Client Update
Brexit and Other News for Insurers

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INTRODUCTION

Regulatory and industry developments have continued apace since our previous Client Update summarising insurance developments in the first part of 2016. The UK's vote to leave the European Union has dominated headlines since 24 June and prompted a swift statement from the FCA. In this client update, we consider this and other comments and proposals from the UK regulators, plans for a U.S.-EU "covered agreement" on re/insurance measures and upcoming UK legislation.

On 6 July, members of Debevoise & Plimpton's global Insurance Group hosted a conference call discussing the implications of Brexit for insurers in the UK, Europe and further afield. A recording of the session is available on our website.

FCA STATEMENT FOLLOWING UK VOTE TO EXIT EU

The Financial Conduct Authority (the "FCA") released a statement on 24 June saying that the UK vote to leave the European Union "has significant implications for the UK".

Highlighting the significant amount of financial regulation deriving from EU legislation, the FCA made it clear that such regulation remains in force until any changes become law. Additionally, firms should "continue with implementation plans for legislation that is still to come into effect". The impact on the UK's regulatory framework will only become clear once the type of relationship the UK will have with the EU is determined.

Sam Woods, the chief executive officer of the Prudential Regulation Authority (the "PRA"), has commented that the Brexit vote will have an effect on negotiating positions in the EU over Solvency II matters. The risk margin formula under the directive is viewed as "procyclical" by UK insurers and may be one area UK regulators could seek to relax following a Brexit. Until that time,

however, reform sought by the PRA will be more difficult to achieve if other European regulators become less sympathetic to UK positions.

For further analysis of the potential effects of the Brexit referendum on insurers, see our client update.

PRA UPDATES SUPERVISORY STATEMENT ON CAPITAL EXTRACTIONS BY GENERAL INSURANCE FIRMS IN RUN-OFF

The PRA has issued an update to its 2014 supervisory statement on capital extractions by run-off firms in the general insurance sector. The update reflects proposals the PRA consulted on in Q4 2015 and Q1 2016 and the move from Individual Capital Adequacy Standards to the Solvency II regime.

The supervisory statement sets out the PRA's expectations of general insurance firms in run-off that are proposing a capital extraction. In addition to updating references to the PRA Rulebook and bringing the capital requirement language of the supervisory statement into line with that of Solvency II, the update makes it clear that firms are expected to request the PRA's views "at an early stage", should a capital extraction be proposed. Additionally, requests for PRA approval must now be made by the firm's CEO or CFO. This is narrower than before, when any approved person could make the request, but given the likely involvement of the CFO in extraction proposals, this should not be an issue.

The factors that the PRA will take into account when considering a proposed capital extraction have not changed, although the firm's own risk and solvency assessment ("ORSA") now plays a role in the process for Solvency II firms. Such a firm will need to review its solvency capital requirement ("SCR") and overall solvency needs "as required for inclusion in [its] ORSA" when assessing its likely position after the proposed extraction. Further, alongside its request to the PRA, any Solvency II firm should also provide its most recent ORSA.

Finally, the examples of instances where the PRA is more likely to request an independent opinion as part of its review have changed: the test of whether the proposed extraction results in projected coverage that is less than 200% over a firm's individual capital assessment has been replaced. Instead, the PRA will look to whether the projected financial resources in a stressed scenario are less than either its overall solvency needs or its SCR.

EIOPA RECOMMENDS EXTENDING INFRASTRUCTURE ASSET CLASS

The expansion of the infrastructure asset class to cover certain investments in infrastructure corporates has been recommended in a recent EIOPA paper.

Including "high-quality" investments in the asset class would expand the group of equity investments receiving beneficial Solvency II treatment.

Given the current low interest rate environment, infrastructure investments are more appealing to insurers, who value their higher returns and the stability of their long-term cashflows. The proposals mean that under the Solvency II standard formula, investments in infrastructure corporates which satisfy various conditions would benefit from reduced risk charges.

EIOPA expects the European Commission to issue an amendment to the Solvency II Delegated Regulation on the basis of its advice.

PRA CONSULTS ON MONITORING MODEL DRIFT

Developing one of the themes of a speech recently given by its Director of General Insurance (reported in our previous client update), the PRA has published a consultation paper on monitoring model drift for firms with an approved internal model. Also covering standard formula SCR reporting, the consultation is relevant to all PRA-regulated Solvency II solo re/insurance firms with an approved solo internal model.

"Model drift" involves a firm's capital requirements gradually reducing as its internal model evolves, until they eventually fail to accurately reflect the firm's risk profile.

The PRA's proposals include having relevant firms privately report their standard formula SCR information on an annual basis and calculating model drift ratios from the point of approval, and requiring a re-base following a change in risk profile or major model change. Any change in these ratios could lead to a supervisory review to investigate the reasons for such a change.

FCA CONSULTS ON CAPPING EARLY EXIT PENSION CHARGES

In anticipation of certain provisions of the Bank of England and Financial Services Act 2016 entering into force, the FCA has issued a consultation paper on its proposed cap to early exit pension charges.

For existing contract-based personal pensions, the current proposals set the cap at 1% of the value of the member's pension. No exit fee at all will be permitted for contracts entered into after the proposals come into force.

The FCA stated that this consultation is unrelated to its review of the fair treatment of long-standing customers in the life insurance sector (reported in

our previous client update), highlighting that the consultation does not cover other types of charges levied.

IAIS UPDATES G-SII ASSESSMENT METHODOLOGY

The International Association of Insurance Supervisors ("IAIS") published its revised assessment methodology for the designation of global systemically important insurers ("G-SIIs") as part of its three-year review cycle and following consultations in Q4 2015.

The new methodology takes a five-phase approach, including qualitative and quantitative elements, and incorporates the IAIS's new framework around insurance product features likely to increase the potential for systemic risk. The new framework discontinues the "confusing" non-traditional, non-insurance product label, and the new methodology incorporates absolute reference values for certain indicators.

See our client update for further analysis.

STRESS TEST UPDATES—PRA AND EIOPA

The PRA published a letter from Chris Moulder, Director of General Insurance, indicating that the industry has passed the general insurance stress tests undertaken in 2015 that involved 26 insurance groups.

The European Insurance and Occupational Pensions Authority's ("EIOPA") EU-wide insurance industry stress tests launched on 24 May (for further information, see our previous client update) and since that time, the advisory body has issued updated specifications and announced its intention to publish a weekly Q&A to assist participants. The submission deadline for industry participants was 15 July 2016.

U.S.-EU BILATERAL AGREEMENT ON RE/INSURANCE MEASURES

Following two days of meetings in Washington, D.C., the European Commission published a joint statement on U.S.-EU negotiations towards a bilateral agreement on re/insurance measures. The second such meeting in 2016 is part of the formal negotiation process initiated by the Obama administration towards a "covered agreement" and continues dialogue that has been ongoing since 2012.

Progress towards an agreement will be of particular interest for reinsurers in the EU that underwrite business in the U.S. and as such are currently obliged to comply with U.S. reinsurance collateral requirements, as well as EU solvency

regulations. The additional capital costs have traditionally meant European reinsurers are less competitive than their U.S. counterparts. Note, however, that the UK is one of the approved jurisdictions whose reinsurers can receive "certified reinsurer" status to benefit from relaxed collateral requirements.

As the U.S. has been granted provisional Solvency II equivalence by the European Commission in respect of group solvency calculations only, U.S. negotiators may also seek to address the outstanding group supervision and reinsurance equivalency issues under that directive.

No time frame for finalising any agreement has yet been proposed, but according to the joint statement, "[b]oth sides agreed to continue in good faith to pursue an agreement" and "are considering next steps to ensure advancement of the negotiations".

EU'S TTIP FINANCIAL SERVICES OFFER PUBLISHED

As part of the most recent round of Transatlantic Trade and Investment Partnership ("TTIP") negotiations in July, the European Commission has published the revised position of the EU in respect of financial services. A number of similar documents have been published across other sectors.

Regulatory cooperation and market access issues should be dealt with in TTIP, according to the Commission, which also clarified that it is seeking to simplify technical regulations and create global trade rules without lowering standards.

EIOPA SIGNS MEMORANDUM WITH CHINESE REGULATOR

EIOPA announced the signing of a memorandum of understanding with the China Insurance Regulatory Commission ("CIRC") on 15 June 2016.

The memorandum is intended to form the basis for cooperation between EIOPA and CIRC to: (i) build a practical framework for the exchange of supervisory information; (ii) provide updates on developments in regulatory and supervisory frameworks for insurance and private pensions; and (iii) increase mutual understanding of the European and Chinese insurance supervisory regimes.

The parties stressed that no legal obligations have been created and that the memorandum is not the legal basis for exchanging confidential information.

The memorandum has been published on EIOPA's website.

IAIS RISK-BASED GLOBAL INSURANCE CAPITAL STANDARD CONSULTATION

The IAIS has launched a three-month consultation as part of its ongoing project to develop a risk-based, group-wide global insurance capital standard. The 2016 consultation document is the second issued by the IAIS on this subject, with the first having been published in 2014.

The consultation seeks feedback on three aspects of the current risk-based global insurance capital standard, which is scheduled for adoption in mid 2017 for confidential reporting purposes. The three key aspects under scrutiny relate to confidential reporting: (i) valuation methodologies; (ii) qualifying capital resources; and (iii) a standard method for determining the capital requirement.

Further analysis is available in our recent client update.

RISK TRANSFER SPEECH BY PRA'S DIRECTOR OF LIFE INSURANCE

At the Bulk Annuities and Longevity Risk Transfer conference in London, the PRA's Director of Life Insurance, Andrew Bulley, gave a speech setting out the regulator's perspective on risk transfer.

Bulley developed on comments from his February speech (see our previous client update for further information) that firms may become active in the longevity reinsurance market for reasons other than a genuine transfer of risk, stating that "it would be unacceptable to us if firms were to use this market primarily as a tool to achieve regulatory arbitrage and to avoid key in-built requirements of our new solvency regime rather than to manage their risks in the interests of their policyholder and the firm".

Notably, boards of insurance companies are expected to understand the risk transfer taking place and to consider whether other risks, including counterparty credit risk and concentration risk, arise.

EIOPA ANNOUNCES THEMATIC REVIEW ON MARKET CONDUCT

EIOPA is to launch an EU-wide thematic review on market conduct for firms in the unit-linked life insurance market. Participating insurance companies will report back at the end of Q3 2016, with results to be published in 2017.

EIOPA aims to assess 60% of each national market, both in terms of gross written premiums and assets of unit linked funds. The review will focus on: (i) the existence and characteristics of monetary incentives and remuneration; (ii)

addressing conflicts of interest; and (iii) the structuring of unit-linked life insurance products.

UPCOMING UK INSURANCE LEGISLATION

The Insurance Act 2015 came into force on 12 August 2016, with most provisions applicable to insurance contracts entered into from that date. One of the most discussed changes is the new scope of precontractual disclosure.

In addition, the Insurance Act will be amended by the Enterprise Act 2016, such that all contracts entered into on or after 4 May 2017 will contain an implied term requiring the re/insurer to pay any sums due in respect of a claim within a “reasonable time”. Commercial parties may contract out of the implied term in certain circumstances. Any claim by an insured for damages due to breach of the implied term must be brought within 12 months of full payment of sums due.

The Bank of England and Financial Services Act 2016 was also recently passed by Parliament and will end the subsidiary status of the PRA and establish a new Prudential Regulation Committee within the Bank of England to replace the Board of the PRA. The transition will take place in the coming year.

Finally, the Law Commission is progressing its “insurable interest” project. A draft Insurable Interest Bill was published as part of a recent consultation. The Bill aims to clarify the law in this area and it is expected that the resulting Bill will follow the special parliamentary procedure for uncontroversial Law Commission bills.

FCA CONSULTS ON WIND-DOWN PLANNING GUIDANCE

Following requests from industry, the FCA launched a consultation on its draft Approach Document providing guidance as to what should be covered in a solo regulated firm’s effective wind-down plan.

Wind-down planning involves a firm assessing how its regulated business could be closed down in an orderly manner, including under stressed conditions. An effective plan seeks to ensure that a failing firm may cease its regulated activities and have its permission cancelled with a “minimal adverse impact” on clients, counterparties and the market.

The FCA stressed that the proposed Approach Document will not be binding on firms, but hopes that the guidance will benefit firms and their advisors.

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Please do not hesitate to contact us with any questions.