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BREXIT AND INSURANCE

THE NEED TO PLAN AHEAD

Britain's decision to leave the European Union will have a major impact on the global insurance industry, and not just for organizations based in the UK. This note outlines key issues and areas in which insurance companies should be planning ahead, including:

- Impact on the workforce
- Impact on pension plans
- Impact on insurance assets and liabilities

UK insurers currently have access to a market of 500 million people through the EU, and a substantial amount of insurance and reinsurance is distributed and underwritten through the UK. John Nelson, chairman of Lloyd's of London, points out that EU membership brings three specific benefits to the UK insurance industry:

1. Passporting rights mean funds don't have to be localized in other EU jurisdictions to meet liabilities.
2. Lloyd's enjoys bilateral agreements negotiated by the EU with third-party countries.
3. Eighty percent of the capital deployed at Lloyd's comes from outside the UK and is attracted, in part, by access to the single market.

There are likely to be lengthy negotiations on the UK's ongoing access to EU markets, potentially resulting in a series of bilateral treaties to enable UK firms to passport into the EU (and affording the same privileges to EU insurers and brokers wanting to operate in the UK).

The approach to the regulation of UK insurers is unlikely to change. The Prudential Regulation Authority (PRA) was heavily involved in the negotiation of the Solvency II Directive, based on the UK's own "risk-based" system, so we can expect the PRA to continue its commitment to a Solvency II-type system for insurance companies.

IMPACT ON THE WORKFORCE

Workforce repercussions will continue to emerge as political decisions are made regarding the actual terms of the exit. Brexit raises some fundamental issues around employers' decisions to keep their operations within the UK that will require significant planning. It will be important to have robust contingency plans in place to prepare for potential disruption. In the face of tight regulation around operational risk, many will have thought through the implications of Brexit already and may have undertaken preliminary evaluations of alternative locations for their UK operations. Some will opt to stay; some will opt to move elsewhere.

Skilled labor from EU countries makes up a large percentage of the workforce in the UK insurance sector, particularly in London. If restrictions are placed on EU workers within the UK workforce, companies will need to revise their workforce strategies. In an era of rapidly evolving business models, especially the disruption from digital challengers, it isn't just traditional insurance expertise such as underwriting and claims that will be hard to find but new skills such as social media marketing and data analytics. Less freedom of labor movement will make it all the more critical for talent managers to access smart tools — such as workforce analytics and long-term strategic workforce planning — to future-proof the organization.

Attraction and retention strategies should also be reviewed, as the fundamental employee value proposition may have changed. Brexit is the start of a long and uncertain political process, and it will be imperative to reassure employees that there will be no knee-jerk reactions. Many employees are drawn to the UK, and particularly to London due to its cosmopolitan nature. Even if things don't end up changing much in practice, the Leave vote may have made some feel rejected. Employees will be worried about job safety due to the potential economic downturn as well as companies moving activity away from the UK into an EU country.

For organizations that decide to move some or all of their business, relocating staff or creating entirely new centers of operations and trading outside the UK may be a complicated undertaking. Although dramatic exchange rate movements may make some locations more or less attractive in the short term, few organizations will be basing investment decisions on volatile market and asset prices. Relocation decisions are more likely to be based on external labor market fundamentals, which require in-depth analysis of key drivers such as local labor costs, current and future skills availability, comparative costs of living and employment legislation.

For example, companies should be considering the impact of an end to reciprocity on state healthcare costs for foreign nationals across member states. Many companies will also want to understand the nature of the trade deals the UK eventually negotiates before they consider relocation. Furthermore, the prospective country's long-term economic prospects, regulatory environment and corporate tax structures will need to be taken into account before moving staff. Although London's status as a premier financial center is likely to remain intact — London is ranked first in the Global Financial Centers index and benefits from a large and comprehensive infrastructure, an international language and a concentration of expertise — some companies may move portions of their staff to next-tier hubs, such as Dublin, Frankfurt, Paris and Amsterdam. Places like Warsaw, Prague, Budapest and Lisbon may also be considered for operations. Robust internal and external data and insight are critical to inform the right decisions.

Given the uncertainty regarding the terms of Brexit and the timeframe for company decisions, communication will be critical to address the many concerns employees may have.

HOW BREXIT HAS AFFECTED MARKETS

For most observers, Brexit was unexpected, and markets were largely caught by surprise, with falls in risk assets and particularly sharp movements in exchange rates and bond yields. Immediately after Brexit, the pound traded at the lowest level against the US dollar since 1985, with gilt yields falling to record lows. Although there has been some degree of stabilization since, significant uncertainty remains in the markets (especially currency and fixed income), and the future path is unclear.

Contributing to this is the continuing political upheaval in the UK — uncertainty as to the terms under which Brexit will take place (and, indeed, if it even will take place) as well as the potential for future political stress across Europe with many elections coming up. There is no cause for panic in the short term but certainly a need to exercise caution — particularly given the potential for the position to get much worse.

It's difficult to estimate the longer-term structural economic impact from Brexit, especially as the nature of the future relationship between the UK and the EU is unclear. The UK has negative trade and current account balances, and the budget deficit leaves limited scope for the government to offset short-term economic impacts through fiscal policy. The UK economy benefits more from trade with the EU than the EU does from the UK, relative to its size, placing the UK in a weaker bargaining position. GDP growth forecasts for the UK have been reduced for 2016 and 2017. Some equity markets (for example, FTSE 100) haven't been as severely impacted by Brexit because many large British companies are well diversified geographically. But for smaller companies with more reliance on the UK market, the position has typically been worse.

The Bank of England is likely to cut interest rates and keep them close to zero for a prolonged period, and Brexit is also likely to have an impact on monetary policy for other major central banks (for example, reducing the probability of a US rate increase).

Along with the direct financial impact on asset valuations, the reduced liquidity in current markets increases the cost of any trading activity. In addition to the market movements we've seen to date, there is now an increased probability of extreme events, and the potential for contagion across the Eurozone is significantly higher.

IMPACT ON PENSION PLANS

The change in financial markets and future economic prospects will impact the funding of pension plans. As with all large employers in the UK, a significant part of an insurance organization's balance sheets relates to the employer's final-salary benefit obligations. Although many UK insurers have closed their defined benefit plans to new entrants and/or future accrual, large legacy liabilities typically remain.

The funding position of traditional final salary plans feeds into both the accounting and regulatory balance sheets of plan sponsors. For the regulatory balance sheet, insurers are also required to set aside capital to mitigate the potential downside volatility of such liabilities. These pension liabilities are typically long term and assessed relative to long-term fixed-interest yields. There's generally a far greater mismatch between the assets and liabilities of the pension plan due to changes in long-term yields than for the insurance business, and the fall in UK yields has materially worsened the funding position for many plans.

Market volatility and uncertainty in the wake of the Brexit vote will also have an ongoing impact on the funding position, consequently creating greater variability in costs. Insurers may therefore need to accelerate plans to review and mitigate defined benefit pension risks. It has never been more important for plans sponsors to work in partnership with plan trustees to arrive at sensible outcomes that weigh the need for benefit security against the fact that higher contributions are now likely to be relatively less affordable.

And it doesn't stop there. Defined contribution pension plans, in which the employee, not the employer, bears the risk of meeting future pension requirements, will also be impacted by market uncertainty. The underlying investments in these plans fluctuate in value, and the cost of buying an annuity at retirement is now more expensive. Employers need to pay close attention to the impact on the financial wellness of employees who are depending on defined contribution plans to fund retirement. This may require a fundamental review of the overall employee benefits package and should certainly entail an appraisal of the intrinsic value employees perceive in their "total rewards."

IMPACT ON INSURANCE ASSETS AND LIABILITIES

The changes in financial markets will also impact an insurer's invested assets and its overall solvency/balance sheet position.

Insurers that aren't tightly managing their assets relative to their liabilities will find that currency movements and the fall in government bond yields have caused increased volatility, potentially leading to balance sheet losses. The decline in equities and other risky assets will also have reduced capital buffers and solvency ratios.

Insurers can do a number of things to protect their investment portfolios in the aftermath of Brexit. They should first examine whether the changes in their solvency positions and other key drivers of risk appetite have changed enough to warrant a review of the overall level of market risk being taken. In addition to changes in the balance sheet position, return expectations for many asset classes have shifted (for example, cash and fixed income returns). This may indicate the need for a review of overall risk exposure as well as how risk is being allocated within the overall portfolio.

With the increased risk and uncertainty, insurers should also consider protecting their investments against a worsening situation through downside risk management. A robust governance framework and efficient monitoring will help insurers react dynamically to emerging opportunities and risks. Insurers may also want to consider whether they have sufficient liquidity in stressed scenarios. Conversely, depending on their situations, some insurers may be in a position to gain from a liquidity premium by investing in more illiquid assets.

MERGERS AND ACQUISITIONS

Brexit could also impact cross-border mergers and acquisitions. Insurance M&A activity around the world has been particularly high in the last few years. Asian insurers have shown significant interest in buying companies in Europe and North America. How that interest evolves as a result of Brexit depends on the buyer. For example, Chinese insurers may approach investing in the UK and Europe more tentatively, as assets are now harder to value. However, Japanese insurers that need to diversify and take advantage of higher growth and investment returns overseas because of low-growth domestic economy are likely to remain interested, especially with a stronger yen. Some multinational insurers that have already considered or planned to acquire UK firms may also take advantage of the weak pound if Brexit hasn't changed their strategic rationale.

Insurance companies should be making full use of the many internal and external resources available. Mercer is a leading consultant in advising insurers on managing their people and investment issues. Our experts are ready to advise you on any of the issues outlined in this note.

For more information on how Mercer can help you navigate the complex issues and implications of the Brexit vote for the global insurance industry, please contact:

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