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Brexit: What Does It Mean for U.S. Insurers?

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2016 was a year of election results that defied the pollsters' expectations. In June, the United Kingdom electorate voted to exit the European Union (EU) in a narrow vote (52 percent to 48 percent), which signified the start of an interesting year of populist voting. In this article, the authors look back on what has happened since the Brexit referendum and explore what the future might hold, focusing on what this means for U.S. insurers in particular, on issues impacting operations, regulation and financial reporting.

BACKGROUND

The EU grew out of the European Economic Community (EEC) founded by France, West Germany, Italy, Belgium, Netherlands and Luxembourg in 1957. From the start the U.K. had a somewhat strained relationship with the EU; the U.K.'s initial membership application was vetoed by France under Charles de Gaulle, and the U.K. did not join until 1973. The EU grew rapidly after the fall of the Iron Curtain, with 13 of the current 28 member countries joining after 2002.

A handful of European countries are not members of the EU; the two largest are Switzerland and Norway. Switzerland and Norway are part of the European single market, which includes allowing the free movement of people, as well as contributing to the EU budget. Since reducing immigration was a key part of the U.K. referendum campaign, it is not clear how this, or a similar, type of arrangement would work for the U.K.

Switzerland, which has a substantial financial services sector, is a particularly interesting parallel for the U.K. Switzerland's relationship with the EU is governed by a series of bilateral agreements. One important difference is that Switzerland's banks do not have "passporting" rights (as explained later); it is expected that U.K. banks would lobby hard to retain these.

THE REFERENDUM

In the June 2016 referendum, the U.K. voted to leave the EU. The referendum is not legally binding on the U.K. government, and there are recent examples of governments ignoring referendums.

The process for a country to leave the EU is governed by Article 50 of the Lisbon treaty. The country informs the EU that it intends to leave and begins exit negotiations, with a maximum period for negotiations of two years. The only country to leave previously was Greenland in 1985 so there is little precedent.

The British government has made it clear that it intends to act upon the referendum result and has pressed forward with leaving the EU. Following legal challenges and a ruling by the Supreme Court on Jan. 24, 2017, the government was prevented from enacting Article 50 without the permission of Parliament. Subsequently, the government brought The European Union (Notification of Withdrawal) Act 2017[1] to the house to allow them to enact Article 50. On Feb. 1, 2017, the bill passed the lower house of Parliament (the Commons) by a large margin. At the time of writing, in early February, the bill still has to pass the upper house (the Lords) where it might face a stiffer challenge, delaying or even stopping the government's plans of enacting Article 50 by March 31, 2017.

In the seven months since the referendum, there has been significant discussion on what the terms of separation will be. An oft-quoted sound bite from the prime minister is "Brexit means Brexit"; what this means is that it looks likely that the U.K. will leave the EU by way of a "hard Brexit" and retain none of the structures of the EU. A large challenge in determining how the

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terms of separation will ultimately look is the stance of the EU Parliament, which will not engage in any discussions prior to Article 50 being triggered. In addition to Brexit, when the negotiations are taking place the EU will have in mind the message it is sending to other states and regions who want to leave the union; if they give too much then the EU itself might collapse.

IMMEDIATE IMPACT

The initial market response to the referendum result was highly negative. Sterling fell to the lowest level against the dollar in 30 years and the FTSE 100 index fell 3.15 percent on June 24, 2016. This market reaction was mirrored by the Dow Jones (–3.04 percent) and Nikkei 225 (–8.46 percent). The markets recovered somewhat over the following days, with the FTSE 100 recovering all lost value as of close of business June 29, 2016.

There was also considerable political upheaval and uncertainty in the U.K. The major political parties had all campaigned to remain in the EU. Prime Minister David Cameron resigned, and the new leader of the ruling Conservative party, Theresa May, became prime minister.

LONG-TERM ECONOMIC IMPACT

Over the next two years the U.K. government will be negotiating with the EU on how the relationship will operate in the future: what rules will still apply to the U.K.; how much funding they will be required to contribute; and what voice they will continue to have. Until these discussions are concluded and the market has settled post-separation, it is hard to tell what the ultimate impacts will be. The following issues are certain to be those that influence future choices and decisions of U.S. insurers with U.K. and European exposure.

Passporting

Under current rules, U.K. companies can sell business across the EU. This is referred to as "passporting" and means that a financial institution with a base in one EU country can do business in all of them. Passporting has contributed to London being a world financial center. If this is revoked, U.S. companies that operate across Europe with a main base in the U.K. will need to consider where they are geographically located; for example, they may feel it is better to move to Frankfurt, Paris or Dublin than to stay in London. There may be a major departure of financial firms from the U.K. if the terms are substantially better to remain located within the EU. Also, companies may feel that it is easier to sell off blocks of business, which will in turn provide an opportunity for well-capitalized insurers.

Investment Markets

The outcome of the referendum caused a large shock to global stock markets, driving investors to the security of U.K. Gilts and U.S. Treasurys, which in turn pushed down their yields. Since June the exchange rate has remained at historical lows; this has in turn led to an influx of foreign capital to the U.K. and pushed the FTSE beyond 7,100 at the end of the year, up 19 percent since the shock to the market. The U.K. has adopted further quantitative easing and bond prices continue to be offered at very low rates. The low interest rate environment is likely to be the continued norm in the U.K. for the foreseeable future, despite the rises in U.S. interest rates in late 2016.

IMPACT ON INSURANCE FINANCIAL REPORTING

The majority of the rules in Britain's financial sector have been written by the EU and the country will now have to negotiate new trading terms with the remainder of the bloc. In principal these could be cancelled as the U.K. leaves the EU, and Britain could adopt completely different practices to the rest of Europe. However, the global trend in recent years has been toward harmonization of standards, so it seems likely that the U.K. would retain many of the current standards. The Financial Conduct Authority (one of the U.K. regulatory bodies) recently stated, "Much financial regulation currently applicable in the U.K. derives from EU legislation. This regulation will remain applicable until any changes are made, which will be a matter for government and parliament."[2] This should give comfort that there will be no immediate changes in financial or insurance regulations following separation from the EU.

Solvency II

Solvency II (SII) was introduced by the European Insurance and Occupational Pensions Authority (EIOPA) and implemented in 2016 after many years of delays. It requires all companies[3] operating within the EU to calculate their technical provisions on a best-estimate basis and add to this a risk capital amount based on a 1-in-200-year stress. Along with the technical calculations there are onerous reporting requirements.

Looking forward there are a number of possible options for the U.K. regulatory body, the Prudential Regulation Authority (PRA):

- Continue with the SII standard without any modifications and without any future input over changes to the standard

- Revert to Solvency I
- Create a new standard

Given the level of effort that has gone into SII over the past seven years, it seems very unlikely that companies would have the appetite for a change in regulations. Broadly, the approach to SII is considered to be a sensible one and for this reason it is unlikely that the PRA would want to implement a major change to reserving and reporting requirements. Gold plating (i.e., adding extra regulations) of SII is explicitly prohibited by EIOPA; however, the PRA might look to do this as previous U.K. regulators did with the Individual Capital Assessment under Solvency I. The creation of an "SII plus" would likely not diverge greatly from the SII standards to ensure that equivalency was maintained to ease consolidation of reporting across Europe.

For U.S. insurance companies with U.K. operations, from a liability reporting point of view, there would be little change required If SII persists. The continued use of SII should not cause any issues in itself as it will be a well-embedded process by the time separation occurs.

IFRS/IASB guidance

The International Accounting Standards Board (IASB) is currently drafting a new insurance contracts standard (IFRS 17) that is expected to be finalized in the first half of 2017, and under the current regime the U.K. would comply with IFRS 17. It seems likely that the U.K. will apply the new standard when issued, given that this is not explicitly related to EU membership. Britain is unlikely to want to differ markedly from standards applied by the rest of the world, and the industry has already invested a good deal of work in preparing for the new standard.

In 2014, the U.S. Financial Accounting Standards Board (FASB) decided to move away from the IASB convergence project and pursue its own "targeted changes" to U.S. GAAP for insurance contracts. It is possible that once outside of the EU, the U.K. would also choose to move away from the IASB standard. However, the U.K. is starting in a different place from the United States in terms of current standards, and in terms of the size of its internal market; subsequently it seems less likely that the U.K. would choose to go its own way.

CFO Forum

The CFO Forum is an industry coalition that aims to "influence the development of financial reporting, value-based reporting, and related regulatory developments for insurance enterprises on behalf of its members, who represent a significant part of the European insurance industry."[4] The CFO Forum is made up of the CFOs of major European insurance companies and is not an EU body. As such Brexit will have no direct impact on its membership, although Brexit will of course be a major topic that they discuss. One of the significant outputs from the CFO Forum has been the guidelines for European embedded value (EEV) and market-consistent embedded value (MCEV). There is likely to be no impact on these guidelines as they are principle-based and not specific to countries being within the EU. Only a few U.S. insurers calculate an embedded value for internal or public reporting purposes, and there will be little or no impact on how these are determined as a result of Brexit.

Auditor Rotation

On June 17, 2016, EU regulation came into effect that mandated the rotation of auditors for public interest entities (PIEs)[5] whereby firms are required to replace their auditors every 10 years (with the potential to extend under certain circumstances). As with SII, this European law has been adopted into U.K. law, making it more difficult to repeal. Added to this, prior to the EU law, the Competition and Markets Authority (a U.K. government department whose role is to make markets work well for consumers) had already introduced proposals for the mandatory tender and rotation of audits. These two facts make it highly likely that the U.K. will retain the auditor rotation requirements.

Gender-neutral Pricing

Since Dec. 21, 2012, insurance companies in the EU have had to price products on a gender-neutral basis. For example, car insurance premiums are the same for male and female drivers, even though female drivers are involved in fewer accidents than males. Life insurance costs the same regardless of gender, even though mortality rates are different for men and women. Reserves continue to be gender-specific. When the law

was introduced, the insurance industry had concerns about its implementation, especially for products with a significant difference between male and female experience. Gender-neutral pricing is an EU requirement, so once Britain leaves the EU the government would be free to remove the requirement for gender-neutral pricing and permit a return to gender-specific pricing. The insurance industry may lobby for the removal of gender-neutral pricing after Brexit, but it is unclear whether the government would want to revoke the gender-neutral pricing law. In addition, the public might not accept different prices for men and women, now that they have become accustomed to paying the same price.

FURTHER POSSIBILITIES

At this stage there is much speculation about the possible ramifications of Brexit. There is talk of the breakup of the U.K. While the discussions of a second referendum have died down, with the imminent triggering of Article 50 this is likely to come back to the fore. There is also speculation about the possibility of further breakup of the EU, with nationalist parties in France and Italy, among others, seeing the British vote to leave as encouragement for their own anti-EU policies. The impact of further political upheaval is unclear; however, it would almost certainly produce greater uncertainty in the marketplace, which could infect U.S. markets.

Discussion of possible doomsday scenarios is fun for the media (and for the quintessentially British activity of discussion over a pint in the pub). However, given the increase in global connectedness it seems unlikely at this point that the U.K. will impose different regulations on insurers compared to the rest of the world. ■

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ENDNOTES

1 *https://www.publications.parliament.uk/pa/bills/cbill/2016-2017/0132/17132.pdf.*

2 *https://www.fca.org.uk/news/european-union-referendum-result-statement.*

3 Small company exemptions do exist for the smallest insurance companies where the gross premium income is less than €5 million or gross technical provisions are less than €25 million.

4 *http://www.cfoforum.nl/index.html.*

5 *https://www.kpmg.com/BE/en/IssuesAndInsights/ArticlesPublications/Documents/EU-Audit-Reform-Fact-Sheet-MFR.pdf.*