MILLIMAN BRIEFING NOTE

EIOPA's opinion on the impact of Brexit on the solvency position of (re)insurers

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EIOPA have issued an opinion paper[1] focusing on the impact of Brexit on the solvency position of undertakings in the EU 27 Member States. This briefing note summarises the main points raised in the EIOPA opinion paper.

On 29 March 2017, the UK announced its intention to withdraw from the EU ("Brexit"). It will withdraw on the date specified in the withdrawal agreement, or 29 March 2019 if no agreement is reached. The UK government has announced that, as part of Brexit, it intends to leave the European single market. If this occurs, the UK will be classified as a third country under the Solvency II framework. The EIOPA opinion paper focuses on this particular scenario, and it calls on National Supervisory Authorities ("NSAs") to prepare for this scenario. It asks NSAs to ensure that undertakings under their supervision are prepared for this scenario and include it in their own risk and solvency assessment ("ORSA").

The EIOPA paper is somewhat narrow in scope. It doesn't opine on issues such as whether there will be a transitional period, or whether the future UK prudential regime will be deemed to be equivalent to Solvency II after the withdrawal date. We note that it is highly likely that the UK regime will be deemed to be equivalent, provided that there are no significant changes to the regime, given that it is starting from a position of full compliance with Solvency II rules. Instead, the EIOPA paper notes that negotiations are ongoing, the final outcome of the Brexit process is unknown, and it focuses on the particular scenario where the UK leaves the single market on the withdrawal date and is classified as a third country.

It notes that this scenario could affect technical provisions, own funds and capital requirements for (re)insurers in both the UK and in the other EU countries which remain in the EU after Brexit ("EU27"). It focuses on the issues faced by EU27 undertakings after the withdrawal date.

It says that undertakings should prepare for this scenario in their risk management processes. It lists 14 particular issues which may affect the solvency position of EU27 (re)insurers if the UK leaves the single market on the withdrawal date and becomes a third country. (Re)insurers in the EU27 should consider whether their solvency position would be impacted by any of these issues. The issues listed in the EIOPA Opinion are summarised in the remainder of this document.

Exposures to UK government bonds

The SCR standard formula risk charge for spread risk and market risk concentration is zero for the government bonds of all EU Member States. The SCR for exposures to the UK central government, its central bank and to the three UK regional governments may increase after Brexit, depending on the credit quality rating of the UK government bonds.

Matching adjustment and volatility adjustment

The matching adjustment and the volatility adjustment to the risk-free rate may change for sterling-denominated assets. Their calculation depends on the fundamental spread of assets. The fundamental spread for UK assets will increase from 30% to 35% of the long-term average spread after Brexit, which could affect the level of the matching adjustment and the volatility adjustment.

External credit ratings

UK credit rating agencies will no longer qualify as external credit assessment institutions ("ECAIs") after Brexit, and therefore their credit ratings will not be allowed in Solvency II calculations. This may affect:

- Spread risk, market risk concentration and counterparty default risk SCRs, as these depend on the credit ratings of assets.
- Recognition of risk-mitigating techniques in the SCR calculation, as these may depend on the credit rating of the counterparty.
- The matching adjustment to risk-free interest rates, as this is based on the credit ratings of the assets in the matching adjustment portfolio.

[1] EIOPA-BoS-18/201, issued in May 2018

We note that credit ratings from UK rating agencies are unlikely to be significantly different from credit ratings from EU rating agencies, in which case this issue should be immaterial.

Unrated exposures

The market risk concentration SCR and counterparty default risk SCR may increase for companies with exposures to unrated UK undertakings. Currently, the concentration and counterparty default SCRs for exposures to unrated undertakings are based on the solvency ratio of the undertaking, with lower capital requirements if the ratio is greater than 100%. This will not be allowed for unrated UK companies after Brexit.

Similarly, lower capital requirements for exposures to unrated UK financial and credit institutions (that are subject to the Capital Requirements Directive[2] and comply with the banking capital requirements) will no longer apply.

Risk-mitigating effect of Reinsurance

In this scenario, the UK will be treated as a third country after the withdrawal date, and the UK solvency regime will be governed by UK law rather than EU law. If the UK solvency regime is deemed to be equivalent to Solvency II, then the risk-mitigating effect of reinsurance from UK reinsurers will be treated in the same manner as reinsurance from EU27 reinsurers. If this regime is deemed to be not equivalent to Solvency II, then the risk-mitigating effect of reinsurance from UK reinsurers will only be recognised in the Solvency II calculations if the UK reinsurer has a credit quality rating of 3 or higher.

The EIOPA Opinion has not speculated on whether the UK will continue to use a Solvency II-equivalent regime after Brexit, or whether it will diverge to a non-equivalent regime, as negotiations are ongoing and there is considerable uncertainty about the final outcome of the Brexit process.

Reinsurance recoverables

After Brexit, UK undertakings may not be able to provide reinsurance services in some EU 27 Member States unless they take measures to secure market access. UK undertakings which haven't secured market access in the EU after Brexit may be unable to make payments in full or in a timely manner. EU27 undertakings which have reinsurance recoverables from UK undertakings may have to reduce the value of those reinsurance recoverables in their accounts, as payments from the UK undertaking may not be made in full or in a timely manner if that undertaking has not secured full market access.

[2] Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms

Special purpose vehicles

Amounts recoverable from Special Purpose Vehicles ("SPVs") are usually treated like reinsurance recoverables. The recognition of recoverables from UK SPVs may change, depending on the laws adopted by the UK after Brexit.

Participations in financial and credit institutions

In some cases, participations in financial and credit institutions (as defined in the Capital Requirements Directive) are deducted from eligible own funds. While UK financial and credit institutions will no longer be covered by the Capital Requirements Directive after the withdrawal date, undertakings which deduct participations from own funds must continue to deduct participations in UK financial and credit institutions from own funds.

Letter of credit and guarantees

Some letters of credit or guarantees can be recognised as Tier II ancillary own funds. Depending on their characteristics, letters of credit and guarantees provided by UK credit institutions may no longer be recognised as Tier 2 ancillary own funds after Brexit.

We note that this is unlikely to be a key issue for most undertakings.

Ensuring service continuity

Undertakings must take measures to ensure continuity of service for contracts concluded in the UK under Freedom of Establishment and Freedom to Provide Services rules.

If measures have not been taken or if the measures taken are ineffective, undertakings may lose their authorisation to service these contracts, which would affect the technical provisions held in respect of such contracts, because the expected profit may not be earned in full or in a timely manner.

Group supervision

For insurance groups with a UK parent and EU-based subsidiaries, the scope of group supervision will change as the parent company will not be located in the EU.

Some insurance groups use group internal models to calculate the SCR for both the group and its subsidiaries. If the group has a UK parent, the internal model for all EU subsidiaries must be re-approved by the relevant NSA. Without an approved internal

model, the SCR for these subsidiaries must be calculated on the basis of the standard formula.

The EIOPA Opinion does not include speculation about whether a transitional period would apply in relation to this issue, to avoid large changes in solvency coverages for affected companies.

National Supervisory Authorities

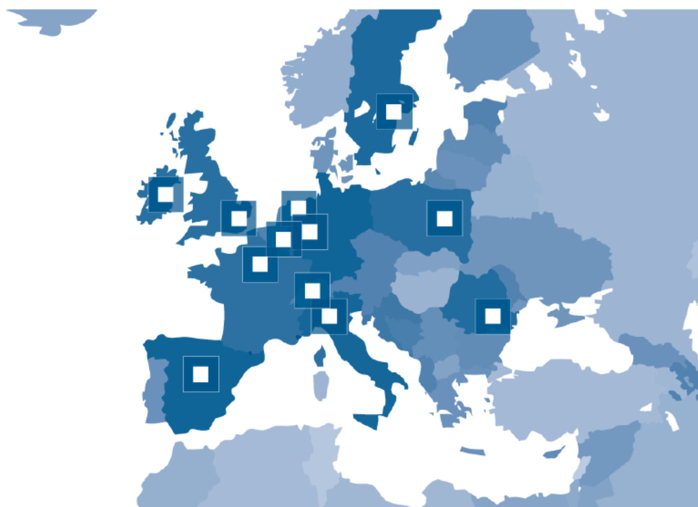
EIOPA has asked National Supervisory Authorities to ensure that the risks for the solvency position of (re)insurers arising from Brexit are properly identified, measured, monitored, managed and reported. It calls on the NSAs to provide EIOPA with the necessary information for it to monitor the impact of Brexit. It asks them to assess the risks arising for their national markets, and if necessary to take mitigating actions.

These issues may lead to increased interaction between regulators and insurers over the coming months. The Central Bank of Ireland ("CBI") has already written to some Irish firms to assess the impact of these issues.

EIOPA has also issued an opinion about disclosure of information to customers about the impact of Brexit. It has asked NSAs to remind insurers of their duty to inform their customers about any impact that Brexit might have on their insurance policies[3].

The CBI has issued a statement welcoming EIOPA's opinions[4] and reminding undertakings that they should have robust contingency measures in place to minimise the impact on their customers, investors and markets.

FIGURE 1: EUROPEAN MILLIMAN LOCATIONS



How Milliman can help

GLOBAL NETWORK

Milliman has 61 offices worldwide, with more than 3,000 employees, providing a comprehensive network to deal with any business needs that may arise.

With over 250 consultants and 12 offices spread throughout Europe, Milliman is ready to assist with queries related to any territory.

EXPERTISE AND EXPERIENCE

Milliman offers technical expertise, local market knowledge and a track record of working with regulators. We are well acquainted with the regulatory requirements for new insurer authorisations and with the regime governing cross-border passporting.

We are accustomed to working with the major legal firms and/or tax advisers to successfully deliver for clients. We also work with local third-party administrators and insurance administration outsourcers.

We have experience helping entities to transfer their existing EU business from the UK to EU 27 Member States via Part VII transfer.

We are experts in Solvency II, going beyond the mere compliance aspects to help you to optimise your business from a Solvency II perspective. We have been involved in Solvency II projects with major life, health and non-life insurance companies. Our experience spans all three pillars of Solvency II, including modelling projected balance sheets, technical provisions, SCR calculations and Own Risk and Solvency Assessments.

[3] EIOPA Opinion on Disclosure of Information to Customers

[4] Statement - Central Bank of Ireland welcomes the European Supervisory Authorities' publication of Brexit Opinions

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