CloserLook

Brexit: What now for US insurers?

The world turned upside down?

The decision by voters in the United Kingdom to exit the European Union, known as "Brexit," was a surprising one: prognosticators in the days leading up to the vote assigned a fairly low probability for the "leave" supporters to come out on top.[1] Additional uncertainty related to the potential for additional EU member nations to seek an exit, or even for constituencies within the UK to seek their own path with respect to the EU, has the potential to further complicate an already challenging situation.

Financial institutions in the UK and Europe will bear the brunt of this event over both the short and longer term, as the timetable for full separation will take two years following invocation of Article 50 of the Lisbon Treaty. What about their counterparts in the United States? Some very large US firms operate globally, with a meaningful presence in the UK and Europe. For them, the impacts are more direct and immediate. But many more US financial institutions are purely domestic, so the impacts of Brexit will be part of larger regulatory and economic forces that may emerge as the UK executes its departure.

In the remainder of this document, one of a series of reports, we will explore the implications of Brexit for the insurance business in the United States, looking at financial, regulatory, operational, and strategic considerations for US insurance executives. Those interested in understanding the impact of Brexit on other financial industry sectors are encouraged to review our companion pieces in this series.

[1] Justin Wolfers, "Brexit Hits U.S. Stock Market Harder Than an Election," *New York Times*, June 24, 2016.

Implications of Brexit for US Insurers

That the June 23 Brexit vote took place less than a week after the signature global stakeholder seminar of the International Association of Insurance Supervisors (IAIS) in Hungary—with the next IAIS meeting scheduled for London in 2017—aptly captures both the irony and uncertainty facing US insurers.

Since the fiscal turndown of the last decade, regulatory uncertainty has been a major concern. New regulation has been developed based on a broadening of both operational and geographic scope. Insurers worldwide have been engaged in adapting to proposed changes, based partly on the idea of a global regulatory standard ensuring comparability across regimes.

It is too early to call out the detailed implications of Brexit and the timeline for those changes. However, it does raise a great deal of uncertainty for companies and increases the challenge of doing cross-border business. The challenges are numerous, with strategic, financial, and operational implications. Companies should consider early on what the impacts might be in the short and long term and whether there are benefits to being an early mover.

Those effects could be compounded if other countries seek to leave the European Union. To help ensure that exiting is not seen as an attractive option, EU officials negotiating the terms of withdrawal with Britain may seek to impose onerous terms—such as the elimination of passporting, which allows UK companies to easily do business across borders of member countries. That could have a significant impact on US insurers with international operations using the UK as a base for their European organization and require a reexamination of operating models.

Ongoing regulatory negotiations at the IAIS may need to be extended until clarity is achieved. This continuing uncertainty complicates planning efforts, especially for insurers operating in the current EU, but also for all insurers that will be subject to various global standards, including revised insurance core principles (ICPs).

A level regulatory playing field for US insurers in the Solvency II market depends on an EU declaration of US regulatory equivalence. That was expected to be facilitated by the current negotiations on a covered agreement between US federal authorities and the EU. A quick resolution may now be more difficult. That raises questions on the path forward and the distance yet to go.

The political contagion effect is difficult to foresee. A period of regulatory dissonance may strengthen calls for global insurance regulatory standards. On the other hand, countries with robust and effective regulatory structures may be more inclined to maintain their current systems, possibly increasing the cost of operating across national boundaries.

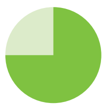
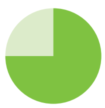
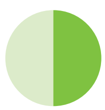
There are numerous potential considerations for US insurers in the post-Brexit era. We briefly examine some of the more salient below.

Areas of focus

Financial		
Implications	**Scale of impact**	**Likely impact on US insurers**
Interest rates		• Increases pressure on central banks to maintain low interest rates to mitigate economic risks. • Prolongs the period of low investment returns, requiring revision of investment strategy and allocations. • Increases the need for tighter asset liability management as well as improved underwriting and pricing models.
Foreign exchange and currency volatility		• Clear short-term earnings implications for US insurers with EU operations. • Possible increased collateral requirements to cover open positions that may lead to liquidity challenges. • Potential impact on hedging strategies.
Capital cost		• Cost of raising capital may rise because of associated volatility and possible reduction in available funds.

Key: No impact Minimal Moderate Material High

Areas of focus

Regulatory strategy		
Implications	**Scale of impact**	**Likely impact on US insurers**
Global regulatory standards		• Regulatory uncertainty will increase for the foreseeable future. • Prior to Brexit, the prospect was for a lengthy debate on various measures, including capital standards. This vote may extend that process. • Prolonged uncertainty may be the new normal, with concomitant increased risk.
Fragmentation		• Strong national regulators may reassert control over country-specific regulatory environments, slowing the process toward creating a level playing field. • Cost of compliance to meet differing regulatory authorities may increase.
Regulatory arbitrage		• At a time of heightened volatility and uncertainty, regulators may drop standards because of the need to make their countries attractive as a place to do business. • This may increase the risk profile of insurers, making it more important to maintain effective risk management and not rely on local regulators.

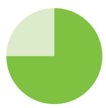
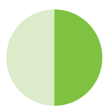
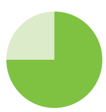
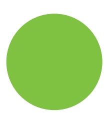
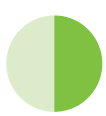
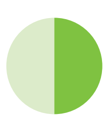
Key: No impact Minimal Moderate Material High

Areas of focus

Operations		
Implications	**Scale of impact**	**Likely impact on US insurers**
Legal and tax impacts		• Legal entity structures may need to be reconsidered. • Insurers previously planning to have the UK regulator oversee all of their EU operations may need to revise business plans, including tax planning. • UK changes toward global tax policies previously agreed upon by the EU, such as BEPS or CBC, should be considered. • Contractual obligation and arrangements with customers and commercial counterparties need to be reevaluated.
Cost of doing business		• Current policy terms and conditions will have to be reviewed and new policy information prepared and distributed based on UK or EU location. • Supplier costs may rise with possible loss of open EU market. • Insurers may face uncertainty on Solvency II equivalence for the UK. • Systems may need to be reconfigured to reflect the new reality (e.g., assets may need to be differentiated between UK, EU).
Governance and operational infrastructure		• Passporting arrangement changes may affect product distribution and regulatory costs. • Probable change in the right to work cross-border in all current EU countries may lead some insurers to relocate or bilocate to properly serve client base. • Bilocation may result in a need for separate boards and governance structures. • Relocation or bilocation could raise tax issues, including employment tax. • New training for staff will need to be provided based on the domicile.

Key: No impact Minimal Moderate Material High

Areas of focus

Strategy and business model		
Implications	**Scale of impact**	**Likely impact on US insurers**
Economic and political uncertainty leading to a slowdown in global economy		• May spur more carriers to consider consolidation. • Increases pressure on underwriting in an environment of limited premium growth and lower investment returns, where earning opportunities may be limited.
Competitive positioning and investment decisions		• Need to reevaluate strategy for growth opportunities, particularly for insurers that may have been looking into the EU for future economic expansion.
Opportunities		• M&A options likely to expand as non-US insurers seek to acquire US carriers for diversification, as well as to capitalize on the stable and profitable US market amidst global volatility. • EU uncertainty may create disruption but also expansion opportunities for US insurers, as affected EU or non-EU companies evaluate where they do or seek to do business.
Contingency planning		
Risk management		• Companies have an opportunity to build out their risk frameworks through the ORSA process and use these new tools to examine the risk and financial implications on their business.
Potential political changes		• Brexit vote may possibly be followed by other political shifts, necessitating preparation for significant changes in the EU operational climate. Among the considerations: – What does the British withdrawal mean for the remaining EU states? – How will company risk be affected in the context of a new EU that could possibly shrink further?
Sovereign debt		• The ability of various EU countries to service their sovereign debt may be affected, a consideration for capital management.

Key: No impact  Minimal  Moderate  Material  High

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