Position Paper

# The Future Economic Relations between the EU and the UK

## Challenges faced by the insurance industry

Economic relations with the United Kingdom will become less intense after Brexit. This will especially be the case for the financial services industry. To minimise the direct and indirect consequences, Brexit will have on insurance business, several aspects are of key importance:

→ Use of existing rules on mutual market access (e.g. equivalence)
→ Close supervisory cooperation
→ Legal certainty in the field of investments and an environment facilitating adjustments
→ Legally sound transfer of data
→ Freedom of movement for highly skilled professionals
→ Completion of the Capital Markets Union (CMU)

Due to the ongoing high level of uncertainty, companies are for precautionary reasons preparing for a "hard Brexit". To minimize disruptions following such an undesirable outcome, it is equally important that legislators and supervisors prepare emergency arrangements as well.

GDV
DIE DEUTSCHEN VERSICHERER

## Brexit negotiations: Ongoing uncertainty

On 30th March 2019 – i.e. in significantly less than a year – the United Kingdom will most likely leave the European Union. The withdrawal negotiations, which started in summer 2017, are now entering a decisive stage. Despite some progress achieved, for instance regarding the agreement on a transition period, one year of negotiations has by no means been enough to agree on all open Brexit-related questions. The biggest challenge remains finding a viable solution for the inner-Irish border. Ongoing political disputes within the British Government and Parliament even after the publication of the White Paper about the "right" Brexit strategy add to the general feeling of uncertainty.

In parallel to the ongoing withdrawal negotiations, first discussions on the future relationship between the EU-27 and the UK started in spring. According to the EU, due to the position of the British Government which has repeatedly stressed its intention to withdraw from the European Economic Area and the Customs Union, the only option for the future economic relationship is a free trade agreement. In July 2018, the British Government issued a White Paper which proposes the establishment of a free trade area for goods. Common to both proposals for the future economic relationship is the focus on trade in goods – but not services.

Considering the slow pace of the Brexit negotiations, combined with the persistently high level of political uncertainty in the UK, **we see two possible main scenarios for Brexit and the future relations between the EU and the UK:**

1 **Transition phase and an agreement on the future relationship**: Agreement on an orderly withdrawal from the EU, including a transition period until 31st December 2020 and a future economic partnership (e.g. a free trade agreement) in particular focussed on goods. In this scenario, there would be an agreement, but the EU-UK economic relationship would be much looser compared to the pre-Brexit world.

2 **"Hard Brexit"** without a withdrawal agreement (aka "cliff edge"): Disorderly withdrawal from the EU on 30th March 2019, without any transition period. Future trade organised under WTO rules.

Post-Brexit economic relations will in any case not be as close as they are today. This holds particularly true for the financial services industry, which will face the end of the freedom to provide services and freedom of establishment (passporting). For this reason, the tool of equivalence, provided for in a number of pieces of financial services legislation, will gain in importance for cooperation with the British financial services industry. Other challenges must be addressed within the framework of a free trade agreement or separately as in the case of data transfers.

Economic relations between the EU and the UK will become less close. This holds particularly true for the financial services industry.

**From the viewpoint of the business community, the transition period, which will only come into force in case of a successful withdrawal agreement, is a particularly important milestone to achieve**. It would give legal certainty to economic actors until year-end 2020. For the financial services industry it would allow for almost two more years under which passporting rights could be used. Hence, there would be more time to adapt business activities to the ultimate post-Brexit setting. That said, past experience shows that negotiations of free trade agreements are usually extremely time consuming activities. Hence, there remains a considerable risk that even during this prolonged period a viable trade agreement is not found. Should, however, the time suffice it would be desirable to provide for an implementation phase during which companies can adapt to the new rules. Such an implementation phase would especially be helpful if an agreement were found (as is often the case) in last minute negotiations.

By contrast, failure of negotiations (cliff edge) would clearly be the worst-case scenario. However, to minimise this risk, the British government and Parliament might in the end consider accepting to stay part of a customs union with the EU.

Our analysis of the issue has shown that the main Brexit-related challenges for insurers are operational in nature, and they seem manageable on the whole. Many insurers have already taken steps to adapt to the new conditions after the loss of passporting rights. We do not expect any decline of insurance services offered on the German market. Nevertheless, both government and supervisors should think about emergency provisions for a potential "hard Brexit" to contain potential frictions, not to mention turbulences, which cannot be ruled out given the unprecedented nature of this exercise.

Legal certainty about the planned transition period is needed as soon as possible.

We have published a first position paper on Brexit ("German Insurers and Brexit: Six key positions") in summer 2017. In the present paper, we develop the German insurance industry's positions based on the course of events since the start of the Brexit negotiations, specifying requirements for our future relations and for continuing existing policies in the best interests of costumers.

## 1. Long-term: Use of mutual market access

Neither the European Commission nor the British Government has made any proposals to include provisions on future cooperation in financial services. Therefore, it has to be assumed that post-Brexit unrestricted mutual market access for financial services will end. It is the position of the German insurance industry that any new form of mutual market access for new business, while desirable in and of itself, would only be appropriate if a regulatory level playing field can be maintained.

Third-country equivalence: Important tool for future market access, provided there is a regulatory level playing-field. Ensure reciprocity.

However, insurers must in any case be able to pursue their existing cross-border business as efficiently and smoothly as possible. For this reason, we propose making use of **third-country equivalence**, as provided for under EU legislation on financial services. The corresponding assessments underlying equivalence decisions should therefore be initiated as early as possible (ideally during the transition period). Since the UK is still an EU member state and needs to comply with new and existing EU rules, it should be possible to finalise the assessment procedures in a timely manner. In the long run, it will be vital to strike a balance between market access on the one hand and regulatory divergence on the other.

In parallel, the current **provisions on equivalence should be reassessed** to improve transparency, legal certainty and planning security. In the future, the European Parliament should also have a say in this matter.

One of the major current problems is the fact that equivalence decisions can unilaterally be withdrawn at very short notice. Moreover, the various equivalence provisions are not designed for the scenario of a country leaving the EU; modifications may be necessary here. Harmonising the currently very tailored approach of equivalence provisions, and possibly improving the mechanism, should also be discussed. Currently, a third country, which has been granted the status of an equivalent country, is not required to accept the supervision of EEA insurers as equivalent. As a consequence, it is possible that EU insurers are not granted access to the markets of the UK (lack of "reciprocity"). Reciprocity granting EU financial service providers access to the UK market should therefore be a key requirement for equivalence decisions.

In addition, it would be desirable to assess to what extent a more far-reaching mutual market access could be established within the framework of an agreement with the UK under Articles 171, 175 Solvency II Directive. Harmonised regulatory framework conditions ("level playing-field") are a key prerequisite for both options described. In this respect, the bilateral agreement between the EU and the USA ("covered agreement") could serve as an example.

## 2. Short-term: Close supervisory cooperation

Insurance companies are faced with the challenge to adapt their cross-border business activities to post-Brexit conditions at short notice. To be able to do so, they need **fast and proper approval procedures**. If possible, licensing processes should ideally take into account existing business licenses under current legislation. In addition, the organisational measures required to continue cross-border activities (establishment of subsidiaries, third-country branches) have an impact on the level of own funds to be held. These should be in line with Solvency II standards as far as possible; the same applies to governance structures for subsidiaries and third-country branches, respectively.

For these reasons, it would be highly desirable if supervisory authorities could cooperate as closely as possible, e.g. with regards to the mutual recognition of internal models or using joint colleges of supervisors; for the same purposes, suitable rules should ideally be established for the extensive exchange of information between supervisors. Additional regulatory measures, such as reporting requirements or risk buffers for doing business with the UK, should not go beyond well-established Solvency II standards.

Of course, the necessary condition for this to be feasible is a regulatory system in the UK which continues to be fully in line with Solvency II provisions after Brexit. Supervisory arbitrage at the expense of insurers in continental Europe must in any case be avoided.

Agreement on the nature of the future cooperation between UK and EU supervisory authorities is needed as soon as possible.

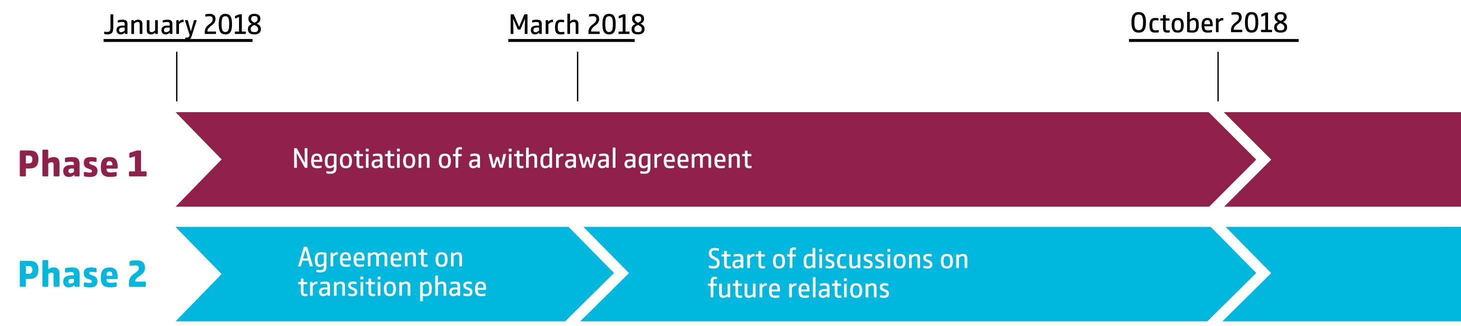
## 3. Adjustments for derivatives and ratings

Due to the importance of London as an international financial centre, a vast number of financial transactions and services for the euro area are offered and processed in the British capital. For institutional investors, derivatives in the financial portfolios will be among the biggest Brexit-related challenges; in addition, a close eye should be kept on the use of ratings.

Among other instruments, insurers use exchange traded derivatives and derivatives subject to clearing obligations to hedge their investment risks. The vast majority of clearing activities involving euro-denominated interest

## Brexit: Next steps

**Possible timeline**



Derivatives: Consider transitional provisions for existing contracts, limit effects on solvency positions.

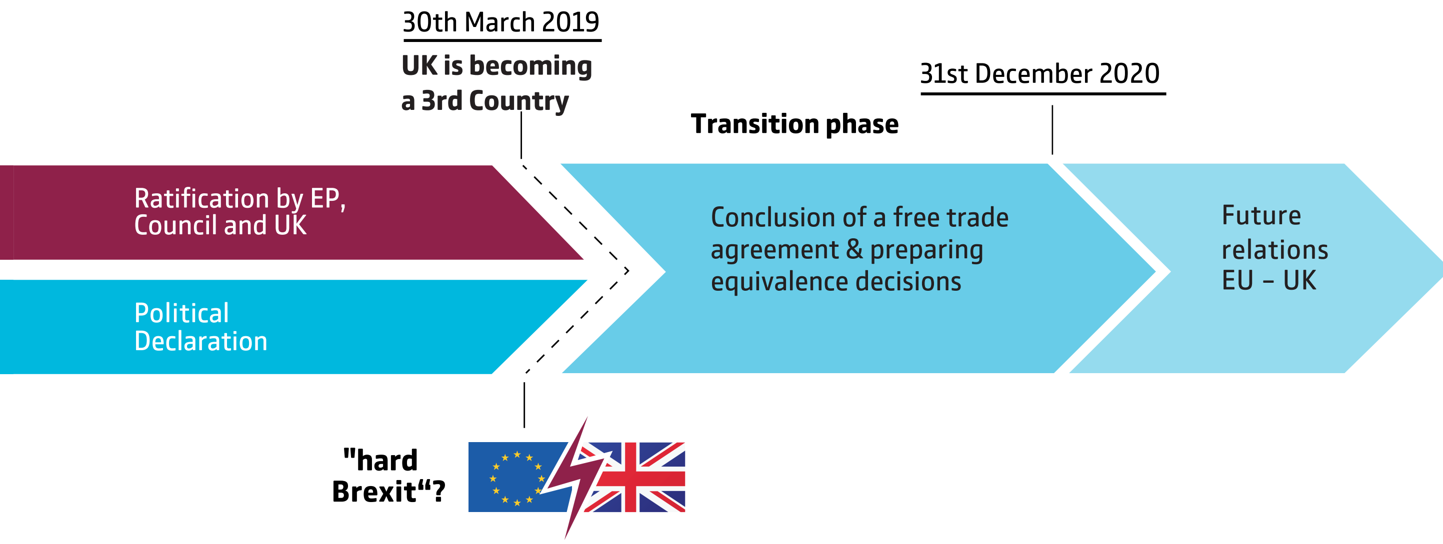
rate derivatives is handled by British central counterparty clearing houses (CCPs). If the UK becomes a third country due to Brexit, insurers will have to check their portfolios and decide on necessary modifications and reorganisation measures, e.g. because British CCPs will no longer be recognised by European supervisors. In order to do so, insurers need **legal certainty** and an appropriate preparation period, since the restructuring of derivatives is expensive, time-consuming and requires extensive negotiations. Moreover, insurers must comply with specific regulations on long-term minimum residual maturities of derivatives.

Due to the major role played by British CCPs in the clearing of euro-denominated derivatives and the resulting systemic risks for the euro area, there is a risk that British CCPs will not be recognised as third-country CCPs if the current proposals for the EMIR Review are adopted. At the same time, clearing alternatives in the EU 27 are being expanded. Considering the importance of financial stability, however, **transitional provisions for existing contracts should be considered in order to allow for an organised transfer**. At the same time, political stakeholders should create the framework conditions required for the establishment of an efficient and competitive clearing services infrastructure in the EU 27.

Also exchange traded derivatives and derivatives subject to trading obligations according to MiFID and MiFIR should benefit from practicable transitional solutions. Otherwise, exchange traded derivatives, for example, might lose their status and risk being classified as OTC derivatives.

Furthermore, if derivatives traded/cleared in the UK are no longer considered as risk-mitigating within the meaning of Article 209 of the Delegated Regulation of Solvency II after the United Kingdom becomes a third country, insurers could face **considerable negative effects on their solvency positions**. To avoid this, transitional provisions could include supervisory exceptions for existing derivatives contracts concluded and settled with insurers before the UK withdrawal date.

External ratings are a key element in the calculation of own funds requirements under Solvency II. Post-Brexit, there is a risk that it will no longer be possible to use ratings established in the UK for the calculation of insurers' risk capital because EU supervisors will not recognise the ratings anymore. That said,



there is fortunately at this point in time little evidence of major limitations to the post-Brexit use of ratings.

The rating industry is characterised by a strong international division of labour. Hence, the major rating agencies currently registered in the UK mostly have branches in the EU 27. Should no equivalence be achieved by the time the UK leaves the EU, short-term modifications of organisational structures could make it possible for them to be registered with ESMA. The corresponding application procedures should be treated with high priority to avoid any interruptions in the use of ratings. The overall objective should ideally be for the EU Commission to take an equivalence decision (such as the existing decision for ratings issued in the USA), allowing the further use of UK ratings directly after Brexit.

## 4. Legally sound transfer of data

Brexit should not lead to a situation where the transfer of data to the UK is only possible with great difficulty or – in a worst-case scenario – not at all. After leaving the European Union, the United Kingdom will become a third country within the meaning of the General Data Protection Regulation (GDPR).

The transfer of data is key for conducting insurance business within a group. Cooperation with UK stakeholders, particularly service providers and reinsurers, is also indispensable. To be able to continue data transfers, European insurers are trying to prepare for the post-Brexit world, but the lack of legal certainty is making this almost impossible: It is unclear whether they can continue to use the standard contractual clauses commonly applied for data transfers in third countries, since they are currently reviewed by the Court of Justice of the European Union. Other possible legal bases, such as Binding Corporate Rules or Codes of Conduct, are only partially suitable for specific data transfers and would have to be approved by the European Commission first – which is hardly feasible before March 2019 under the scenario of a "hard Brexit".

**The most desirable solution would therefore be a transfer on the basis of an adequacy decision** by the European Commission. For the Commission to take such a decision, the United Kingdom needs to ensure that its post-Brexit standards for data protection are essentially identical to the protection granted under the GDPR. The United Kingdom could achieve this by incorporating the GDPR – which has been applicable law in the UK since 25th May 2018 – into national legislation without any changes after leaving the EU.

Data transfers must remain feasible: Therefore, adequacy decision according to the General Data Protection Regulation are of key importance.

## 5. Freedom of movement for highly skilled professionals to the greatest extent possible

Brexit will end the freedom of movement for workers between the EU and the UK. However, for both economic areas, while not as tightly knit together as before, there will continue to be a need for some labour movement, especially for highly skilled professionals. For this reason, it is in both parties' best interests to grant each other access to their respective labour market segments with as little restrictions and bureaucratic burdens as possible.

This applies to all EU citizens currently working in the UK and British citizens currently working in the EU 27 – according to the draft withdrawal agreement. This group of people will maintain their rights to a large extent.

In addition to that, an agreement must be found regarding the conditions under which European workers may take up employment in the UK (and UK citizens in the EU 27) after Brexit. **This agreement should not impose complex legal requirements e.g. with regards to recruitment processes**. This is also a precondition for strengthening financial centres in continental Europe. The EU Blue Card Directive, which regulates the migration of highly qualified non-EU citizens and will therefore also apply to British citizens, should be used as an example.

Establish unbureaucratic procedures for the internal secondment of staff.

From the insurance industry's perspective, finding an unbureaucratic solution for the internal secondment of staff is of key importance as well. The end of passporting and the need for the EU and the UK to establish new business units in each other's legal spheres might increase the need for group-internal staff secondments. Hence, the EU and the UK should agree that staff secondments in the context of service provision should remain possible, with a minimum amount of bureaucratic burden involved.

## 6. Completion of the Capital Markets Union

The completion of the Capital Markets Union is a highly complex objective and can therefore only be achieved in the long run. The main objectives of the Capital Markets Union are better financing conditions for the real economy and less fragmented capital markets in the individual member states.

**Due to Brexit, the completion of the Capital Markets Union has become even more important**. With the completion of the Capital Markets Union, there is good reason to expect that any negative Brexit-related effects for both the economy and financial markets could substantially be reduced in the EU. Highly developed and efficient capital markets are of key importance for growth and employment in the European Union. Currently, companies are still facing very heterogeneous financing conditions within the euro area and in financial intermediation, there is still a dominance of bank loans in the EU.

As one of the world's largest economic regions, the EU needs highly developed, efficient financial markets.

Access to various sources of funding is highly important for the economic development. Harmonised, deep capital markets are particularly important for insurers as one of the biggest groups of investors. Insurers could play an even bigger role in financing the real economy. Therefore, the still very high fragmentation of the European capital markets should be overcome.

The initiatives for the further development of the European market for private placements and securitisations, the improvement of conditions for infrastructure investments and an appropriate harmonisation of the European market for covered bonds are important milestones for creating the Capital Markets Union. However, insurers need suitable framework conditions and real investment opportunities to be able to play an important, stabilising role in broadening the financing base of the real economy, e.g. by granting loans.

In any case, the financial markets in the euro area should not suffer negative consequences from Brexit. The future provision of financial services in the euro area seems to be secured, since there are attempts to expand the related offer.

## 7. Preparing for a "hard Brexit": Major challenges for companies and the Government

Both supervisors and the German Insurance Association have always stressed the importance of preparing for a "hard Brexit" – after all, it remains very unclear whether the ongoing Brexit negotiations will be successful. Therefore, it can be assumed that German insurers have been adjusting (or are still adjusting) their business processes to prepare for this "cliff edge" scenario. **However, additional measures might still be needed with regards to existing contracts in cross-border business and derivative hedging transactions**.

A "hard Brexit" would immediately make it impossible to process cross-border insurance business between the EU and the UK. According to the European Insurance and Occupational Pensions Authority (EIOPA), insurers would no longer be allowed to accept premium payments or pay out annuities or other benefits without new authorisations.

Continuing cross-border business post-Brexit in compliance with supervisory provisions might prove impossible due to the narrow timetable. The establishment of subsidiaries/branches under British supervision often takes a lot of time, typically between 12 and 18 months. However, the existence of a legal entity authorised to carry out insurance business is a precondition for portfolio transfers. In addition, the transfer of contract portfolios to a different supervisory jurisdiction requires considerable efforts and an extensive and time-consuming supervisory assessment.

For these reasons, it remains uncertain whether insurers – despite all efforts taken – will be able to fully adapt their business processes to the post-Brexit framework conditions before the end of March 2019.

In the interest of consumers and in order to protect policyholders, Brexit should in no way lead to a situation where insurers are considered doing "unauthorised insurance business", despite verifiable, substantial and risk-adequate steps taken to adapt their business. Insurers and consumers need legal certainty. Therefore, appropriate precautionary measures ("Brexit emergency legislation") should be taken for a still possible hard exit scenario. Moreover, the efforts taken by insurers should be assessed on a "best effort" basis. However, it is mainly up to British supervision to accelerate the required approval processes for future business activity in the UK as a third country. Fortunately, British supervisors have already initiated corresponding initiatives and political activities should continue to support the direction taken.

As far as derivative transactions subject to clearing obligations are concerned, it is important that policymakers bear in mind that British clearing houses would lose their supervisory approval for the EU in a "hard Brexit" scenario and would therefore be classified as third country CCPs. As a result, clearing activities would have to be transferred to the EU 27 immediately, potentially entailing (at least short-term) market turbulences. Considering this, it is vital to avoid a situation where existing derivative transactions would have to be dissolved. Therefore, corresponding supervisory transition periods for these transactions are highly desirable as well.

Supervisors must act to mitigate the risk of "unauthorised insurance business".

**Impressum**

**Editor**
Gesamtverband der Deutschen Versicherungswirtschaft e. V.
Wilhelmstraße 43/43 G, 10117 Berlin
Postfach 08 02 64, 10002 Berlin
Tel. 030 2020–5000, Fax 030 2020–6000
www.gdv.de, berlin@gdv.de

GDV DIE DEUTSCHEN VERSICHERER

**Authors**
Dr. Rolf Ketzler
Tel. +49–30 2020–5132
E-Mail: r.ketzler@gdv.de

Dr. Klaus Wiener
Tel. 030 2020–5800
E-Mail: k.wiener@gdv.de

**Editorial Deadline:**
15.07.2018

**Responsible for Content:**
Dr. Klaus Wiener,
Member of the Managment Board
Chief Economist
Tel. +49–30 2020–5800
E-Mail: k.wiener@gdv.de

**Pictures:**
shutterstock / vchal