Article from

International News

October 2019
Issue 78

Why Should Life Insurers Care About Brexit?

By Ronald Klein

Editor's note: International News *is pleased to feature this article, which won second place in the International Section 2019 Country Feature Call for Papers.*

THE SEVERABILITY CLAUSE

Reinsurance is my life. Ever since 1990, when I first entered the world of reinsurance, I immediately fell in love. Reinsurance is a transaction between sophisticated parties and is a risk management tool to solve problems. Sometimes these problems are simple and sometimes they are quite complex. While I really enjoyed creating innovative internal solutions for the company for which I was working, the real "buzz" was when I could solve a problem for a client company.

With almost 30 years of reinsurance experience under my belt, I have been frequently asked to present at various conferences on reinsurance. Also, working for some of the largest insurers and reinsurers in the world has afforded me a unique perspective from both sides of the equation.

My favorite presentation was at a Society of Actuaries (SOA) Advanced Reinsurance Seminar, where I was asked to speak about common reinsurance treaty pitfalls. It is amazing that I have been speaking about this one particular pitfall for many years, yet it seems to still be prevalent today—the Severability Clause.

A typical reinsurance treaty Severability Clause will state:

> *If any provision of this Agreement is determined to be invalid or unenforceable, such determination shall not impair or affect the validity or the enforceability of the remaining provisions of this Agreement.*

It is easy to see why this provision has been put into treaties. Neither party would want a treaty to become invalid if a minor provision was deemed unenforceable. For example, what if interest charged for unpaid balances was based upon the London Interbank Offered Rate (LIBOR) and LIBOR became a non-recognized benchmark? Should the treaty become invalid? I don't think that either party would have wanted the other party to be able to cancel a treaty in this circumstance. In this example, the interest rate for unpaid balances is probably not an important part of the risk transferred.

However, what if something unforeseen occurred such as a country seceding from the entity under which the treaty pertains? Furthermore, what if this newly separated country had some type of trade barrier precluding it from making claim payments to another country? In this example, the country may be forbidden to make claim payments but the treaty would require the counterparty to continue to pay premiums. The claim payment clause would be "severed," but the remainder of the treaty would continue to be enforceable.

The example I always use is a simple trade where I agree to pay GBP 1 million to a British company in exchange for GBP 1 million worth of gold to take place on November 1, 2019. What if it is deemed illegal to trade gold post Brexit and there is a typical Severability Clause in the contract? Does this mean that I still have to pay the GBP 1 million to the counterparty even though I do not expect to receive the gold?

While at a major U.S. insurer, I had the Severability Clauses in all of our life reinsurance treaties changed to the following:

> *If any provision of this Agreement is determined to be invalid or unenforceable, such determination shall not impair or affect the validity or the enforceability of the remaining provisions of this Agreement except if the invalid or unenforceable provision will materially alter the original purpose of the Agreement, in which case the Parties agree to adjust the Agreement to its original intent.*

Many will argue that materiality is difficult to define, and I would agree that there could be some gray areas. However, a provision that precludes claim payments would be quite material to the treaty, while a provision to set interest charges on

a benchmark interest rate would not be material. In our gold example, I would argue that not being able to receive the gold is quite material to the contract.

FSOC ANNUAL REPORT

So, why the lecture on the Severability Clause? With Brexit looming, there are many changes that could occur affecting reinsurance treaties. With one of the most well-known reinsurers in the world—Lloyd's of London—based in the U.K., many reinsurance treaties could be affected. And, there are some large insurance companies based in the U.K. that could also be affected.

The Financial Stability Oversight Council (FSOC) recently published its Annual Report, which identified Brexit as a major risk factor to the U.S. financial services industries. In the report's Executive Summary, the following was written in the second paragraph:

> *At the same time, financial stability risks outside the U.S. appear to have increased; most notably, the potential for a disorderly United Kingdom (UK) exit from the European Union (EU) in March 2019 could have serious implications for the functioning of some global financial markets and firms.*

And, it also has called for an alternative to LIBOR as a benchmark interest rate:

> *The weaknesses of the London Interbank Offered Rate (LIBOR) may undermine market integrity and the uncertainty surrounding its sustainability could threaten U.S. financial institutions and the U.S. financial system more broadly. The Council commends the progress of the Alternative Reference Rates Committee (ARRC) in identifying the Secured Overnight Financing Rate (SOFR) as an appropriate alternative reference rate and in its subsequent steps to facilitate a transition to SOFR.*

FSOC was established as part by the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as Dodd-Frank, after the financial crisis. In short, it has three main objectives: (1) identify risks to financial stability, (2) promote market discipline and (3) respond to emerging threats. The Annual Report was written while the stock market was performing well and unemployment rates in the U.S. were at record lows. It is interesting that it looked at Brexit as a major threat to the financial stability of the U.S. financial markets.

COVERED AGREEMENTS

While the U.S. is looking at Brexit as a risk, the U.K. is attempting to negotiate financial agreements to replicate mutual access to markets that it enjoyed as part of the European Union (EU). Anyone involved in international reinsurance is very aware of the agreement between the EU and the U.S. to minimize collateral requirements—commonly referred to as the Covered Agreement. With Brexit looming, the U.K. had to negotiate its own version of a Covered Agreement—which it recently did and will become effective upon the U.K.'s exit from the EU. The agreement is basically identical to the EU–U.S. agreement.

Covered Agreements and LIBOR are just two examples of items that could affect reinsurance treaties with the U.K. post Brexit. I am sure that there are many more agreements with many other countries that will need to be (re-)negotiated. No doubt, the simplest thing for the U.K. to do is to copy any existing agreements that the counterparty already has in place with the EU. Which begs the question, why leave the EU if you will just mimic all international agreements with counterparties—but that topic is for another article.

TREATY MAINTENANCE BEFORE THE STORM

What Brexit does mean is that any person working for an insurer or reinsurer that has a reinsurance treaty where one counterparty is in the U.K., should review this contract carefully. The slightest change could cause some unforeseen financial events for the treaty. The materiality of an unenforceable clause may be called into question. While I would love to be correct with my long-standing argument that typical Severability Clauses are poorly worded, it would be very damaging to the reinsurance industry if this causes unintended harm to one party of a treaty. Sometimes it is better not to be correct.

The best thing for those involved in reinsurance to do is to review these treaties now and have discussions with your counterparties. Make sure to change wordings so that the intent of the treaty provisions is better documented. In fact, a blanket agreement between counterparties that covers all treaties between the parties may be in the best interest of both companies.

International reinsurance is a fascinating business. Counterparties attempt to capture all possible events in their contracts, but this is just not possible. In addition, with changes in personnel, the true intent of the original treaty may be lost over time. Significant reinsurance treaties must be reviewed periodically and adjustments may be necessary. The Severability Clause could be one treaty provision that should be refreshed—especially with Brexit looming. ■

Ronald Klein, FSA, MAAA, is director of global aging at the Geneva Association in Zurich, Switzerland. He can be reached at *ronniefsa@aol.com*.