# Brexit Restructuring

**What you need to know**

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# Brexit restructuring: what you need to know

The vote to leave the EU has significant implications for the insurance market, both UK insurers and insurers in the 27 remaining EU countries (EU 27) that currently write business within the UK.

At the heart of the issue is how insurers in each of the UK and EU 27 access business in the others' market. Currently this is achieved through passporting rights, either freedom to provide services or to write business through a local branch. However, these rights are only available to insurers operating within the European Economic Area (the EEA comprises the EU countries plus Iceland, Lichtenstein and Norway).

### Who will this affect?

In total, KPMG's analysis shows that around 1,000 insurers based in the UK/Gibraltar and EEA could potentially be affected if passporting rights are not retained as part of the exit negotiations.

The UK financial services industry has been vocal about the need to retain passporting rights. However, KPMG's analysis shows that there are actually a greater number of EU 27 based insurers using passporting rights to access the UK insurance market than vice versa.

Notwithstanding this, the extent of disruption caused by a loss of passporting rights will be greater for UK insurers affected, due to the number of countries which they could potentially become unable to access post-Brexit.

Insurers operating entirely within either the UK or the EU 27 will not have this concern, although they are still impacted by the economic effects that the Referendum result has created.

However there are four main groups of insurers that will be impacted if passporting rights are not retained:

- Brexit will most acutely impact those UK insurers that write a significant proportion of their business in the EEA countries via freedom of services (FOS) or through a branch network. There are over 300 UK insurers potentially affected.
- EU based insurers that write business in the UK through FOS licences or a branch – this could impact around 700 insurers to a greater or lesser extent.
- Non-EU insurance groups that have used the UK as an entry point to sell business in the EEA under FOS licences.
- Lloyd's of London.

From our discussions with insurance clients, it is evident that they are actively reviewing the potential impact on their ability to write business in EEA jurisdictions.

For some insurers, Brexit will be a marginal issue. But many others do not have the comfort of waiting to see how the EU-UK negotiations will develop. These insurers will need to start investing management time and cost to work out how they will be affected, and what they need to do to retain their client base, service offering, and competitive edge.

In this article we set out six pieces of advice to insurers that wish to protect and enhance their businesses in a post Brexit world.

### 1. Think strategically

Firstly, think big and make sure that your planning is not simply reactive but also strategic in its scope.

Some groups have already made public announcements on their intention to consider legal entity restructuring.

From KPMG's discussions with clients we know that boards see insurance restructuring as a priority agenda item. The stage of assessment varies by company, but many have already begun detailed restructuring planning. This includes an analysis of preferred domicile for their new EU base, as well as detailed options analyses regarding the preferred restructuring mechanism.

However, clients are also asking us what should they do to seize opportunities from Brexit and so any restructuring plan must also be considered from the context of moving beyond protecting business, to identifying ways to enhance it.






Our advice is that insurers should not simply be looking at the impact of Brexit from the perspective of protecting existing business in the EEA markets but also examining how they can use Brexit as an impetus to change their business model in terms of what products they sell and in which markets.

The planning process must therefore be dovetailed with wider strategic considerations such as decisions on portfolio management ("Go or Grow" considerations), Dynamic Strategic Planning (for instance more sophisticated scenario analysis and developing a series of potential game-plans).

### 2. Know your options

To continue to write insurance business across the EEA in the absence of something akin to passporting rights, UK insurers will need to restructure their businesses. There are various restructuring options that are available and insurers will need to determine which are applicable for their particular circumstances. These include:

- Create (or acquire) a new licensed insurance entity in any EEA country and obtain passporting rights from that insurer to ensure continued access to the remaining EEA countries, leaving the UK insurer to service the UK insurance market only.
- Undertake a cross-border merger between a UK and an EEA-based insurer and domicile it within the EEA. The UK business could then either become a 'third country branch' subject to UK regulatory supervision or could be transferred into a UK stand-alone insurer.
- A UK insurer could change its corporate status from a limited to a public limited company, as a first step to becoming a Societas Europaea (SE). This is a company that is subject to European (rather than local country) corporate law. Once established, an SE can be transferred from one EEA member state to another, subject to regulatory and tax approvals.
- Where cross-border business is undertaken through branches (rather than freedom of services licences), the exit terms may include some form of grandfathering arrangement to recognise these as 'third country branches'. However this is far from certain at this stage, and an alternative could be to convert the branches into subsidiaries. This is less likely to be a preferred option where a UK insurer has several EU 27 branches, due to the duplication of regulatory and capital requirements. However, it may be an option where only one branch is involved. This would involve a transfer of insurance portfolios and possibly a Scheme of Arrangement.
- In instances where the amount of business written in a country that would become closed to the insurer is fairly marginal, it might be feasible for the insurer to partner with other insurers to provide some sort of alliance or fronting arrangement. Clearly such arrangements come at a cost and may also attract regulatory scrutiny in the longer run.

### 3. Understand the timing, costs and risks

Whilst Brexit planning is perhaps unique in terms of the scale of its likely impact on the European insurance industry, the considerations that apply to any restructuring will be similar to "normal course" restructurings that have been undertaken in the past.

Based on our experience, the eventual restructuring plan will be a compromise between the need to balance the often competing interests of minimising execution risk, optimising tax, capital efficiency, regulatory and people issues.

- **Execution risk.** There is no point selecting an option which presents almost insurmountable execution risk in terms of legal complexity, timing risks or which has highly variable financial outcomes.
- **Tax implications.** Any restructuring plan will need to quantify the potential tax costs of any given option, including both those related to the restructuring

option and the end state. This includes corporation tax rates, amount of losses carried forward and the exposure to losing these, any outstanding tax liabilities, the VAT impact and also any tax charges that may arise on the restructuring itself. Under the EU Cross-Border Mergers Directive, there are specific tax provisions that can reduce (or even eliminate) the tax costs of a merger which is clearly advantageous from a restructuring perspective. However, there is a significant risk that these reliefs would only apply while the UK remains within the EU.

- **Capital efficiency.** Insurers need to assess what the impact will be on the amount of capital required and identify any trapped capital that could arise across the group due to the solvency requirements of having more than one entity. Any restructuring is also likely to reduce the level of diversification benefits recognised, which could impact on intra-group dividend flows.

- **Regulatory requirements.** Every form of restructuring discussed above will require regulatory notification and approval. A key consideration will be whether the regulator in the preferred future domicile is willing to take on the supervision of the proposed new EEA insurance vehicle. The UK regulators have significant resources available to authorise and supervise on an on-going basis, but a number of the other insurance markets are much smaller, requiring a lower level of regulatory and supervisory resources. While many regulators will be able to increase their resource levels over time, they may not be able to take on a significant portfolio increase over the short term. This could lead to some companies that do not advance their plans quickly finding that their preferred jurisdiction does not have capacity to absorb them.

- **People.** Issues related to staff may also present challenges: do key decision-makers need to have a physical presence in the EU, or can they operate from the UK? To what extent can operations be outsourced back to the UK? There are also questions remaining about staff consultation and notification requirements, and the location of significant people functions and operations. In addition, the current free movement of people within the EEA could be lost post-exit.

**4. Be realistic on restructuring timetable**

Although many restructuring options are plausible, few, if any, are "quick fixes". The timeframe to plan, initiate and complete one or a combination of these options is likely to take between one and two years, but could be longer as we get closer to the UK's actual exit from the EU and the volume of restructuring proposals increases.

For example:

- creating a new entity from scratch is costly, takes detailed planning, operational set-up and is subject to regulatory approval

- acquiring an insurer requires sourcing such companies, without paying a large premium for them. Also expansion of their business will require regulatory notification and approval if new licences are required

- a merger or acquisition will be subject to regulatory change of control approval.

Then there is the issue that any target insurer may have contingent, long-tail liabilities or pension liabilities. In all cases, where the solution involves the existence of two or more legal entities, the insurance group will need to hold more capital to satisfy Solvency II requirements than it did before the restructuring.

Changing an insurer's legal status to an SE and use of the Cross-Border Mergers Directive can likely only be effected while the UK remains within the EU. Similarly, portfolio transfers will be simpler while both entities remain within the EEA.

Change of controller, portfolio transfers, redomestication of an SE, authorisation of new insurers are all subject to regulatory approval. Other issues, particularly around employee consultations, may also prove problematic.

**5. Build in flexibility**

Unfortunately, there are no definite answers on what form Brexit will take. As such, unlike most other restructuring projects, insurers do not know what exactly they must plan for.

Insurers should start by examining how Brexit is likely to impact their businesses under a scenario in which passporting rights will no longer be available. At the same time, any Brexit restructuring must include some optionality to deal with the, as yet, undetermined legal and regulatory outcome of Brexit negotiations (for instance the hoped-for future passporting access for UK insurers).

This is easier said than done and therefore it is imperative that the planning process forms part of the dynamic strategic planning of the business.

**6. Act now**

Whilst there is some dispute about the timeframe, once Article 50 is triggered, the UK (and EU) may have as little as two years to prepare for Brexit. Although this timeline is capable of being extended, this requires unanimous agreement of the entire EU 27, whose agreement cannot be presumed.

As already noted, any restructuring involving insurance entities could take up to two years. Further, Brexit restructurings will be different in terms of the scale and timing of the change required. In terms of timing, insurers face two time-critical issues.

Firstly, as noted above, the variety of restructuring options that are currently available to insurers are likely to contract once the UK leaves the EU. Any major restructuring project could be more complicated and costly – particularly from a tax perspective – without these restructuring options.

Secondly, the UK and other EU 27 regulators are likely to face a spate of restructuring requests over the coming 12 months as insurers submit new licensing applications, requests for approved persons and approvals for portfolio transfers. At a time when regulators are having to deal with the first year of Solvency II implementation, the additional demands of dealing with Brexit could place severe strain on regulatory resources across many of the EEA countries. KPMG believes that this will mean that the earlier insurers start planning, the more chance they will have of gaining the regulatory approval they require.

**Conclusion**

Whilst the outcome of Brexit negotiations are uncertain, insurers must act now to develop a robust restructuring plan that provides sufficient flexibility, and a realistic timetable, to protect and enhance their business.



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