Why Brexit will have a big impact on the Captive insurance market

INTRODUCTION

With just under six months to go until the UK leaves the EU a lot of attention has been paid to how the insurance industry is responding to Brexit and the disruption it will cause. There has been much less information about Captives - yet the implications for them are far-reaching. Simon Burtwell, Jenny Coletta, Ben Reid, and Martin Powell of EY provide an overview of the key challenges.

The scale of the Brexit challenge for the insurance industry is very substantial. (Re)insurers, brokers and MGAs who write EU or UK business cross-border through Freedom of Services or Freedom of Establishment are all potentially impacted if these freedoms disappear upon Brexit. Insurance firms are having to restructure their UK and European operations to continue to trade cross-border with the EU27. Some of these organisations have been planning for Brexit since before the 2016 referendum, with many now very firmly in the implementation stages.

On 19 March 2018, the UK and EU issued a draft Withdrawal Agreement that provides an agreed draft legal framework for the treatment of key issues during the Brexit implementation period. Some of the text has been agreed in full but there are significant areas where the detail has to be finalised. The transition period will end with the UK formally leaving the EU on 31 December 2020. Legal certainty on the agreement, including the transition period, will come only with legal ratification. The UK and the EU negotiating teams aim to finalise the entire Withdrawal Agreement by October 2018.

Assuming the Withdrawal Agreement is ratified, the deadline for completing restructuring will therefore become 31 December 2020. This is a welcome delay but key details concerning insurance regulation, in particular the Free Trade Agreement sought by the UK with the EU27, remains undecided leaving insurers faced with the choice of continuing their implementation plans or waiting for regulatory issues to be decided and hoping that there is sufficient time to implement any necessary changes.

36 UK headquartered (re)insurers have publicly announced their Brexit plans for establishing new operations in the EU27 from which to write EU business. Insurers are now in the process of relocating or setting up these new entities, appointing Boards and local executives, which in many cases is requiring recruitment or relocation. Applications for authorisation have been submitted to regulators, which involve significant capital modelling exercises and operating model design to support the establishment of the new operations. For many groups, restructuring into Europe also means Part VII transfers of insurance portfolios. Timelines for approvals are now very tight as, in the absence of final agreement on the transition period, many groups are continuing to target 31 December 2018 transfers in order to capture 1 January renewals.

Many EU27 insurers with branches in the UK are submitting applications to the PRA for authorisation as third country branches, a status previously seldom used. They are discussing with the PRA and FCA the regulators' expectations as to aspects of the third-country branch regime that are not yet fully defined, including the identification of branch assets and liabilities, requirements as to UK capital beyond the current minimal requirement, and the extent to which branch governance functions must be onshored or may still be directed from Head Office.

Furthermore, there is an expectation that the largest branches - those with over £500m of liabilities protected by the Financial Services Compensation Scheme, or occupying a particularly important position in a part of the UK market - should establish UK companies instead. This will require additional capital and a Board of Directors, amongst other enhanced supervision requirements, as well as a transfer of existing business to the new legal entity.

(Re)insurers are working hard to establish business plans, operating models and funding flows in order to communicate with clients in the 2018 autumn renewals season. In the context of operating models, a key area of challenge is how UK underwriters will write multinational programmes going forward and in particular bind or place EU policies. There is a high level of optimism among brokers that these activities will still be able to be conducted from the UK, though there is little to be found by way of certainty.

The stakes are high - timelines are tight, Brexit programme costs are in some cases significant and for many groups could be substantial.

There are, of course, opportunities from Brexit including additional focus on growth in the EU27. Firms recognise that, to make their Brexit planning worthwhile, they should look to the future.

So what does this mean for captive managers and the buyers of international programmes?

Captives which are located outside of the UK in the EEA but write UK risk may face similar challenges to those outlined above in respect of loss of inwards passport entitlements (particularly where compulsory classes of insurance are concerned). Such captives may need to consider restructuring programmes, probably to use a third-party insurance fronter in the UK. This is likely to have cost implications, particularly as such fronters are likely to be incurring significant Brexit restructuring costs themselves. Furthermore, systems changes may be required in order to bifurcate UK risks from EU27 programmes.

Captives outside the EEA will typically use third party fronters across the EEA. In these cases, captive owners will need to check whether the fronters they use can still write the business and service the back book. There may also be additional costs to consider if insurers seek to pass on any additional cost of capital by way of rate increases.

In addition to the above regulatory areas, there are also other frictional costs which could add further expense for the industry. For example, when the UK leaves the EU it will no longer be part of the Customs union. Accordingly, services provided to and from the UK could be subject to additional VAT cost. For insurers and captives not all of this cost will be recoverable and will therefore have above-the-line impacts. Insurers and captive owners may also face exit tax bills as a result of moving Freedom of Services portfolios or renewals rights out of the UK.

So the insurance market is facing some significant challenges. The way in which multinational programmes are brokered, structured and bound is likely to change. At the same time the industry has additional cost burdens to manage. This may have impacts for multinationals and the way in which they buy insurance coverage.

We would therefore recommend that multinational risk managers take the following steps in advance of the autumn renewals season:

- Communicate with (re)insurers and brokers to understand their contingency plans and how to align with these.
- Review and restructure insurance programmes that insure UK risk into EEA captives to deal with any new regulatory considerations. Does the structure need to change significantly in the context of these?
- Use the opportunity for a wider review of the programme, e.g. are the right risks being insured. Is there an option of withdrawing, changing or increasing risks insured by the captive?
- Tie in with a wider risk review - for example examining the impact of the OECD's Base Erosion and Profit Shifting (BEPS) guidance and resulting local tax rule changes, including US Tax Reform.
- Consider whether captive insurance could be the answer to Brexit complexity for global programmes? Is it easier to aggregate UK and EEA risks though a captive and then place as reinsurance?