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A lasting legacy

Brexit and the non-life run-off sector

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The market for non-life run-off acquisition is booming. Driven by the prospect of robust returns, acquirers are scouring the market for opportunities whilst vendors are keen to divest, to improve capital efficiency, remove P&L volatility and a number of other reasons.

Along with traditional buyers, new private equity-backed entrants are increasingly coming to market, attracted by the comparative level and uncorrelated nature of the returns, further increasing competition.

In amongst this heightened activity, these deal hungry organisations need to take time to assess the impact of Brexit on their business and group structure. In doing so, there are two key objectives that acquirers should be focused on: being able to manage existing liabilities at the point of Brexit, and creating a structure that is fit for purpose to acquire portfolios post-Brexit. Brexit will have two potentially major impacts on run-off acquirers:

— Firstly, there may be a need to restructure existing business models if 'mixed' portfolios of direct UK and EU risks are currently held in order to split them into separate UK and EU portfolios (most likely through the use of expensive and time consuming portfolio transfers).

— Secondly, even if a regulatory solution can be found to the issue of servicing existing back-books, the acquisition of UK and EU run-off portfolios in a post-Brexit world will most likely also require segregation into UK and EU portfolios, each to be serviced by their respective UK and EU carriers, potentially requiring significant change to existing operating models.

Maintaining the ability to service cross-border run-off portfolios post Brexit

A number of run-off acquirers have made efforts to consolidate European portfolios into a single vehicle. These consolidators have a mixture of portfolios containing bundles of risks which are located across the EU and the UK.

A key question is whether it will be possible to service pre-Brexit run-off portfolios that sit 'on the wrong side' of the EU/UK border post-Brexit without requiring local authorisation. Along with many other businesses, run-off acquirers are having to plan in an uncertain regulatory landscape.

The approach and policy regarding the servicing of back-books appears to vary across the EU. Some jurisdictions require the underlying policies that relate to their domestic policyholders to be serviced by an authorised insurer whereas other regulators allow for the remote servicing of policies to be undertaken from a non-authorised carrier (provided no regulated activities are undertaken in the jurisdiction). Although the books of business acquired are usually completely closed books, the transfer of such portfolios into a new entity effectively means that the acquiring insurer is treated in the same way as if it were actively underwriting. This may require changes in the current regulatory permissions held.

The extent to which EU regulators will agree a protocol to allow insurers to service pre-Brexit portfolios from 'the wrong side' of the EU/UK border post-Brexit is therefore uncertain. To date, the onus has been put on firms to mitigate the risk of unauthorised activity, rather than establishing any form of grandfathering regime that would enable the servicing of these contracts in situ. If a pragmatic solution cannot be found then some acquirers may be forced to split portfolios between UK and EU risks, potentially requiring the authorisation of a new insurance entity within the group.

Most UK insurers impacted by this issue are implementing 'No Regret' strategies and are pro-actively transferring contracts to an EU platform. Similarly, EU insurers have been seeking UK branch authorisation to deal with UK portfolios.

Impacted run-off acquirers should be considering the same solutions and taking action now. Whilst an extended transitional period creates greater opportunity for run-off players to reduce the size of their back-books, it is unlikely that the transitional arrangements currently being discussed will be for a sufficiently extended period to allow run-off companies to fully settle their existing mixed EU/UK direct portfolios. A prospective 'cliff edge' scenario still exists and so the draft transitional arrangements should not lull legacy acquirers into complacency. The transitional arrangements are, after all, still very much in draft and rely upon the resolution of several difficult topics – including the Irish Border issue.

What should run-off acquirers be doing now?

Given the uncertainty regarding the treatment of back-books, what can run-off acquirers do now to prepare their businesses for a post Brexit landscape?

1 **Analyse and catalogue the risks in run-off portfolios** – obtain a detailed understanding, through a ground-up analysis of owned portfolios, to assess the location of the underlying risks by EU jurisdiction, the split of reinsurance and direct business as well as the split between personal lines and commercial risks. It will also be important to look at the run-off profile of these liabilities over time to identify those portfolios where material exposures/reserves will be held post the end of the transitional period.

2 **Portfolio mapping** – create a risk matrix of the portfolio that maps the liabilities and risk types to EU jurisdiction and create a heat map of the likely regulatory response in each relevant jurisdiction.

3 **Horizon scanning** – undertake regular regulatory horizon scanning to assess relevant Brexit pronouncements, particularly in respect of transitional arrangements and treatment of back-books.

4 **Cost benefit analysis of potential solutions** – assess the options that are available including the creation of new service companies or branches and the potential need to create a new carrier in an EU or UK jurisdiction.

5 **Engage with the regulators** – organisations should engage with regulators in each jurisdiction to obtain their guidance on their likely approach to the servicing of EU policies from the UK and vice versa.

These ground-up reviews of the current business models may have additional consequences. Quite apart from identifying areas for Brexit readiness, cost will be a major concern for many organisations both pre and post Brexit. This analysis could also be useful as a catalyst for change, identifying areas for restructuring and efficiency.

Need for dual UK and EU platforms

Legacy acquisition will remain vibrant and run-off portfolios will still be an attractive proposition post-Brexit. Many in the run-off sector believe that Brexit will provide very real prospects for acquirers, with continental Europe in particular presenting growth opportunities. The UK may also provide genuine growth opportunities, as EU insurers grapple with sub-scale operations in the UK in the face of the potential cost and regulatory burden of continued market access.

Going forward, when assessing new legacy deals, regulators across the EU are likely to require run-off acquirers to service EU risks from an EU run-off platform with the UK regulators having a similar requirement for the servicing of UK policyholders.

Run-off acquirers will therefore need to establish dual UK and EU platforms if they intend to assume portfolios of direct EU business. The new business models that Brexit will impose on the run-off sector, as well as the wider economic consequences of Brexit, will require run-off acquirers to address a number of tax, regulatory, capital and cost implications. Those that respond to these challenges now will be best equipped to deal with the opportunities presented in the future.

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