SLAUGHTER AND MAY/

INSURANCE OUTLOOK 2021

Focus on Financial Institutions – Part of the Horizon Scanning series

2020 was a year like no other in recent history and 2021 has started in a similar vein. From an insurance sector perspective, as well as dealing with the impact of the COVID-19 pandemic, firms have been grappling with final preparations for Brexit, the prospect of regulatory change and the stepping up of various climate change and sustainability initiatives. Through all of this deal activity in the sector has remained strong. In this briefing we discuss the significance of these themes for the year ahead.

Brexit

After many delays and uncertainties, the UK has finally detached itself fully from the EU. Like other financial services firms, insurers have had a long period to prepare themselves for the impact of Brexit - although Brexit-related planning has continued right up to the end of the transition period as with, for example, the Lloyd's of London Part VII transfer scheme, which became effective in December.

The last minute UK-EU Trade and Co-operation Agreement, as expected, did not provide anything substantively different for the financial services sector from a "no deal" scenario, in particular in terms of loss of passporting for firms.

Some key areas of focus for insurers and their advisers are touched on below.

Onshored rules

The regulation of insurers, particularly the prudential regulation of insurers, has been a patchwork of UK and EU rules ever since the introduction of the Lamfalussy framework for European financial services legislation, with its multiple Levels of regulation. Ultimately leaving the EU will lead to a more integrated set of rules but in the short term things are arguably more complicated rather than less.

For at least the first part of 2021 the prudential regulation of insurers in the UK will involve a modified version of the PRA Rulebook combined with the onshored versions of relevant EU legislation, principally the Level 2 Delegated Regulation (as amended by the Solvency 2 and Insurance (Amendment, etc.) (EU Exit) Regulations 2019/407, which fixed deficiencies which would otherwise result from the UK having left the EU).

Ultimately leaving the EU will lead to a more integrated set of rules but in the short term things are arguably more complicated rather than less.

Assuming the outcome of the UK Government's consultation on the Future Regulatory Framework Review (discussed in our October 2020 briefing note) is a reinstatement of the original structure under FSMA, we can expect to see the Level 2 Rules and potentially some technical standards incorporated into the PRA Rulebook in the not too distant future. Other technical standards will remain standalone documents but under the responsibility of the PRA.

There is some uncertainty over the future applicability of Level 3 guidelines issued by EIOPA. They have not been onshored under the Withdrawal Act and therefore no longer have any official status in the regulatory regime. The PRA has not formally adopted any of the guidelines. Where the PRA has, however, previously followed EIOPA guidelines in its regulation of firms it seems unlikely that we will see a major change of regulatory approach. In the absence of guidance from the PRA this does leave firms and their advisers in a somewhat unsatisfactory position in terms of certainty over how the rules will be interpreted.

Temporary transitional powers

Not all of the regulatory changes resulting from leaving the EU will take effect immediately. The regulators have been given powers to make transitional directions to avoid a cliff edge effect. On 28 December 2020 the PRA published a transitional direction which applies until 31 March 2022. Key provisions include that, during the temporary transitional period:

- EU undertakings will not be treated as third country undertakings under the onshored rules, which means that firms can continue to apply the prudential treatment that applied before the end of the Brexit Transition Period to their relationships with EEA undertakings
- any preferential treatment afforded to EU assets and exposures will continue, including for example qualifying infrastructure assets and entities, equities listed in EEA countries and risk mitigation contracts with EEA (re)insurance undertakings
- where an insurer is part of a group which has an EEA group supervisor, the PRA will not seek to undertake the tasks of group supervisor unless the PRA deems it appropriate or the group ceases to be supervised by an EEA supervisor.

Insurance business transfer schemes

Mutual recognition of insurance business transfer schemes between the UK and EU has now ended. In addition, FSMA has been amended so that the Part VII process will only be available where (i) the whole or part of the business carried on in the United Kingdom by an authorised person who has permission to effect or carry out contracts of insurance is to be transferred and (ii) the transfer results in the business transferred being carried on from an establishment of the transferee in the United Kingdom or Gibraltar. Transfers will therefore be essentially domestic although they can involve a UK authorised branch of an overseas firm.

Insurance groups which needed to transfer policies internally for Brexit related reasons will have already concluded those transfers. Future transfers outside the UK will not be possible using FSMA. In general it is unlikely, in any event, that the regulators would be comfortable in future with policies being transferred outside the UK (and therefore to a different regulatory regime) but in cases where there is a rationale for doing this - such as where policyholders are resident in the EU - alternative structures will need to be found.

Obligations to customers in the EU

Inevitably, there will be some policyholders of UK insurers resident in the EU and there is additionally the risk that UK policyholders will move to EU jurisdictions in the future. Some but not all EU jurisdictions have implemented temporary regimes to allow these policyholders to continue to be serviced without penalties for the UK insurer, provided that no new business is being written. Where EU policyholders are identified, UK insurers will need to take local law advice to avoid breaching applicable law or regulation.

A particular issue arises in the case of pensions derisking arrangements, which may involve a buy-out option for the pension scheme trustee. On buy-out, the insurers is obliged to issue individual annuities to scheme members, who in some cases may be resident in the EU. It is unclear if such annuities would be considered to be continuations of existing contracts and arrangements which would fall within any of the temporary regimes or otherwise be exempt from the need for authorisation.

Deal activity

Deal activity in the insurance sector has been surprisingly robust in the face of a global pandemic, repeated lockdowns and the end of the Brexit transition period. In terms of number of announced deals, UK insurance sector M&A activity was comparable between 2020 and 2019. The largest deal by far announced in 2020 was the proposed acquisition of Willis by Aon, valued at approximately $30 billion, but even without this transaction total deal value was higher in 2020 than 2019. Other major deals have included the £7.2 billion bid for RSA by a subsidiary of Intact Financial Corporation, acting in consortium with Tryg A/S, which was announced in November and is expected to complete in Q2 2021. We are advising RSA on the bid.

Another continuing theme has been insurers divesting and restructuring to focus on core activities. Following the completion of the demerger of Prudential and M&G in 2019, further partial divestment by Prudential took place in 2020 with the £500 million equity investment by Athene in Prudential's US business and accompanying reinsurance. Aviva has disposed of a number of its Asian businesses, including divestments in Indonesia, Singapore and Vietnam. We acted for Prudential and Aviva, respectively, on these transactions.

A robust market – 50+ deals in the UK insurance market during 2020, with an aggregate value of over £43,000m

The Lloyd's market has seen high levels of acquisition and investment activity in 2020. Transactions have been partly driven by the prospect of a hardening insurance market and partly by opportunities for innovation. In September we advised Blackstone's Tactical Opportunities business on its investment in Ki, the first fully digital and algorithmically-driven Lloyd's syndicate. The Future at Lloyd's strategy will continue to promote increased digitisation as well as streamlining of new business entrants through its "syndicate in a box" solution, which welcomed four new syndicates during 2020 and had ten more in the pipeline as at November 2020.

The evolving prudential regulatory landscape

Reviews of Solvency II

EIOPA delivered its final opinion to the European Commission on the review of Solvency II on 17 December 2020 and a legislative proposal amending the regime is expected during 2021, most likely in the middle or second half of the year. In the UK, the Government's call for evidence on Solvency II, as well as its consultation on the Future Regulatory Framework Review, closes on 19 February. Any legislative changes arising out of the reviews are likely to take effect in H2 2021.

Areas of potential change include: amendments to the risk margin calculation, the volatility adjustment, the methodology for establishing the risk free rate and the calculation of the capital charge for interest rate risk; simplification of reporting requirements; clarification of group supervision rules; and, in the UK, adjustments to the matching adjustment rules.

In addition, both the European and UK reviews contemplate introducing new measures to encourage sustainable and socially useful investment by insurers, although the prudential justification for such measures is not entirely clear.

Recovery and resolution

In response to the initial request from the Commission, EIOPA has advised that new recovery and resolution powers should be introduced for the insurance sector. These will not be of direct relevance to UK insurance firms but will affect insurance groups with EU operations and are likely to inform the approach of the UK in developing its own recovery and resolution plans.

In a Dear CEO letter on its insurance supervision priorities for 2021, the PRA confirmed that it intends to develop its approach to recovery and resolution planning, which will include requiring firms to demonstrate that they have a suitable structure and business model and adequate contingency plans to be able to exit the market smoothly without detriment to policyholders or spill-overs to other firms. The Dear CEO letter does not mention the introduction of resolution powers in the insurance sector but it seems likely that HM Treasury will consider these in the future.

In addition to the plans at European level, the IAIS also recommends the availability of resolution powers in its Insurance Core Principles and is currently consulting on further guidance in this area.

Sustainability and climate change

Sustainability and climate changes issues are expected to be high on the agenda for the insurance sector in 2021, with a number of developments in the pipeline.

Sustainable investment

There is a drive from government, both domestically in the UK and at the EU level, for insurers to contribute to investment in infrastructure and other aspects of the "real economy" and in sustainable assets. This potentially may lead to changes in regulation introducing lower capital charges for these types of investment, or other similar incentives to invest. At the moment, however, availability of "green" assets suitable for investment by insurers appears to be limited and the market may therefore need to develop further before insurers can take advantage of such incentives. Separately, organisations such as Insure Our Future continue to lobby for insurers to divest from the fossil fuel industry and to stop insuring coal, oil and gas projects and companies.

Managing risks

The PRA has issued a number of statements regarding the exposure of insurers to climate change related risks, and this will continue to be an area of regulatory focus. In April 2019 it published a supervisory statement setting out its expectations on enhancing banks' and insurers' approaches to managing the financial risks from climate change (SS3/19). In July 2020 the PRA confirmed that firms should have fully embedded the expectations set out in that statement by the end of 2021.

Feedback from the PRA on the 2019 Insurance Stress Test, published in June 2020, suggested that many insurers have more work to do on climate change related risks and in particular that climate risk management is not yet sufficiently embedded. More work may therefore need to be done in this area by some firms to ensure they meet the end of the year deadline.

The Bank of England plans to launch its Biennial Exploratory Scenario on the financial risks from climate change in June 2021, which will test the resilience of the current business models of the largest banks, insurers and the financial system to climate related risks. Initial submissions from those involved in the exercise will be due at the end of September and results will be published in Q1 2022.

Climate change disclosures

Under new rules published by the FCA in December, listed insurers will, like other premium listed commercial companies, be expected to make climate-related disclosures in their annual reports for financial periods starting on or after 1 January 2021, based on the framework established by the Task Force on Climate-related Financial Disclosures (TCFD). Disclosures will not be mandatory, but if a company does not include a disclosure then it will need to explain why.

In SS3/19, the PRA stated that all banks and insurers (whether listed or not) should consider whether further disclosures over and above those required under relevant sectoral rules or Companies Act requirements are necessary to enhance transparency on their approach to managing the financial risks from climate change, including considering engaging with the TCFD framework and other initiatives in developing their approach to climate-related financial disclosure. This stops short of mandating particular disclosures for insurers but the PRA is likely to look increasingly carefully at the extent of insurers' disclosures in the context of their public reporting obligations.

Sustainability will dominate agendas as regulators concentrate on climate risk

In November HM Treasury published a roadmap towards mandatory climate-related disclosures, which it intends will be aligned with the TCFD recommendations. No additional regulatory requirements are proposed at the moment specifically for insurers – HMT notes that "the PRA continues, through its supervisory expectations and engagement, to embed climate-related financial reporting for these firms by end-2021", and that the PRA will consider after this time whether any additional measures are required.

The roadmap indicates that by the end of 2022 HMT expects 89% of insurer assets to be covered by mandatory disclosure under non-sectoral requirements, including the new rules for premium listed commercial companies and future contemplated rules for large private companies.

FCA priorities

On the conduct side, FCA priorities include implementing its proposed remedies under the general insurance pricing practices review and continued work in relation to COVID-19, both with regard to retail customers and, in the context of business interruption insurance, SMEs. It also plans to make proposals following on from its discussion paper on introducing a duty of care for financial services firms.

COVID-19 issues

The FCA set out its expectations of how the insurance sector should deal with COVID-19 related issues on its website in March 2020 and an updated version of those expectations remain in place. In particular, the FCA expects firms to consider their TCF obligations in their dealings with customers, including at renewal where policy terms may have changed in the light of the pandemic. In May the FCA issued specific guidance for insurance and premium finance firms in respect of customers in financial difficulty arising out of the pandemic. The latest amended version of this guidance took effect from 1 November 2020 and remains in place until revoked, reflecting the ongoing issues faced by retail customers in the current environment.

Actions which insurers are expected to consider where customers are facing financial difficulty include re-assessing the risk profile of the customer and considering whether there are other products the firm can offer which would better meet the customer's needs and revising the cover accordingly.

Another key area of focus for the FCA has been the extent to which policies issued to SMEs will respond to business interruption claims arising out of the pandemic. We are acting for a number of major insurers in relation to this issue. Following on from the outcome of the business insurance test case in September, the FCA issued draft guidance in December on how the presence of COVID-19 may be proved, based on the High Court's judgment and declarations. It has stated that it will update this guidance if necessary following the result of the appeal to the Supreme Court, which is expected this month. The finalised guidance will apply from the date of issue until the end of 2021, by when the FCA expects all relevant claims to have been resolved.

General insurance pricing

The consultation period for the FCA's consultation on remedies in respect of its general insurance pricing practices review (CP20/19) closes on 25 January and a policy statement is expected in Q2 2021. The FCA proposes that any new rules would come into force four months after publication of the policy statement. Firms whose home or motor insurance pricing practices are currently based on "lifetime value" models are likely to need to make structural amendments in time for implementation. Additionally, all firms selling retail general insurance or pure protection products should consider what actions they may need to take if the proposed amendments to the rules on product oversight and governance come into effect.

A duty of care for financial services firms?

The FCA published the feedback statement to its discussion paper on a possible duty of care for financial services firms back in April 2019. In the September 2020 update to the Regulatory Initiatives Grid (published jointly by HM Treasury, the Bank of England and the key UK financial services regulators), the FCA indicated that it would publish a consultation paper on options to change its regulatory framework to reflect the feedback statement in H2 2021. Among other things, possible options discussed by the FCA in the feedback statement included introducing new or revised Principles for Businesses to strengthen and clarify firms' duties to consumers and a potential private right of action for breaches of the Principles.

FCA priorities include fair value in general insurance pricing, COVID-19 consumer issues and a possible duty of care for firms

Jonathan Marks

Partner

T +44 (0)20 7090 3056

E jonathan.marks@slaughterandmay.com

Robert Chaplin

Partner

T +44 (0)20 7090 3202

E robert.chaplin@slaughterandmay.com

Beth Dobson

PSL Counsel

T +44 (0)20 7090 3070

E beth.dobson@slaughterandmay.com

This briefing is part of the Slaughter and May Horizon Scanning series

Click here for more details or to receive updates as part of this series. Themes include Beyond Borders, Governance, Sustainability & Society, Digital, Navigating the Storm and Focus on Financial Institutions. Focus on Financial Institutions explores the financial services sector which continues to be affected by digital/technology disruption and regulatory reform. COVID- 19 has added to the burden as financial institutions adapted to a new operating model overnight. This focus brings together our thinking on these points and aims to promote discussion and debate in relation to financial institutions' responses.

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650