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Brexit—What Does it Mean for U.S. Insurers?

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The story starts with a referendum one day. Before 9 a.m. the following morning, global stock markets have crashed, the currency has collapsed and the Prime Minister has stepped down. While this sounds like the beginning of a Hollywood blockbuster movie, it is in fact not too far from what happened overnight in the United Kingdom on June 23rd/24th when 52 percent of the electorate voted in a referendum to leave the European Union (EU).

In this article we discuss the background to Britain's membership in the EU and some of the implications of the vote to leave, focusing on the potential impacts to financial reporting for U.S. insurance companies.

BACKGROUND

The EU grew out of the European Economic Community (EEC) founded by France, West Germany, Italy, Belgium, Netherlands and Luxembourg in 1957. (The EEC was itself a successor to the European Coal and Steel Community founded in 1951). 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. In 1975 the U.K. held a referendum similar to the one held this year; however, unlike this referendum the outcome was to remain in the EEC. 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 (see below for definition of passporting); it is expected that U.K. banks would lobby hard to retain these.

WHAT HAPPENS NEXT?

The referendum is not technically binding on the U.K. government. There are recent examples of governments ignoring referendums; for example, in 2015 the Greek government ignored a referendum rejecting the terms of the EU bailout. However, it seems unlikely that the U.K. government would be able to completely ignore the referendum result.

Unlike the United States, there is a mechanism for member states to leave the EU. The process 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. As we write this in late June there seems to be no hurry on the part of the U.K. government to trigger Article 50, though it is expected that it will be triggered sometime between September and December 2016. Other EU countries are currently declining to enter into informal discussions prior to Article 50 being formally triggered, so it seems likely that the two year maximum negotiation period will be strictly adhered to.

In short, there will probably be an initial six months of uncertainty until Article 50 is triggered, followed by at least another two years of uncertainty while negotiations take place.

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. The referendum result triggered leadership contests in the ruling Conservative party, the main opposition Labour party passed a vote of no confidence in its leader, and the leader of UKIP (United Kingdom Independence Party and a strong proponent of Brexit) has stepped down to the ire of European Parliamentary members.

LONG TERM ECONOMIC IMPACT

Over the next two years the U.K. government will be negotiating with the EU 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 which 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 then U.S. companies that operate across Europe with a main base in the U.K. will need to consider where they are geographically located. 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 large shock to global stock markets, driving investors to the security of Gilts and Treasuries which in turn pushed down their yields. While markets may well rebound, global uncertainty will lead to more complexity in assumption setting for asset returns and also in margin setting for principle-based reserves (PBR) and Economic Capital. With investors moving to more secure investments, U.S. Treasury yields will be forced down and the low interest rate environment which has been experienced for the past several years will likely persist.

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 canceled 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 towards harmonization of standards, so it seems likely that the U.K. would retain many of the current standards. The Financial Conduct Authority 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."[1] 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[2] 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, and
- 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., layering in additional 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 a "SII plus" would likely not diverge greatly from the SII standards to ensure that equivalency was maintained to ease consolidation of reporting across Europe.

If SII persists, then for U.S. insurance companies with U.K. operations, from a liability reporting point of view, there would be little change required. 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 IASB is currently drafting a new Insurance Contracts Standard (i.e., IFRS 4 Phase 2), and under the current regime the U.K. would comply with this. 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 on preparing for the new standard.

In 2014, the U.S. 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 U.S. 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 a non-EU entity which 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.”[3] The CFO Forum is made up of the CFOs of major European insurance companies and as such the 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 principles based and not specific to countries being within the EU. Only a few U.S. insurers calculate an EV 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 this year, EU regulation came into effect which mandated the rotation of auditors for public interest entities[4] (PIE) 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 audit rotation requirements.

Further Possibilities

At this stage there is much speculation about the possible ramifications of Brexit. There is talk of the break-up of the U.K.; the Scottish First Minister has already indicated that a second referendum on Scottish independence is “highly likely” based on the fact that Scotland overwhelmingly voted to stay in the EU. There is also speculation about the possibility of further break-up 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 market place, which could infect U.S. markets.

Discussion of possible doomsday scenarios is fun for the media (and for the quintessentially British activity of discussing 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. ■

ENDNOTES

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

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

3 http://www.cfoforum.nl/index.html

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

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