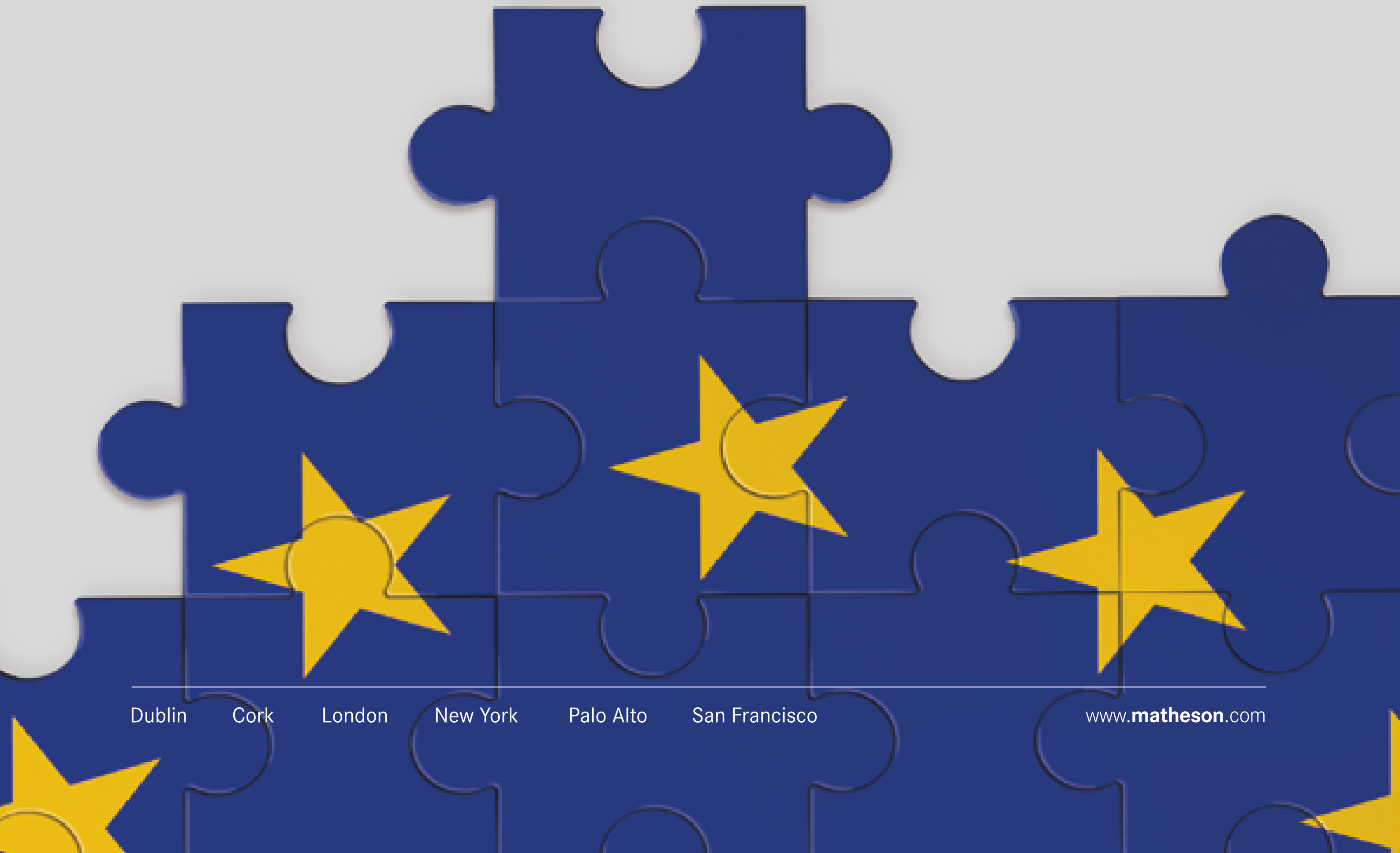
Matheson

# Brexit: Is Equivalence a Solution for Insurance?

8 October 2020



# Brexit: Is Equivalence a Solution for Insurance?

We have considered in a broader context whether the European Union ("**EU**") equivalence framework provides an appropriate basis for the future relationship between the EU and the United Kingdom ("**UK**") – see our paper "**Brexit – Is Equivalence a Solution for Financial Services?**". With the prospect of no agreement being reached by the end of the transition period becoming increasingly likely, our view (as outlined in the above paper) with respect to equivalence generally is that the existing equivalence framework does not provide an acceptable, long-term, sustainable solution for the UK-based financial services industry as a whole to access EU markets. Predictability, stability and transparency are key for financial services firms to implement their distribution, marketing and growth planning in the medium to long-term and the existing regime does not offer these benefits.

In this paper, we consider in detail:

- the likely impact of no agreement and no equivalence determination being made on the insurance industry, both from a UK and Irish perspective; and
- the provisions made for equivalence under Solvency II[1] and what equivalence determinations would mean for the UK and the EU respectively, if made.

We have also prepared papers assessing and summarising the expected legal impacts arising from no agreement on financial services being reached by year end for each of the areas of: **investment funds**, **derivatives clearing**, **banking**, **MiFID firms**, and **fintech and payments**; together with an analysis of equivalence as a viable or relevant mechanism in each case.

1 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance ("**Solvency II**")





## No Agreement: Irish-based Insurers and Access to the UK

As outlined, the first scenario for consideration is one where no agreement is reached and no equivalence determinations, in the area of insurance, are made. Such an outcome would result in the UK becoming a third country and the current EU passporting regime[2] , which Irish authorised insurers currently rely on to access the UK market, no longer being available. The following addresses the consequences of this scenario, for Irish authorised insurers, in the context of contract continuity and contingency plans.

### Contract Continuity - Temporary Permissions Regime

To minimise disruption post-Brexit, the UK has implemented a Temporary Permissions Regime ("**TPR**") giving European firms temporary permission under Part 4A of the Financial Services and Markets Act 2000 ("**FSMA**") to passport into the UK post the transition period. The TPR provides a contingency mechanism to ensure firms can continue their business with minimal disruption until they choose whether to leave the UK market or establish a UK authorised entity.

In order to avail of the TPR, an Irish insurer[3] must have notified the Prudential Regulation Authority ("**PRA**") using the Connect system before the 11 April 2019.[4] It is anticipated that the regime will apply for a maximum of three years until 31 December 2023.

### Contract Continuity - Financial Service Contracts Regime

Should an Irish insurer have failed to apply for the TPR it will automatically be subject to the Financial Service Contracts Regime ("**FSCR**"). The FSCR was introduced by the UK Government to ensure existing contractual obligations not covered by the TPR can continue to be met. The FSCR will permit an Irish insurer to service its UK contracts entered into pre-Brexit so that it can wind down / run–off this business in an orderly fashion. Crucially – no new business can be written under the FSCR. The FSCR will apply for a period of 15 years for insurance contracts but an extension is permissible based on a joint assessment by the FCA and the PRA.

### Contingency Plans

If an Irish insurer wishes to retain access to the UK market either:

- beyond the TPR deadline; or
- if it failed to register under the TPR, beyond 31 December 2020,

it will need to establish a UK authorised entity and comply with the requirements of the UK's insurance regime applicable at the relevant date of its authorisation, post 31 December 2020.

In the context of those who have registered for the TPR, the Financial Conduct Authority ("**FCA**") has explained that:

> "*after exit, firms who notified the FCA of their intention to use the TPR will be contacted and provided with a landing slot when they will need to submit their application for full UK authorisation. Upon authorisation, we will generally expect firms to have a physical presence in the UK to help ensure effective supervision*."

2 the right to establish a branch or provide cross-border services in another European Economic Area ("EEA") member state
3 **Reuters** report that circa 228 Irish Insurers have registered for the TPR.
4 The PRA has recently confirmed that if an insurer has not taken the necessary steps to enter the TPR, it may still do so by submitting an application for permission under Part 4A of FSMA (or for variation of an existing 'top-up' permission) before the end of the transition period.

With regards to the UK insurance regime applicable post 31 December 2020, it is the UK's stated intention that EU financial services legislation which will be in force at the end of 2020 will be imported into UK law under the European Union (Withdrawal) Act 2018 ("**EUWA**") on Exit Day and the UK legislation originally passed to implement each piece of EU law on day one, will be retained and will be known as "*retained EU law*". The Solvency II legislation falls within the scope of EUWA. Allied to this, a specific statutory instrument has already been made to create an "*onshored*" version of Solvency II, this amends the original legislation so that references to EU institutions are replaced with references to UK institutions and other necessary amendments to ensure the effective working of the law post 31 December 2020. However, the clear indication is that the UK insurance regime will, initially at least, represent as closely as possible, the Solvency II regime[5].

## No Agreement: UK-based Insurers and Access to Ireland

We now consider the foregoing scenario from the perceptive of UK authorised insurers. Should no agreement be reached, such insurers would no longer be able to rely on the existing EU Passporting Regime as they currently do to access the Irish market and the wider EU market. The following addresses the consequences of this, for UK authorised insurers, in the context of contract continuity and contingency plans.

### Contract Continuity

To date, the EU has not adopted or proposed to adopt any special arrangements, akin to the UK's TPR or FSCR, to facilitate continued access to the EEA by UK firms following a no agreement scenario. However, in February 2019, the European Insurance and Occupational Pensions Authority ("**EIOPA**") issued a recommendation to national competent authorities in light of the UK leaving the EU. Recommendation 2 thereof stated that:

> "*competent authorities should apply a legal framework or mechanism to facilitate the orderly run-off of business which [would become] unauthorised or they should require the insurance undertakings to immediately take all necessary measures to become authorised under Union law".*

It also spoke to the need to prevent any new insurance contracts being put in place[6].

In March 2019, the Irish Government published the Withdrawal of the United Kingdom from the European Union (Consequential Provisions) Act 2019 ("**Brexit Omnibus Act 2019**"). The Brexit Omnibus Act 2019 was primarily drafted in contemplation of the Withdrawal Agreement not being signed and the UK crashing out of Europe. In respect of EIOPA's Recommendation, Part 8 of the Brexit Omnibus Act 2019 incorporated provisions in respect of insurance contract continuity. However, as the Withdrawal Agreement was signed, these provisions of the Brexit Omnibus Act 2019 were not required and were never commenced.

As we now move into a phase of the negotiations where no agreement is a tangible prospect, and in the absence of an EU wide arrangement similar to the TPR and the FSCR, we can expect individual EEA jurisdictions to begin enacting legislation to protect their citizens and businesses which deal with UK based insurers, as they did in 2019. This is a message which was recently reinforced by the European

5 There is a suggestion that there may be some additional changes to ensure the legislation is reflective of the UK insurance industry specifically but no legislation to this effect have been formalised.

6 This built on the position outlined in **EIOPA's Opinion** on service continuity in Insurance in light of the UK withdrawal from the European Union.





Commission ("**Commission**"), in its updated Notice for Readiness for the Insurance / Reinsurance Sectors released in July, 2020, wherein it detailed that:

> *"the loss of the EU authorisation may affect the ability of UK insurance undertakings to continue performing certain obligations and activities and ensure service continuity with regard to contracts concluded before the end of the transition period. According to the Solvency II Directive, firms are required to take measures to ensure that contracts can continue to be serviced. To this end, firms should assess the implications of the end of the transition period on their operations and contract portfolios and, also in cooperation with the relevant national supervisors, identify and mitigate risks".*

On 15 September 2020, the Irish Government took steps in this direction when it published the general scheme of the Withdrawal of the United Kingdom from the European Union (Consequential Provisions) Bill 2020 ("**Brexit Omnibus Bill 2020**").[7] The Brexit Omnibus Bill 2020, in so far as it impacts insurance contract continuity, is largely modelled on the Brexit Omnibus Act 2019.

Part 8 of the Brexit Omnibus Act 2019 addressed insurance contract continuity and proposed to insert an additional provision into Regulation 13 of the European Union (Insurance and Reinsurance) Regulations 2015 ("2015 Regulations")[8], permitting a UK[9] insurer to administer its run-off business in Ireland for a period of three years from the date of enactment of the Brexit Omnibus Act 2019 "*in order to terminate its activity*" in Ireland. Crucially, no new business was to be permitted but compliance with the general good requirements would remain a requirement.

The provisions of Part 10 of the Brexit Omnibus Bill 2020 remain closely aligned to the provisions of Part 8 of the Brexit Omnibus Act 2019 in relation to new business and general good requirements. One critical change, however, is in the extension of the temporary run-off regime from a period of three years to fifteen years. This is a welcome development for UK based insurers and aligns with the FSCR approach in the UK.

In order to avail of this regime, a UK insurer will have to, not later than three months from the date the Brexit Omnibus Bill 2020 comes into operation or such other date permitted under the terms of the Brexit Omnibus Bill 2020, notify the Central Bank that the relevant regulation will apply to its business.

A further change to the provisions of the Brexit Omnibus Act 2019 is the inclusion of a review clause in respect of the temporary run-off regime. Section 4 of Part 10, includes a requirement for the Central Bank to make a report to the Minister for Finance at the end of year 12 following enactment of the legislation, setting out its view on the run-off regime.[10] While Section 4 does not allow for the possibility of extending the run-off regime beyond the stipulated fifteen years, if the Minister for Finance, having reviewed the Central Bank's report deems such action as necessary, one would expect that such a step would be considered at that time. However, UK insurers should, for now, plan to operate their run-off business within the 15 year time period.

7 As the Brexit Omnibus Bill 2020 is, at the time of writing, only at General Scheme stage, Part 10 could be subject to change as it progresses through the legislative process.

8 It also proposed to insert an additional provision into Regulation 3 under the European Union (Insurance Distribution) Regulations 2018, this provision mirrors the additional proposed provision under the 2015 Regulations. Where references are made in this section to UK insurers, same should be interpreted as applying equally to UK insurance intermediaries.

9 For the purposes of this section, any reference to the UK includes Gibraltar.

10 The report is intended to cover both insurance undertakings and persons carrying on insurance distribution business taking account of a number of principles and policies, including the need to protect policyholders, the number of firms remaining in run-off, and the nature of the policies in question.

## Contingency Plans

At this stage, most UK insurers have already considered the options available to them to continue to write business in Ireland and / or the EU more widely and have put their plans in place. These were facilitated in a number of ways, including:

- establishing an Irish authorised insurer as a subsidiary to access not only the Irish market but to avail of the EU passporting regime;
- establishing an EU authorised insurer elsewhere and passporting into Ireland in that way;
- entering into formal fronting arrangements with EU authorised carriers to access the Irish market; or
- establishing a branch, seeking local authorisation in Ireland for Irish business only but have no passporting rights to the EEA.[11]

In the event that a UK insurer has not yet developed a contingency plan, it would need to do so without delay, particularly with regards to its obligations to inform customers of the position regarding policies post 31 December 2020, a point which the Commission stressed in its Notice for Readiness.[12] From our experience, the main delay around securing authorisation is likely to be the identification of parties for relevant roles, particularly PCF roles and securing their necessary approvals from the Central Bank. Consequently, any firm looking to seek Central Bank authorisation should commence identification of appropriate candidates as a matter of priority[13].

In respect of those UK firms which have been authorised or are likely to be authorised before 31 December, 2020, authorisation is only the beginning of its relationship with the Central Bank. Upon authorisation these firms will be expected to meet all conditions attaching to its authorisation as well as adhering to the applicable regulatory framework. The Central Bank will expect significant substance behind the insurer's operations in Ireland, with the hearts and minds of the insurer and the decisions pertaining to the business being made here.

11 This is provided for under Articles 162 – 170 of Solvency II.

12 *"According to Articles 183-186 of the Solvency II Directive and Articles 17-25 of Directive (EU) 2016/97, policyholders/customers should be informed about the impact of the end of the transition period on their rights and on the provision of insurance services, including the upcoming loss by the relevant insurance undertaking/intermediary of its EU authorisation."*

13 This was also detailed in the **Central Bank's Brexit Task Force Report** in January 2020 – see page 21 of same.



Brexit: Is Equivalence a Solution for Insurance?

Matheson

## Equivalence

As detailed in our paper "Brexit – Is Equivalence a Solution for Financial Services?", equivalence means different things for different sectors. In the context of the insurance sector - comprised of insurance, reinsurance and insurance distribution; equivalence represents dramatically different things for each and is not necessarily the panacea which many hoped it could be. For instance, the Insurance Distribution Directive does not provide for any form of equivalence determination. Consequently, insurance intermediaries will solely be dealing with the WTO arrangements in the event of no agreement.

Solvency II, on the other hand, identifies three distinct areas for equivalence assessment:

| **Reinsurance –** third country reinsurers | **Solvency calculation –** EEA insurers operating in a third country | **Group supervision –** Third country insurers with activities in the EEA |
|---|---|---|
| Under Article 172 of Solvency II, if a third country's rules are deemed equivalent, reinsurers from that country must be treated by EEA supervisors in the same way as the EEA reinsurers. | Under Article 227 of Solvency II, a positive equivalence decision allows EEA international insurance groups to use the local rules relating to capital (own funds) and capital requirements rather than the Solvency II rules meaning related companies in the third country will not have to recalculate their data in conformity with the Solvency II requirements. | Under Article 260 of Solvency II, if a third country's rules are deemed equivalent, insurers from third countries with activities in the EEA are permitted under certain conditions to rely on the group supervision exercised by the third country. This would free third country international groups from being subject to dual group supervision. |

The Commission, with the assistance of EIOPA, will assess a third country's application for equivalence be it in one or more of the three areas. This assessment focuses on the results of the third country's regulatory regimes, rather than the similarities between the regulatory regimes. The assessment criteria differs in respect of each area. More detail on these can be found in EIOPA's guidelines on the methodology for equivalences assessments under Solvency II.

Equivalence in these areas can take one of three forms: full, temporary or permanent. The distinction between the three is set out in the following table:

| | |
|---|---|
| **Full** | Can be determined for third country reinsurers, EEA insurers operating in a third country and third country insurers with activities in the EEA for an unlimited period. |
| **Temporary** | Can be determined (if progress is being made towards full equivalence ie, an equivalent solvency regime is expected to be adopted and applied by the third country within a foreseeable future) for third country reinsurers and third country insurers with activities in the EEA for a limited period (currently until 31 December 2020 with the possibility to extend by one year) |
| **Provisional** | Can be determined (if progress is being made towards full equivalence ie, an equivalent solvency regime is expected to be adopted and applied by the third country within a foreseeable future) for EEA insurers operating in a third country only, for a limited period of ten years. This can be renewed for further ten-year periods. |

To date the Commission has taken a number of equivalence decisions for third countries namely:

- **Switzerland**: Full equivalence for all three areas - solvency calculation, group supervision and reinsurance - for an unlimited period.
- **Bermuda**: Full equivalence for all three areas - solvency calculation, group supervision and reinsurance - for an unlimited period.
- **Japan**: Temporary equivalence for reinsurance ending on 31 December 2020 and provisional equivalence for solvency calculation for ten years beginning on 1 January 2016.
- **United States**, **Australia, Brazil, Mexico and Canada:** Provisional equivalence for solvency calculation for a period of ten years beginning 1 January 2016.

## A UK Equivalence Determination by the EU

Although work on the assessment of the UK financial services regime, which included Solvency II, was to be completed by the EU by the end of June 2020, the EU has advised that this work is still ongoing, delayed largely by the lack of responsiveness from the UK to equivalence questionnaires.[14]

If an equivalence determination is made in respect of Solvency II before the end of the implementation period, that will provide certainty in respect of the areas pertaining to equivalence evaluations. However, if it is delayed beyond 31 December 2020, this will leave those firms who are hoping for an equivalence determination to be made, in a predicament with no clear guidance as to when the determination is likely to be handed down. Such a predicament may not be an acceptable position for many firms and they may have decided to put in place contingency plans, regardless of an equivalence determination.

Even if the UK is determined by the EU to be equivalent, it will only be equivalent in the three ways identified above, namely in the areas of reinsurance, solvency calculations and group supervision. Crucially, this will not replicate access to the EEA market that passporting currently offers and for many insurers without that market access, their business models are not sustainable. This is why we have seen many insurers establishing legal entities and seeking and securing full authorisation in Ireland as insurance undertakings, under Solvency II, and subsequently transferring the relevant portfolios from the UK entity to the new Irish authorised entity.

From a reinsurer's perspective, an equivalence determination is significant as reinsurance contracts entered into with reinsurers in an equivalent third country must be treated in the same manner as contracts entered into with EEA based reinsurers.[15] This will benefit not only the reinsurer in question but also the EEA-based insurers who are party to reinsurance arrangements with such reinsurers. The provisions under Solvency II in respect of the credit given for reinsurance and the impact on counterparty default risk charges in solvency calculations will mirror those where reinsurance is secured with an EEA authorised reinsurer. So the arguments in favour of equivalence in the context of reinsurers in particular work both ways.

14 UK completed 4 of the 28 questionnaires by the deadline and as such the EU was not in a position to conclude a determination by the agreed date. The UK have explained that many of the questionnaires had 1000s of questions and some were delivered late in May and so it was not feasible to respond in time.

15 On **27 July 2020**, insurance lobby group, London Market Group, called on the UK to make an application for equivalence to the Commission to avoid the "regulatory upheaval" of a no-deal Brexit noting "*an EU determination of reinsurance equivalence under Solvency II is vital in case a future agreement does not provide adequate EU market access for UK-based reinsurers*".



Brexit: Is Equivalence a Solution for Insurance?

Matheson

As regards the determination of equivalence in respect of supervisory capital and group supervision, while these are ultimately beneficial for those firms which are covered by same, they do not have broad application and have no impact on market access.

As previously identified, underpinning all of the above, is the fact that these equivalence determinations can be withdrawn without reason, at one month's notice, a less than ideal basis on which to make business decisions.

Another Work Around?

There is one other provision under Solvency II which could be considered as a "work around" for the limited nature of equivalence permitted under Solvency II. The provision in question is Article 171 of Solvency II. This article provides that the EU:

> *"may, by means of agreements concluded pursuant to the Treaty with one or more third countries, agree to the application of provisions different to those provided for in this Section, for the purpose of ensuring, under conditions of reciprocity, adequate protection for policy holders and insured persons in the Member States."*

If minded, the EU could agree to a unique arrangement with the UK in the area of insurance, with reciprocal arrangements for EU policyholders. However, there is no indication that this is currently being considered by the EU.

## EU Equivalence Determination by the UK

The House of Lords Select Committee on the European Union released oral evidence given on 2 July 2020[16] by John Glen, Economic Secretary and City Minister, HM Treasury, relating to the committee's inquiry on financial services post 31 December 2020. On the question of equivalence assessments, Mr Glen confirmed that the UK had made its assessments of EU financial services legislation and that the UK expects to make its outcome known only as part of the structured dialogue with the EU. He indicated that the UK will not announce its decision unilaterally if the EU has not completed the process[17]. Despite this, it is generally expected that the UK will find EU financial services legislation equivalent across the board, which would include Solvency II.

Whether the basis for these determinations of equivalence would be the EU financial services legislation retained and onshored (as detailed in 2.4 above) creating identical, equivalence regimes for the UK, is not clear. In the event that it is, then the same points raised above in respect of the extent of equivalence under Solvency II would apply here. This will of course be clarified in due course. In the meantime, the details set out above regarding the TPR are what will be relevant to immediate access to the UK market by Irish Insurers, post 31 December 2020.

16 Please note that the **link** to said oral evidence has since been removed from the UK Parliament's webpage.

17 "*I do not think anyone would expect us unilaterally to make that decision known in the context of the EU not completing the process*" John Glenn.

Matheson

## Concluding Comments

For the reasons explained, the concept of equivalence is not adequate, under current legislation, to provide UK insurers with continued broad access to the EU market (and as a consequence, is unlikely to be useful as a basis for EU firms to access the UK market in a reciprocal manner). The potential negative impacts of a "no deal" Brexit remain therefore very real. Firms need now to dust off those Brexit plans and prepare to "road test" them, while any firm that has not yet put in place robust arrangements to address market access and contract continuity needs to urgently review its position.

*8 October 2020*

*Please get in touch with your usual Matheson contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this paper.*

*Full details of Matheson's Financial Institutions Group, together with further updates, articles and briefing notes written by members of the team, can be accessed at* www.matheson.com*. Further Brexit-related updates, articles and briefing notes may be accessed on our* Brexit Forum*.*

## Contacts

**Darren Maher**
Partner
**T** +353 1 232 2398
**E** darren.maher@matheson.com

**Liam Flynn**
Partner
**T** +353 1 232 2025
**E** liam.flynn@matheson.com

**Grainne Callanan**
Partner
**T** +353 1 232 2050
**E** grainne.callanan@matheson.com