempts to make this process fit into electoral cycles.

3. Defining 'best third country' status – the new trading relationship

- The UK Government has consistently talked about securing a 'deep and special' trading relationship with the EU post-Brexit. The industry's preferred option for securing such a relationship is a bespoke Free Trade Agreement which enshrines mutual recognition of each party's domestic rules. Mutual recognition must also enshrine the need for broad regulatory alignment between the EU and UK overseen by an independent dispute resolution mechanism. The UK Government's White Paper – which reflects the Prime Minister's 'Chequers Agreement' – appears to support this outcome for goods but, crucially, not for services such as insurance.
- Currently, there is little – and diminishing – confidence that the UK will be able to agree a separation that provides sufficient market access for financial services. In other words, while the mutual recognition model is the preferred outcome, it is not viewed as the most likely outcome. If mutual recognition is not politically achievable, then the UK Government must set out an alternative model of market access.
- The UK Government is developing such a plan having discussed the goal of achieving 'best third country' status. Whatever model this involves, the White Paper indicates a trade deal covering services relying instead on enhanced equivalence. The UK Government needs to address key industry concerns relating to equivalence. Currently, third country equivalence is only partially covered in EU financial services directives. The nature of that equivalence is also highly politicised and subject to the discretion of the European Commission. All respondents regard this as a major backward step compared to the current passporting regime.

- The Government's White Paper may not be the final word on the issue of mutual recognition. As a leaked version of an alternative white paper, compiled by DExEU argued: "a model is required which can address the unique interconnectedness of the UK and EU financial systems" The DExEU paper effectively rejects the equivalence model by arguing that this model should provide an objective framework which is "reciprocal, mutually agreed and permanent". Given the number of ministerial resignations since the Chequers meeting, it is not clear how sustainable the PM's plan is or how the fault lines within the Government may further reshape the UK's negotiating position.

4. The UK should not become a rule-taker

- Market practitioners support the views of UK policymakers in rejecting the view that the UK should become a rule-taker, an outcome closely associated with the Norwegian model based on EEA membership. The UK should instead seek to combine regulatory alignment with the EU Single Market wherever possible whilst allowing the UK authorities to develop rules which are appropriate to the scale, nature and size of the UK market.

5. Protecting workers' rights

- There should be a clear statement on protecting the legal rights of EU migrant workers already in the UK, as well as those who may come to the UK during the transition period in the lead up to December 2020. Many thousands of EU migrant workers are currently employed in the UK insurance sector. It is estimated that there are at least 2,000 working in the London Market, and potentially thousands more working across the UK sector.
- The UK Government and the EU Commission have now set out a joint document stating that EU and UK citizens can continue to live and work as they currently do under the same conditions as under Union law. The UK Government has also set out its 'three simple requirements' for EU citizens to remain in the UK. The agreement reached on migrant worker's status is welcomed, but it is unlikely to achieve any legal basis before early 2019. This needs to be expedited as quickly as possible. Until this happens, the future legal status of these workers remains in doubt.

- Following calls from the Mayor of London, there would be industry support for an additional immigration quota for the City of London carved out from the overall UK net migration target, which would allow the London Market to hire highly-qualified EU workers without unnecessary constraints. Anecdotally, some firms reported difficulties in hiring senior people from outside the EU as a result of the Government's decision to scrap the Highly Skilled Migrant Programme and introduce the new five-tier points-based system. With the Government committed to reducing migration to the "tens of thousands" there are fears that UK insurers will find it harder still to attract global talent.

6. Protecting investment in research and development

- UK Government commitment to maintain funding streams for EU-back research and innovation into areas which promote innovation in insurance including artificial intelligence (AI), autonomous vehicles, health and life sciences.



2000+

EU migrant workers are employed within the London insurance market alone.

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Brexit Outcomes

What is the likely end-state?

PROGRESSIVE ALLIANCE

Water down Theresa May's red lines to achieve more generous/comprehensive settlement from EU on a future FTA. Opposition parties have committed to a formal customs deal with EU.

TORY COMPROMISE: CHEQUERS

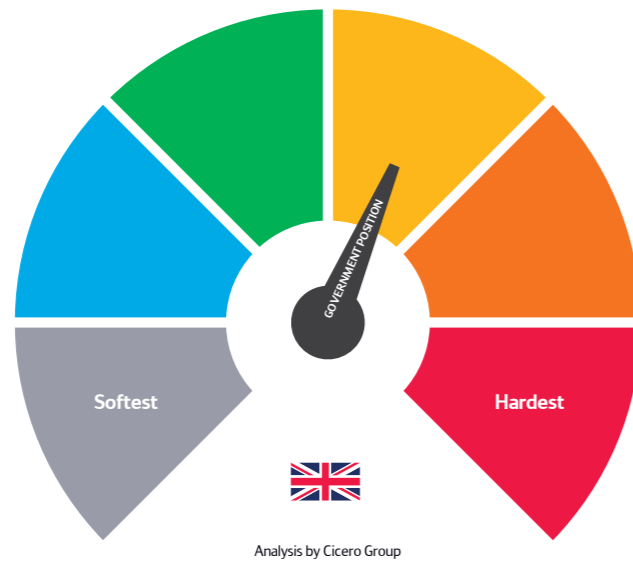
Implementation period of two years with EU Customs Union (EUCU) - type arrangements and recognition of EU standards. Softens on ECJ jurisdiction red-line (end 'direct' jurisdiction). Seek extensive bespoke future relationship but remain outside Single Market and EUCU. Anticipate UK following EU rules in some areas.

SINGLE MARKET MEMBERSHIP

Leave EU, but remain within the EEA. This would require the UK to do a U-turn on Freedom of Movement rules. No FTA required.

REMAIN IN EU

Revoke article 50 and remain within the EU. Possibly lose existing budget rebate and opt-outs?



'HARD' BREXIT

Cut the cord – UK sovereignty is bottom line. No new EU rules, limited transition and no future payments. A low access, high controls similar to a conventional FTA with EU. Maximal freedom for UK to chart new course, but with very little/no time for adjustment.

NO DEAL

WTO trade, 3rd country relationship. No transition.

While there are different views with the insurance industry as to what kind of Brexit they would like to see, all respondents agreed that the UK can ill afford to pursue anything other than a clean and orderly withdrawal. The current political stalemate in the UK will have to be broken – and quickly – if the UK insurance sector, and wider UK economy, are to achieve any kind of outcome which they can support.

The most likely outcome right now is difficult to gauge. While Brexiteer politicians have been talking up the prospect of a 'no deal' outcome, this is largely seen as a ploy to strengthen the UK Government's negotiating hand. Insurers' contingency plans have, as a matter of necessity on advice from regulators, taken into consideration the possibility of a 'no deal' outcome. However, this is seen by senior industry leaders as by far the least desirable outcome and one which would inflict maximum collateral damage on the UK's international financial services sector. This outcome should be avoided at all costs.

Cross-border insurers could live with a 'hard' Brexit if forced. But this would still require a sizeable transition period to help firms migrate to new business models as well as dealing with concerns about continuity on long-term contracts. A hard Brexit would bring to an end the current passporting rights, potentially limiting the UK's role as gateway to the Single Market, but the City of London will still maintain its position as a global hub, which could be enhanced if new Free Trade Agreements improve the UK's trading relationships with other global markets. The economic downsides of this outcome will be immediate whereas the upsides may take years to materialise.

With the lack of a clear Parliamentary majority for any of the Brexit outcomes, we are faced with several months of muddle and further compromise.

The Prime Minister's Chequers compromise represents a retreat from the initial red lines set out at the Lancaster House speech in what is seen as a pragmatic move towards a 'Soft Brexit for goods' albeit with a 'Hard Brexit for services'. However, we still expect to see further shifts in the UK Government's position in the coming months.

The 'progressive alliance' within Parliament (which includes a number of Conservative MPs) is highly unlikely to allow the UK Government to withdraw from the EU without first having some kind of transitional plan in place: 'Crashing out of the EU' will not be politically palatable. Nor will this be seen as anything other than a nightmare scenario for the UK insurance sector.

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STAY IN EU	SINGLE MARKET MEMBERSHIP	'PROGRESSIVE ALLIANCE'	TORY COMPROMISE	HARD BREXIT	NO DEAL
Business impact: Minimum – status quo. However, could lead to political paralysis.	Business impact: Low in short term – UK loses ability to influence EU rules going forward – damaging in long term?	Business impact: Med-low – Open question as to whether special deal for City can be done with these concessions.	Business impact: Medium – longer transition helpful. Still problematic for services sector. Simply delays possible cliff edge?	Business impact: High. Would require rapid adjustment. UK becomes a third-country with no deal on financial services.	Business impact: The 'nightmare' scenario with a major short-term hit to business continuity. Potential for capital flight from UK.

PART 1 – Why the UK matters to the EU Single Market, and why the Single Market matters to our insurers

The decision to leave the European Union on 23 June 2016 marked a defining moment in the UK's history. It also marked a key milestone in the development of the European Project, representing at least a temporary reversal of the trend established with the Treaty of Rome in 1957, which committed member states towards deeper political, economic and monetary integration.

The UK took the momentous decision to join the European Economic Area in 1973 alongside Ireland and Denmark. As one respondent we spoke to commented, the UK "arrived late to the party". By the time it entered the then-European Economic Community, or EEC, the organisational structures were already in place; so too were the political dynamics and funding priorities which had already been established without UK influence. Even during its years of EU membership, the UK remained largely detached from the goal of 'ever deeper' European integration.

However, this changed to some extent with the development of the Internal Market from the 1980s onwards. The UK had been an influential voice in passing the Single European Act in 1986, which created the goal of establishing a single market by 31 December 1992. This marked the first revision of the 1957 Treaty of Rome and gave significant impetus in the development of the four fundamental freedoms: the free movement of goods, services, capital and people.

Building on this new impetus, it was the UK Council Presidency in 1998 which formally adopted the creation of a Single Market legislative programme for financial services. This led to the introduction of the first Financial Services Action Plan in 1999.¹ This plan resulted in 42 separate legal measures designed to remove barriers to cross-border financial trade within the EU. This was particularly central in deepening cross-border integration in the insurance sector, containing proposals such as the Insurance Mediation Directive (IMD) and the Distance Marketing Directive (DMD). The EU Commission also pressed ahead with the 4th (and subsequently 5th) Motor Insurance Directive and work began on developing the EU-wide Solvency II framework.

Viewed against the backdrop of Brexit, it is ironic that the UK has done more than any other EU Member State to create the freedom of services and capital which is now driving huge financial benefits to insurers, banks and asset managers operating in the City of London and across the UK. For example, the UK was the leading voice in the development of the EU's prudential framework for insurers on Solvency II. This framework created a third-country branch regime for non-EEA insurers and reinsurers.

The register of insurance undertakings maintained by the European Insurance and Occupational Pensions Authority (EIOPA) identified a total of 58 third-country insurance or reinsurance branch licences across the EEA. Of these, 41 are based in the UK.² This illustrates how the Single Market has encouraged cross-border market activity. It also underlines how the UK has directly benefitted in attracting inward investment, with the UK itself often seen as a gateway to the Single Market for insurers outside Europe.

Within the current Single Market rules, companies incorporated in countries other than the UK in the European Economic Area (EEA) can make use of inbound passports when accessing the UK market. Outbound passports refer to UK firms passporting into other EEA markets. This passporting capacity enables firms to establish UK branches under the Freedom of Establishment (FOE) rights, or to sell directly on a cross-border basis into the UK from other EEA countries under the Freedom of Service (FOS) provisions.

Ways in which inbound passports affect the UK market

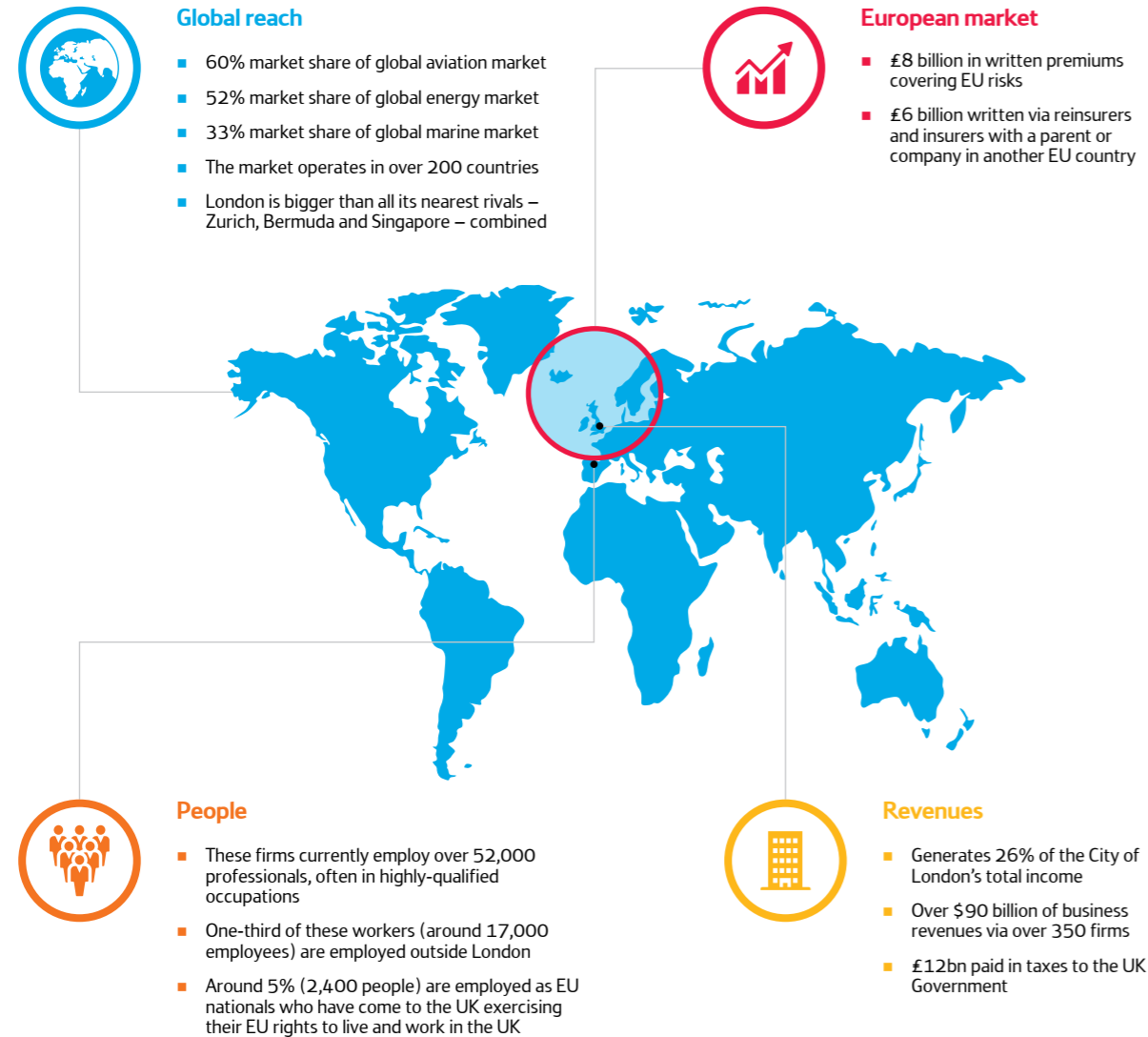
- Servicing global clients via the London market: London branches of insurers headquartered in other EEA countries are estimated to underwrite almost £6 billion of insurance premiums in the London market.³ This business is servicing a global client base.
- Servicing the UK's domestic market through branch networks: many EEA companies write insurance to domestic retail and commercial customers using a UK branch. Some of the largest insurers in the UK market fall into this category including AXA (incorporated in France), Allianz (Germany), Generali (Italy), Aegon (Netherlands), Zurich (Switzerland), Munich Re (Germany) and Ageas (Belgium).
- Servicing the UK's domestic market through direct channels: other EEA companies sell insurance directly into the UK market using the Freedom of Service passport via digital platforms. This business has been historically small in volume compared to branch network 'Establishment' passporting.

UK INSURANCE: THE GATEWAY BETWEEN THE EU SINGLE MARKET AND THE GLOBAL MARKET

Thanks in some part to the benefits of the EU Single Market, the UK's insurance sector has become a truly global success story. Today, the industry manages investments of £1.9 trillion (25% of the UK's net worth) and employs around 330,000 people. It also exports over £21 billion of services across the EU Single Market every year. Getting the best deal possible post-Brexit will have a profound effect on maintaining that global success story.

As our respondents indicated, this is particularly true within the London Market as a leading global hub providing insurance and reinsurance to a global client network. This global nature of the London Market, and the importance of the EU Single Market in securing that success, can be demonstrated when looking at its share of the global insurance and reinsurance market in key economic sectors:

KEY MARKET FACTS:⁴



With the UK potentially closing the door on such extensive cross-border liberalisation, the key question we consider in this report is simple to pose, yet impossible to answer: **what comes next?**

What has already emerged is an industry consensus among respondents who consider it highly unlikely that the UK will be able to maintain its current level of market access in any post-Brexit trade scenario. The race is on among negotiators on both sides to determine what kind of arrangements the EU and UK

can secure. The high-level principles have been set out. But as the UK and EU move towards a more definitive position on what that trading position will look like, it is likely to highlight the obvious political tensions and differences of opinion, not just within Theresa May's government, but also between the other 27 EU Member States. For insurers operating cross-border businesses in the UK, the time to wait and see what the politicians agree has already passed. Contingency planning is not only under way; those plans are being activated.





The insurance industry makes a substantial contribution to the overall UK economy. This should give the sector a significant voice in shaping the UK's priorities in a future UK-EU relationship. Brexit is seen as both a business threat and a potential opportunity, though at this stage in the negotiations, insurance business leaders naturally emphasise the downside to business risks. It is these top-

line issues which are shaping the debate on what kind of Brexit insurers envisage. Alongside these concerns are a whole host of day-to-day operational issues. As mentioned above, many firms have developed and put in place contingency plans to address the business threats arising from any legal and regulation cliff-edges, as well as future market dislocation and regulatory divergence.

POTENTIAL COSTS AND BENEFITS OF BREXIT



Prospects for trade?

The potential benefits arising from the UK's decision to exit the EU may not materialise for many years. While a new network of free trade agreements may deliver benefits to the UK, such benefits are not anticipated to materialise until well beyond 2020. Only at that point will the UK be free to enter into its own trade agreements with other EU and non-EU countries. Furthermore, the demand for such trade deals with third countries is relatively low on the insurance industry's agenda. Maintaining good market access with existing trading partners in the EU remains the top business priority.



Impact of uncertainty

In contrast to the potential benefits, the costs of Brexit are already tangible and impacting on firms' ability to make long-term plans. The deadweight cost of business uncertainty arising from Brexit is having an impact on decisions about long-term investments and, in many companies, business location. It is also having some impact on the ability to hire and retain EU migrant workers who are uncertain about their future working status in the UK. Contract continuity represents a further major business continuity concern, particularly in the event of a 'no deal' scenario.



A regulatory bonfire?

A further potential benefit has already been taken off the table: we already know that there will not be a regulatory dividend arising from Brexit. Market practitioners are not expecting to see the UK liberalise or deregulate the marketplace. Indeed, they are demanding the opposite, expressing a clear view that the UK will need to maintain regulatory alignment if it is to achieve any kind of market access at the end of the transition period in December 2020 and beyond.



Transitional costs

The associated transitional costs of ensuring cross-border business operations can continue once passporting rules cease to apply to the UK market are also very real. Transitional plans are already being activated. One firm we spoke to has already allocated more than £50 million on additional IT infrastructure, relocation costs (including new office rentals and office fit-out costs), new hires, regulatory authorisations, client marketing and legal and professional services fees. This compares to firms in the banking sector, where individual banks have reported transitional costs in excess of £150 million. These costs will only continue to rise throughout the Brexit process.

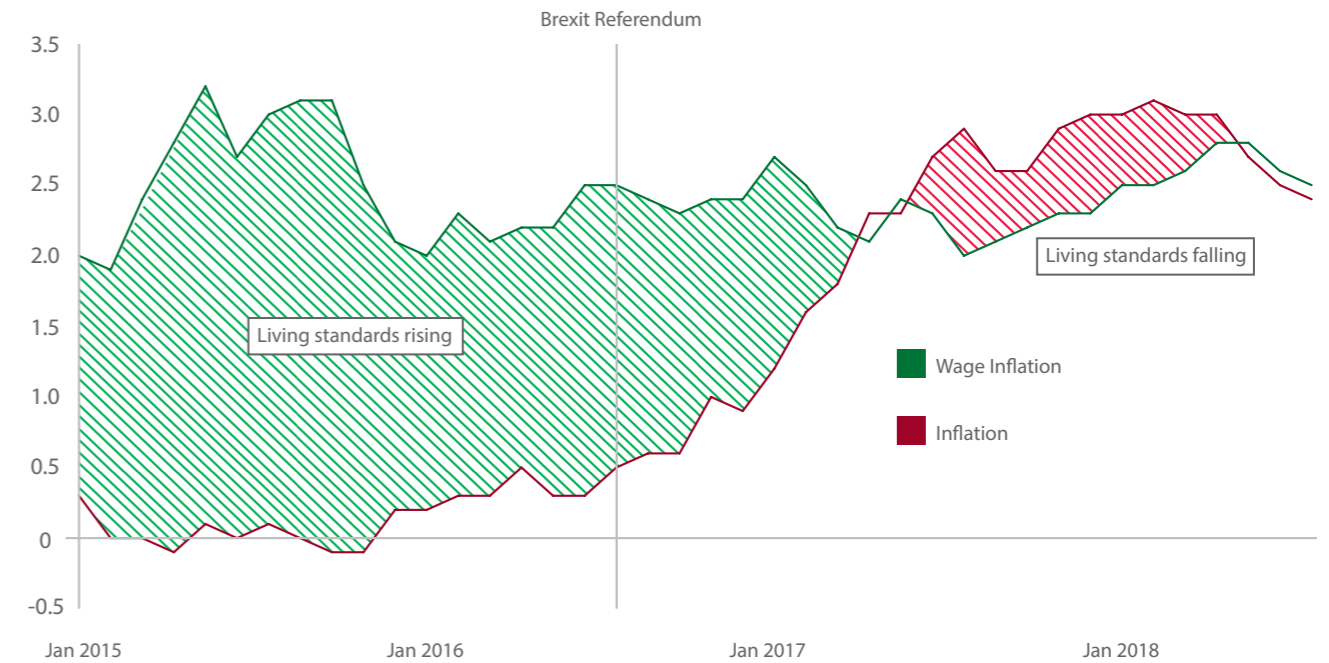
PART 2 – Brexit impact: Two years on

It is almost two years since the UK took the historic decision to leave the EU. The days immediately following the referendum created huge political and financial uncertainty and instability. Some of these issues were covered in our first report published in May 2016 on the eve of the referendum vote. The most obvious impact was the immediate change of leadership with David Cameron resigning on the steps of Downing Street to be eventually replaced by Theresa May as Prime Minister.

Alongside the political fall-out, currency markets experienced the greatest volatility with the pound falling around 20% against both the US Dollar and the Euro. On the back of this major devaluation, UK inflation headed towards 3%, as a result of which real incomes fell throughout 2017. One positive was the impact on UK equities. With large FTSE businesses earning 80% of their revenues overseas, the much-cheaper pound boosted their earnings sending the FTSE to a new high.

Crucially, the UK avoided an economic recession, but growth has fallen from being among the highest in the G7 countries to the lowest. Even before Brexit has taken place, the UK economy is estimated to be 0.5% smaller than it would have been following a Remain vote.⁵ Like all other businesses, insurers are feeling the ill-wind of Brexit as the uncertainty hits consumer confidence (impacting on spending) and business confidence (impacting on investment).

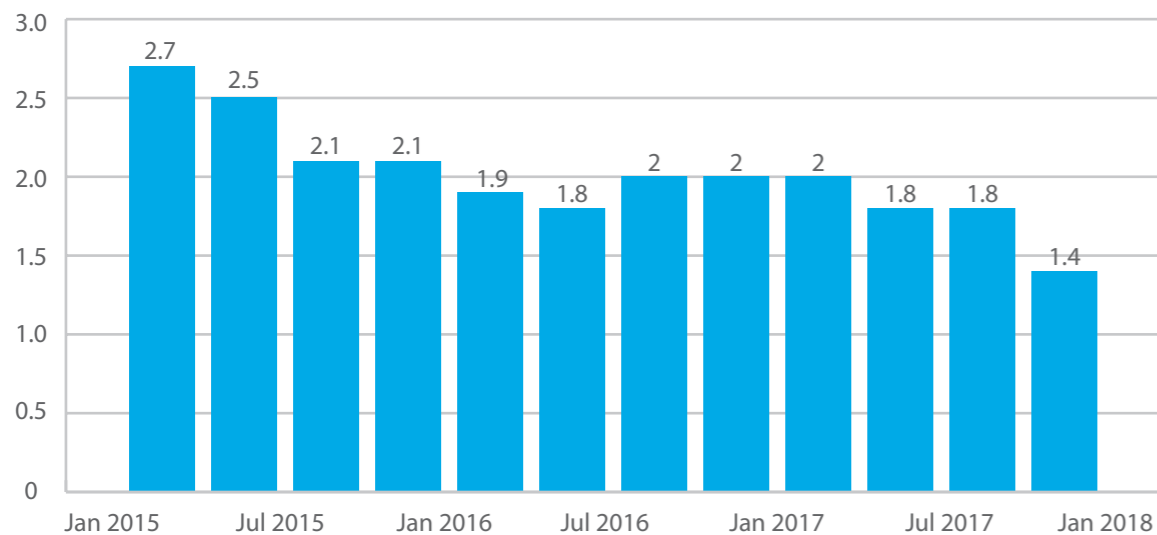
INFLATION RISING AND LIVING STANDARDS FALLING⁷



THE IMMEDIATE IMPACT OF BREXIT: KEY NUMBERS

Economic growth has slowed⁶

UK GDP Annual Growth Rate



Inflation rose from 0.5% to over 3 percent
Real incomes have been falling as a result as salaries grow at 2.5 percent

THE POUND FELL BY AROUND 20% AGAINST THE US DOLLAR⁸



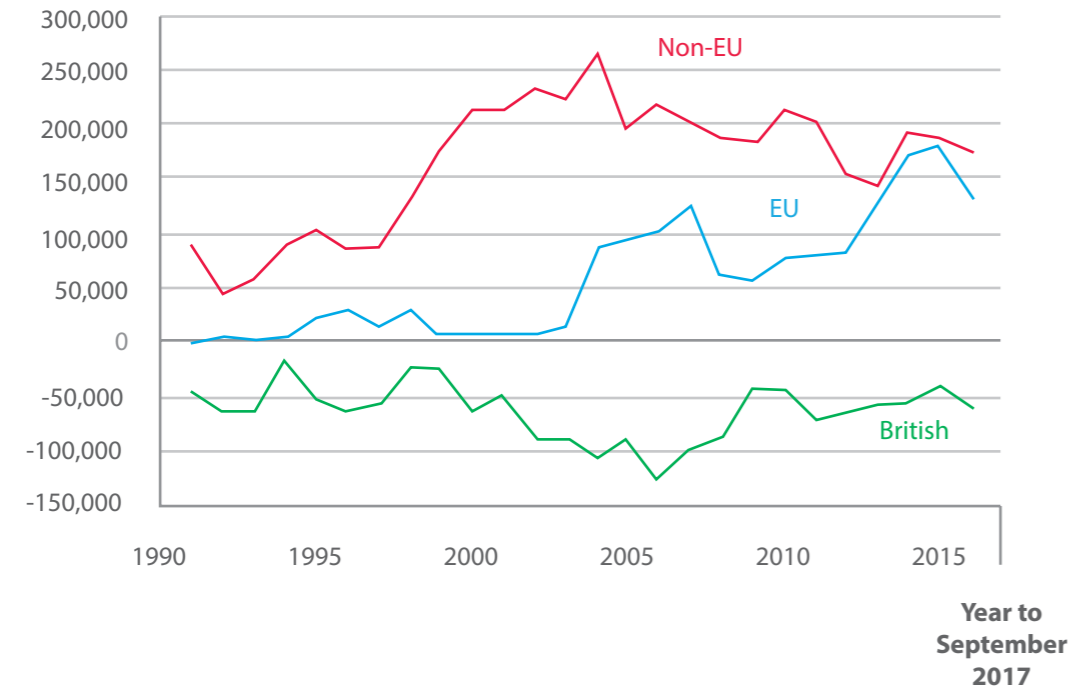
One of the less obvious impacts of Brexit has been the change in sentiment towards the UK among Europe's migrant workers. Immediately prior to the referendum vote, the UK was experiencing annual net migration of around 330,000. Around half of all inward migration was coming from other EU Member States as workers exercised their fundamental rights under the free movement of

people. The latest figures suggest that this has fallen to around 220,000 annually, with most of the fall attributed to fewer EU workers arriving in the UK. Some of the companies we spoke to already reported difficulties in convincing potential senior management hires to relocate to the UK, given the uncertainty surrounding their future employment and citizenship status.

The UK Government's decision to scrap the Highly Skilled Migrant Programme and replace it with the new five-tiered points-based system for migrant workers outside of the EU has already had an impact on firms attempting to secure visas for senior managers outside of Europe. With the Government maintaining its commitment to reduce overall net migration to "the tens of thousands" (down from the current 220,000), the fears about securing the brightest and most talented in the global talent pool will only grow. Insurers gave their support to the idea, supported by the Mayor of London Sadiq

Khan, that the City of London should be granted a carve-out from the national migration targets in an attempt to ease visa restrictions on highly skilled workers. The recent announcement by the UK Government to ring-fence the NHS from the highly skilled workers quotas provides two welcome benefits in this respect. Firstly, it relieves pressure on the current quotas around one-third of which were allocated to healthcare workers, and secondly, it provides a template for other sectors, such as insurance and financial services, which are also highly exposed to global labour markets.

MIGRATION INTO THE UK HAS DIPPED SHARPLY – ESPECIALLY FROM THE EU⁹



Ongoing political uncertainty in the UK

A major source of business concern

The political context within the UK, and notably within the Conservative Government, is seen as the major source for ambiguity. By not setting out clearly what a new trading relationship looks like, the Prime Minister has, until now, been able to maintain the uneasy truce between the various pro-Brexit and pro-EU factions within her own party. But this feeds uncertainty in corporate boardrooms, and has in part helped to fuel some of the relocation decisions with jobs moving from the City of London to other EU financial centres.

The delicate political balancing act has become more fraught following May's decision to hold a general election in June 2017. The general election helped to fuel uncertainty, as it raised the prospect of a potential change in the Government, and with it a change of direction in the UK's Brexit policy. This uncertainty was institutionalised on 8 June 2017 once it became clear that the UK had returned a hung Parliament: Theresa May held onto the keys of Number 10, but her Government could no longer count on a majority in either House of Parliament. This dynamic will make it much more difficult for the Government to set out a clear strategy and to successfully deliver that strategy in the UK Parliament.

On 13 December 2017, the Government suffered the first of what has proven to be many Parliamentary defeats, as the House of Commons voted to secure a 'meaningful vote' on the final deal agreed between the UK and the EU. On 18 April 2018, the House of Lords also voted to amend Government legislation calling for the UK to remain within the Customs Union.¹⁰ The EU Withdrawal Bill finally achieved Parliamentary approval on 20 June 2018, ensuring that EU laws will still be enforceable in the UK after Brexit. However, it is likely there will be many more Parliamentary votes on more contentious issues arising as the 'Brexit laws' make their way through UK Parliament.

A further complicating factor arising from the general election was the need for the Conservative Government to secure the support of Northern Ireland's Democratic Unionist Party (DUP) to prop up its power base. This effectively internalises the complicated political situation in Ireland to within the Government's Parliamentary arithmetic in Westminster. The future of power-sharing, the desire to maintain an open border between the Republic of Ireland and the North, and the need to maintain the Good Friday Agreement, could all result in a seismic shift in UK Government policy: there is potential for the UK (or at least part of the UK) to remain inside the Customs Union and potentially also the Single Market. No political progress has been made on this point during the first half of 2018.



Firing the Brexit starting gun

The Article 50 process

The economic and social impacts outlined on the previous pages result purely from changes in market sentiment following the referendum result, rather than any legal change in the status of the UK within the EU. Those changes will only take place following the conclusion of the Article 50 process under the Lisbon Treaty.

The rest of this section sets out how that political agreement will be reached during the Article 50 process.

The first significant milestone in the Brexit process came on 29 March 2017 when the UK Government took the historic step to trigger Article 50. This gave formal legal notice of the UK's intention to leave the EU, thus beginning the two-year process of negotiating the UK's withdrawal from the EU. That process would be phased in two stages:



Phase 1:

define the UK's terms of exit



Phase 2:

the future UK-EU bilateral trade relationship

PHASE 1 – AGREEING THE 'DIVORCE' SETTLEMENT

In December 2017 the UK Government and EU negotiators reached an important milestone in the Article 50 process. After six months of intense negotiations about the nature of the 'divorce' settlement between the UK and EU, a political agreement was reached. This addressed the issues of workers' rights for all EU migrant workers. There are over 3 million EU migrant workers working in the UK. They account for 5% of the workforce in the London Market. The divorce settlement also agreed the size of the UK's exit payments (in the region of £40 billion) and the need to maintain regulatory alignment to maintain an open border between Ireland and Northern Ireland. This agreement removed a major source of business uncertainty. However, there are still many political and technical issues to be overcome, notably on the issue of the Irish border. Whether it will be possible to maintain an open border without also remaining in some kind of customs union remains to be seen.

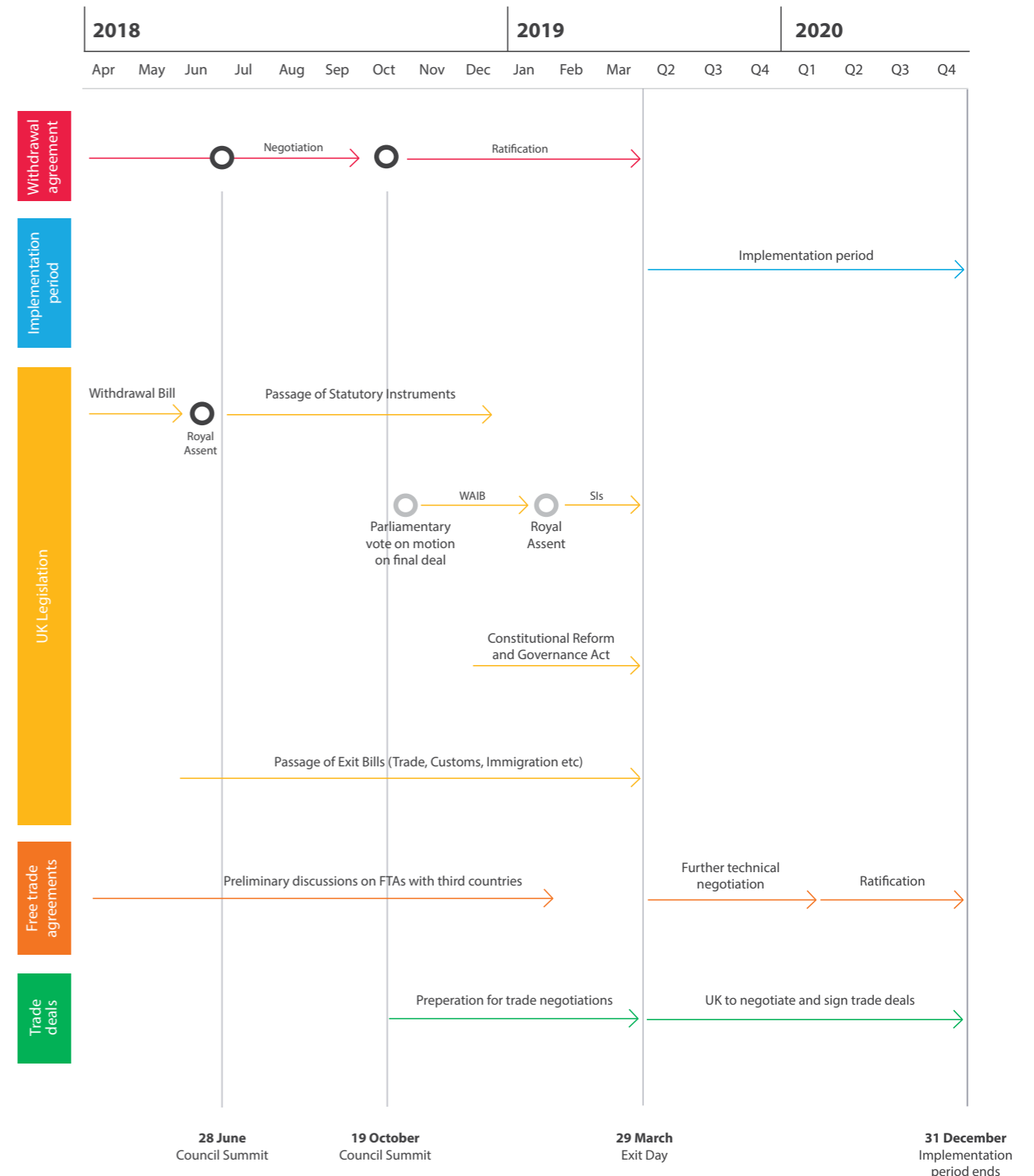
TRANSITION PERIOD – MAINTAINING 'BUSINESS AS USUAL' BEYOND MARCH 2019

At the end of Phase 1 it became clear that the UK and the EU would need to agree a transition period to avoid any financial instability arising from a potential 'cliff-edge' situation, should the UK leave the EU in 2019 without first having agreed a new trade agreement. Such an outcome would prove particularly destabilising in financial and insurance markets, where uncertainty over existing cross-border contracts in insurance and derivative markets became a major political concern. To avoid such an outcome, the UK Government has been able to secure agreement with its EU counterparts on the nature of a transition agreement, which will see the UK maintain its membership of the Single Market and Customs Union up to December 2020. This removes the threat of any immediate 'cliff-edge' with the UK dropping out of the EU Single Market in March 2019. However, the crucial point from the perspective of UK and international insurers doing business in the UK is what happens to the UK-EU relationship on 1 January 2021 – assuming the agreements reached to date do not unravel.

PHASE 2 – THE NEW TRADING RELATIONSHIP

Attention is now turning to what kind of new trading relationship the UK and EU can hammer out between them. The UK and EU have both worked hard to avoid the immediate danger of a 'cliff-edge' departure. The prospect of the UK 'simply walking away' from its international commitments would not only represent a major reputational hit for the UK in the eyes of foreign governments and investors, but it would also create the risk of huge legal uncertainty. This is particularly true for the UK's insurance sector which is highly globalised in terms of its global capital base, cross-border legal entities and insurance contracts, as well as having a highly-mobile workforce. Having put in place a transition period to avoid this risk, we now have a clear timetable which takes the negotiating parties up to the end of 2020. The timetable for negotiating a new trade deal is set out on the next page.

FUTURE NEGOTIATION TIMELINE



Part 3 – The future EU-UK trade relationship

The various options versus the political context

The UK Government has remained deliberately guarded in setting out the likely ‘red lines’ for any future trade agreement with the EU, keen not to reveal its negotiating hand too early. However, the Prime Minister Theresa May has put forward clearly defined parameters for the future trading arrangement. On 17 January 2017, May set out 12 key objectives for the UK Government as part of her ‘Lancaster House’ speech.¹¹ The main objectives of relevance to the UK insurance sector are reproduced below:



CONTROL OF IMMIGRATION

Giving the UK Parliament the power to control how many people enter the UK from EU Member States (such powers already exist in respect of third countries). This requires the UK to leave the EU’s Single Market thereby removing the rights of EU citizens to exercise free movement into the UK.



CONTROL OF OUR OWN LAWS

Meaning that all legislative powers will revert to the UK Parliament and devolved administrations, as well as bringing about an end to the jurisdiction of the European Court of Justice in the UK courts.

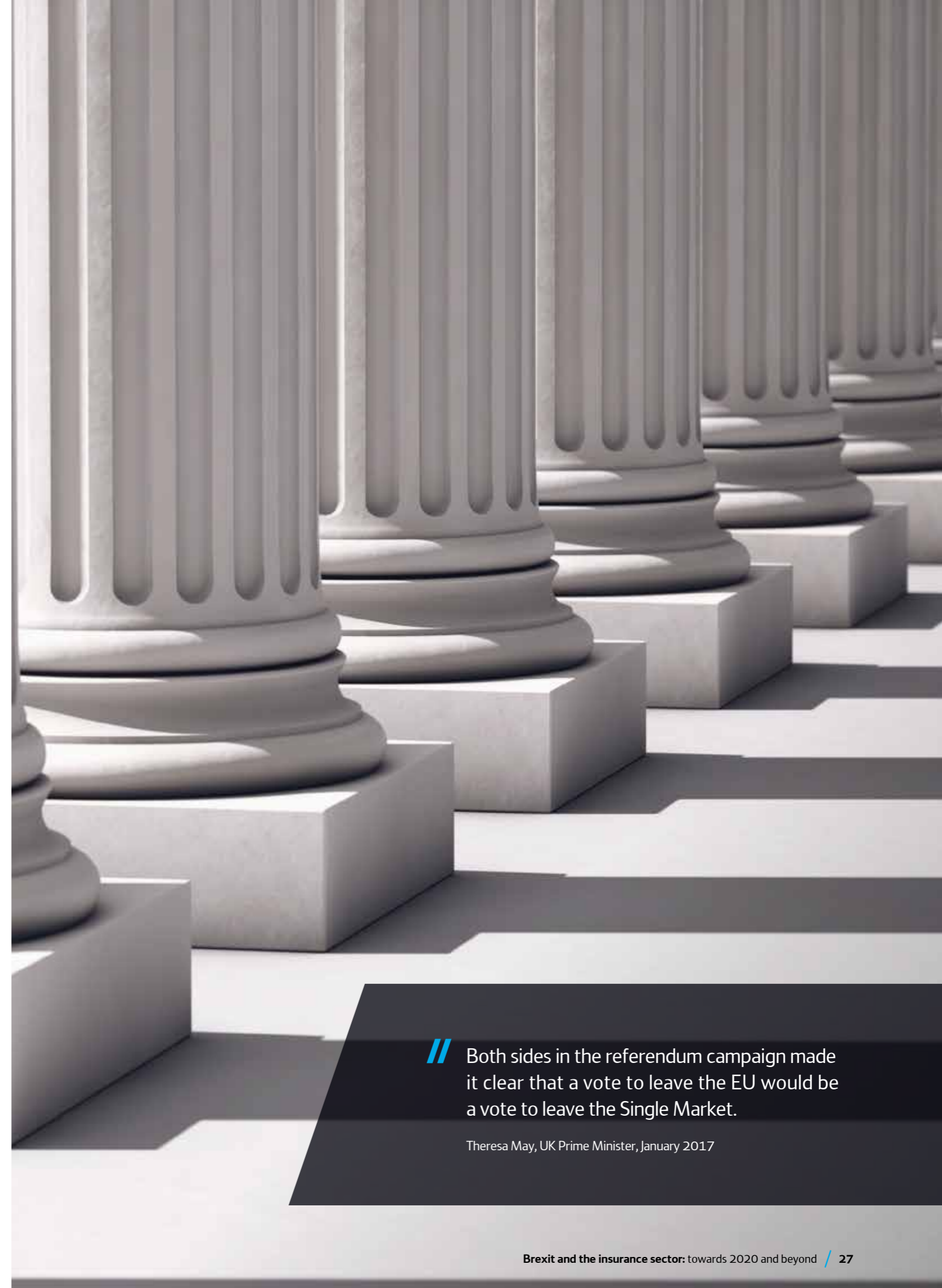


NEW TRADE AGREEMENTS WITH OTHER COUNTRIES

Representing a pivot away from trade with the EU in favour of a more global approach to developing future trading relations. This does not mean being bound by the Common External Tariff or the Common Commercial Policy. The UK Government has ruled out remaining in the current Customs Union, but has not ruled out developing an associate membership or some other arrangement.

The details of how this agenda will be pursued, and what it will mean for insurers in key business areas such as ensuring continued market access, as well as being able to recruit talent from across Europe, remain largely unclear.

While ever ‘the clock is ticking’ towards the March 2019 deadline, the continued lack of clarity on the terms of any future trading arrangement remains a key concern for market practitioners.



Both sides in the referendum campaign made it clear that a vote to leave the EU would be a vote to leave the Single Market.

Theresa May, UK Prime Minister, January 2017

// The scope for market ambiguity reduces the closer we get to a political text.

Survey respondent

TRADE PRIORITIES FOR INSURERS

Based on our interviews with market practitioners, we set out below some broad themes as to what insurers want to see from any future trade agreement. These themes reveal a clear disconnect between the interests of the insurance sector and the stated position of the UK Government as set out in the Prime Minister's Lancaster House speech and subsequently, in the White Paper published in July 2018.

From the perspective of leading insurers, the current status quo represents the best outcome. Leaving the EU will involve diminished market access for the UK, whatever model is applied, with negative impacts on the overall insurance sector. If the UK is to leave the EU, and the status quo is not sustainable, then it must fall to politicians to limit the potential for collateral damage by supporting the closest possible alignment as part of what could be typified as a 'soft Brexit' approach. This is characterised by recognising that access to the EU Single Market is a major part of the UK's attractiveness as a destination for inward investment, particularly among US insurers.

OPTIONS FOR THE UK

1. Remain in the Single Market and the Customs Union – the Norwegian model

The Norway model, which would see the UK leave the EU but remain within the European Economic Area (EEA), would maintain access to the Single Market, but would also involve sacrificing the UK's 'red lines'. The UK has set out its position clearly: continued membership of the Single Market and Customs Union would require free movement of people and ECJ rulings to apply to UK courts, and would not therefore be consistent with the view expressed by the British people on 23 June 2016. It would also involve the UK potentially becoming a rule-taker. In the example of Norway, it pays over €600 million annually for Single Market access but is not allowed to influence Single Market legislation. Under a Norway-style Brexit, the UK would leave the EU, join the European Free Trade Area (EFTA) and then become the 31st member of the European Economic Area (EEA). This would offer the benefit of continued membership of the European Single Market, maintaining close alignment on financial

and insurance services, whilst enabling the UK to withdraw from controversial programmes like the Common Agricultural Policy and Common Fisheries Policy.

The Bank of England has suggested that such an outcome would not be satisfactory for the UK. The senior executives we interviewed took a similar line, arguing that given the size and scope of the UK market, it would be necessary for the UK to have some say over the development of future EU rules, if Single Market rules continue to be applied to the UK market after 2020. However, respondents also acknowledged that this would be a major concession for the UK to secure and did not feel that such an outcome was politically agreeable.

It remains unlikely whether the option of a Norwegian model would prove politically palatable in the current climate, though this could change if the UK finds itself unable to negotiate a better alternative. As the political debate has intensified within the Conservative Party in recent months, it has become increasingly clear that even agreeing a consistent government policy, let alone successfully pushing that policy through Parliament, will be fraught with difficulty.

There is not a clear majority in the UK Parliament for leaving the Customs Union. Both the House of Lords and the House of Commons will press for amendments to legislation on exiting the EU, which in effect maintains the UK's membership of the Customs Union. This would require the UK to continue to accept ECJ rulings and may also require the UK to remain within the Single Market. In what constitutes a major political headache for the Prime Minister, there are a sizeable number of Conservatives in both Houses of Parliament that would support continued membership of either 'the' (existing) or 'a' (new and bespoke) Customs Union. The Government's support for a customs union backstop which would keep the UK inside the Customs Union beyond 2020 is seen by some in the industry as a way of maintaining the status quo indefinitely resulting in 'a Norway model by default'.

The Labour Opposition is demanding a 'jobs first' Brexit, in which continued Customs Union membership creates the best basis for maintaining a frictionless trade arrangement for UK manufacturers. Notably, this outcome would not extend any benefits to services like insurance, which would still lose their passporting rights even if the UK remains within the Customs Union.

However, other parties such as the Liberal Democrats also wish to see the UK remain in the EU Single Market, while in Scotland and Northern Ireland, which both voted Remain, the major parties are still actively campaigning to keep the UK within the EU. Both the Scottish Nationalists and Sinn Fein are, at the very least, pressing hard for the UK to remain within the Single Market and the Customs Union.

The Government's support for a customs union backstop which would keep the UK inside the Customs Union beyond 2020 is seen by some in the industry as a way of maintaining the status quo indefinitely resulting in 'a Norway model by default'.

The situation in Northern Ireland provides an added dimension arising from the presence of a 310-mile land border with the Republic of Ireland. Both the UK and Irish Governments wish to keep this border open as part of the Good Friday Agreement, but this is now looking increasingly difficult given the problems with the alternatives to the Customs Union. The UK Government has set out two alternative options:



1.

A maximum facilitation system or 'Max-Fac' which relies heavily on new technology to police the new customs border between the UK and the EU.



2.

A customs partnership between the UK and EU which would involve the UK collecting customs duties on goods bound for the EU.

Neither of these options have been warmly received by the European Commission, which has suggested its own fall-back position in which Northern Ireland remains within the Customs Union either temporarily beyond 2020, or on a permanent basis. Michel Barnier, the lead EU negotiator, has ruled out applying this outcome across the whole UK.

An additional practical concern which may mitigate against leaving the Customs Union is the associated financial costs with the UK Government's own assessment, provided by HMRC, suggesting that the new arrangements would potentially cost firms up to £20 billion annually in new trade tariffs. As a result of all of these pressures, the UK could yet remain within the Customs Union and Single Market well beyond the current 2020 deadline. This would have a profound impact on insurance businesses which make use of the EU passport.

// UK-EU financial trade should be based on a framework which is reciprocal, mutually agreed and permanent.

DEXEU alternative White Paper, July 2018

2. Mutual recognition – a bespoke UK-EU model

An alternative option would mean agreeing mutual recognition of regulations as well as regulatory supervision. The UK Government's White Paper in February 2017, and the Article 50 letter served by the UK on 29 March 2017, set out an ambition to maintain the freest trade in financial services possible. A bespoke mutual access model covering retail and wholesale financial services, set out in a bespoke UK-EU Free Trade Agreement (FTA), was seen by market practitioners as the best model for achieving that goal.

The London Market Group (LMG) has called publicly for a Free Trade Agreement which would seek to put in place such recognition. To support this demand, LMG cites numerous international agreements which seek to reduce non-tariff barriers to insurance and reinsurance services.

- In November 2017, the US and EU authorities concluded a Covered Agreement to removing trade barriers. This agreement removes statutory collateral and local presence requirements for EU and US reinsurers operating in each other's markets. It also provides recognition of home group supervision and enhances regulatory cooperation.
- Similarly, the bilateral agreement between the EU and Switzerland covering non-life insurance, which has been in effect since 1993:
 - Reduces capital requirements to the possession of a minimum guarantee fund or a minimum solvency margin.
 - Provides for home state supervision on capital between the EU and Switzerland.
 - Provides a joint committee of Swiss and EU representatives to administer the agreement which includes an arbitration process in the case of any disputes.

The LMG has called for a similar process of market recognition based on home regulator approvals, with full recognition given by EU regulators of prudential supervision put in place by the Prudential Regulation Authority (PRA) in the UK, and vice versa. The LMG has also called for the Insurance Distribution Directive 2018 rules to provide the basis in any future FTA on ensuring for mutual recognition on market access for insurance brokers.

In practical terms, the UK and the EU would have matching regulatory and supervisory frameworks on day one after the UK exits the EU. This uniquely high degree of regulatory alignment would form the basis for any model based on mutual recognition. However, as many parties have indicated and in views mirrored by our respondents, this would require some mechanism for assessing and maintaining regulatory alignment over time as the distinct EU and UK regulatory and supervisory frameworks evolve.

A report by the International Regulatory Strategy Group (IRSG) in 2017 indicated that a 'one size fits all' approach would not be possible. In short, divergence will occur on certain issues over time, and there should be transparent processes put in place, based on technical (rather than political) assessments of whether and how divergence has occurred.

The IRSG has proposed that the dispute mechanism would consist of independent financial experts, possibly drawn from experts on global standard setting bodies. These experts would judge whether divergence has occurred judged against provisions contained in a UK-EU FTA. Under this process, if it were deemed that the UK had diverged, and the independent process ruled that market access should be reduced, then there should also be a process in which affected firms are given a reasonable period of time to adapt their business models. The UK Government's stated position is that any EU-UK bespoke arrangement will require a new dispute resolution mechanism, most likely to be distinct from the current World Trade Organisation (WTO) or Court of Justice of the European Union (CJEU) mechanisms. The UK has ruled out the prospect of the European Court of Justice applying rulings to the UK after 2020.

While this would clearly represent the desired outcome when viewed from industry leaders, there is also a sense of realism that this outcome currently looks highly unlikely, given that the EU response to such an independent arbiter has been less than lukewarm. Michel Barnier, the EU's chief negotiator, has made clear that no such mutual recognition deal is on the table, reiterating the EU central point that maintaining the integrity of the Single Market remains critical; if the UK leaves the EU, then Single Market access must be diminished. There also appears to be little political appetite within the EU to subject itself to a dispute resolution mechanism beyond that of the European Court of Justice.

At the same time, it remains unclear over whether the UK would – or indeed should – seek to disapply the ECJ jurisdiction in all areas. While the UK Government has made the jurisdiction of the ECJ a red line, this need not be the case for financial services. There is clearly scope for the UK to make compromises. Industry leaders we spoke to indicated that there would be little resistance from insurers to continue to apply ECJ rulings. Many UK insurers currently operate on a cross-border basis within the EU, and are therefore highly familiar with the concept of joint supervision and already apply ECJ rulings across their pan-EU operations.

As recently as March 2018, the UK Treasury was supporting such an approach. Philip Hammond, the Chancellor, set out the UK's objectives for a partnership in financial services based on three key principles (which are clearly incompatible with an equivalence-based model):

1. A process for establishing regulatory requirements for cross-border trade between the UK and the EU.

2. Cooperation agreements that are reciprocal, reliable, and that prioritise financial stability.
3. A legal framework that makes this structure durable and reliable for participants in the market and for the businesses that use their service.

// It isn't clear what the UK Government means when it talks about best third country status. If it is based on equivalence, then the UK's relationship with the EU will be neither deep nor special.

Survey respondent

3. Equivalence for third country regimes

Equivalence has been discussed extensively throughout the Brexit process, and is likely to figure large in the phase 2 negotiations, if only because of the political barriers to achieving either of the two preferable outcomes above. The EU already has a third country equivalence regime (TCR) in place in various pieces of Single Market legislation. However, there are two central concerns with relying on this approach:

- Only a small proportion of the regulations which currently benefit from the passporting regime are actually covered by any equivalence standards. Furthermore, there is only very limited coverage within the insurance directives, and
- A further concern is that equivalence is discretionary. Under the current rules, the European Commission reserves the right to withdraw equivalence at 30 days' notice.

The problems with relying on equivalence were brought into focus in December 2017 when the EU granted Swiss stock exchanges access to EU markets but did so on a time-limited basis for one year. Switzerland's ability to maintain access will be subjected to wider discussions about the nature of the EU-Swiss relationship, which is likely to be driven at least in part by political considerations. This process is far from transparent and furthermore Switzerland has no right of appeal.

Faced with such concerns, it has been argued that the system of equivalence could be modified to ensure more stable terms of market access, replacing the Commission's discretion with an UK-EU agreement based on a comprehensive scope of regulations

and an independent arbitration mechanism. This could well be the direction of travel set out by the UK Government which is privately beginning to concede that a trade agreement covering services such as insurance is politically unlikely. The UK has discussed the potential for creating what it calls the ‘best third country’ status, in which the UK has clear separation from the EU Single Market but is able to agree more favourable terms of market entry compared to other third countries like Switzerland.

However, as outlined in a report recently published by the Centre for European Reform: “In practice, this would not be equivalence, but mutual recognition.... There is little appetite in the EU for such reform” (CER report, March 2018, p.5).

4. No deal scenario – fall back on WTO rules

The final outcome would see the UK fail to reach any exit agreement or future trade agreement with the EU. In this instance, future trade would be dictated by existing World Trade Organisation (WTO) rules. The UK is currently covered by WTO rules, only because of its membership of the EU. The UK would have to reapply to join the WTO upon leaving the EU.

The insurance industry, and the wider financial services sector, harboured growing concerns during 2017 that a no-deal scenario might be the most likely outcome of the protracted negotiations. Given the high level of market uncertainty, some firms, as we have seen, have already triggered contingency plans. The political agreements reached in the first phase of negotiations in December 2017, and the agreement on the transition framework up to 2020, have soothed industry nerves. However, the longer it takes to give those agreements legally-binding status, the less valuable they become.

This is particularly true in the case of UK insurers, where what happens to long-term contracts is a major concern – as has been flagged by the Bank of England in its November 2017 Financial Stability Report. Here it crunched the numbers on Brexit’s economic impact on existing cross-border contracts:

// Initial estimates suggest around £20 billion of insurance liabilities and six million UK policy-holders could be affected because their contract is with an insurer based in the EEA.¹²

Bank of England

Cross-border contracts written prior to Brexit will still in many cases be in operation beyond 29 March 2019. In the case of liability contracts, which can run for 10 years, or pension contracts, which can run for more than 30 years, it remains highly uncertain what will happen to those contracts. The Association of British Insurers (ABI) has suggested that insurers needed clarity on this point by 2017, given that transferring contracts is a judicial process which requires at least two years. This deadline has already passed without the much-needed certainty.

THE GOVERNMENT WHITE PAPER

After months of political wrangling, the UK Government published its White Paper in July 2018 setting out a future trading relationship with the EU, laying the foundation for the future.

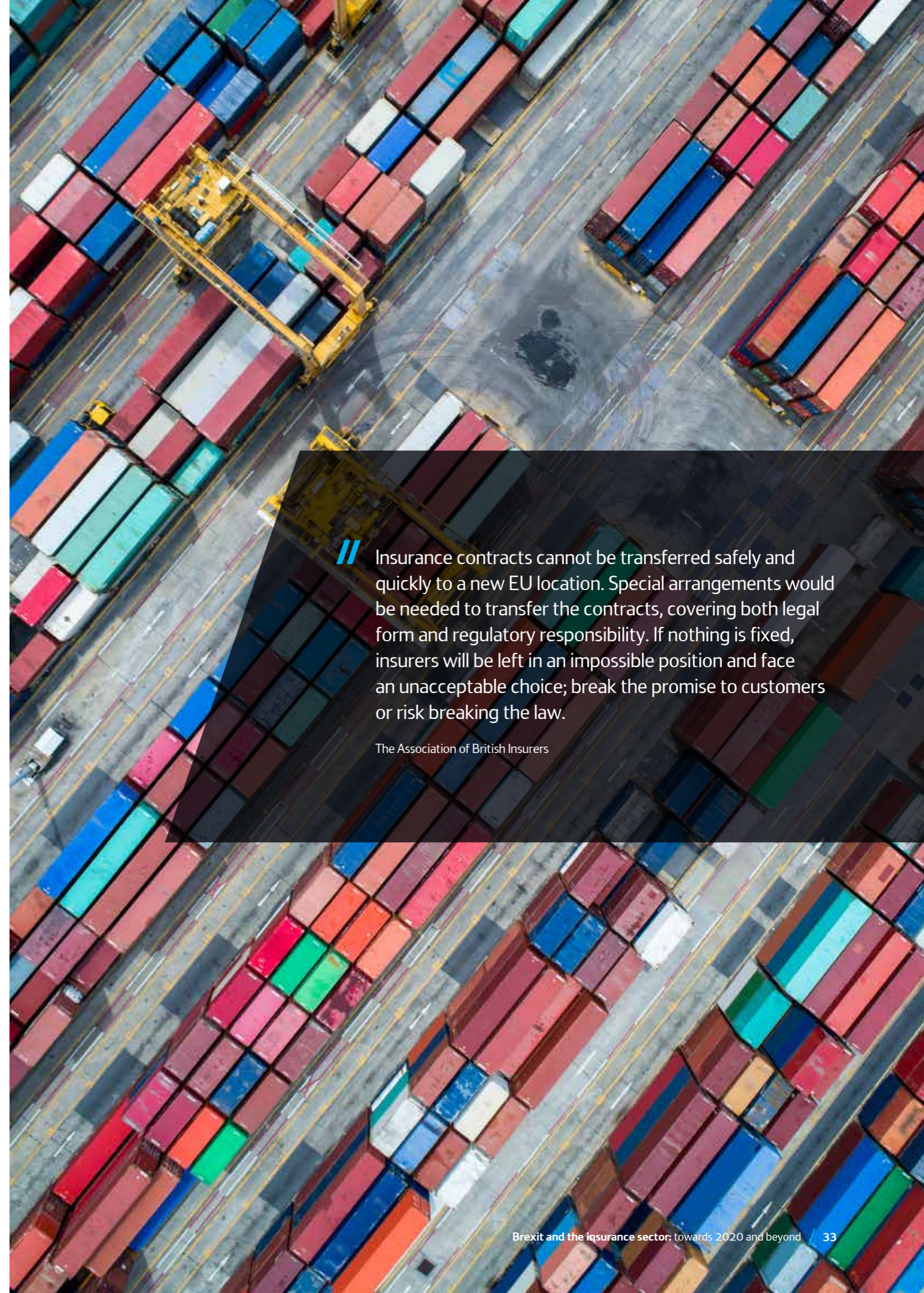
From the four options highlighted previously, the UK Government has set out a vision for enhanced equivalence, which grants UK and EU firms equal market. The introduction of the European Union Withdrawal Bill seeks to address part of this issue. When the UK Government repeals the European Communities Act 1973, the legal basis for enforcing all EU law in the UK will be removed. The UK Government has sought to translate existing EU legislation into domestic law via the European Union (Withdrawal) Bill. The former City Minister Steven Barclay MP set out the Government’s objective as follows: “We are not looking to make policy changes. In essence, it is a cut-and-paste of the status quo. We are not seeking to deregulate.”¹³

Adopting the whole of the European acquis into UK law is no small task. The process involves translating over 12,000 EU regulations into UK law, and the adaptation of 7,900 statutory instruments which implement EU legislation.¹⁴ Industry is broadly supportive of the Government’s aim of providing clarity and continuity.

This should ensure that the UK achieves regulatory equivalence on day one after it ceases to be a full member of the EU. Based on the White Paper proposals, the Government then sets out a divergent path in the future treatment of trade in physical goods versus the trade in services. In terms of physical goods, the UK proposes:

- To maintain a “common rulebook” for all goods traded with the EU, including agricultural products.
- A treaty to be signed committing the UK to “continued harmonisation” with EU rules avoiding friction at the UK-EU border, including Northern Ireland.
- The borders between the UK and EU will be treated as a “combined customs territory”.

Under this proposal, the UK Parliament will oversee the UK’s trade policy. The Government also proposes a “joint institutional framework” be established to interpret UK-EU agreements. It is also envisaged that free movement of people will end but it will be



// Insurance contracts cannot be transferred safely and quickly to a new EU location. Special arrangements would be needed to transfer the contracts, covering both legal form and regulatory responsibility. If nothing is fixed, insurers will be left in an impossible position and face an unacceptable choice; break the promise to customers or risk breaking the law.

The Association of British Insurers



replaced by a “mobility framework”. ECJ rulings will no longer apply to the UK courts but the UK would still pay “due regard” to those rulings. It remains unclear how this relationship will work in practice or whether a political agreement can be reached with the EU.

EU equivalence and insurance services

A key issue for the insurance sector will be the treatment of services under this new arrangement. The UK Government envisaged that there will be different arrangements for services, with greater regulatory flexibility. The legislative agenda in respect of the insurance market, and services generally, is very dynamic. We can expect to see a lot of regulatory change within the Single Market over the coming years: data protection and cyber reporting; new prudential rules on insurance brokers; conduct rules on retail insurance sales; and broader efforts to complete the Single Market for retail financial services. For the UK, ensuring market access will mean maintaining equivalence with these new rules. However, the UK Government has indicated a desire to maintain the freedom to distance the UK from the EU rulebook if new EU rules do not align with the UK’s economic interests.

Our survey respondents raised many question marks about how far the UK should be prepared to go in maintaining equivalence. While there is no desire to strip away existing EU rules, there can be no guarantees that all future EU legislation will be appropriate for the UK market. Respondents did not support the view that the UK should become a rule-taker. This implies some degree of market support for the Government’s position but there are also genuine concerns about the potential for future regulatory divergence over time and the impact this might have on market access for insurance. As one respondent indicated, the Government position seems to be “a soft Brexit on goods and agriculture, and a hard Brexit on services and the City of London”. Certainly, there are many in the City of London who would be very worried about any future EU trading relationship which does not fully consider the market access requirements for international insurance businesses based in the UK.

The issue of equivalence was given only muted support by respondents due to the ongoing lack of certainty about how such equivalence would be granted and maintained, as well as the lack of a political agreement on the need for an independent dispute resolution mechanism. These concerns have been brought into sharper focus recently as political differences emerge within the EU. The French Government has indicated a preference for utilising the equivalence regime, however, the German Government has voiced concerns that equivalence is ‘patchy’ at best in terms of its market coverage (as discussed above, not all EU directives contain third country equivalence rules), and such a reliance could lead to an increased risk of financial instability.¹⁵

UK market practitioners share these concerns relating to third-country equivalence. For example, Solvency II provides very limited equivalence provision aimed at ensuring there are no penalties for business ceded to equivalent reinsurers or for minimising the potential for regulatory overlays for insurers and reinsurers subject to group supervision. The Insurance Distribution Directive (which replaces the Insurance Mediation Directive, or IMD, in 2018) will provide a separate prudential regime for insurance brokers, as well as setting out conduct of business rules for distributors including insurers and brokers. The IDD contains no equivalence regime and no third country brand regime. Equivalence can only be achieved in any meaningful sense by rewriting existing EU directives, which is not realistic.

Respondents all agreed that much greater work is required in the development of any future equivalence regime – if that is the market access mechanism to be adopted.

Part 4 – Impact of Brexit on UK insurers so far

The Brexit negotiations will determine the future nature of market access. However, Prime Minister Theresa May has ruled out continued membership of the EU Single Market. In response, the EU Taskforce, headed by chief negotiator Michel Barnier, has been consistent since 2016 in arguing that leaving the Single Market will mean the loss of UK passporting rights. In the absence of any clarity, firms are already developing contingency plans, and are doing so based on a working assumption that no deal on market access will be struck.

Post-exit day, EEA firms wishing to do business in the UK domestic market, or globally via the London Market, will be required to apply to the Financial Conduct Authority (FCA) for authorisation. In December 2017, the UK Government announced that it will, if necessary, legislate to provide a temporary permission regime for EEA firms passporting into the UK to enable firms continue to write new business and fulfil existing contracts while they are seeking full authorisation. This will help to provide some degree of legal certainty. However, the requirement to undertake authorisation is an extensive and costly process, constituting an additional cost of doing business in the UK, and potentially a new barrier to trading in the UK.

UK insurers are clear in their demands. As an absolute priority, the UK and EU need to turn the December 2017 agreement on phase 1 negotiations, including migrant workers' rights, as well as the March 2018 agreement on the transition period, into legally – binding legislation as soon as possible. This will be a complex process involving the European Council, European Commission and European Parliament, as well as the 28 national parliaments of the Member States. It is still not entirely clear what role the UK Parliament will have in exercising its right to a 'meaningful' vote; it could still result in the UK being bounced out of the EU with no deal in place.

The closer we get to the March 2019 exit date without having a legally-binding transition period agreed, the less valuable such a transition agreement becomes especially as the agreements reached to date are still not 'done deals'. The UK has made clear that the December 2017 'divorce agreement', and the transition period agreed in March 2018, are contingent upon agreeing a framework for future trade: nothing is agreed, until everything is agreed. As a result, firms have been forced to plan on the basis that there will be a no deal scenario. Indeed, most firms have already taken the prudent position that this is the most likely outcome and are planning on that basis.

Nothing is agreed, until everything is agreed



// In two years' time it is unlikely that the UK will be integrated in the EU legal system and consequently, there is a real risk that the judgments of English courts may not be enforced in Member States easily.

Survey respondent

// When it comes to relocating business operations, the sands are already shifting under London's feet. International firms, all of whom will be customers of UK legal services firms, are already signalling that they will move operations. Plans are being activated.

Survey respondent

// Key reasons for selecting Dublin as our European office include the similarities between the British and Irish legal system, compatible regulatory and taxation frameworks, along with the mature regulatory environment that Ireland offers with regard to an insurance business such as North.

Paul Jennings and Alan Wilson, North's Joint MDs

ENSURING EU MARKET PLACE: ACTIVATING 'PLAN B'

Michel Barnier, the EU's lead negotiator, has reminded his UK counterparts that the clock is ticking towards 29 March 2019. The same time pressures are being felt in insurance company boardrooms across the City of London.

All firms are having to evaluate their business models to determine what can and cannot to continue to be undertaken in a worst-case scenario: i.e. the UK leaves the EU without securing a deal.

In the first instances, firms are looking to see what steps they can take to mitigate any negative business impacts, but they are also looking at what material impacts will be felt on their business – for example, ceasing certain business lines or selling business divisions.

Many firms are already creating, and executing, plans to move part of their business out of the UK. Much work is being done to identify alternative trading locations and make preparations to create a physical presence in other European markets. This task is relatively easy for inward investors operating insurance businesses already headquartered in other EEA member states.

For insurers headquartered in the UK, this task is more onerous and more expensive. Already, some firms have 'gone live' opening up new operations in other member states.

Several UK-domiciled firms with pan-European operations have already sought to future-proof that business against Brexit by creating new legal entities in other EU Member States. The potential business risks arising from the lack of passporting rights, and the continued lack of certainty or clarity about future market access, have made such steps inevitable.

March 2018 represented not only the one-year countdown to Britain formally leaving the EU. It also marked a key milestone, or deadline, for UK firms looking to trigger their post-Brexit strategy. In the absence of any certainty around the future nature of the UK-EU trading relationship, that was the date identified by several firms when Brexit action plans would need to be activated. Respondents also made it clear that the longer the uncertainty around the future trading relationship lasts, the more fundamental those action plans will need to be.

// We have concluded that Dublin offers the best location to serve European members post-Brexit. The tax, regulatory and legal regimes are similar to the UK, which means that the transition will be easier to manage than some of the other competing locations. We will seek regulatory approval and progress our plans to establish a presence in Dublin during 2018.

Jeremy Grose, CEO, The Standard Club

// It is important that we are able to provide the market and customers with an effective solution that means business can carry on without interruption when the UK leaves the EU. Brussels met the critical elements of providing a robust regulatory framework in a central European location and will enable Lloyd's to continue to provide specialist underwriting expertise to our customers.¹⁶

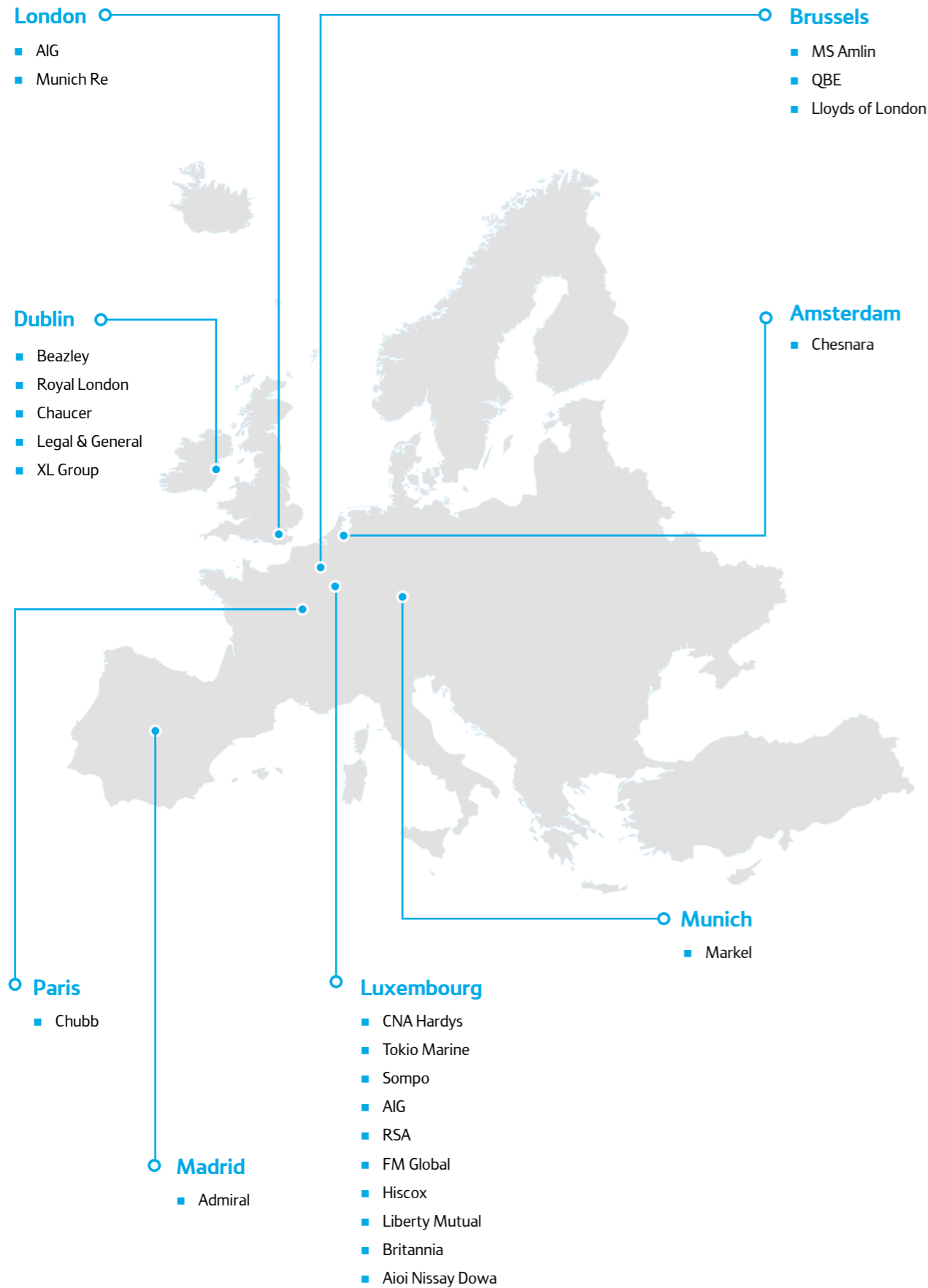
Inga Beale, CEO, Lloyds of London

To date, insurers' efforts have focussed on Dublin as the preferred back-up plan. With its reputation for sound financial regulation, its English-speaking status, and continued passporting rights as an EU Member State, Ireland is in many ways a natural choice. The authorities in Ireland have been quick to seize on the opportunities arising from Brexit. The Irish Government and the Irish Inward Development Agency (IDA) have created a strategy of pursuing trade and investment arising from Brexit, which targets a number of key sectors including financial services. An important consideration is that it is not just the insurers themselves who are looking to relocate part of their operations to Dublin. There has also been some movement in the wider business ecosystem of legal and professional services which will be required to provide services to the growing insurance sector.

It is worth noting that while the sands indeed may be shifting, the movement has not been as great as many predicted, either at the time of the referendum campaign in 2016, or during the period after the UK Government triggered Article 50 in spring 2017. Much of the industry's concerns during 2017 stemmed from the failure of the negotiating parties to make more rapid progress towards reaching an agreement on the UK's divorce settlement. It also became apparent towards late 2017 that a transition period would be required to prevent a 'cliff-edge' in which the UK would leave the EU without having first agreed a new bilateral relationship.

The uncertainty surrounding both the divorce settlement and the transition period meant that insurance executives had to not only develop a Plan B but take active steps to implement those plans. Indeed, in late 2017, two of the UK's leading marine liability insurers, The Standard Club and North P&I Club, took steps to establish new EU subsidiaries in Ireland.

**RELOCATION PLANS AND ALTERNATIVE INSURANCE HUBS:
PREPARING FOR THE LOSS OF PASSPORT**



BUSINESS CONTINGENCY PLANNING – ISSUES FACING INSURERS

Business aspects	Specific issues	
	Insurers	Customers
<p>Legal entities/ passporting rights</p>	<ul style="list-style-type: none"> ■ Removal of Single Market rights of establishment ■ Removal of Single Market rights to provide cross-border services 	
<p>Employment</p>	<ul style="list-style-type: none"> ■ Requirement for working visas ■ Need to ensure mutual recognition of professional qualifications ■ Potential difficulties in relocating families 	
<p>Contracts</p>	<ul style="list-style-type: none"> ■ Maintaining existing agency and distribution agreements 	<ul style="list-style-type: none"> ■ Continuity of cover on existing insurance agreements ■ Settling cross-border claims
<p>Technology and Data</p>	<ul style="list-style-type: none"> ■ Data protection and management of cross-border data flows 	<ul style="list-style-type: none"> ■ Data privacy ■ Geo-blocking
<p>Consumers</p>		<ul style="list-style-type: none"> ■ Reduced choice and competition (less access to EEA insurers) ■ Impacts on premiums levels
<p>Regulation</p>	<ul style="list-style-type: none"> ■ Regulatory divergence over time 	<ul style="list-style-type: none"> ■ Uneven playing field on consumer protection and disclosure standards

Part 5 – Future considerations

Brexit and the impact on innovation in the UK insurance sector

The EU promotes investment and innovation in the insurance sector in many ways. From research and development to skills and training, the development of new regulation and regional development funding, the EU plays a key role to supporting the whole of the insurance value chain.



1. RESEARCH AND DEVELOPMENT

With InsurTech and HealthTech rapidly changing the insurance market, the EU has provided the UK with a significant source of funding for research and development. Horizon 2020 provides a significant proportion of EU-level public funding for collaborative and single company innovation. The UK's life sciences sector is the second largest recipient from 'Horizon 2020', receiving around 15.4% of the total funds available. The UK also receives EU Structural and Investment funds, some of which are allocated to research and innovation. It has been estimated that leaving the EU would leave a significant funding gap of €1.6bn.¹⁷ The UK Parliament has looked specifically at the potential impact of Brexit on funding research collaboration and innovation in health and life sciences, which raises significant concerns about the UK's ongoing ability to tap into these resources post-Brexit.



2. REGIONAL DEVELOPMENT FUNDING

Similar concerns extend to regional funding with several insurers having committed to making business investments based on long-term assumptions about regional development funding from EU sources.





3. DATA PROTECTION AND REGULATORY DIVERGENCE

With innovation already forming a key driver of insurance business models, it will be critical that in the post-Brexit environment, the UK develops approaches to regulating innovative technologies in a way which does not become a future barrier to EU market entry. It was widely acknowledged among respondents that:

The UK has already become established as a global leader in the important growth areas of FinTech, InsurTech and RegTech, with the UK having developed innovative approaches to regulating new technology.

The Financial Conduct Authority (FCA) has run three cohorts as part of its Regulatory Sandbox exercise since launching the initiative in 2016. In total, 60 firms have been able to test their innovation with real customers in the live market under controlled conditions.¹⁸ Many of the earlier innovations focus on payments and blockchain technology.

However, InsurTech has become a large driver of innovation in UK financial services. Of the 60 firms currently developing new technologies for financial services, 10 involve technology solutions applicable to the insurance market with innovations covering the development of automated claims processes, automated customer identification, consumer protection, flood insurance, trade credit insurance, the use of telematics in motor insurance, flight insurance and the development of insurance platforms. However, the use of predictive analytics and data are key drivers across many of these innovations, particularly when applied to Artificial Intelligence or AI which is driving a lot of innovation within insurance. The development of regulation in these areas is still in its infancy.

The need for more stringent data protection is becoming a hot political topic following recent scandals involving largescale data breaches. The pan-European General Data Protection Regulations, or GDPR, only took effect from 21 May 2018. This will be a significant stepping stone in the future development of regulations surrounding the emerging digital economy. Ensuring future alignment between the UK and EU in this rapidly developing area will be critical in maintaining the ability to operate cross-border between the UK and EU Single Market. The prospect of the EU erecting a regulatory wall inhibiting the flow of data between the Single Market and third countries, like the UK, is a concern to some in the sector.



4. INNOVATION AND THE FREE MOVEMENT OF PEOPLE

Brexit may also drive further concerns around innovation given the likely limitations on the free movement of people. The UK has been successful in rapidly developing a major ecosystem of graphic designers, creatives, programmers and tech entrepreneurs who are increasingly at the heart of the UK's rapidly evolving insurance sector. It has been estimated that there are already over 80,000 computer programmers working in London alone.¹⁹ Many of these professionals are servicing innovation in the FinTech and InsurTech arena with a series of insurance innovation hubs springing up in and around the capital. This growth has been secured, at least in part, because of the free movement of people within the EU Single Market and the UK's ability to attract the brightest and best from across the European Union. Any efforts to restrict this movement is likely to have a negative impact on the quality of the UK's tech workforce, as well as the insurance sector's ability to develop home-grown innovation. Such restriction seems likely given the Government's stated policy goal of reducing net migration to the 'tens of thousands'²⁰, as highlighted by a reduction from the recent levels of net migration of more than 3330,000 annually²¹ are likely to have a negative impact on the quality of the UK's tech workforce, as well as the insurance sector's ability to develop homegrown innovation. Such innovation will play a key role not only in developing a more efficient and profitable insurance sector domestically, but also in maintaining the long-term global competitiveness of the UK insurance sector abroad. Closing the door to an international talent pool could put the UK's position as a global leader in innovation at risk.

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¹⁹ Parker Fitzgerald, October 2017

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This report does not represent the views of Kennedys Law LLP. The report is based on interviews with 20 senior professionals working in the UK insurance industry. The report attempts to present a balanced debate based on the interviews we conducted. While there was a clear majority of respondents who supported the UK's continued membership of the EU, Kennedys Law LLP is not aligned with any campaign group, nor does this report seek to make recommendations on whether the UK should remain in or leave the EU.

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