The London Market and the negotiations with the EU

Businesses across the EU and the world spend £65 billion per annum in the UK on commercial insurance, brought to the market through brokers, making the London Market one of the UK's major export industries.

These are global companies that need insurance so that they can do business every day across the world. Planes do not take off, ships do not leave ports, and business and commerce cannot function without this insurance. And businesses fail every day because disaster strikes and they are not properly insured.

This international business and foreign investment come to the UK because we have a unique market which pools risk and capital and is not replicated anywhere else in the world. The key strength of the London Market is its ability to **provide clients with global policies** to cover all of these risks.

The success of the market is key to maintaining the UK's competitive position and will play a significant role in growing our exports and delivering increased levels of foreign inward investment as major financial organisations seek to participate in the London Market.

As the trading centre for global insurance and reinsurance risks, the London Market is responsible for:

A £65 BILLION MARKET SERVING OVER 200 TERRITORIES	52,000 EMPLOYEES, 17,000 OUTSIDE LONDON
TAX OF £4-6 BILLION PER ANNUM	MORE THAN 25% OF THE CITY'S GDP

Since the United Kingdom's vote to leave the European Union three years ago, London Market firms have taken the steps required to ensure that they can **continue to serve clients no matter what the outcome of negotiations.** However, this has involved UK based brokers and insurers having to split their companies and creating new entities in the EU27 in anticipation of the prospect of the passporting arrangements provided under the two relevant EU directives - Solvency II and the Insurance Distribution Directive (IDD) - no-longer being available to UK firms following Britain's withdrawal from the EU.

Solvency II has no equivalence regime that would facilitate market access for direct insurance, and the Insurance Distribution Directive – which gives cross border access to brokers - has no equivalence regime and no third country branch regime. This could make it more difficult for UK-based brokers to operate in the EU, and for EU-based brokers outside of the UK to bring business to specialists in London.

UK based insurers and brokers have found solutions which provide continuity for their customers and policyholders and permit the continued concentration of capital and expertise in London, but this has been achieved through significant and ongoing expense of splitting their companies, to the detriment of EU and non-EU customers.

Key issues

- The international commercial insurance market, including the Lloyd's market, is of a fundamentally different character to both that of the domestic personal lines market and the life and pensions market.

- The **London Market Group is requesting that the UK Government seeks a legally certain method of permitting UK insurance brokers to service contracts where there is an EU policyholder with an EU risk.**

- The London Market Group is **requesting that the UK Government seeks equivalence rulings under the existing Solvency II legislation: for reinsurance, group supervision and group solvency.**

    - **Reinsurance equivalence** (Article 172) will ensure that UK based reinsurance firms and Lloyd's can continue to trade on equal terms within the EU and critically offer the global policies that clients demand.
    - **Group supervision equivalence** (Article 260) will allow UK groups to rely on the UK supervisor to be treated as the group supervisor for their whole group, including their EU companies, where the head office is located in the UK. Without it, UK groups will have their EU operations supervised in the EU and may be required to set up an EU holding company. Similarly, it will allow EU companies to keep their UK operations within the group supervision of their home state, saving companies in both the UK and EU significant costs and inconvenience of restructuring their business.
    - **Group solvency equivalence** (Article 227) has benefits for UK firms in reducing bureaucracy as it will remove requirements to run capital resource and capital requirement calculations in accordance with two separate regulatory regimes.

- A relationship based on equivalence would not make the UK a 'rule taker' or prevent the Government implementing domestically focused reforms to the UK solvency regime, nor prevent the UK having its own independent regulatory regime from the EU similar to the approach adopted by Bermuda, Switzerland, Japan and the USA.

- Both Bermuda and Switzerland have equivalence in all three areas of the EU Solvency II regime yet maintain their own regulatory systems and Solvency regimes. They have not adopted the Solvency II legislation and maintain regulatory freedom over their own domestic markets.

- The London Market's strength lies in encouraging inward investment. This creates a pool of expertise that is not replicated anywhere else in the world and offers brokers and clients, across the EU and the world, unparalleled choices as to where they place their risks. Much of this investment comes from EU entities who choose to do business in London. Our latest *London Matters* research highlights that over two thirds of capital within the London Market is foreign owned, and a significant proportion of this comes from the EU.

- The UK and EU granting each other Group supervision equivalence has mutual benefits for both markets:
  - For EU companies it means that their UK operations remain part of the group supervision of their home state, saving them significant costs and inconvenience of restructuring their business; and
  - It will allow UK groups to rely on the UK supervisor to be treated as the group supervisor for their whole group, including their EU companies, where the head office is located in the UK, preventing the need for significant restructuring.
- The UK Government is rightly asking for a mechanism for "structured withdrawal of equivalence" in the negotiations. If successful, this should make the ongoing assessment of equivalence less political and increase certainty for both the EU and UK in maintaining the equivalence status over the longer term.

Challenges of equivalence: The position of brokers

UK brokers bring independence and crucial expertise to the placing of complex commercial risks on behalf of EU policyholders. Clients' interests are almost always represented by professional brokers throughout London Market placements, enabling them to make an informed choice as to their insurance provider.

Brokers are a critical part of the London Market eco-system, bringing the business to the underwriters while providing expert advice and support to the client throughout the process. This support includes managing claims on the client's behalf, which is vital given the potentially large number of carriers that may be involved in providing cover for a single policy.

There are around 200 independent broking firms operating in the London Market and this expertise does not exist outside the UK. Insurance brokers make up just under 60% of all the UK financial services passports into the EU.[1]

The Insurance Distribution Directive (IDD)[2] - the EU legislation which sets regulatory requirements for broking firms designing and selling insurance products - has no equivalence regime and no third country branch regime.

To overcome this challenge UK based brokers have found solutions which provide continuity for their customers, but this has been achieved through significant and ongoing expense of splitting their companies, by creating a subsidiary in a EU27 member state, with a branch in the UK.

These solutions are based on a single recommendation of less than a page in length from the EU regulator - European Insurance and Occupational Pensions Authority (EIOPA)[3] - to member state regulators, published in February 2019. This guidance is not binding under EU law. It provides no certainty to UK-based brokers seeking to serve EU policyholders and bring business to UK-based carriers.

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[1] Andrew Bailey, Chief Executive, FCA, Speech to BIBA conference, May 2018
[2] Insurance Distribution Directive: https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32016L0097
[3] EIOPA, Recommendation 9 – Distribution activities - Recommendations for the insurance sector in light of the United Kingdom withdrawing from the European Union, February 2019

Unless there is a political or regulatory solution which provides an alternative basis for EU market access for insurance brokers, the situation would result in EU business flows passing through EU27-based brokers only, reducing access for EU policyholders to the London Market and the most suitable commercial (re)insurance products (and vice versa). It could also undermine the strength of the London Market, which relies on broking expertise.

Why a new deal with the EU is vital

It is in both the UK's and EU's interests to ensure that London Market firms have access on a cross-border basis, given over £9bn of premium is brought annually to the London Insurance Market by brokers on behalf of EU clients, and over £8bn of business is underwritten in London by branches of European operations.

The London Insurance Market supports a wide range of EU business, pooling risk and facilitating the flow of trade and commerce across the EU, as well as acting as a bridge to markets in North America and rapidly growing countries in South America, Asia and Africa.

When negotiating its future trading relationship with the European Union the Government should prioritise market access for UK based firms providing cover for non-life commercial large risks to corporate clients, allowing EU clients continued access to the broadest range of insurance services, expertise and capacity available in the London Market.

Over the last thirty years the EU has set clear precedents that **commercial customers with complex risks and service requirements do not require the same measures as a retail customer and can have greater freedom to access markets across borders and in third countries to obtain the most effective and efficient service.**

It is the LMG's belief that there is a workable solution, and that the concept of non-life, commercial "large risks" for sophisticated commercial clients could be used as the basis of a framework for future trade discussions, allowing brokers and insurers greater market access to EU and other third countries. The concept of a differing approach for "large risk" business already exists in both IDD and Solvency II

While not as comprehensive as a mutual market access arrangement, it would preserve the ability of EU clients to continue to access the London Market to cover their most complex risks. This approach has a number of benefits, both for clients who will see costs reduced, and for regulators who should be reassured that sophisticated **commercial clients with complex risks and service requirements, do not require the same measures as a retail customer.**

The next stage of trade negotiations

We welcome that the current deal the UK Government has negotiated provides for an implementation period until at least 31 December 2020, which will ensure continuity for London Market firms while the future trading relationship is negotiated and could allow firms time to complete elements of their contingency plans.

There is **nonetheless still a danger of a cliff-edge no-deal** in the event that no agreement on the future trading arrangement is made by 31st December 2020. If this is looking likely then the implementation period should be extended to avoid disruption to renewals, which could lead to policy holders seeking to place their risks in alternative jurisdictions.

The following urgent matters require attention within the next stages of the trade negotiation with the EU:

Secure equivalence in the areas where it is available (see above)	An **EU determination of UK reinsurance equivalence under Solvency II, as well as group supervision and group solvency,** by the time that the UK leaves the EU/end of the transitional period is important for reinsurance to continue to trade on equal terms within the EU, and maintain direct foreign investment in to the London Market. (see above)
Avoid regulatory upheaval	The **UK should avoid regulatory upheaval in the short term**, to increase the likelihood of obtaining an arrangement permitting access to EU markets and allowing EU supervisors to continue to rely on UK regulators. There is little appetite amongst LMG members for regulatory upheaval given that the implementation of Solvency II cost the industry c.£2.7 billion.
Maintain current levels of market presence	To ensure the **continued presence of EU insurers in the London Market**, the Prudential Regulation Authority (PRA) should utilise 'light-touch' application of existing third-country branches of EU-based brokers and insurers and not require them to create a new UK subsidiary. These firms have already satisfied the regulators of their ability to undertake business in the UK and their continued presence in the UK would secure jobs and continued inward investment.
Longer term: Negotiate and secure an enhanced equivalence framework where there currently is no equivalence	If a new agreement is based upon equivalence as anticipated by the Political Declaration, **existing equivalence tests must be enhanced** and be extended to allow sophisticated commercial customers to seek cover for large and complex risks on a cross-border basis from equivalent third countries. Additional equivalence tests in the Solvency II and IDD legislation for specialist risks would give EU commercial clients greater market access to UK and other third countries. This is particularly vital for UK based brokers given that the current legislation – the Insurance Distribution Directive - has no equivalence arrangement, as previously stated.
Ensure contract continuity beyond 31 December 2020	In the event of a 'no-deal' outcome at the end of 2020 the Government will need to provide certainty regarding the **legal status of the claims** in the event an insurer's portfolio transfer (Part VII) is incomplete on 31 December 2020. When combined with the loss of passporting rights, a 'no deal' outcome could compromise the ability of London Market firms to legally service both live and expired contracts with EU27 policyholders, including the payment of valid claims. An agreement that accepts UK insurers can run off to expiry is therefore required. Under current arrangements, any UK based broking firm that has chosen not to create an EU authorised vehicle to continue servicing EU policyholders with EU risks will have to cease dealing with such contracts unless specific provision is made for insurance intermediation in the future trading arrangements with EU. Regardless of the status of any insurer, this would render most London Market claims unpayable due to the complexity of the process. Provision for UK brokers to also "run off" these contracts is essential.

<u>**Contractual continuity for the industry and its customers in event of a no deal outcome**</u>

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There must be a political and regulatory agreement with the EU that ensures that there will be no legal barriers in the UK or EU, to the fulfilment of (re)insurance contracts entered into prior to Brexit (or the end of the transition period).

In an opinion published in December 2017 EIOPA[4] made clear that without taking mitigating actions before the withdrawal, insurance undertakings will usually not be able to safeguard the continuity of their services with regard to existing cross-border insurance contracts, including the payment of claims on those contracts. This was confirmed by a Notice to Stakeholders issued by the European Commission on 8 February 2018.[5]

There are a number of specific considerations for insurance contracts, which will impact on EU customers:

- Commercial insurance contracts can be of several years' duration and contracts in force for a year may commence less than 12 months before the Brexit date. This means that contracts which have been underwritten on the current passporting regime will have obligations which go beyond 31 December 2020.

- Contracts which have expired in terms of the insurance period covered are still a source of ongoing commitments. One example is the payment of outstanding claims. (The time period to resolve a claim may be long, for example where a liability claim depends on a decision of a court in an EU member state; or where the realisation that an event might lead to a claim does not come until sometime after the event in question took place).

[4] EIOPA, Service continuity in insurance in light of the withdrawal of the UK from the EU, December 2017 https://www.eiopa.europa.eu/content/service-continuity-insurance-light-%C2%A0withdrawal-uk-eu
[5] EU Commission, Notice to stakeholders: Withdrawal of the UK and the EU rules in the field of insurance and reinsurance, 8 February 2018 https://ec.europa.eu/info/sites/info/files/file_import/insurance_en.pdf

- London Market claims, especially those written on a syndicated basis across multiple insurers are complex to process. In general, the insured client would not be able to negotiate the claims process without the assistance of a London Market broker.

- The ability of the London Market to service these contracts and to pay the valid claims of its clients will be constrained because both the broker and the potentially multiple insurer will no longer have passporting rights, so will be unauthorised to do so. In some countries - Ireland, The Netherlands, Spain and Poland - it is illegal for an unauthorised insurer to carry on business, which means that they cannot legally enter into insurance activity, including the payment of claims. In other words, insurers may have to break the law in order to fulfil their contractual obligations. Since many of the policies sold in the London Market are global in nature, we could find ourselves in a scenarios where a client has a claim affecting its assets in multiple EU countries and only some of the claim can legitimately be paid.

- For a UK based broker to continue servicing contracts where there is an EU policyholder with an EU risk it will need to transfer the client relationship to a suitably authorised EU intermediary. However, for a number of SME sized London brokers, the creation of an EU subsidiary is not commercially viable.

- To ensure that they can still service existing contracts, many insurance firms based in London will be required to transfer their EU business portfolios - using a Part VII process - to other insurance entities based in the EU27. Many contracts written in the London Market are multinational, transferring them to new EU entities could be a particularly costly and lengthy process, often taking eighteen months, and will be made more complicated by pressure on the regulators and legal system due to the large number of applications. There is a risk that the transfer may not be completed by 31 December 2020, leaving clients uncertain about whether their existing contracts will be fulfilled.

- While the LMG welcomes an implementation/transition period between the UK and EU until 31 December 2020, it will be not, of itself, resolve the problem of contract continuity. Without a separate agreement on this point, any transition period will still ultimately lead to a cliff edge scenario.

Solvency II equivalence and other third countries

A relationship with the EU based on equivalence would not necessarily make the UK a 'rule taker' or prevent the Government implementing domestically focused reforms to the UK solvency regime, nor prevent the UK having its own independent regulatory regime from the EU, as the following countries have done:

Bermuda

Bermuda secured full equivalence in all three areas of Solvency II with the EU for its internationally focused reinsurance industry while maintaining a separate regulatory framework for its life insurance industry which is predominately domestically focused. EIOPA also granted equivalence to Bermuda despite finding its regime for regulating captive insurers and special purpose insurers not to be equivalent, and identifying a number of what the EU regulator found to be "significant weaknesses" in relation to the disclosure requirements and around its valuation framework, which in Bermuda is currently not risk based for a number of classes.

Switzerland

The EU granted Switzerland full equivalence in all three areas of Solvency II in 2015. This allowed Switzerland to retain its own domestic solvency test. Full equivalence was also granted despite Swiss based reinsurance captives - which are exempt from the Swiss Solvency Test - being found to be only "partly equivalent" due to the lower confidence levels applied to their solvency calculations. EIOPA also identified differences in relation to public disclosure requirements, particularly around the reduced level of public disclosure required in Switzerland and the lack of equivalent compliance and audit functions.

Japan

Japan was granted temporary reinsurance equivalence as part of the EU-Japan Strategic Partnership Agreement in 2016 and provisional equivalence under Article 227(5) of Solvency II for group solvency equivalence, which is time-limited for 10 years. This was granted despite the level of policyholder protection provided by Japan's solvency regime being deemed only "partly equivalent" to that of the EU. The determination of temporary equivalence under Article 172(4) of Solvency II is valid for five years and ends on December 31 2020. At that point, the European Commission can undertake assessments of the development in Japan's regime, which would give rise to either a determination of full equivalence or non-renewal of temporary equivalence. Temporary equivalence may be extended by up to one year where necessary to allow EIOPA and the European Commission to assess how the regime has evolved over the period.

The United States (US)

While the United States does not have equivalence with the EU under Solvency II, and has stated that it would not apply for equivalence, an alternative arrangement, the US-EU Covered Agreement, has been negotiated which gives the US many of the advantages of reinsurance equivalence while retaining its own state-led regulatory system. This is a bilateral treaty between the two states, unlike an equivalence judgement which is a unilateral decision within the EU's gift. The Covered Agreement secures the eventual removal of mandatory collateral requirements for EU and US reinsurers operating in each other's markets, while also recognising home group supervision and encouraging regulatory cooperation. A report by the Reinsurance Advisory Board of Insurance Europe for the EU Commission recommended that the breaking down of barriers through the Covered Agreement will save European businesses an estimated $400 million per year.

About the London Market Group

The London Insurance Market leads the world in providing specialty commercial insurance and four key market constituents - the International Underwriting Association of London (IUA), Lloyd's, the Lloyd's Market Association (LMA) and the London & International Insurance Brokers' Association (LIIBA).

These bodies in turn represent companies that generate over 26% of the City of London's total income, employing 52,000 people – of which 17,000 work outside of London - and controlling over £65 billion of revenue. The LMG is the only body which speaks collectively for all practitioners in this significant market, representing the views of insurance brokers, those insurers and reinsurers operating within Lloyd's, and branches of overseas insurers and reinsurers operating in London – reflecting the full extent of the Market.

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