Brexit alert: Update for EEA firms passporting into the UK

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The UK's withdrawal from the European Union will mean an end to passporting rights, although these could remain until the end of 2020 under the current draft transitional arrangements. This raises concerns over both future market access and the ability to service existing insurance contracts that remain in force at the withdrawal date.

The issues not only impact UK insurers that access the European market, but also EEA insurers that access the UK market through either a UK branch or using a freedom of services (FOS) licence. Such firms need to urgently consider and address the implications for their future UK market access.

Our experience shows that EEA insurers using FOS licences into the UK (EEA FOS insurers) have generally lagged behind in their Brexit analysis and planning compared to those with a UK branch presence. This could be down to the fact that UK authorisation requirements are driven by whether or not insurance related activities are undertaken in the UK (with the argument being made by EEA FOS insurers that these are all occurring remotely from the UK and hence no changes or UK authorisation may be necessary). Nonetheless, EEA FOS insurers will need to ensure that their operating models do not create a risk of breaching UK authorisation requirements (either in terms of new business generation or the servicing of existing contracts).

Firms that do not create a UK establishment or conduct any regulated activity in the UK may not be structurally affected by Brexit. However, any regulated activity performed in the UK will trigger UK authorisation requirements post-Brexit. For example, if an EEA FOS insurer grants a UK agent authority to underwrite or make claims decisions that could be deemed to be carrying on a regulated activity in the UK.

Recent UK pronouncements suggest that measures will be taken unilaterally at a UK level to ensure existing policies held by UK policyholders can continue to be serviced post-Brexit. However, the full details of how the proposed 'temporary permission' will work are as yet unknown, and this is in any case unlikely to remain in place indefinitely.

This article therefore considers the main options available to EEA insurers in light of the guidance provided by the PRA and the steps they should be undertaking now in order to manage their UK business.

Recent PRA regulatory guidance for EEA insurers writing business in the UK

In January this year, the PRA released a consultation paper aimed primarily at providing some clarity to EEA firms that currently operate in the UK through either UK branches or on a FOS basis.

The paper starts from the premise that such permissions will fall away at Brexit, leaving EEA firms to be considered on a consistent basis to other third-country firms and what this then means from an authorisation perspective. Importantly however, it does not address the question of what activities carried out by EEA FOS insurers could be deemed to be undertaking regulated activities in the UK.

The proposals put forward by the PRA for insurers are broadly consistent with our expectations and can be summarised as follows:

- **Regulatory equivalence and 'supervisability' of the firm as a whole:** the PRA assessment against international standards, with a presumption that EEA firms will meet this requirement. Without this, a UK branch would not be possible;
- **Protected business:** would the business to be written in the UK be covered by the Financial Services Compensation Scheme (FSCS)? While the rules are complex, this broadly covers all life policies, all compulsory insurances and most general insurance policies held by individuals and small businesses. If the protected business' liabilities are likely to exceed £200m, then the PRA will possibly require a UK subsidiary;
- **Protection of UK branch policyholders:** no discrimination against branch policyholders in a winding-up situation and appropriate protection if the firm as a whole becomes insolvent;
- **Risks to financial stability:** business below the £200m threshold could still be required to be written from a subsidiary where there is a lack of substitutable products available in the UK market; the proposed branch would be significant in proportion to the overall UK market in that line of business; or due to the level of interconnectivity with other market participants;
- **Significance of branch to the legal entity as a whole.**

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In light of the PRA's recent paper, what are the options available to EEA insurers with UK business?

Withdraw from UK market and place UK book into run-off

Both EEA insurers and UK policyholders need certainty that the commitments under contracts legally sold under current passporting arrangements that remain in force at the point of the UK's exit will continue to be honoured.

While the servicing obligation is set out in the terms of the insurance contracts themselves, the question arises as to whether servicing such contracts will be possible without UK authorisation?

Where the insurer has a UK branch and gains UK regulatory authorisation for this to continue as a branch of a third country insurer post Brexit, servicing this business will not be an issue. However, any EEA insurer that has sold business into the UK under FOS licences or that chooses to close its UK branch operations will need to ensure that it does not inadvertently breach UK authorisation requirements.

Within the UK, authorisation is required where the activities of 'effecting' (relating to entering into new business) and/or 'carrying out' (relating to servicing of existing business) contracts of insurance are conducted in the UK. Both activities are widely drawn and conducting unauthorised business is a criminal offence subject to fines and imprisonment. It is therefore critical that EEA insurers determine whether any of their activities will require UK authorisation post-Brexit.

For EEA insurers that intend to cease UK activities (where, for instance, the level of UK premium is insufficient to justify a new UK branch or subsidiary), the UK's HM Treasury pronounced in January that they will take action to ensure that existing insurance contracts can be honoured by EEA insurers without breaching UK authorisation requirements.

This appears to be a pragmatic solution and would involve a 'temporary permission' enabling affected EEA insurers to meet their UK contractual obligations for a limited period post-Brexit. That said, the PRA cautions firms that this should only be a 'fall-back' option.

Unfortunately for UK insurers, no similar solution has yet to emanate from Europe, which the Bank of England estimates as covering 30 million EEA policyholders covered by UK insurers. Instead, the EIOPA Opinion of 21 December envisages that UK insurers will need to make their own arrangements to ensure they can legally service pre-Brexit European policies, such as effecting costly portfolio transfers.

Authorisation of a new UK insurance subsidiary

Whilst the PRA consultation paper provided some much needed clarity to EEA insurers over the branch versus subsidiary question, there is little detail regarding the actual application process.

More detailed guidance should be covered in a second consultation paper from the PRA originally planned for February 2018, but this could be delayed depending on the discussions regarding transitional arrangements (see below). However, at this stage we do not anticipate any significant changes to the authorisation process for new UK insurance subsidiaries.

Authorisation of a UK Branch

Most insurers with an established UK branch would have preferred a simple process to 'convert' the branch into a third country insurer authorised branch post-Brexit. However, there is now a general recognition that this is not possible and it will be necessary to follow a formal authorisation process. This is consistent with EIOPA's comment in its Opinion on supervisory convergence in light of the UK withdrawing from the EU that **"there cannot be any automatic recognition of an authorisation granted by another supervisory authority."**

The process will be identical for both new and established UK branches of EEA insurers, although established branches may have an advantage in justifying the proposed business model, by using their existing UK track record to support the viability and sustainability of their UK regulatory business plan.

The governance and senior management requirements for branches are less onerous than for stand-alone insurers, which should help make the authorisation process simpler. A key consideration for the PRA will be to understand the financial condition of the legal entity as a whole, the interaction between branch and head office and its ability to cooperate effectively with the home state supervisor.

Firms should be aware that any locally granted Solvency II permissions will not be automatically recognised by the PRA and, if relevant to the branch, will need to be reapplied for in the UK. In particular, this could result in the UK branch solvency capital requirement being determined under the standard formula, regardless of whether the legal entity has internal model approval, until such approval is granted by the PRA in respect of the UK branch. This is consistent with the EIOPA opinion mentioned above and our understanding is that the PRA would consider any internal model application at the same time as the branch application.

On the basis of our discussions with UK regulators, it does not appear that there will be any significant changes to the current application process or documentation requirements for UK insurance branches. Although we anticipate that formal guidance will be issued later this year once there is greater clarity around any transitional arrangements.

One of the main issues that we believe the PRA will need to provide clarification is the meaning of branch assets and the extent to which branch assets will need to be ring-fenced for the benefit of UK policyholders.

In terms of timing, the PRA had stated that it will be open to receive authorisation applications from January 2018, with firms aiming to submit these by the end of March 2018 to ensure the authorisation process can be completed before the UK's formal exit from the EU.

However, the discussions at European level regarding transitional arrangements could mean a deferral to this timetable. This is especially applicable to branch applications, as the PRA has no ability to approve any branch application from an EEA insurer while the UK is a Member State. The application process for UK branches of EEA insurers is therefore more akin to a 'pre-application' process, similar in concept to the approval of internal models in the run-up to Solvency II.

The UK has an approval deadline of six months to consider complete applications and 12 months for incomplete ones, although the regulators offer a 'pre-application' phase to increase the chances of the formal application being deemed complete when received. This enables applicants to submit their draft regulatory business plan and deal with feedback from the regulators without the formal approval window clock starting.

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Transitional arrangements

The European Commission published a Position Paper on 7 February entitled **"Transitional Arrangements in the Withdrawal Agreement"**, which built on a European Council paper of 29 January. As drafted, this would mean that during the transition period, for most purposes, the UK would be treated as if it were a Member State (but without certain constitutional powers).

For insurers, this should mean that both UK and EEA insurers would be able to continue operating under passporting licences until the end of the transitional period. It should also mean that any legislation that would be relied upon to effect mergers or portfolio transfers would continue to be available until the end of the transitional period, giving insurers and regulators some much needed time to effect such processes.

The conundrum this creates for EEA insurers is whether to commence their application preparations now using the materials available on the PRA's authorisation webpage given the short time remaining until Brexit and the lack of certainty regarding agreement of the proposed transitional arrangements; or to delay starting the application process to avoid the risk of having to re-do their regulatory projections again in 2020.

Next steps

Despite having sight of the draft transitional arrangements, all of the firms with UK branches that we have discussed this with are continuing with their plans to submit authorisation application to the PRA by March 2018 to avoid the risk of being unauthorised and unable to legally transact insurance business at the date the UK's formal exit from the EU.

For EU FOS insurers, there is also uncertainty regarding what process may be involved in gaining the proposed 'temporary permission', so again we are seeing firms continue with their contingency plans.

For those EU FOS firms that have yet to consider fully their options for accessing the UK market post-Brexit, the first step should be an assessment of the business case for retaining UK market access (for example whether the volume and profitability of this business warrants the costs and effort of potentially major business redesign). From this analysis it will then be possible to assess the optimum structure.

Unfortunately, time is not on the side of insurers that have not yet started their Brexit planning.

The PRA has been encouraging EEA insurers to hold introductory meetings with them to discuss their post-Brexit contingency plans.

These meetings should, at a minimum, cover an overview of current UK products and volumes of business, operating model, UK branch structure (if applicable) and interaction with head office.

Where guidance is sought on whether UK authorisation will be required, firms should discuss with the PRA any activities undertaken in the UK, including those undertaken through authorised agents. Where authorisation is sought, insurers should provide the rationale for seeking this and proposed timeline.

Given the time involved in preparing the application pack and supporting materials, we would advise EEA groups wishing to retain access to the UK market against slowing down their preparations – at least until there is greater clarity that both sides agree to the transitional arrangements now proposed. A key risk in waiting is that the transitional agreements (as drafted) will form part of the main UK Withdrawal Agreement, so finalisation of these could come very close to the date of UK departure, leaving insufficient time to respond.

More detailed guidance on the authorisation processes should be covered in a second consultation paper from the PRA later this year, and we hope that further clarification of the proposed UK 'temporary permissions' will be produced at the same or similar time.

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