CLIENT MEMORANDUM

BREXIT – UK VOTES TO LEAVE THE EUROPEAN UNION

UK remains in the European Union - for now

Implications for the Insurance Industry

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On 23 June the British electorate voted on the question of whether or not to remain a member of the European Union (“EU”). The result of the vote was for the United Kingdom to leave the EU, the so-called “Brexit”. At present the result of the vote has more political significance than direct legal significance – with the Prime Minister’s, David Cameron’s resignation being the most prominent political fall-out to date. But, for the time being, the UK remains in the EU and enjoys all the benefits and is subject to all the burdens of membership.

The immediate next steps are also going to be largely driven by politics rather than by any defined legal road map. They will be subject to a number of key dependencies, including the reaction of the other leaders of the larger EU Member States and, closer to home, the Scottish government. However, it is fair to assume that, as a result of this vote, the process of withdrawal will begin. But what “withdrawal” actually means has yet to be determined. It was a feature of the referendum campaign that advocates of “leave” did not spell out a particular model for a post-Brexit relationship with the EU other than a desire to “take back control”.

This client memorandum will briefly consider some key implications for the insurance sector. There are likely to be immediate effects of the referendum result on “business as usual” as well as wider short to medium-term effects.

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The immediate effects will likely include:

- Currency volatility. Sterling had a mild rally in the days leading up to the referendum based on the market's view that the vote would be to remain. With the "leave" vote, that rally was reversed and we have already seen the pound lose value. How far it will fall is impossible to say, but for UK insurers with any significant claims exposures denominated in foreign currencies, and whose solvency capital is denominated in pounds, there could be solvency strains. Volatility is likely to continue.
- Allied to this, market instability and severe fluctuations in the value of UK equities are likely to continue whilst markets absorb the implications of the referendum result. Consequently, volatility on the asset side of the balance sheet could also add to solvency strain.
- If the UK goes into recession – as the Bank of England has predicted - consumers may defer product purchases pending more certain information. This will have an impact on insurance products as well as other consumer products, and lapse risk on life insurance may increase.
- The UK regulatory authorities are likely to be under extreme pressure given the weight of the issues they need to face. All regulatory business-as-usual activity could be severely delayed.
- Insurers will be reviewing their contracts to check that no "illegality", "change of law" or "material adverse effect" provisions are triggered.

How will a Brexit occur?

The short answer to this is that no-one really knows for sure. Domestically, the move to exit the EU will require primary legislation to be passed in the UK in the usual way by both houses of the UK Parliament, including the amendment or repeal of the original legislation that paved the way to membership, the European Communities Act 1972.

With regard to the EU, Article 50 of the Treaty on European Union (the "Treaty") requires any Member State to notify the European Council of its intention to leave. The Treaty is not prescriptive about how and when such a notice is to be given, so the most likely scenario is that before anything is done there will, at a minimum, be a series of summits between EU leaders and the President of the European Council before any formal steps are taken under Article 50. Again, there has been no political consensus within the UK as to when formal notice of withdrawal should be given. Notice is unlikely to be given before a new Prime Minister has been chosen and this may not occur before October this year.

In any case, the giving of a notice under Article 50 will not give rise to an immediate exit, but is merely the start of a two-year negotiation period. During this period the Member States of the EU are required to "negotiate and conclude an agreement with [the UK], setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union". The agreement would require a qualified majority of Member States (excluding the UK itself) on the European Council to vote in favour, after obtaining the consent of the European Parliament.

The agreement would come into force on the date contemplated by the agreement or, failing any such agreement, exit would occur two years from the date the formal notice to withdraw was given by the UK. Given the complexity of the exit negotiations, it is fair to say that the UK would remain in the EU for a bare minimum period of two years. During this period, the laws and other aspects of the UK's membership of the EU will continue unchanged.

It is impossible to predict what form of agreement might be entered into as part of the exit negotiations. Commentators mention membership of the EEA (a model adopted by Norway, Iceland and Lichtenstein) or membership of the European Free Trade Area (which adds Switzerland to the EEA). Whilst many politicians seem to believe these are attractive alternatives to pursue, others will point out that this does not deal with the issue that caused many to vote to leave, as in each case the free movement of people would need to continue. Without free movement of people continuing, it is highly unlikely that full access to the European Single Market would be possible.

Medium term effects on insurers

As stated above, the action required in the UK in order to commence the exit is the repeal of the European Communities Act 1972. However, a full repeal is unlikely to be the correct approach. Saving provisions will be required to maintain the status quo, at least for a transitional period. There will be a process of disentangling UK legislation from EU laws, and filling in the gaps in terms of both legislation and supervisory capability will be complex.

Solvency II, a European directive, is already implemented in the UK and it is likely that the UK Parliament will elect to pass laws affirming the status of the UK legislation passed pursuant to the Solvency II Directive. This is due to the belief that, as far as possible, the UK's insurance regulatory regime post-exit will seek to be "equivalent" to Solvency II. The driver will be to ensure that UK insurers and reinsurers continue to be in the same position as European insurers and reinsurers, that they can continue to offer reinsurance to European cedants without fear of any solvency deterrent for their clients, and that they remain competitive.

Outside of the European directives, amendments will still be required to take account of the new relationship between the EU and the UK, such as the appointment and oversight of the UK regulators in place of EU organisations such as the European Insurance and Occupational Pensions Authority. The Regulation supporting Solvency II currently has direct effect in the UK without the need for legislation from the UK Parliament. Depending on the exit "model", the UK Parliament may decide on a wholesale replacement of existing EU Regulations with local laws. However, some gaps are inevitable, and it is unclear how the regulations will operate during the transition.

The loss of access to the Single Market, and therefore the "passporting" regime, would be the major impact for the insurance industry. Currently UK-based (re)insurers are not required to obtain parallel authorisations in any other Member State that they offer their services in and (re)insurers incorporated in one EEA Member State can establish a branch or provide services in another Member State on the basis of their authorisation and supervision by their state of incorporation.

Insurers and reinsurers that currently make use of "passporting" rights should consider their structures and whether they should reorganise their groups so as to ensure that they have continued access to the European Single Market. We could see a period of (re)insurer group restructurings: this could include the re-domiciling of the main UK carrier into a continuing European Member State or the incorporation of existing European branch operations into authorised insurers in the Member State of the branch. We may see an increase in (re)insurance groups establishing a *Societas Europaea* (SE) in their groups, a form of company regulated by EU law. A feature of an SE company is that it can move its place of domicile from one EU Member State to another. During the two-year exit negotiation period, UK companies could convert to SE status, move their place of domicile to an EU Member State and thereby maintain access to the EU Single Market.

Many insurance groups have taken advantage of the UK as a tax-favoured location for an ultimate or intermediate holding company and may need to reconsider this following the Brexit. Whilst this may not have an immediate impact on the taxation of profits, which is within the competence of individual Member States in any case, much of the UK tax law has developed to reflect EU requirements and these may be undone over time. Perhaps more significantly, the beneficial treatment that arises from EU directives on inbound income from EU subsidiaries for withholding tax purposes may no longer apply, in which case companies would revert to reliance on less comprehensive double tax treaties. In order to fill this gap, the renegotiation of these treaties with the remaining Member States may also need to be put on the agenda.

Insurance groups outside the UK and the EU that are considering entering these markets should consider carefully an appropriate structure that could give access to the pool of insurance expertise that exists in the London market as well as giving them access to the European Single Market. Groups will have a window in this period to put into effect a suitable structure for the post-Brexit world using the legal tools available under the European regulatory regime before they are lost.

We expect firms operating in all areas of the London insurance and reinsurance ecosystem, whether underwriters, actuaries, accountants and auditors, brokers and other intermediaries, law firms, HR firms, or other professionals in the London market to respond in a creative and dynamic way to the challenges that have been presented by the voters of the UK. The resulting uncertainty does not lend itself to a one-size-fits-all response within the diverse areas of the insurance sector. In short, there will be leaders and followers in adopting contingency plans and other appropriate measures to maintain and seek competitive advantages. This dynamism will result in winners and losers over the next few years following the historic Brexit vote. We would be happy to advise clients on their options at this time of uncertainty.

If you have any questions regarding this memorandum, please contact Nicholas Bugler (44 20 3580 4704; nbugler@willkie.com), Joseph D. Ferraro (44 20 3580 4707; jferraro@willkie.com), Andrew Tromans (44 20 3580 4715; atromans@willkie.com) or the Willkie attorney with whom you regularly work.

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