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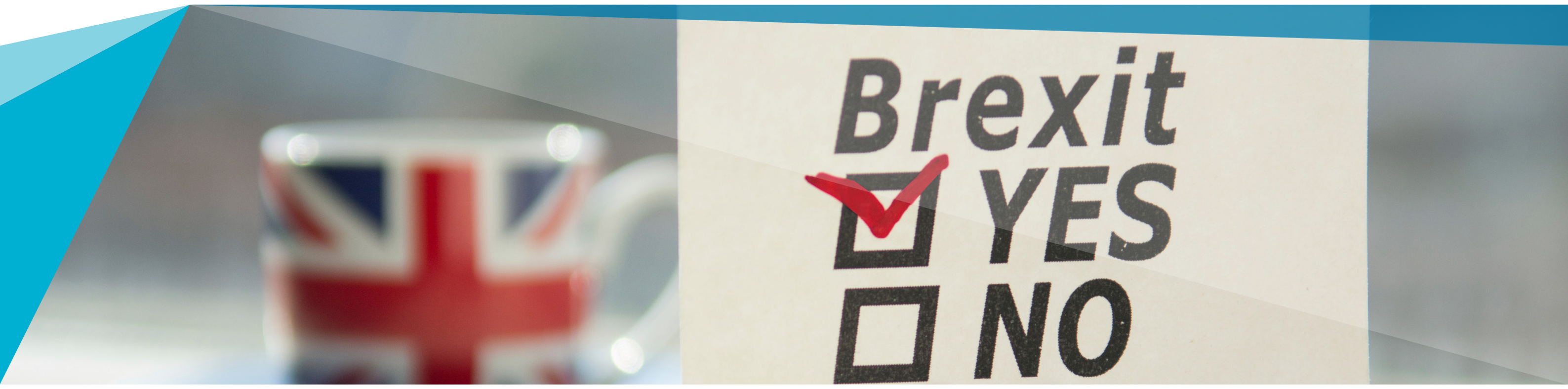
INSURANCE IMPLICATIONS FOLLOWING THE UK VOTE TO LEAVE THE EU



In a referendum held on 23 June 2016, the United Kingdom (UK) voted to leave the European Union (EU).

EXECUTIVE SUMMARY

The UK vote to leave the EU will have several implications for insurance buyers and insurance carriers.

For risk professionals, many of the key issues that affect them will be decided during the negotiations over the coming years that will determine the UK's new relationship with the EU. However, firms need to begin assessing which areas of their business could be affected and begin having discussions with their insurers and risk advisers. Most urgently, this applies to people issues and decisions about project timings.

For insurers, this vote could also have significant implications. With the likelihood of some level of market turmoil in the near future, coupled with currency depreciation of the GBP, the direction of negotiations could cause consequential stress on insurers' capital positions, leading to possible credit ratings downgrades for them and other financial institutions.

In addition, with potential changes to how the EU's Freedom of Service Directive operates in the UK, the right of UK-based insurers and brokers to carry out business in the EU could be restricted following the transition period.

We will continue to keep clients updated as these negotiations continue.

NOW THE UK HAS VOTED TO LEAVE, WHAT HAPPENS NEXT?

While the UK's relationship with the EU will undoubtedly change, the exact implications of the UK's decision to leave the EU are far from certain at this point.

Article 50 of the Treaty on European Union outlines the process for a member state leaving the EU. Once the government notifies the European Council of the UK's decision to withdraw, there will be a two-year transition period to negotiate the terms of its exit and the shape of the UK's future relationship with the Union. Any extension to the transition period will have to be agreed to by all remaining EU members.

The current situation is unprecedented, however, insofar as no member state has previously voted to leave the EU. Due to the complexity of the necessary negotiations involved in the UK's exit from the EU, the UK Cabinet Office has predicted it could take up to a decade or more for the two parties to negotiate a new agreement and replace existing trade deals.[1]

1. *The Process for Withdrawing from the European Union*, HM Government, February 2016, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/504216/The_process_for_withdrawing_from_the_EU_print_ready.pdf.

POSSIBLE SCENARIOS FOR EU MEMBERSHIP ALTERNATIVES

Prior to the referendum taking place, the UK Government issued a paper outlining the possible scenarios that could come to pass in terms of the future relationship between the UK and the EU.[2] We briefly outline four possible scenarios below:

Scenario one:
A tariff-free trade agreement is made between the UK and EU.

Under this scenario, the UK would have its own immigration policy and independent trade policy, as well as some access to the single market. It is believed this would have a moderate impact on the UK economy.

Scenario two:
The UK becomes part of the European Economic Area (EEA).

This scenario is likely to have the lowest impact on the UK economy and trade, since EEA countries have access to the single market. EU regulations and directives would still apply in the UK, which would still contribute to the EU budget. However, it would not have an independent immigration policy.

Scenario three:
The UK enters into a bilateral integration treaty with the EU.

In this scenario, the UK would enter into an agreement with the EU that is similar to agreements between Switzerland and the EU. This would likely have a moderate impact on the UK economy, trade, and immigration. The UK would likely have some access to the single market, but no bilateral agreements providing full access of service.

Scenario four:
The UK makes no access agreements and trades with the EU as a third country.

If no trade agreements are reached and only World Trade Organization terms apply, the UK would trade with the EU in a similar way to countries like the US. This scenario would likely have the highest impact on the UK economy and the lowest possibility that the UK would be able to trade under the single market. The UK's immigration policy would also become independent.

WHAT TO CONSIDER POST-REFERENDUM

Now that the UK has decided to leave the EU, companies will need to consider the impact the exit will have on a range of risk and insurance issues.

Given the possible scenarios outlined by the UK Government, below we outline some key areas companies should be considering in their contingency plans.

MARKET VOLATILITY

There is likely to be some level of market turmoil in the near future. Following the initial depreciation in the GBP, further currency volatility can be expected over the next few weeks. This is likely to continue to some degree – depending on the scenario agreed – as negotiations are carried out, which could cause consequential stress on capital positions, leading to possible credit ratings downgrades for insurers and other financial institutions.

UK overseas investment may also be affected. Last year, there were record levels of global activity in mergers and acquisitions (M&A), with an estimated USD4.78 trillion worth of deals announced. In the run-up to the referendum many sources spoke of a slowing down of M&A activity in the UK. In the early days post-referendum, there is likely to be continued speculation about the UK's ability to attract overseas investment during this period of transition. It is difficult to forecast the extent and longevity of this uncertainty as the exit negotiations continue.

The UK's decision to leave may prompt other EU countries to hold referendums on continued EU membership, which would have additional serious implications for the European economy.

2. *Alternatives to membership: possible models for the United Kingdom outside the European Union*, HM Government, March, 2016, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/504661/Alternatives_to_membership_possible_models_for_the_UK_outside_the_EU_Accessible.pdf.

MATERIAL CHANGE IN RISK

The UK's decision to leave the EU has the potential to cause key aspects of an insurance buyer's business or planned transactions to change, resulting in a possible material change to the buyer's risk profile. For example, some buyers may look to defer projects until there is greater certainty in the marketplace.

Now is the time for buyers to raise and resolve any implications the impending changes may have on their risk with their insurers and risk advisers.

PEOPLE ISSUES

As part of the EU, UK citizens currently have freedom of movement in all other EU member states. Freedom of movement is a fundamental right in the EU, which enables non-UK EU citizens to work freely in the UK, and UK nationals to work in other EU countries.

Following the "leave" vote this could change depending on which of the scenarios, detailed above, becomes the preferred option. These negotiations will determine under what circumstances EU citizens will be able to enter and work in the UK, and will also determine the conditions in which EU citizens already in the UK, and UK citizens living in the EU, will be able to continue in their current positions. There is also a potential for changes to UK pension schemes under the new structures.

PASSPORTING ISSUES

The right of insurers and brokers to passport (that is, to carry out business in other countries from a single country licence) into the EEA could be restricted following the transition period.

As a result, insurers wishing to carry on business in other EEA states could be required to obtain licences in each member state, or form a new legal entity based in one of them, depending on which option is adopted. Similarly, an EU insurer could now need an additional licence to carry on insurance business in the UK, or to form a new UK entity. Writing business through local branches will require local authorisation and capital being deposited to support the branch in some cases.

Future negotiations will provide greater clarity on the manner in which UK and EU insurers are able to carry out business in their respective countries. It is possible that we could see some insurers with UK operations establishing greater presences in continental Europe in order to more easily operate under the single licence, particularly those insurers who make extensive use of the passporting rights currently.

For example, AIG recently stated it would consider establishing an operations centre within the EU if the UK votes to leave.[3]

Lloyd's of London also indicated it was investigating the possibility of negotiating passporting rights across the EU in the event of Brexit. It stated that it plans to work with the UK Government and EU institutions during any negotiations to retain market access for Lloyd's and the London market and create as much regulatory certainty as possible.[4]

CHANGE IN THE LEGAL AND REGULATORY ENVIRONMENTS

After the UK leaves the EU, the Freedom of Service (FOS) Directive may no longer apply to the UK and therefore its access to the single market would have to be renegotiated during the transition period.

FOS is the right to provide business services on a cross-border basis within the EU. For insurance contracts, in particular, this means that a contract can be underwritten in an EU member country that is different from that in which the risk is located.

These contracts – which are commonly used by multinational companies as a means to secure locally admitted coverage in multiple EU countries – could be affected, depending on what the impending negotiations yield. In addition, the UK may no longer benefit from treaties between the EU and non-EU countries going forward, meaning that organisations could face new barriers when providing services outside of the EU. Also, UK judgements may no longer be enforceable in the rest of the EEA.

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3. *Business Magazine*. "AIG weighs European Union hub beyond London if Brexit prevails". Available at: http://www.insurancebusinessmag.com/uk/news/breaking-news/aig-weighs-european-union-hub-beyond-london-if-brexit-prevails-33371.aspx, accessed 16 June 2016.
4. https://www.lloyds.com/news-and-insight/press-centre/speeches/2016/02/the-implications-of-brexit-for-the-london-insurance-market

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CONCLUSION

It is still unknown how the UK's relationship with the EU will be structured after negotiations are concluded. The length and outcome of various aspects of the negotiations will determine the extent of the impact on companies and their insurers.

We advise clients to keep a close eye on developments during this period and have a plan in place to address various outcomes, including speaking with their insurers and risk advisers to address altered risk profiles and changes in insurance needs.

Marsh will be working to further understand what Brexit will mean for clients and will be issuing further guidance as the impact becomes clearer.

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