# Making Brexit work for UK insurers


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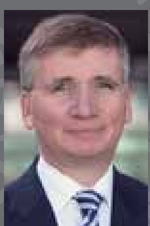
# Foreword

Ever since insurance syndicates began operating around Edward Lloyd's coffee house in London in the late 17th century, the insurance industry has long been associated with the commercial success of the city and of the United Kingdom in general. With clients and commitments spanning the globe, the UK insurance sector exemplifies British economic leadership. For generations, British insurers have represented an important source of jobs and competitiveness for the financial services sector.

Today, the nation's insurance industry faces unprecedented uncertainty after the British people voted on 23 June 2016, to leave the European Union, and we at EY have explored the potential ramifications. While the British insurance industry employs 340,000 people and has traditionally drawn insurance services and asset management from across Europe, its central role could be jeopardized by the Brexit vote. Moreover, the needs and specific concerns of UK insurers differ from those of investment bankers, trading house or commercial banks.

To better understand the priorities and opportunities Brexit creates for the UK insurance industry, EY has collaborated with Oxford Economics to gauge the attitudes of British insurers and set out priorities for upcoming conversations about how Britain intends to leave the EU. We would like to especially thank Michael Zielenziger at Oxford Economics for his contributions to this report.

While the insurance industry generally opposed Brexit, we believe this "Brexit moment" can serve as a catalyzing opportunity. We believe that using diligence and imagination, the UK insurance industry can use Brexit to secure its future. The challenges Brexit pose can help the industry maintain preeminence as a leader in developing and deploying new products and services and in expanding the nation's role in underwriting risk and assuring economic security for citizens and companies alike.



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# Introduction

As a global industry with major commercial accounts and millions of individual customers across Europe, it is difficult to imagine a group less supportive of withdrawal from the European Union (EU) than the UK insurance industry. Today, the UK enjoys a trade surplus exceeding £18 billion around insurance, and this surplus clearly benefits the whole of the British people. Insurance contributed around £12 billion in taxes in 2014, providing well more than 300,000 jobs and managing investments of £1.9 trillion. That's equivalent to 25 percent of the UK's total net worth.

Yet now that the British people have voted for Brexit, it is in the insurance industry's best interests to see the government embrace a rapid timetable for an orderly exit from the EU. As Prime Minister Theresa May has put it plainly, "The people have spoken. Brexit means Brexit. I mean what I say." The Prime Minister has also pledged that the UK should be "the global leader in free trade."

Most British insurers recognize that delay creates instability and legal uncertainty: both are bad for business and investment. Moreover, since the process of negotiating a UK exit from the European Union is likely to be complex and potentially time-consuming, British firms with significant business operations in the rest of Europe will be compelled to consider "worst case" options if there is no clear sense of how the British divorce will take place.

Instead, it is preferable for the UK government to move with deliberate speed to set out the terms of UK withdrawal in a decisive manner. As one insurance executive put it, "To think we can sit around for two or three years to see whether passporting is preserved is simply unrealistic. Our employees and customers won't wait and see."

At the same time, the UK insurance industry should turn this "Brexit moment" into an opportunity to foster invention and transformation to secure the future of the UK insurance sector as a world leader in innovation, customer responsiveness and development, and deployment of new products and services.

These conclusions highlight the findings of more than two dozen interviews conducted by Oxford Economics, an independent economic research and consulting firm, with senior executives and sector leaders in the commercial, life and specialty insurance markets, as well as asset managers closely linked to insurance. Together, these firms make London (and the UK) a pre-eminent center of the global insurance industry. Oxford Economics collaborated with EY to produce this paper.

Plainly, specialty insurers and the London Market of reinsurers in particular, have concerns that differ in some areas from those of life, property and commercial insurers. But all believe that Brexit can serve as a lightning rod to help the industry pursue more rapid innovation and, in some case, regulatory regimes that enhance the industry and maintain robust regulatory regimes, but without some of the unnecessary burdens imposed by the European Union.

The UK insurance industry should turn this "Brexit moment" into an opportunity to foster invention and transformations.


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# Brexit has no precedent

There is no precedent for the Brexit challenge facing Her Majesty's Government: "passporting" and other issues regarding relations between members and non-members of the EU were conceived for those who hoped eventually to become full members of the EU, not for those who wanted out of the union. We recognize, therefore, that negotiations regarding the UK's withdrawal from the EU will be complex and somewhat fluid: indeed, this paper is not intended as a point-by-point legal brief. Instead, we hope it lays out some general goals and opportunities on which the insurance sector can broadly focus.

However it evolves, the realities of Brexit should serve as a clear opportunity for both the industry and the Government to take some decisive steps:

- Solidify the UK's position as a global leader in insurance services by making it easier to do business
- Develop innovative products and solutions consistent with the digital and mobile eras
- Equip the industry to face future challenges in a world of slowing growth and low interest rates

We also recognize that not every outcome of the UK's withdrawal from the EU will be adverse for the British insurance industry. Some European carriers may choose to abandon the UK retail insurance market, and this consolidation may benefit UK firms. Likewise, the rapid depreciation of the currency after the 23 June vote could make the cost of doing business in the UK less onerous, invite the "reshoring" of some back-office activities now located abroad and raise the value of profits earned overseas.

However, a great deal of effort will be required of business groups and policy-makers alike to protect the UK's future centrality and competitiveness in the global insurance ecosystem. This paper will also discuss measures identified by the C-suite in insurance and asset management that would help the UK industry maintain and grow its capacity and competitiveness.

It is important to note that insurance firms, unlike banks, are not traders and deal-makers. Rather than dealing with money as a commodity, they manage risks — individual, bespoke solutions that are priced according to unique circumstance and specific hazards.

The UK insurance industry employs some 340,000 people and generates more premiums than any other market in Europe.

## Basic principles to guide negotiations

Insurers and asset managers are conscious that many of their clients or customers had no opportunity to participate in the referendum. They are hopeful that those businesses should not be harmed by its impact or effects. In other words, in negotiating a withdrawal from Europe, the UK government should focus equally on clients within the EU who could be harmed from Brexit. It would not be in the interest of negotiators in Brussels to harm German or Italian individuals or businesses who routinely did insurance work in London, even if over time EU member nations might hope to gain some benefit from the eventual divorce.

Therefore, certain assumptions seem appropriate:

- All current contracts and coverages should be "grandfathered" to a date certain to prevent any "rush for the exits" or rapid disintegration of a highly efficient and well-coordinated industry with interests on both sides of the English Channel. This should be made to apply to business models and permissions that have already been granted in order to afford insurers as much "business confidence" as possible.
- As the negotiations on separation will undoubtedly be complicated, "milestones" or "frameworks" should be put in place that set out specific, mutually agreed dates by which certain aspects of the divorce are finalized. The insurance industry wants as little uncertainty as possible; any actions that reinforce some measure of certainty will enhance investment flows and UK employment.
- Do not delay negotiations regarding Brexit. A broad consensus of industry believes that it will need to plan for a "worst case" exit from the EU, regardless of the negotiating posture taken by the UK government. Therefore, for the insurance industry, it is best to move directly to invoke Article 50 and proceed with plans to exit.

## "Broad equivalence" matters

The principal goal of the negotiations with Brussels should be the maintenance of **broad equivalence** with the EU in terms of how insurance is treated across the market. The insurance industry aims to maintain high levels of mutual access to Europe even if the UK is no longer part of the single market.

So-called passporting rules may not be the appropriate model for many insurers in the future, because this system was created for nations hoping to *enter* the EU, not those intending to *leave*. Moreover, passporting would leave many UK insurers at the mercy of regulators in Brussels with no seat at the table; i.e., they would become rule-takers and not rule-makers, and could be forced to make significant changes to their business practices or business model without adequate notice or consultation with EU officials. While a passport regime is often considered crucial for firms such as US investment banks doing business across Europe from a base in London, the passport, while welcome, is less critical to UK insurers.

UK life insurers do not conduct nearly as much cross-border business as commercial insurers. Furthermore, the UK's largest life insurers tend to have independently capitalized European subsidiaries. Therefore, if the UK should lose its passporting rights, the larger entities may not need to make significant changes to the geographical distribution of capital within their businesses.

The same cannot be said with as much certainty for Lloyd's and the London Market Group, which conducts about 14% of its business with the EU and believes that upwards of £7.5 billion in annual premiums could be at stake if passporting goes away as a result of Brexit. It is clear that the issues confronting specialty insurers are complex. Nevertheless, Lloyd's insurers can and should use the "Brexit moment" to develop innovative new insurance opportunities in areas ranging from cybersecurity to climate change in order to demonstrate to the rest of Europe that reducing access to the London specialty market would cause unwanted new hardship on European commercial interests.

Indeed, as will be documented below, UK policy-makers should take measures to **enhance London's status** as the pre-eminent hub of insurance, re-insurance and specialty coverages in order to make plain to the rest of the EU the costs that could be associated with destroying the broad equivalence that insurance now holds in EU.

## Insurance matters to the UK

Over many centuries, the UK has acquired significant competitive advantage in providing financial services around the world because of the skills and experience of the people who work in the industry.

Since the Lloyd's market began operating in Edward Lloyd's coffee house on Tower Street about 1688, London has always been a global center of insurance expertise and underwriting specialization. Today, it is estimated that some 340,000 people work in the insurance sector, including 114,300 directly employed by insurance companies and 219,700 in auxiliary services. The industry manages about 25% of the nation's GDP, produces an estimated £29.8 billion in annual GDP[1] and manages more than 50% of the world's commercial insurance industry by premium.[2] It generates more in annual premiums than any market outside of the United States and Japan and has traditionally served as the hub for insurance and asset management across Europe. It remains today the world's pre-eminent reinsurance center for aviation, marine, energy and catastrophic risk. No market is better positioned to underwrite complex risks than London. Insurance also represents a major UK export to the rest of Europe, totaling more than £2.4 billion in 2014.

Naturally, both insurance underwriters and their asset managers hope to continue doing business across Europe.

1. UK Office of national Statistics, 2015.
2. Figures from the London Market Group, as of November 2014.

## Goals for Brexit negotiations

A key principle underlying future negotiations with the EU should focus on developing some form of broad equivalence between funds seeking to serve customers in Europe and European clients who want to continue conducting insurance work in London.

In truth, there is no one single insurance market across the European Union. Different products are often sold in each country, and the market in each member state of the EU is not uniform. However, the UK insurance industry wants its clients – especially commercial insurance and specialty risk holders – to maintain access to the London market, which offers a unique ecosystem of risk underwriters, portfolio managers, reinsurance specialists, commercial firms and brokers.

To achieve this, the UK government should make plain that it will accept virtually all the standards of the Solvency II regime governing capital requirements, risk management and transparency, but that in order to promote innovative products and better deploy capital in a low-growth, low-interest-rate era, it may well accept some changes at the margin – a strategy we liken to "threading the needle" and will detail below.

Likewise, the Brexit divorce should signal to the UK's Prudential Regulation Authority (PRA) that it should be not, as a matter of course, "gold plate" additional requirements over and above Solvency II requirements, which many industry officials believe has often been the default course. For a number of insurers, EU rules have served as a brake on certain efforts by the PRA to create even stricter regulations. In the future, without EU involvement, it is hoped the PRA can create a balance between robust regulation and an environment that spurs a growth agenda so that the PRA and the Financial Conduct Authority (FCA) can issue authorizations more rapidly for new insurers and new insurance vehicles.

It will be incumbent on the UK industry, however – working together with the government – to demonstrate that losing easy access to London will impose opportunity costs on European clients and customers. The industry can best demonstrate this by announcing plans to actively:

- **Invest in developing expertise in emerging areas** such as big data and the Internet of Things, which are likely to have significant impact on how insurance coverage is written in the future. Developing new expertise, perhaps by creating a research consortium of public and private groups, will demonstrate London's determination to remain a global leader in developing new products and services.
- **Create attractive new product lines** that "put distance" between London and other potential rivals in Europe; a good example is the new effort by London-based firms to develop innovative products designed to protect against cybersecurity risk.
- **Look beyond the EU** to develop new service offerings and products that will be attractive to growing regions of East Asia, Africa and Latin America, as well as to the wealthy North American market.

For asset managers, this means the ability to **delegate management of funds** to advisers in the UK should be maintained, as it is today. London should be able to clearly explain that no pensioner in Barcelona or retirement fund in Stuttgart should somehow be compromised because of the Brexit vote.

For insurers and asset managers alike, the UK should also develop standards that are generally aligned with EU mandates regarding data management without formally adopting those standards.

The industry manages about 25% of the nation's GDP, produces an estimated £29.8 billion in annual GDP and manages more than 50% of the world's commercial insurance industry by premium.

Without EU membership, the UK can take steps that allow the insurance industry to invest across a longer time horizon.

## Measures to enhance UK insurance industry

As indicated earlier, the UK insurance industry should view the Brexit vote as a transformative opportunity that gives the industry license to make changes that help give better services to customers, create innovative products tailored to the current challenges of the macroeconomic climate and help propel the industry more rapidly into the digital age.

Naturally, we do not believe the UK should seek to boost its competitiveness by lowering its standards of financial propriety or conduct. So while it should accept in principle the requirements of Solvency II, it should push for certain adjustments that can make insurers more responsive to current market conditions.

Chief among them, it could change so-called "matching adjustment requirements" to make it easier for funds with long-term investment horizons to invest more readily in much-needed infrastructure projects. At a time when bond yields are low, individuals are living longer and governments across the world are often delaying plans to rebuild bridges, roads and other much-needed capital projects, redeploying some of the assets being held by insurers to meet long-term obligations represents a common-sense modification. It will not only allow pension and long-term savings funds to capture somewhat higher returns in a market now burdened by historically low interest rates, but it will create thousands of job opportunities.

Another common-sense change would be to raise the insurance limit on deposits beyond the EU maximum. The UK was forced to lower its maximum in the case of a bank failure from £85,000 in 2010 to £75,000 in 2015 to meet Brussels' requirement. On leaving the EU, the UK could once again raise these levels to demonstrate its commitment to running creditworthy and reliable financial institutions, even when outside EU jurisdiction.

Likewise, while the Lloyd's market has embarked on a series of efforts to modernize its trading system, the Brexit vote should accelerate this process. While Lloyds remains deeply reluctant to abandon the "face to face" component of its underwriting system, an acceleration of its Target Operating Model modernization program would be appropriate in order to demonstrate to non-UK firms that Lloyds wants to remain the central player in global reinsurance.

Many insurers believe the PRA has been significantly more strict than other regulators so that UK insurers meet and exceed standards created by the European Union. A more pragmatic approach, on issues like "ring fencing," for example, would be welcomed by the industry and would not be likely to cause any material loss of confidence by the investing public.

It would also be sensible for the UK insurance market to accommodate the digital age more readily than its EU counterparts. Amending EU rules to reduce requirements for "wet signatures" on documents and other such changes should be readily adopted. This is but one example where leaving the EU could boost the innovation and competitiveness of the UK insurance industry.

## Insurance-linked securities could boost growth

Another change that Brexit should accelerate is for the securitization of reinsurance capital through insurance-linked securities (ILS). These securities – both from the life and property/casualty sectors – hold great appeal for investors and can help the industry respond more aggressively after natural disaster. Approving the ILS legislation now being discussed by the Treasury for submission to Parliament early in the new year could allow the UK insurance industry to become a leader in developing bonds to mitigate against loss in cases of catastrophic risk.

Likewise, a partnership between the government's Foreign Office and the insurance industry could develop a set of services to be offered to emerging economies to help mitigate catastrophic risk or to help rebuild after a natural disaster takes place.

In a similar vein, Parliament could consider legislation to permit captive insurers to operate in the UK with a lesser regulatory burden in order to compete for the "self-insurance" business in locations such as Bermuda, Luxembourg and other centers of the industry.

## Potential tax changes

There are also a number of tax changes the UK government could consider so that the UK insurance industry remains globally competitive in the post-Brexit environment. First, it should remove the VAT on outsourcing. This now applies to UK insurers based on a decision of the European Court of Justice earlier this year, which ruled that claims handled by a Polish firm for an insurance company were subject to VAT. The government should also consider lowering the insurance industry's corporate tax rate, perhaps to 15%, as a means to establish greater competitiveness in a post-Brexit world. It could also reduce or eliminate the insurance premium tax in the wake of the Brexit vote.

Perhaps even more significantly, the government could, as an explicit policy measure, seek to combat the chronic under-savings of the British people by creating tax incentives for those who buy into pension or life insurance plans. This could help encourage more people to actively plan for their retirement and protect pools of capital so they can continue to be invested to improve the British economy. Recent changes regarding ending compulsory annuitization have only exacerbated the under savings problem in a society where people are living longer lives. Developing new incentives to encourage more savings would boost British society and offer asset managers opportunities to develop new flows of investment capital.

## Innovation will drive growth of the UK insurance sector

The government should also help enhance the innovative capacity of the UK by investing in the creation of technical

"centers of excellence" that can encourage digital disruption that can make the industry more effective and responsive. A major opportunity exists today for UK insurers that develop new products and services based on the merger of big data analytics and the Internet of Things — the ability of everyday objects to become real-time sensors. By developing new risk models and assurance products around these technologies, the UK could pioneer innovative services like variable-rate insurance for major construction and infrastructure projects.

Health and life insurance and wellness services tailored to individual usage patterns and risk are powered by m-health technologies and big data that drive long-term behavioral change. Leveraging home-grown and international health innovations (e.g., focusing on dementia diagnosis and detection, diabetes and super-user intervention) would demonstrate the effectiveness of true public and private partnerships with a common objective in mind – reducing costs and improving outcomes. Following the success of auto-enrollment in UK pensions, a similar approach in health could be considered to alleviate some of the pressures of NHS funding. Other innovations around health and life assurance could also be pioneered by the UK insurance industry, as these are global challenges in which the UK can take the lead and where government can work together with the industry to tackle significantly global challenges around longevity and finance. The UK has now become a leading "FinTech" center in the world, with a multitude of "InsureTechs" emerging over the past few years. New innovations are being leveraged across the insurance and health value chains, reducing costs and significantly enhancing customer and patient service.

The industry will also need to use the Brexit divorce to move more assertively to engage with clients and develop new markets in fast-growing regions of East Asia, Africa and Latin America. Many of these economies today lack the depth of service and expertise the UK insurance industry can provide. Developing a suite of services that insurers might use to help build capacity in emerging markets could help the industry develop and help UK firms maintain their global leadership in managing complex risk and developing commercial relationships with important firm across the globe.

## Avoiding macroeconomic difficulties

Even before the June 23 referendum, the macroeconomic climate in the UK posed challenges for the insurance industry. In the wake of the 2008–09 financial crisis, interest rates in the UK are at record lows, making it difficult for insurers and asset managers to harvest the traditional returns they require to serve their long-term savings and annuity holders.

The new administration must prevent uncertainty about the terms of Brexit from further dragging down the UK economy. Indeed, the new leadership has signaled that it might further loosen fiscal policy at the time of the Autumn Statement. And ahead of this, the Monetary Policy Committee of the Bank of England announced a four-pronged package of measures to loosen monetary policy at its August meeting. A cut in the Bank Rate from 0.5% to 0.25% was combined with the introduction of the Term Funding Scheme (TFS), which is geared toward ensuring that the rate cut is fully passed on to borrowers. The MPC also restarted its QE program and plans to buy £60 ban of gilts and £10 billion of corporate bonds over 6 and 18 months respectively. With the majority of members expecting to vote for a further rate cut if the outlook develops in line with the MPC's new forecast. The Bank Rate could be cut to 0.1% in November. These accommodative policies should stave off the worst possible effects of a "Brexit shock."

It is also likely that a bias toward stimulus rather than austerity would help promote domestic growth as the complex route toward Brexit starts to come into focus.

Moreover, the recent depreciation of sterling will make doing business in the UK somewhat cheaper and, at the margins, potentially reduce the need for outsourcing.

## The talent challenge

London today is a magnet that attracts talent in financial services from across Europe and around the world, and insurance firms and asset managers alike fear that their ability to recruit highly skilled talent could be seriously compromised if Brexit leads to the creation of significant barriers that keep highly skilled professionals out.

The insurance sector requires talent that is able to model and analyze risk, develop sophisticated underwriting models, and create systems to track and engage customers, as well as portfolio managers who can reinvest premiums to generate adequate returns. None of these skills are easy to obtain, and for years London has been able to attract the best and brightest from across Europe and the world.

Unquestionably, an effort to limit the free movement of labor into the UK was a motivator for many who advocated for Brexit. However, the insurance industry hopes that whatever new measures are created recognize and distinguish between labor that is highly skilled and much sought-after and less-skilled labor. As a generational change is clearly taking shape across the Lloyd's Market in particular, the needs of the reinsurance industry to develop a cadre of new talent and underwriting expertise should not be understated, and the industry hopes that immigration standards prompted by withdrawal from the EU will not adversely affect its ability to recruit workers. Insurers also hope that those EU citizens now working in the EU will be "grandfathered in" so they can continue to work and live in the UK.

# Conclusion

The vote for Brexit will by no means destroy the UK insurance industry. Indeed, if managed properly, the industry can emerge more resilient and competitive than ever, even if its ability to operate freely in other EU markets becomes more complicated and costly as a result of the UK's withdrawal.

The insurance industry should use the opportunities created by the Brexit vote to help London remain the best place in the world to conduct business and take steps to make London insurers the most innovative and customer-focused.

Insurers in the UK should prepare for a response from European competitors in a post-Brexit environment. Will European insurers pose a greater competitive threat, or will they be hindered by EU regulations, thereby providing UK insurers with an opportunity to build their presence in Europe and around the world?

From ramping up investments in infrastructure products to developing new forms of bonds to mitigate catastrophic risk, UK insurers can demonstrate to their counterparts in Europe and around the world that they remain committed to serving emerging customer needs with flexible solutions, in a transparent and well-regulated environment. There will also be significant opportunities for the UK government to add flexibility and innovation to its oversight regime, so that UK insurers can remain pre-eminent.

Depending on the outcome of complex negotiations that are yet to begin with Brussels, it is possible that additional costs and complications will beset some UK insurers, especially those with portfolios that overlap the UK and EU. While the impact of these additional costs should not be dismissed lightly, the UK insurance industry can work in partnership with the government so that its leading role in the insurance and asset-management industries can be maintained.

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EYG no. 02878-164GBL

1608-2036309 NE

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