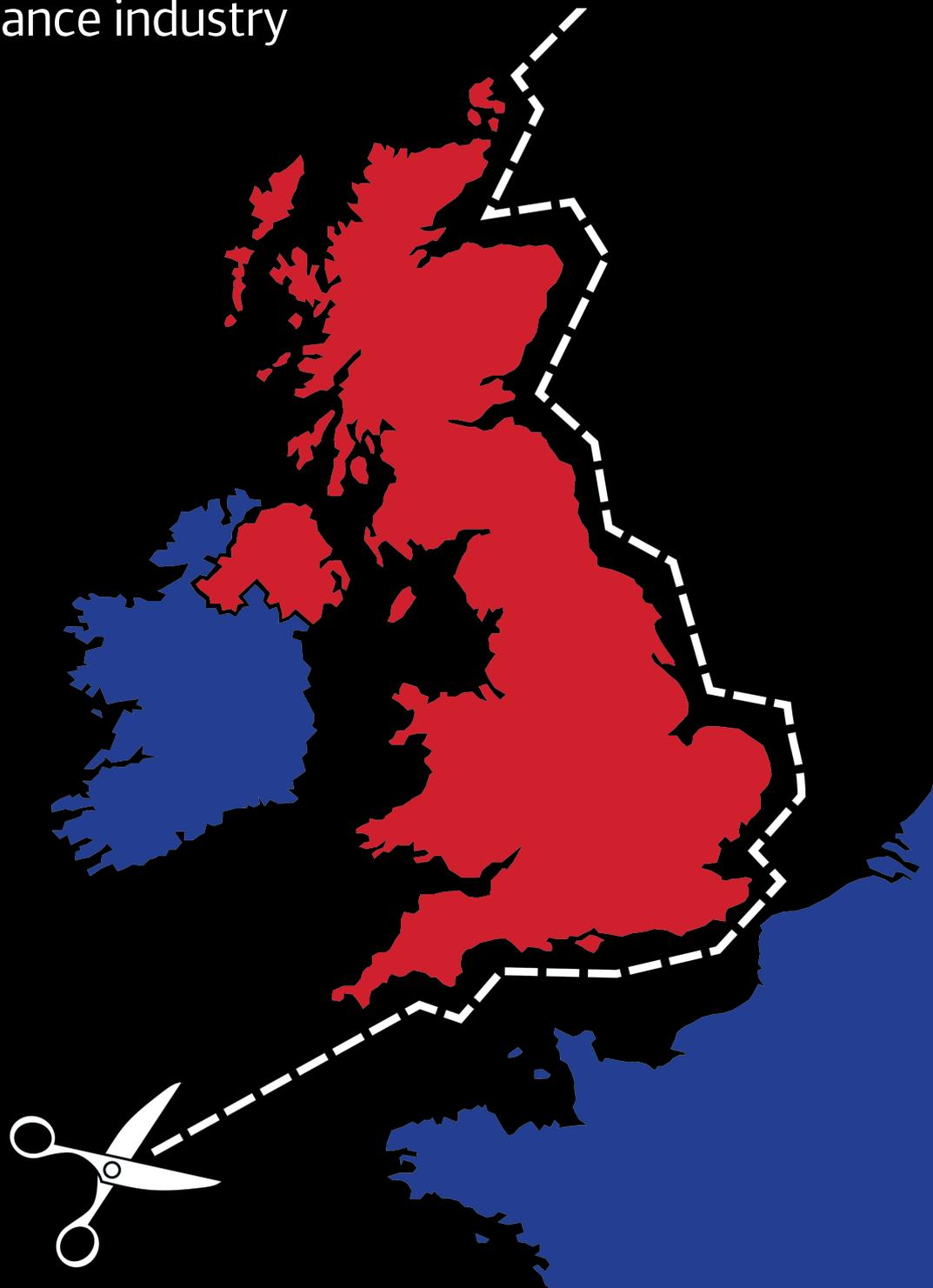


Brexit: the insurers speak

Measuring the impact of a Brexit
on the insurance industry



Foreword

The decision to remain in, or leave, the European Union on 23 June, will mark the most significant constitutional debate in the UK since 1975 (the last European referendum). The significance of the decision extends to all of us, including those who work in the UK's insurance sector. As a leading global export, the UK insurance industry manages investments of £1.9 trillion (25% of the UK's net worth) and employs around 330,000 people. Getting the best deal possible – whatever the outcome of the referendum – will have a profound effect on maintaining that global success story.

I am delighted to introduce this report, especially at a time when campaigns are gaining momentum and businesses and people alike could be forgiven for not knowing what to believe. Tracking sentiment is of course important at such a time. However, what we have set out to do is offer something different. We are not looking to suggest to anyone how they should vote, but to identify the issues that will arise for business leaders in the insurance industry to resolve in the event of a 'Remain' vote, and those to be addressed in the event of a 'Leave' vote.

While corporates do not have a vote on 23 June, they do have an important voice. Our report shows that while there is broad-based insurance industry support for remaining in the EU, there are legitimate business concerns about what will happen in the event of either outcome.

It is important to recognise that whichever way the UK decides to vote, neither outcome will be a vote for status quo. In the event of a 'Leave' vote, the UK will need to devote energy and resource to reframing its trading relationships with the EU and the rest of

the world. The prospect of a 'Remain' vote also raises the possibility of change; the sector will be faced with further EU regulations spanning capital markets (and insurance solvency requirements), data protection and cyber reporting; as well as new rules on the sale of insurance policies and broader efforts to complete the Single Market for retail financial services. Whichever way the UK votes, insurers should be ready for change and ready to adapt.

Politicians of all persuasions need to be sensitive to the global competitiveness of the UK's insurance sector. As the world's leading financial centre, the City of London has built a global reputation for its skills and expertise in insurance and ancillary financial and professional services. Therefore, regardless of the outcome of the referendum, UK politicians must remain mindful of the need to continue to put in place ongoing trading arrangements that can provide reassurance to the market. In doing so, they will protect the UK's strength in acting as a vital gateway between Europe and the rest of the world, which contains many of the fastest growing markets in places like Latin America, Asia and the Middle East.



Our report identifies and considers the fundamental issues that insurers will be required to address following 23 June in respect of each outcome. A key issue is the ability to access the best talent from around the world. This is imperative to ensuring the future health of the UK insurance sector. Such access is particularly vital for the London market, which currently employs around 50,000 highly trained professionals that service an increasingly global client base, and collectively ensure the vibrant and diverse market place that currently exists in our domestic insurance sector. As you will see the jury is out as to whether that imperative is best served by 'Leave' or 'Remain'.

The very British issue of the impact on Scotland of a 'Leave' vote and the risk of it prompting a break-up of the United Kingdom is also brought into sharp focus, and is a significant issue for the insurance industry, particularly on the Life side.

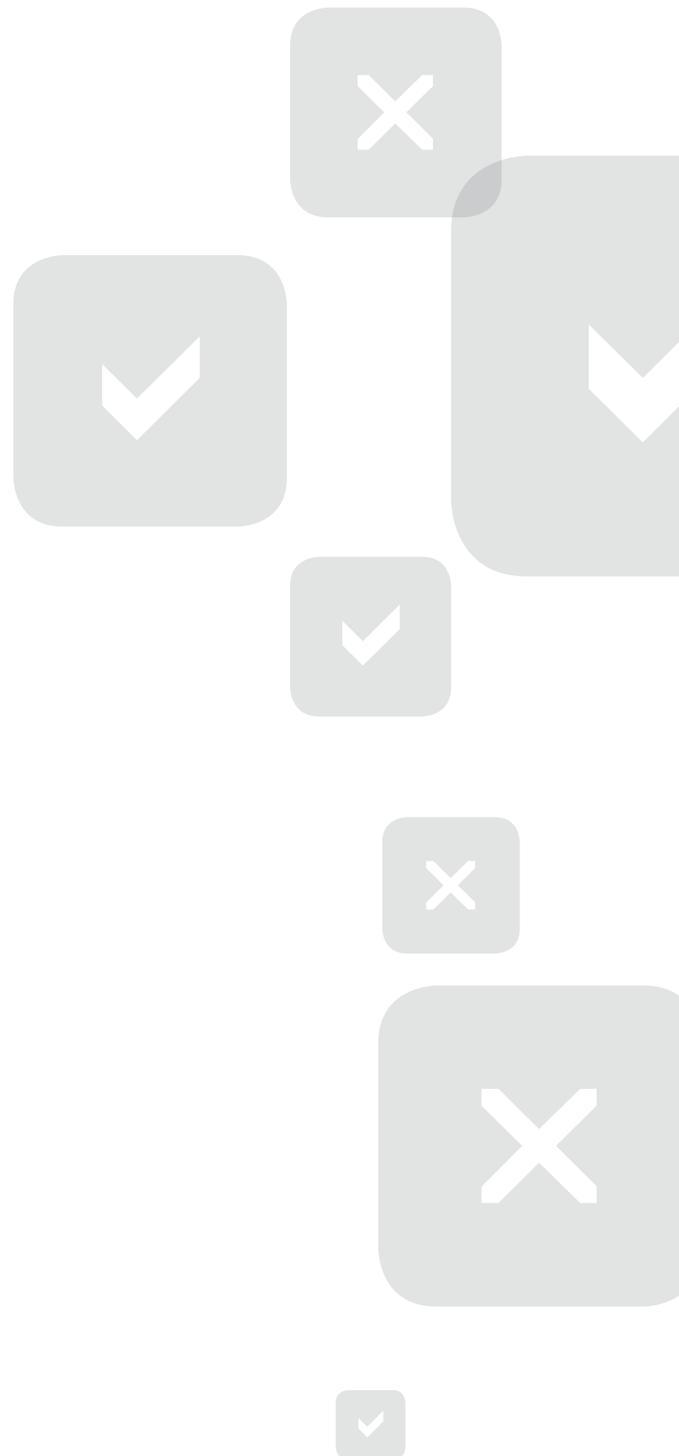
That our research found widespread support for continued EU membership among insurance industry leaders is clear. Where I hope this report transcends mere reportage is by exploring the nuances around that finding, in order to provide a comprehensive and objective review of the threats and opportunities arising either way, without looking to support any eventual recommendation or agenda.

For anyone conducting insurance business full disclosure is crucial. Only with that can an informed decision be made.

All of that said, this looks like a vote which is going to be led in the main by hearts rather than heads and I have no doubt that whatever the outcome the UK insurance market will do what it has to do to retain its position as a global market leader.



Nick Thomas
Senior Partner



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Introduction

On 23 June 2016, those people eligible to vote will decide whether the United Kingdom should leave or remain in the European Union. The polls indicate that the outcome remains uncertain.

The outcome will be significant for the UK's insurance industry. The UK enjoys a £21 billion trade surplus with the rest of the EU in terms of insurance and long-term savings products.¹ For financial services as a whole, the trade surplus stood at £72 billion in 2014.² The depth of integration goes beyond simply trading with other member countries. The UK also attracts huge amounts of Foreign Direct Investment, which is driven in part thanks to access to the Single Market, with over half of the UK's insurance industry now foreign-owned.

The stay campaign argues that the prospect of a divorce between the UK and the EU could have serious implications for the health of the UK's insurance sector as an engine for job creation, inward investment and growth. The leave campaign, however, argues that leaving the EU will provide a major boost to the economy's supply-side with higher growth and lower unemployment as well as deepening its integration with high growth economies in the emerging markets rather than being tied to a low-growth Eurozone.

What is the answer for the insurance industry? What are the main issues that genuinely underpin the questions that should be asked of those who advocate either scenario?

Methodology

Whatever the outcome in June's vote, the impact on the UK insurance sector is potentially huge.

In preparing this report we undertook a series of in-depth interviews with senior executives in the insurance sector.

The interviews discussed a range of issues in relation to a possible Brexit including the likely market impact of both a 'Remain' vote and a 'Leave' vote, as well as the extent to which insurers are developing their contingency plans in the event of a 'Leave' vote.

In total, we spoke to 20 individuals in senior management positions in 13 leading insurance, reinsurance and brokerage companies. The firms involved in this survey were drawn from the UK's general and life insurance market. Based on 2014 financial accounts they represented global revenues in excess of \$180bn giving an indication of their global scale. Interviews were conducted during February and March 2016 on an anonymous basis.

“ The firms involved in this survey were drawn from the UK's general and life insurance market. Based on 2014 financial accounts they represented global revenues in excess of \$180bn. ”

Executive summary

Key findings

The UK is a recognised global leader in insurance

The UK forms the world's leading financial centre. The Global Financial Centres Index 19 (issued April 2016) ranks London number one globally, ahead of New York, Singapore and Hong Kong. Within this overall picture, London is recognised as a leading hub for international insurance.³ Nearly half (46%) of premiums in the London insurance market are derived from business in UK and Ireland, 13% comes from the rest of Europe (excluding UK and Ireland) with the remaining 41% coming from the rest of the world. Access to the EU Single Market is recognised by our respondents as having contributed to the UK's strength as a global leader.

Widespread support for continued EU membership

- Almost all respondents felt that the costs of an EU exit would outweigh any benefits. As a result, there was **near-universal support for the UK to remain within the EU**.
- Whilst we only found one senior executive respondent who advocated a Brexit, there are voices in the broader industry that do support Britain's exit from the EU. A recent Survey by Insurance Day showed that while support for remaining in the EU was high at 64%, 28% support Britain's exit and 8% remain undecided⁴.
- A British Chambers of Commerce survey has also suggested that support for the UK remaining in the EU has dropped among business leaders, with its final poll ahead of the 23 June vote showing 54.1% supported remain (compared to 60% in February 2016).

Uncertainty is the universal concern – but the market impact would be uneven

- The uncertainty that would follow a Brexit is the biggest concern. The consensus market view was that **a renegotiated settlement would take at least five years** to achieve. The firms we spoke to repeatedly said that there were too many unknowns for them to predict accurately the long-term impact of a Brexit on either themselves or the wider UK economy.
- The uncertainty associated with a leave vote could provide a strong incentive to relocate business to other insurance hubs around the world, particularly in the London Market where the client base is global and the workforce is highly mobile. It was considered that the combination of globalisation and digitisation is weakening the need to maintain a physical presence in London. Potentially **up to 48,000 jobs⁵ would be put 'at risk'** (more than twice the size of Britain's steel industry).
- Businesses may start to relocate from the UK within one to two years of a Brexit vote. Some suggest that **jobs may well relocate 'within weeks' of a Brexit vote**. One interviewed firm said that it would be a priority, in the immediate aftermath of a leave vote, to transmit a 'business as usual' message to the market in order to stem any capital flight.
- Firms which make use of passporting rights to do business across Europe had major concerns. Any inability to undertake cross-border activity as now, based on Freedom of Service (FoS) provisions would cause businesses to redraw their corporate strategy and potentially undertake major corporate restructuring. **Brexit could become a major source of M&A activity** in the sector as insurers look to acquire or divest their EU business units.
- The firms who had established 'game-plans' in the event of a Brexit were focusing on how to minimise the impact of volatility as "uncertainty drives discounts" and scares both investors and consumers. In the short-term, firms expect the immediate impacts to be on sterling, credit spreads and interest rates. Over the few years following a Brexit, these impacts could create downward effects on employment, output and ultimately GDP growth.
- Overall, however, most firms said it was too early to undertake detailed contingency planning until the outcome of the vote was known. To do otherwise risked incurring unnecessary cost.

Accessing talent from a global workforce

- The **ability to recruit and retain global talent is a critical success factor** for the UK insurance sector.
- In the event of a 'Remain' vote, there are concerns about the UK's ability to compete for global (non-EU) talent as the only way to reduce net migration would be to introduce tighter restrictions for non-EU migrants. This could have a negative impact on the London's insurance sector's global competitiveness.
- In the event of a 'Leave' vote, the UK may be tempted to limit the free movement of EU citizens. This would hamper insurers' efforts to attract and retain talent from around Europe. Conversely, a leave vote could relieve pressure on the UK to limit non-EU migration. This could make it easier to recruit from the rest of the world.
- In reality, most respondents thought it would prove very difficult, if not impossible, for the UK to negotiate an exit which maintained market access for goods, services and capital (three of the four freedoms) while limiting free movement of people (the fourth freedom) between the UK and the rest of the EU. Respondents felt that Britain would not be able to 'pick and choose' which freedoms would apply under any subsequent free-trade agreement.

Steady as she goes: Brexit unlikely to impact on insurance regulation

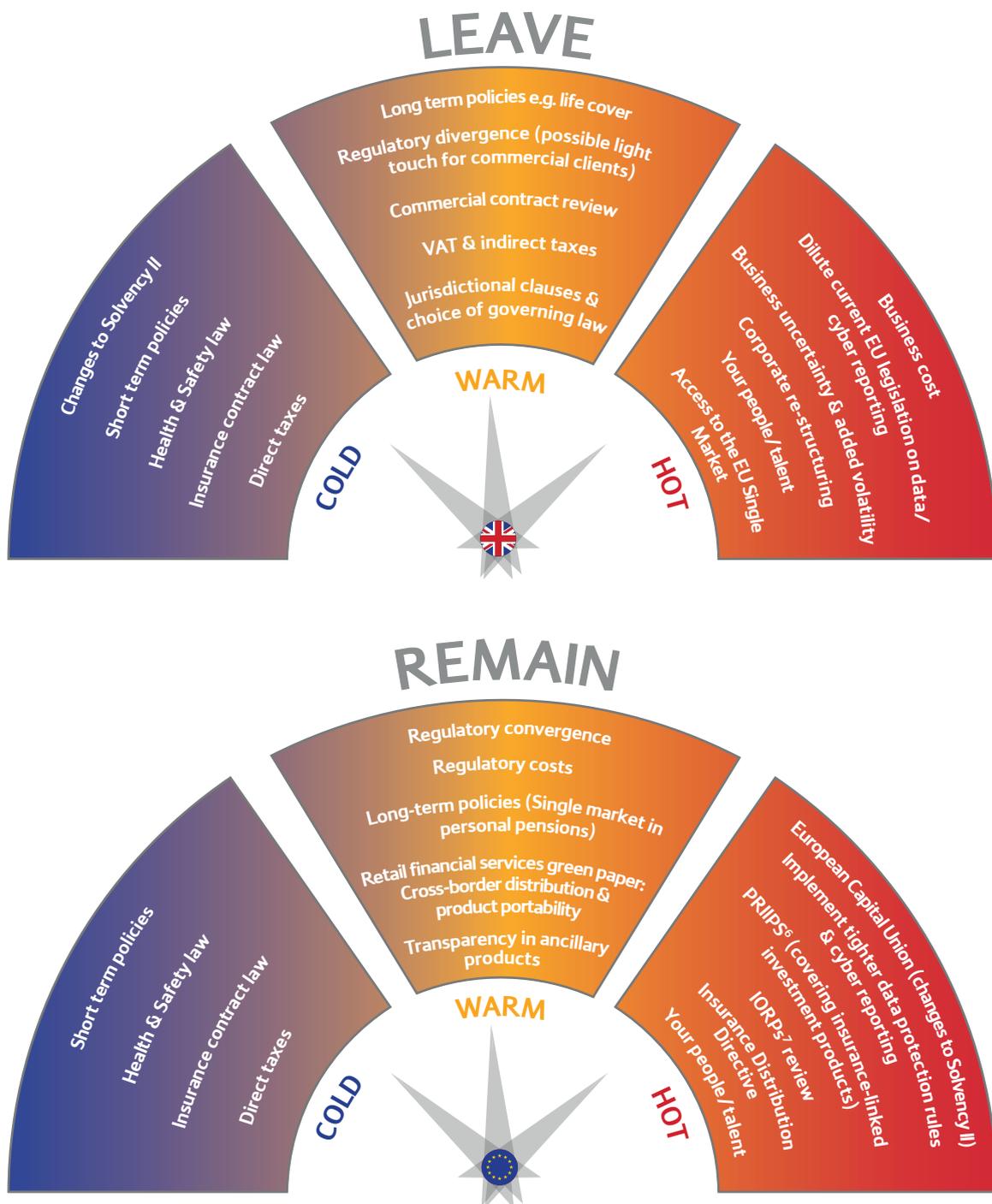
- Vote Leave, the official Brexit campaign, states that EU regulation currently costs UK businesses over £600 million every week. However, respondents dismissed these figures arguing that a UK-led regulatory regime would be just as robust as the current EU-led regime.
- Respondents believed that a **Brexit would not result in a regulatory bonfire**. There was broad consensus that most EU-wide insurance regulatory regimes, notably Solvency II, were 'designed in the UK' and as such UK regulators would be reluctant to make serious amendments to existing rules.
- Even if it left the EU, the UK would still need to follow broadly equivalent regulations in order to negotiate maintenance of market access. In the event of a 'Leave' vote, most respondents could not identify any regulations a UK regulator would (or should) remove. Only one EU legislative initiative – the Gender Discrimination Directive – was highlighted as suitable for removal.

High risk of reduced EU market access

- UK insurance has a global footprint and it is therefore vital that the UK is able to maintain access to key markets around the world both inside the EU and beyond it. There are widespread concerns about the UK's ability to negotiate favourable terms of market access in the event of a vote for a Brexit.
- It was felt that none of the other models for market access – Switzerland, Norway or Canada – would come close to replicating the current level of market access. Even if the UK was deemed to have equivalent regulation, as Bermuda has achieved with Solvency II, this does not equal free market access.
- The cost of a Brexit would not simply be felt in the UK. Professionals working in other EU markets felt that the loss of UK market access would result in UK insurers retreating from their European-wide operational footprint. It was felt that UK insurers currently benefit other EU markets by increasing consumer choice and competitiveness in those markets.

Kennedys' risk management thermometer

Despite the many unknowns that exist with regard to either a vote to leave or a vote to remain, it would be prudent for insurance firms to begin to identify the key risk management actions associated with either scenario. Doing so should assist with firming up contingency plans when deemed appropriate. Some matters are specific to one scenario only, while some are relevant to both outcomes. Insurers will need to assess each issue through either a 'leave lens' or a 'remain lens' in order to place an issue against a suitable degree of risk.



Part 1

The UK is a recognised global leader in insurance

UK insurance sector in numbers

- The UK is the third largest insurance and long-term savings industry in the world and largest in the EU.⁸
- Approximately a quarter of its net premium income comes from overseas business.⁹
- UK insurers contributed £29 billion to the UK economy in 2012.¹⁰
- It holds managed investments worth £1.9 trillion – equivalent to 25% of the UK's total net worth.¹¹
- The sector employed 334,000 people in 2015.¹² Of this 114,300 were directly employed by insurers.
- A further 219,700 people employed in auxiliary services including broking and third party services.¹³

The UK insurance sector – a vital gateway between the EU and global markets

London is recognised as a major hub for international insurance (ranked second globally in September 2015)¹⁴ with 40% of the UK's total financial services currently exported to the EU.¹⁵

Lloyds of London has “conservatively estimated” that the London insurance market is able to write insurance and reinsurance from all 28 member states to the tune of £6 billion worth of premium income.¹⁶

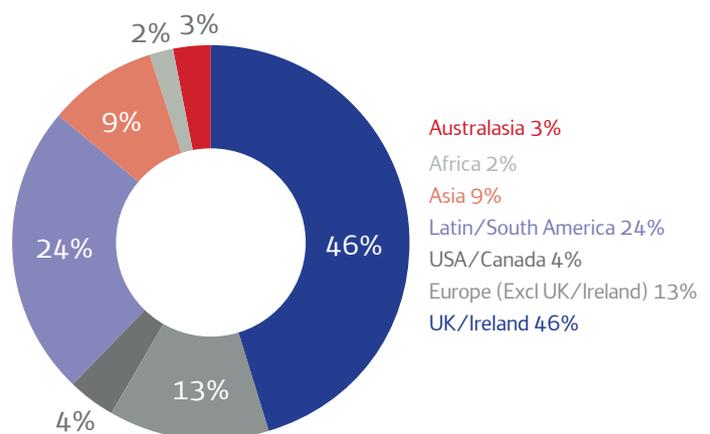
The EU itself has become established as the world's largest insurance market with a world market share of nearly 33% and total insurance premiums of nearly €1.4 trillion. The EU Single Market is also recognised by respondents as having contributed to the UK's strength as a global leader. EU membership has made the UK an attractive place to invest and one of the top global destinations for Foreign Direct Investment (FDI).¹⁷

- Nearly 50,000 people are employed in the internationally focused London Market, which has become a world leader in insurance underwriting, reinsurance and brokerage;
- The London Market's overall gross written premium income was £60 billion in 2013.¹⁸ The overall intellectual and economic premium total for the London company market in 2013 was £24.276 billion.¹⁹ The Lloyd's of London market is worth £26.106 billion gross written premiums.²⁰

Less than half of the premiums (46%) in the London insurance market are derived from business in UK and Ireland. 13% comes from the rest of Europe (excluding UK and Ireland) with the remaining 41% coming from the rest of the world.

The value of the London insurance market in 2013

2013 Premium distribution by territory



London company market premium income over time



This means that the continued ability of the UK, and the London Market in particular, to maintain free market access to all international markets both inside and outside of the EU, remains central to the long-term vitality of the UK insurance market.

Part 2

Widespread support for continued EU membership

Almost all respondents expressed the view that the costs to the UK insurance industry of an EU exit would outweigh any benefits. This contrasts with one poll conducted on insurance professionals which puts support for Britain's exit as high as 28% (that survey also showed that support for remaining in the EU was 64%).²¹ Our interviews revealed differing views across the market on the likely impact of a Brexit. The strength of feeling is dictated by several factors.

Firm's characteristic	Stance on Brexit
Size:	Larger companies are supportive of EU membership. These companies embody the EU's economic integration having large and complex cross-border operations and supply chains. They typically use London as a hub to service their international client base. They benefit from the standardised regulations across the EU (the 'level playing field') and rely on being able to recruit their workforce from around Europe and the rest of the world. EU rules on the free movement of people make it easier to recruit within Europe but potentially harder to recruit from the rest of the world.
Domestic:	UK domestic market companies are more neutral about the likely impacts on their business as the benefits of the financial services passport do not apply. Even these businesses are concerned at the suggestion of likely contagion effects arising from greater economic and financial uncertainty, fears about the potential for increases in business costs and volatility in financial markets.
Structure:	Many global firms will have European operations based on a hub and spoke model, operating out of Dublin. This will limit any negative impact of a UK exit. Firms operating a FoS model will potentially be faced with major business upheavals, including loss of market access unless they engage in major business restructuring. A number of respondents indicated that a Brexit would be likely to drive M&A activity in the sector as firms using FoS provisions would look to reposition their businesses (by divesting their cross-border business operations).
Intensity of global competition:	Firms which are more exposed to globalised markets were the most outspoken in support of the UK's continued EU membership. There was a sense that the City of London's position as a global leader in insurance should not be taken for granted at a time when other financial centres are emerging and the rise of digital communications means that business no longer needs to be tied to any one geographic location. Even a short period of uncertainty (one to two years) may result in a loss – potentially a significant loss – in workforces and operations based in London.

Part 3

Uncertainty is the universal concern

In the event of the UK's exit from the EU, businesses say that they would find it difficult to plan over the medium-term.

Our respondents did not believe that the two-year timescale (under Article 50 of the EU Treaty) for negotiating the UK's exit would be met. The consensus market view was that any final settlement would be likely to take at least five to six years. It has taken the EU and Canada seven years to negotiate their Free Trade Agreement (Comprehensive Trade and Economic Agreement or CETA). Gus O'Donnell, the former head of the UK's home civil service, has indicated that the process could take as long as ten years.

Survey respondents unanimously agreed that the prospect of a prolonged period of business uncertainty about the nature of the UK's trading relationship with the EU and the rest of the world is one of the biggest single risks arising from a potential Brexit. If firms choose to locate to a jurisdiction where the relationship with the EU will be more predictable, we may see business start to move within a relatively short period. These concerns are strongly felt in the London Market where the client base is global and the workforce is highly mobile. The combination of globalisation and digitisation is weakening the need to maintain a physical presence in London.

“ Uncertainty will cause businesses to review their presence in London. We could start to see attrition within one to two years if the negotiations are prolonged. ”

Global insurance brokerage firm

“ The UK current account deficit remains high by historical and international standards. The financing of that deficit is reliant on continuing material inflows of portfolio and foreign direct investment. Those flows have contributed to the financing of the public sector financial deficit and corporate investment... Heightened uncertainty could test the capacity of core funding markets at a time when the liquidity of these markets has shown signs of fragility across advanced economies. ”

Financial Policy Committee, Bank of England, March 2016 ²⁷

The uncertainty arising from Brexit on UK financial markets

Most projections of the economic impact are limited. Predictions are generally restricted to 2017 and are a general forecast, rather than being specific to the insurance sector.

Immediate impacts: within three-six months

- **Currency markets:** Uncertainty around a Brexit has helped push the British Pound down from €1.42 at the end of November 2015 to €1.24 by early April 2016.²² HSBC predicts that sterling will depreciate by a further 15% following a leave vote, leading to a rise in inflation of 5 percentage points.
- **Bond markets:** There could also be impacts on UK gilts. As Sterling moved following the renegotiation announcement, yields on 10-year government bonds rose 3 basis points to 1.45%.
- **Economic growth:** Morgan Stanley believes that in the event of Brexit UK growth will be limited to 1% in 2017, and that inflation will exceed its 2% target.²³ Analysts at Credit Suisse have warned an exit could lead to a reduction in GDP of up to 2%.²⁴
- **Increased risk premia on UK investments:** The Bank of England's Financial Policy Committee stated that heightened and prolonged uncertainty surrounding a possible UK exit has the potential to increase the risk premia investors require on a wider range of UK assets, which could lead to a further depreciation of sterling and affect the cost and availability of financing for a broad range of UK borrowers.
- **Balance of payments:** A drop in capital investment as firms refocus their FDI within other EU countries will worsen the UK's already large current account deficit. In 2015 it came in at £96.2 billion or 5.2% of GDP.²⁵ The UK's current account deficit is the largest in the developed world as a share of GDP. The Bank of England Governor, Mark Carney, has argued that in the event of Brexit the UK would no longer be able to rely on the "kindness of strangers" to finance its current account deficit.²⁶

Medium to long-term impacts: over two years

- **Stabilisation:** The Bank of England has suggested in the Bank's report on an exit from the EU that markets would stabilise in the medium term.
- **Employment levels:** The potential impact on the London Market could be potentially huge with 48,000 jobs (more than twice the size of Britain's steel industry) some of which may be "at risk". The London insurance market has considerable exposure in the event of a Brexit.
- **Corporate restructuring:** Insurance companies, which make use of passporting rights to do business across Europe, may lose market access under any alternative market access agreements forcing them to restructure their EU operations. This could include having to create branch operations within the EU, thereby driving M&A activity in the sector.
- **Regulatory divergence:** Should firms have to engage with separate regulatory and legal environments and have to operate through subsidiaries; opacity may appear in insurers' books of business that can create investor uncertainty. The extra premium that investors then place on their capital to compensate for the extra uncertainty (as a result of 'agency costs') could directly affect a firm's competitiveness.
- **Potential loss of export markets:** Moody's, the credit rating agency, stated that "unless the UK managed to negotiate a new trade arrangement with the EU that preserves at least some of the trade benefits of EU membership, the UK's exports would suffer." Capital Economics has estimated that the UK's financial sector exports to the EU could fall by as much as £10 billion annually.²⁸
- **Potential downgrade by ratings agencies:** Moody's is considering a negative outlook if the UK votes to leave, with "a prolonged period of uncertainty", that "would negatively affect investment" a clear threat to the UK's Aa1 rating.
- **Long-term growth:** According to a report by Open Europe²⁹, the worst case long-term loss to the UK economy of an exit is 2.2% of GDP. However, Open Europe also finds that in a best case, the UK economy could grow following a Brexit by 1.5% of GDP. The variation depends on the nature of any free-trade agreement between the UK and the EU and also the extent of deregulation. UK regulators have indicated that a liberalisation of financial services regulation would be unlikely.
- **Competitiveness of the City of London:** Half of all European headquarters of non-EU firms are based in the UK, and the UK hosts more headquarters of non-EU firms than Germany, France, Switzerland and the Netherlands put together. 59% of international insurance premiums are written in London.³⁰ This business would be at risk of relocating elsewhere in the EU. Henri de Castries, the CEO of AXA, spoke of the "very serious consequences" for the City of London in particular following a vote to leave. By way of example, he argued that the European Central Bank (ECB) would not allow London to be the hub for Euro-clearing in the event of a Brexit.

“ You break a financial centre faster than you create it. ”

Henri de Castries, CEO, Axa

Part 4

Accessing talent from a global workforce

Depending on whether there is a ‘Remain’ or ‘Leave’ vote, there is a potential mixed cost benefit analysis in terms of recruiting and retaining global talent within the UK. In the event of a ‘Leave’ vote, the UK may be tempted to limit the free movement of EU citizens. This would hamper insurers’ efforts to attract and retain talent from around Europe.

Conversely, however, by placing limits on EU migration that a ‘Leave’ vote would allow, this could relieve pressure on the UK to restrict non-EU migration and make it easier to recruit from the rest of the world. Currently, much of the UK’s net migration – around half – comes from EU countries, and most of the EU total comes from just six countries (Spain, Portugal, Italy, Greece, Poland and Lithuania). A number of respondents mentioned that the weight of migration from the EU makes it more difficult to secure work visas for non-EU migrants.

In reality, most respondents thought it would prove very difficult, if not impossible, for the UK to negotiate an exit which maintained market access for goods, services and capital (three of the four freedoms) into the EU while limiting free movement of people (the fourth freedom) from the EU. Respondents felt that Britain would not be able to ‘pick and choose’ which freedoms would apply under any subsequent free-trade agreement.

Perhaps a more ominous potential impact arising from a Brexit would be the loss of employment in the sector, particularly in the City of London. Most respondents thought there would be some loss of employment in the UK insurance sector. Views ranged from a limited impact (“certain back office operations might migrate”) through to a Doom’s Day scenario in which the London Market, in particular, witnesses major attrition.

“The prospects for the London Market could be dire: 48,000 jobs could be placed at risk over the next two years. It isn’t an exaggeration to say that it could all go.”

Lloyds market broker

“Undoubtedly, Brexit will see a loss of jobs in the UK insurance sector. In the short-term this would mean a loss of back-office operations moving to Dublin. This could happen overnight. Longer term we could see whole business units or whole firms move if there’s too much uncertainty.”

Global insurance brokerage firm

According to TheCityUK’s Competitiveness Report, decision-makers specifically cited access to financial markets in the EU as a main reason for locating in the UK.

In over 45% of UK-positive investment cases, decision makers cited access to skilled staff, including EU nationals, as one of the core reasons for choosing the UK.³¹



Part 5: Steady as she goes: Brexit unlikely to impact on insurance regulation

There have been repeated media concerns about the associated compliance costs of EU rules or ‘Brussels red tape’ and the potential impact in reducing market innovation.

Brexit supporters argue that one consequence of integration has been “excessive regulatory zeal”.

EU Directives and Regulations form the so-called *acquis communautaire* - a body of law or quasi-law – which is now 170,000 pages long.³² It has been argued that in the event of a ‘Leave’ vote, the UK would be free to remove any EU regulations which damage the UK economy including social protection legislation, notably EU employment law, and aspects of financial regulation. The prospects for a widespread roll-back of EU rules was not widely shared among our respondents:

“ It is a myth to say that EU regulations cost us billions. Regulation is just a cost of doing business in an orderly market. It isn’t limited to Europe. It’s a feature of all markets globally. ”

Large international general insurance group

Respondents emphasised that European regulation has been broadly positive for business, in creating cross-border alignment on a single level playing field, which results in increased simplification and reduced costs benefitting consumers and firms. Another insurer we interviewed highlighted that Solvency II had driven a significant business opportunity in the bulk annuity buy-out market. Insurers are being forced to restructure their balance sheets which has prompted the sale of billions of pounds of back annuity books. This represents a major source of business growth for firms consolidating closed books and zombie insurance businesses.

The only EU rule that our market participants said they would like to see removed is the Gender Discrimination Directive, which requires insurers to change their pricing policies to treat individual male and female customers equally in terms of premiums and benefits. Otherwise, respondents suggested that it was not the rules themselves that they found to be problematic, but the UK’s approach when interpreting and enforcing EU’s rules:

“ The Financial Conduct Authority is still wedded to gold-plating. They might do it for good reasons, like maintaining market integrity, but it still adds business costs which makes the UK less attractive. We operate in a competitive global market. Insurers don’t have to do business in the UK.

The regulator seems to come up with reasons why you can’t do something, rather than reasons why you can. Regulators in other markets like Ireland or Singapore have a more can-do attitude, which gives them a competitive advantage. ”

Large international insurance broker

Although there is general uncertainty, regulators and insurers broadly agree that the UK's legislative landscape would not suddenly be unravelled if the UK votes to leave the EU in June 2016. Sean McGovern, Chief Risk Officer at Lloyds of London, has rejected claims that a Brexit would create a "regulatory nirvana"³³. Similarly, Andrew Bailey stated in a Treasury Select Committee evidence session in February 2016 that all EU frameworks would remain intact even if the UK voted to leave.

“ The UK is a global leader in financial services regulation. It isn't about to get itself involved in an international race to the bottom. ”

International reinsurance group

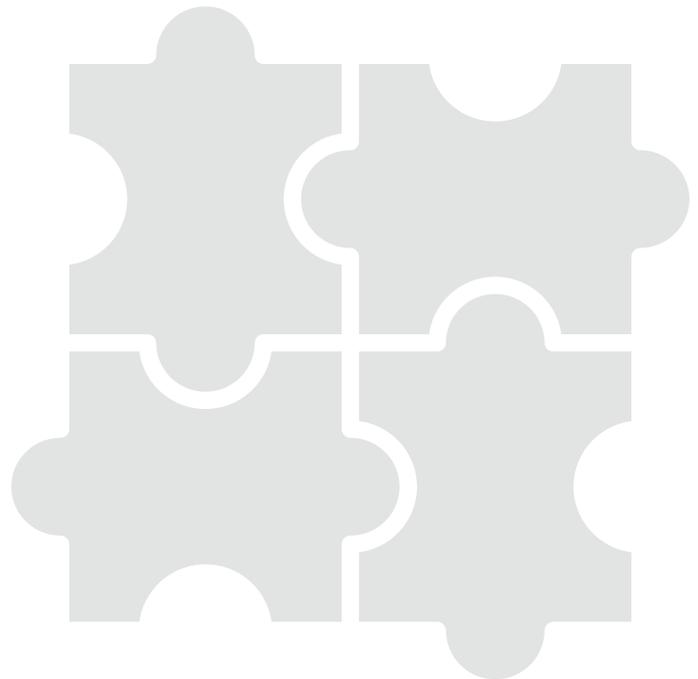
“ UK regulators and politicians will follow the same agenda whether we are in the EU or not. Politically, they can't water down consumer protection rules. Practically, the need for market equivalence means they can't water down Solvency II either. ”

International reinsurance group

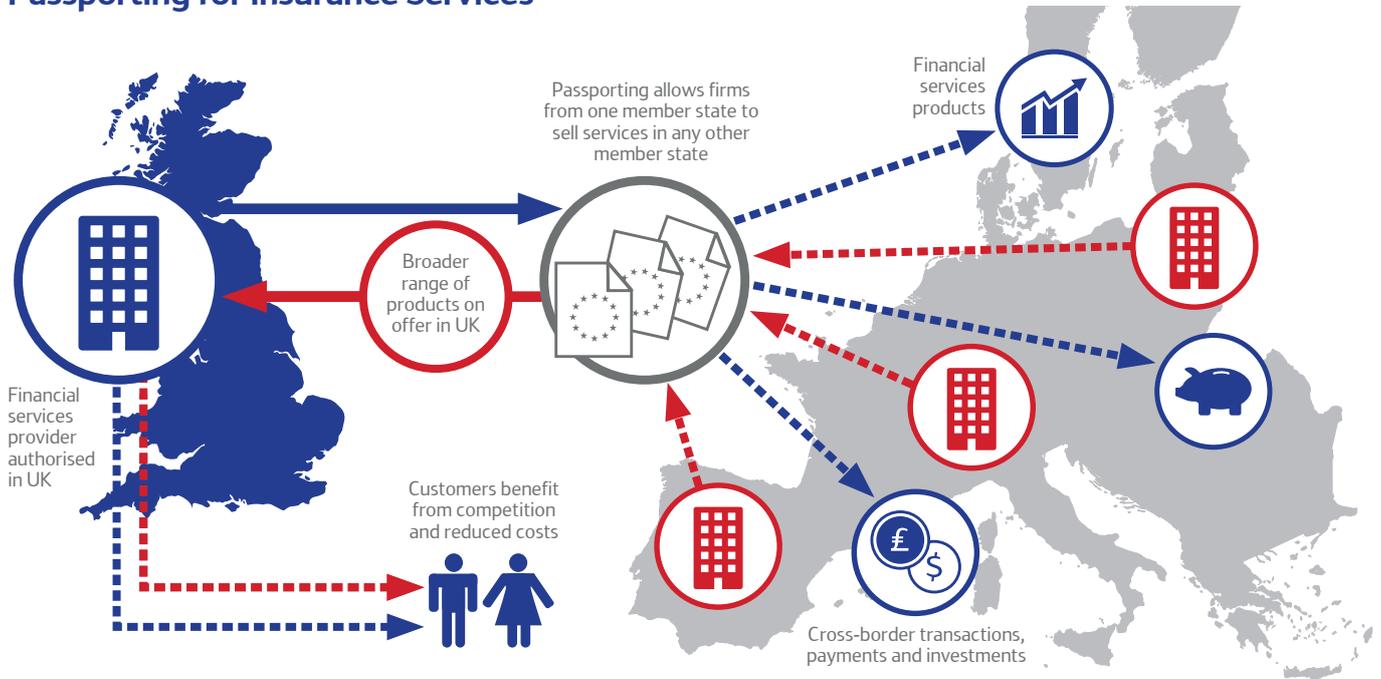
It was also noted by many respondents that much of the EU rulebook had been designed by UK regulators. Many of the EU regulations it was felt had been 'Made in Britain'.

Impact on retail insurance markets

Sitting at the heart of the Single Market freedoms is the freedom for insurers regulated in one EU Member State to provide services or establish operations anywhere in the other Member States. This is underpinned by the concept of the EU 'passport' which has been held up as one of the major benefits of EU membership. The EU passport allows businesses authorised by regulators in the UK (irrespective of their national origin) the ability to offer services remotely across all 28 Member States in the EU. This potentially offers access to over 500 million customers.



Passporting for Insurance Services



At least, that is how the market should work in theory. In practice, the EU's retail insurance market remains highly fragmented. As a result, the benefits of Single Market access could be over-stated. Whilst the passport has played a positive role in contributing to the attractiveness of the UK as a place to do business, insurers are not making widespread use of the EU passport to market their products into other EU Member States. The reason for this is that the FoS Policy provided for in the Second and Third EU Non-Life Insurance Directives (1988 and 1992) has failed to get widespread lift off. Some companies do make use of the FoS Policy but it is generally limited to certain types of niche business lines.

Respondents cited a number of reasons why this was the case. Taken together, the barriers below present challenges for insurers, particularly of small and medium sizes, when undertaking cross border business. These include:

- Differences in contract law and consumer protection legislation between country of origin (where the service is manufactured) and country of destination (where the service is consumed).
- Difficulties in managing cross-border claims management processes.

- Additional marketing costs arising from dealing with local language barriers.
- Differences between EU members in taxation on insurance services leads to issues of tax compliance when calculating and remitting taxes between Member States.
- Difficulties in managing cross-border operational risks.

“ Unfortunately, the idea (for creating the FoS policy) preceded the infrastructure needed to make it truly a success. ”

International insurance group

The introduction of the Insurance Mediation Directive, the fifth Motor Insurance Directive, the Distance Marketing Directive and the E-commerce Directive, have created a welter of new pan-European rules. However they have failed to address the kind of barriers outlined above or provide the necessary spark for Single Market activity in the retail market. Even with the Insurance Distribution Directive (IDD) coming into effect in 2018 (the rules came into force on 22 February 2016 with a two-year transition period), the EU insurance market will still remain a fragmented one.

The incomplete nature of the retail single market reduces the benefits of the single market, and thereby diminishes the potential downsides of leaving the single market. However, respondents were keen to highlight the potential benefits to the UK of completing the single market. As one respondent highlighted, the fact that the UK has the most efficient insurance market in the EU means insurers in the UK would be able to price retail insurance policies more competitively and win greater market share in other EU markets. If however the UK votes to leave the EU, then the potential benefits of a completed Single Market will be lost to the UK:

“ There is a danger that the UK leaves the EU, just as the single market for insurance becomes a reality in the retail market – a potential boon for UK insurers would be lost to German and French insurers. ”

International insurance group

It has been estimated that completing the single market would potentially add another 4% to the UK economy, which equals around £2,800 each year for every UK household.³⁴ The extension of EU trade agreements would add a further 2.2% or €275 billion to the EU's GDP.³⁵

Implications for Solvency II

Commonly known as “Basel for insurers” Solvency II is a European-wide regulation that specifies the levels of capital that insurance companies must hold. It introduces a new, codified regulatory regime that harmonises 14 EU insurance directives and was more than 10 years in the making. Its key objectives are to improve policyholder protection by ensuring better capitalised insurance firms, alongside modernised risk-based supervision. It is indisputable that the Solvency II Directive has been costly to implement. According to the incoming CEO of the FCA, Andrew Bailey, the FSA spent between £100-150m on the introduction of the regulation.³⁶ The ABI has estimated that preparations for Solvency II have cost UK insurers £3 billion³⁷, with the largest UK insurers' costs exceeding £200 million each.³⁸

Speaking as Chief Executive of the Prudential Regulation Authority, Andrew Bailey said the costs of implementing Solvency II were “shocking”³⁹ and “vastly expensive”. Tracey McDermott, acting Chief Executive of the FCA, commented in the same session that without the EU the UK might do some things differently, “such as a more streamlined and efficient Solvency II”, but added that “the UK would still want quite a lot of domestic regulation to cover the ground currently covered by a lot of EU regulation.” Bailey has commented that Solvency II was a delicate compromise and there could be political resistance to unpicking it. Bailey has, however, emphasised that there are “unintended consequences” in the regulation, with issues that still need to be ironed out.

Any adjustments that the UK might make could challenge its case to be granted equivalency by the European Commission. Since the International Association of Insurance Supervisors has chosen Solvency II as a baseline for development of a global safe-and-soundness standard⁴⁰, the UK would be subject to a similar level of standards from global bodies. All respondents we spoke to doubted whether any meaningful changes would take place to the Solvency II framework in the UK in the event of a Brexit.

“ People talk about the cost of Solvency II and maybe recalibrating it. But it is not at all clear how this could be achieved without the UK losing its equivalence standard. ”

UK composite insurance group

Concerns about accessing capital

For UK insurers, raising enough capital to fulfil the Solvency Capital Requirement could potentially become more expensive (compared to remaining within the Single Market) in the event of Brexit. Any associated costs are likely to be passed on to consumers and businesses. As the Solvency Capital Requirement also applies to the quality of capital held by insurers, the impact of a Brexit on UK insurers with assets inside the UK may see a short term devaluation of their UK assets. This would be caused by a possible sharp fall in asset prices. There was apprehension about capital flight and at least one contributor to this report stated that a priority in the event of a Brexit was to assure the market that the insurer remained solvent and “in business”, despite the ‘Leave’ result.

What does equivalence mean in practice?

The EU’s current approach for equivalence varies across directives. The EU currently evaluates the equivalence of insurance regulation on a line by line basis for Solvency II, although transitional arrangements serve to soften the impact⁴⁰. Since Solvency II came into force, two other countries have been granted equivalency – Bermuda and Switzerland. In the case of Bermuda, whilst it has full Solvency II equivalence⁴², equivalency does not equal market access. For the UK to achieve recognised regulatory equivalence outside the EU, it would have to demonstrate that it has a framework with legally binding requirements, effective supervision by authorities and which achieves the same results as the EU corresponding provisions and supervision. This would leave little or no scope to amend the legislation. In short the UK would not lose any significant existing legislation and, in all likelihood, continue to apply it more strictly than the rest of Europe even if the UK were to leave the EU.



Part 6

Risks associated with the loss of EU market access

Free trade agreements and the insurance sector

If the UK voted to leave the EU it would need to negotiate the terms of a new relationship, not only with the EU, but with the rest of the world. The existing network of free trade agreements has tended to focus more on trade in tangible goods, for example removing customs duties or technical trade barriers, rather than promoting trade in intangible services like insurance. The General Agreement on Trade in Services was enshrined by the World Trade Organisation in 1995 while the Trade in Services Agreement (TiSA), which seeks to liberalise worldwide trade in services like banking and insurance, is still some way off being adopted.

While this landscape has not proved an obstacle to the growth of the global insurance market it has influenced how insurers achieve the benefits of globalisation. As a result, most insurers with multinational operations secure market access through physical branch operations (the freedom to create a local establishment or FoE) rather than trading insurance on a cross border basis (the freedom to market services from one country into another or FoS).

Ability to trade with the rest of the world

Supporters of EU membership illustrate how the EU already provides UK firms with access to over 50 markets through bilateral trade agreements. The European Commission estimates that if the EU was to complete all its current free trade talks tomorrow, “it could add 2.2% to the EU’s GDP or €275 billion”.⁴³ However, supporters of Brexit have argued that the UK’s insurance industry’s overseas trade is dominated by non-EU markets (for example, the US accounts for nearly 40% of the UK’s insurance sector’s net earnings⁴⁴) and a Brexit would present an opportunity for the UK to forge its own Free Trade Agreements (FTAs) with third parties on more favourable terms than existing EU agreements. This reflects the UK’s greater willingness than other EU Member States to liberalise its services sector.

Respondents were worried that any new FTA negotiations would take too much time to be completed and could not see sufficient potential benefits of new deals to justify the uncertainty created by losing access to current EU FTAs. The ability to replicate the existing framework of EU FTAs is also a concern reflecting comments made by the US trade representative, Michael Froman in October 2015; “[the United States is] not particularly in the market for FTAs with individual countries” and that in the event of a Brexit, “[the UK] would be subject to the same tariffs – and

other trade-related measures – as China, or Brazil or India.”⁴⁵ The Centre for European Reform has also highlighted that with the UK only accounting for around 4% of global exports of goods and services, it would carry less bargaining power in negotiations as a lone nation.⁴⁶ However, size is not the only consideration when undertaking trade negotiations. Smaller trading blocs can and do successfully negotiate FTAs. For example, Singapore (with its population of 5 million) was able to reach a trade agreement with the US in 2004. Crucially, this agreement contained market liberalisation in the area of financial services.

Ability to trade within the EU: Negotiating a ‘British model’ for EU engagement

It is important to recognise that within the context of the EU Single Market there are a number of insurers who do make use of the existing Single Market FoS freedoms. In the event of a leave vote, respondents signalled widespread concerns about the UK’s ability to negotiate favourable terms of market access. It was felt that none of the other current models for market access – Switzerland, Norway or Canada – would come close to replicating the current level of market access. Even if the UK was deemed to have equivalent regulation, in the way that Bermuda has achieved with Solvency II, this does not equal free market access.

Whilst the UK’s priorities will be to maintain as much Single Market access and continued benefits from existing trade deals as possible, one of the EU’s main concerns will be to prevent exit contagion by ensuring that any new UK-EU arrangement does not incentivise further referenda amongst other member states, especially net budgetary contributors. The UK faces substantial challenges in co-ordinating the two sets of negotiations around both withdrawal and new arrangements, and will meet considerable opposition in its attempts to maintain the economic and trade benefits of EU membership as part of a new FTA.

“ Brussels will have a strong incentive to make sure that there is a high cost of leaving the EU. If the UK can get everything it wants by leaving, without having to make any contributions to maintaining the single market, then why would Germany or Sweden (other big net contributors to the EU budget) remain in the EU? The whole thing would collapse. ”

International composite insurance group

The basis for these negotiations is contained in Article 50 of the EU Treaty. While this sets out the timeframe for negotiating an exit, it does not lay down the process for a member state's withdrawal. It also does not include provisions for how a post-exit agreement should be reached. Off-the-record comments from both UK and EU policymakers have indicated that the withdrawal process will be extremely complicated and unlikely to be completed within the two years stipulated by Article 50. Similarly, the time frame for developing an FTA is predicted to go beyond two years judging from precedent: the EU-South Korea FTA took four years to conclude and the EU's seven year talks with Canada have culminated in an agreement that has not been implemented yet. The Transatlantic Trade and Investment Partnership (TTIP) with the United States will not be concluded until 2019 and the US President Barack Obama has indicated that the UK would not get any trade agreements until after that (and other agreements) have been concluded.

A further complicating factor is that there is no ready-made alternative model which the UK could replicate. As none of the current alternatives would prove attractive, the UK would need to create its own 'British model' for UK-EU engagement.

EEA

Norway enjoys access to the European Single Market. However, Norway must accept EU legislation covering the four freedoms of goods, services, capital and –notably from a UK perspective – the free movement of people; as well as contribute to the EU budget. Norway pays in €656 million annually and gets back €100 million in science and research grants.⁴⁷ Despite having to comply with EU law, Norway has no formal say in EU decision-making. It is not entitled to representation in the European Commission, to have ministers on the European Council or MEPs in the European Parliament.

Cost to the UK: The UK Treasury estimates that 15 years after leaving the EU and joining the EEA the cost to the UK in lost GDP would be around **3.4% to 4.3%**. This would mean an annual loss of around **£2,600 a year** for each household in the UK.⁴⁸

Bilateral agreement

The EU and Switzerland have negotiated over 130 individual bi-lateral sector-by-sector agreements over a period of 30 years. Despite the large number of bi-lateral agreements, the two sides have failed to reach a settlement which allows the Swiss financial services sector to access the Single Market, apart from a non-life insurance agreement signed in 1999. This agreement only covers direct insurance for damage (household, motor vehicle, travel and liability insurance, etc.) and enables Swiss insurers to set up and acquire agencies and branches freely in the EU. Switzerland is required to maintain the free movement of persons and to ensure that all Swiss law be developed with EU legislation in mind in order to ensure reciprocal access to the EU's Single Market. A report commissioned by the Corporation of London dismissed the Swiss model as an example the UK could follow.⁴⁹

Cost to the UK: The UK Treasury estimates that 15 years after leaving the EU and entering a bilateral agreement the cost to the UK in lost GDP would be around **4.6% to 7.8%**. This would mean an annual loss of around **£4,300 a year** for each household in the UK.⁵⁰

Reverting to WTO rules

If the UK reverted to World Trade Organisation (WTO) rules, we can expect a UK-EU FTA to contain similar agreements as other EU FTAs, namely a 'Common Customs Tariff' being levied by the EU on all the UK's exports to the EU. A Brexit would see the resurrection of non-tariff barriers for the cross-border provision of services. Without an FTA covering services, UK-based financial services firms will face the same barriers to entry as existing non-EU countries. As a result, the UK's insurance firms will have to establish branches within individual member states within the EU, and comply with EU regulations, capital requirements, and employment laws.

The UK would not be obliged to accept free movement of persons nor capital. It is also unlikely that the EU will allow the UK to continue participating in existing FTAs with third countries without the UK both contributing to the EU's budget and/or agreeing to comply with EU regulations affecting goods and services. Whilst arguments have been made that leaving the EU would enable the UK to forge stronger trade links with emerging economies such as India and China, the Centre for Policy Studies, a respected think tank, has warned that the UK's predominantly services-led export offer is not well-aligned with China's growing consumer sectors.⁵¹

Cost to the UK: The UK Treasury estimates that 15 years after leaving the EU and entering a bilateral agreement the cost to the UK in lost GDP would be around **5.4% to 9.5%**. This would mean an annual loss of around **£5,200 a year** for each household in the UK.⁵²

These figures have been called into question by a more recent report commissioned by pressure group, Economists for Brexit. They have argued that leaving the 'walled garden of the EU' would mean trading without protective EU custom duties currently imposed on trade with the rest of the world. Just 12% of the UK's GDP is currently derived from EU trade yet all UK firms including those who do not trade with Europe have to abide by EU rules. They further argue that leaving the EU would decrease consumer prices by up to 8%, provide a welfare gain of around 4% of GDP and free the UK from having to comply with the free movement of people.⁵³



Models for UK-EU relations

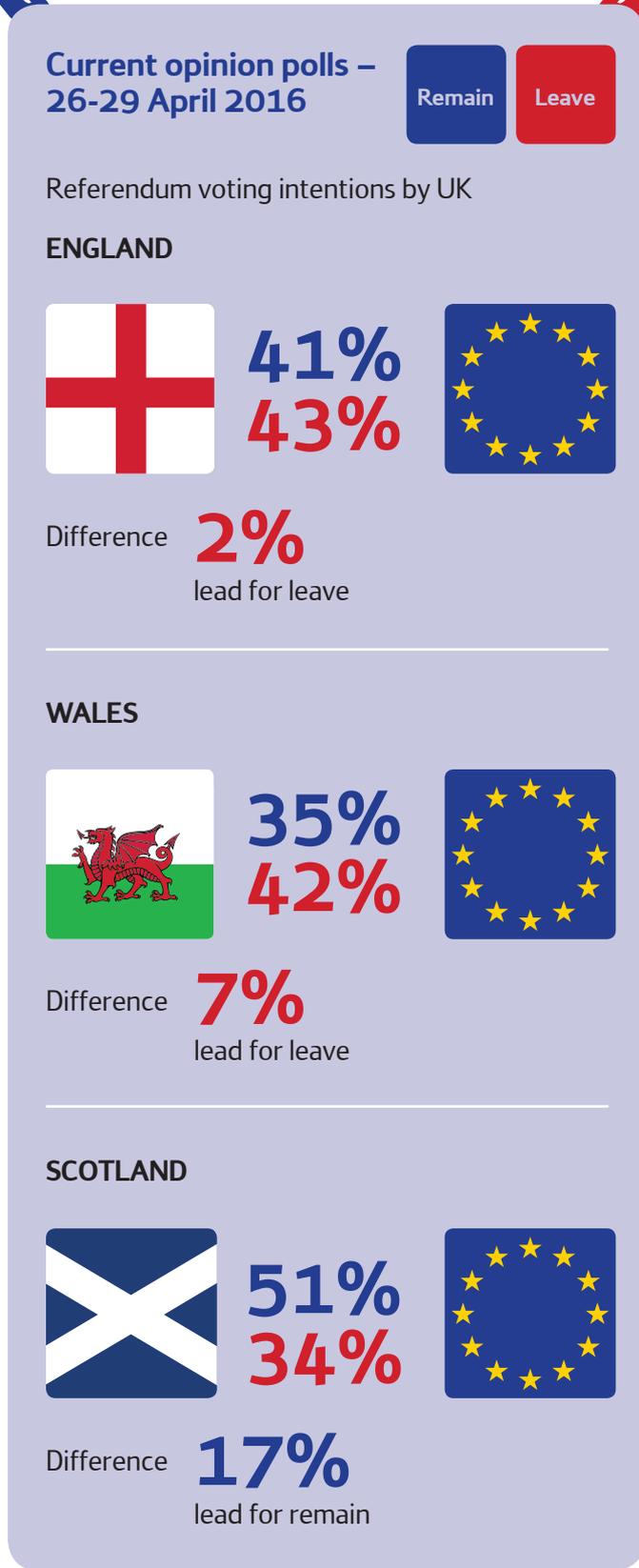
	Access to the Single Market in goods and services			Obligations		Influence
	Tariff-free trade	Customs union & external trade	Level playing field / non-tariff barriers	Other policy & regulations	Financial contribution	Votes on EU rules
REMAIN						
UK <i>(EU member)</i> 	Full	Full. No customs. Access to EU FTAs	Full	UK is not a member of the Eurozone	Pays in annually around £12bn. UK receives rebate	Full
LEAVE						
Norway <i>(EEA member)</i> 	Some tariffs remain	None. Custom costs apply. No access to EU FTAs	Key areas not covered by EEA agreement	Accepts most EU rules including free movement of people	Pays for EEA grants, Norway Grants, admin & programme costs	None
Switzerland <i>(Bilateral agreement / EFTA member)</i> 	Some tariffs remain	None. Custom costs apply. No access to EU FTAs	Limited coverage for services. No financial services passport	Accepts EU rules in sectors covered. Participates in free movement of people	Gives grants to new EU member states. Pays admin & programme costs	None
Canada <i>(Comprehensive Economic & Trade Agreement / CETA)</i> 	Some tariffs remain	None. Custom costs apply. No access to EU FTAs	Partial liberalisation of services. No financial services passport	Firms trading into EU confirm to EU standards	None	None
WTO <i>(Bilateral agreement)</i>	EU external tariffs apply	None. Custom costs apply. No access to EU FTAs	International agreements apply. No financial services passport	Firms trading into EU confirm to EU standards	None	None

	<i>EU member</i>		<i>Comprehensive Economic & Trade Agreement / CETA</i>
	<i>EEA member</i>		<i>Bilateral agreement</i>
	<i>Bilateral agreement / EFTA member</i>		



Brexit and the future of Scotland within the UK

In the event that the UK overall votes to leave the EU but Scotland votes to remain, this is likely to trigger a further referendum on Scottish independence with a strong likelihood that the independence campaign would prove successful a second time around. Such an outcome would be a major source of business uncertainty within the UK raising the prospect of ‘a perfect constitutional storm’ in which the UK negotiates to leave the EU, Scotland negotiates to leave the UK, and Scotland then applies to join the EU as a sovereign state. The long-term outcome could result in increasing divergence between Scotland and the rest of the UK including having separate central banks pursuing separate monetary policies with different currency units, different tax policies, divergent financial regulations and possibly the introduction of trade barriers. In particular, Scottish-based insurers with large client bases in the rest of the UK would be faced with major business upheavals as constitutional uncertainty would become part of the UK business landscape for the next decade.



Source: Opinium

Contingency planning for the known unknowns

The firms we spoke to repeatedly said that there were too many unknowns for them to predict accurately the long-term impact of a Brexit on either themselves or the wider UK economy. A Brexit would cause uncertainty that could create additional volatility. The firms who had established 'game-plans' in the event of a Brexit were focusing on how to minimise the impact of volatility as "uncertainty drives discounts" and scares both investors and consumers. One interviewed firm said that it would be a priority, in the immediate aftermath of a leave vote, to transmit a 'business as usual' message to the market in order to stem any capital flight.

For the international firms interviewed, it was clear that a 'Leave' vote would not lead to immediate action in terms of corporate re-structuring. In the longer-run, there was an expectation that fewer resources and headcount would be located in the UK, but the reductions would be sufficiently small that the overall economic loss to the UK's economy would not be considerable.



Issues for insurers to consider following 23 June

ISSUES	OUTCOME	
	REMAIN	LEAVE
Can firms in the UK continue to access the European Single Market?	<p>The UK would continue to enjoy full access. Firms undertaking cross-border business would not be required to make any changes to their current operations.</p>	<p>The UK would maintain market access in the short-term. In the medium-term it would have to renegotiate its access to the Single Market through a bilateral agreement with the EU.</p> <p>Firms in the UK operating FoS provisions will need to consider how their current operations would be affected by any loss of the UK's passporting arrangement. The potential for tariff barriers on insurance business would be very low under any alternative market access agreement, but non-tariff barriers (equivalence standards on UK regulations) would be a key area of concern.</p>
Access to the rest of the world	<p>The UK would continue to benefit from existing and future EU FTAs.</p> <p>This has limited benefits as most insurers do not rely on FTAs when structuring their cross-border businesses.</p>	<p>Britain would be free to re-enter the WTO and commence work on its own network of FTAs.</p> <p>While this would create a period of uncertainty it is likely to have limited impact on cross-border insurance groups with local branch operations.</p>
Which firms are likely to feel the greatest business impact following 23 June?	<p>No immediate impacts on any businesses.</p> <p>Over the long-term the cost of EU regulation could lead to higher cost of doing business in the UK. This is likely to be felt most by small and medium sized firms.</p> <p>The completion of the Single Market could however add an additional 4% to UK GDP as a result of increased trade. This is likely to benefit larger and/or international firms.</p>	<p>All businesses are likely to feel the short-term impact of increased uncertainty and the prospect of market volatility.</p> <p>In the long-term any loss of passporting freedoms, and the ability of UK firms to freely access the Single Market, will be felt differently depending on the nature of the firms' business.</p> <ul style="list-style-type: none"> ▪ Domestic business only: low impact ▪ Cross-border business serviced via FoE provisions: low-to-medium impact ▪ Cross-border business serviced via FoS provisions: medium-to-high impact

ISSUES	OUTCOME	
	REMAIN	LEAVE
What impact will the vote have on employment protection for workers employed in the UK?	European social protection measures would continue to apply to UK workers in their current scope. Firms would not be allowed to discriminate between EU citizens exercising their right to work in the UK.	The UK would be free to withdraw from the European Social Chapter and disapply EU employment protection rules, such as the Working Time Directive. Rulings by the European Court of Justice (ECJ) would no longer apply to workers in the UK. This would potentially enable the UK to benefit from more flexible labour markets.
What impact will the vote have on hiring skilled workers outside the UK?	<p>Political pressure to reduce net migration figures could result in potential constraints on ability to hire non-EU citizens.</p> <p>Firms already complain about the ability to secure skilled worker visas.</p> <p>Further measures could include increasing the levy on non-migrant workers (being introduced in 2017) or the introduction of a points-based system for non-EU migrants.</p>	<p>Political pressure to reduce net migration figures could result in potential constraints on ability to hire EU citizens.</p> <p>Firms which have workforces drawn from across the EU would need to consider potential visa arrangements. The uncertainty around working status of EU workers could also have an impact on firms attempting to attract workers from other EU countries.</p> <p>Conversely importing skills from the rest of the world may become easier.</p>
Regulation	<p>Further EU regulation will be required to enact the Capital Markets Union and the completion of the Single Market.</p> <p>This is likely to result in both costs and benefits. Smaller firms who do not receive the benefits of cross-border activities will feel the costs disproportionately. Medium- to Large-firms which do operate cross-border will stand to benefit from greater opportunities to trade.</p>	<p>Firms may benefit from limited liberalisation of the UK market, particularly in wholesale markets exposed to more intense global competition.</p> <p>The overall cost of EU regulation – estimated by Brexit campaigners at £600m per week for the whole of the UK – could be reduced but the major elements of the legislative framework (e.g. Solvency II) would remain largely intact.</p> <p>Regulatory divergence between the UK and the EU could drive additional compliance and agency costs for cross-border insurers.</p>
Cost of capital	The existing Solvency II regime would remain unchanged.	A UK-styled Solvency II regime would remain broadly equivalent to EU rules. However, fulfilling the Solvency Capital Requirement could potentially become more expensive. Firms would need to consider the scale of such cost, and the likely impact on policyholder's premiums.



ISSUES	OUTCOME	
	REMAIN	LEAVE
Impact on Sterling	-	A further devaluation of Sterling would be predicted – potentially in the order of 15-20%. This would lead to a devaluation in UK assets. The insurance sector is a major holder of UK assets, equivalent to 25% of the UK's total net worth.
Impact on bond markets	-	Spreads between the UK bond market and Eurozone would be likely to widen boosting returns to UK bondholders. The insurance (general and life) sector is one of the largest holders of UK bonds

Our contributors

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Disclaimer

This report does not represent the views of Kennedys Law LLP. The report is based on interviews with 20 senior professionals working in the UK insurance industry. The report attempts to present a balanced debate based on the interviews we conducted. While there was a clear majority of respondents who supported the UK's continued membership of the EU, Kennedys Law LLP is not aligned with any campaign group, nor does this report seek to make recommendations on whether the UK should remain in or leave the EU.

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Notes

Notes

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