

Brexit: Is there a silver lining? Reconstructing probable models with special reference on the impact of UK insurance industry and EU Immigration

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Abstract

The United Kingdom's (UK) Brexit referendum was one of the most important events in the history of European Union, and in the history of UK's relationship with the rest of Europe. For the first time in a generation there is a serious prospect of a member state leaving the European Union (EU). In Britain the Conservative government, led by the Prime Minister David Cameron, was committed to holding an in-out referendum by the end of 2017. But due to various geopolitical developments the referendum was eventually held on 23rd June.

If the UK leaves EU the impact would depend on the new relationship between UK and EU. We consider five models. The Norwegian-style European Economic Area agreement, Turkish Style customs union, Free Trade Agreement based approach, Swiss style bilateral accord and Australia type Most Favoured Nations based approach.

A great deal has now been written on the economic consequences for the UK of Brexit. Some of this is impartial; much of it is partisan. Very little has been written on the consequences for the rest of the EU.

This paper seeks to address this gap by systematically assessing the evidence on the impact of Brexit on both the UK and the rest of Europe.

At the heart of this analysis are various channels of impact. This is a very important question for the insurance industry at the moment as there is currently a lot of debate over the future of the UK's place within the EU. If the UK exits the EU as decided by the referendum, insurers will have to weigh up the benefits against the disadvantages and make a decision on where their business would see the most value. Where they decide to base themselves in future could have significant impact on the performance and operation of their business.

The aim of this paper is to determine how the UK's decision to remain in or leave the EU will affect insurers' decisions on where to base their operations in future and the impact of immigration on the UK, by evaluating the following:

- The relationship between the EU, the UK and insurers; and the impact of that relationship on insurers globally.
- The opinions expressed in the media regarding the UK leaving or remaining in the EU and how this impacts insurers.
- The views of key industry informants to corroborate the media's reporting.
- Various statistical models by analysis of data from ONS UK, Labour Force Survey.

This paper has been prepared based on our interpretation of the politics of Brexit and our analysis of the best available economic evidence. The uncertainty of the UK business, the strategic dynamism and political contagion are the three most important factors that will mould EU in future.

Keywords: EU, Brexit, Passporting, FTA, EEA, CUS, Bilateral Accords, Immigration, Referendum, Solvency II, Lloyds, Schengen Agreement

1. Introduction

1.1 The history of the European Union

The EU is currently a group of 28 countries, located in Europe, set up with the intention of promoting a more peaceful continent following the devastation of World War II. The formation of the European Coal and Steel Community started to unite countries politically and economically, but the most significant step came in 1957 when Belgium, France, Italy, Luxembourg, the Netherlands and West Germany founded the European Economic Community, by signing the Treaty of Rome. The United Kingdom, perhaps due to not having been occupied and not suffering defeat or occupation in World War II that other countries had, did not join as it felt that their relationships with the North Atlantic Treaty Organisation, a political and military alliance, and the USA were sufficient. During the 1960's there was a period of economic growth for

the EU, particularly attributable to the fact (Fig 1) that EU member countries removed customs duties when trading with each other. There was also agreement on the joint control of food production through the 'common agricultural policy'.

The 1990's also saw the further expansion of the EU with the joining of Austria, Finland and Sweden in 1995, bringing the number of members to 15 and covering most of Western Europe. In 1995 the *Schengen Agreement* came into force in Belgium, France, Germany, Luxembourg, the Netherlands, Portugal and Spain (*not the UK*), removing passport control at borders and allowing free movement of travellers between these countries. In 1997 the Treaty of Amsterdam was signed, building on the Maastricht Treaty, allowing for reform of the EU institutions and more focus on employment and citizens' rights. The final success of the decade was the introduction of the Euro currency¹² in 1999 by 11 of the EU countries. Greece

joined the Euro in 2001; however Denmark, Sweden and the *United Kingdom decided not to join* and to continue maintaining their own currencies.

1.2 The effect on UK insurance market

British voters voted for Leave by a margin of 52 percent to 48 percent. As the results were reported on Thursday evening, markets started to panic. The British pound fell from \$1.50 earlier in the day to \$1.35 in the early hours of Friday morning. That 10 percent drop brought the pound to its lowest value against the dollar since the 1980s.

Despite the chief executive of Lloyd's of London stating that the UK exiting the EU would be "bad for business", there is concern growing that the referendum itself is causing issues for the insurance industry. Reputed accountancy firm EY have suggested that the UK's prime position in Europe for inward investment is at risk by the referendum.

Despite recording 887 foreign direct investment projects (FDI) last year, an 11% increase on 2013, almost one in three investors surveyed in the EY's UK Attractiveness Report believe that they will either slash or put on hold planned investments until the referendum result is known.

Steve Varley, EY chairman and managing partner in UK & Ireland, said "Global investors have a strong perception of the UK as an attractive place to do business. The relatively positive economic news from the UK, compared with other European countries, the Government's efforts to foster FDI, and the UK's dynamic labour market are likely contributors. The message that Britain is 'open for business' is getting across loud and clear to many existing and potential investors worldwide, but new strategies need to be developed to stay ahead in such a competitive market."

However the report stated that "The uncertainty caused by a UK EU Referendum will be disruptive and is a risk to the UK's FDI performance." And this is affecting the insurance industry. In addition to the investment issue, UK insurers are also under threat from mainland European rivals as they play on fears of a UK exit from the EU. According to the ratings agency AM Best, UK based insurers who underwrite a large amount of EU based business need to consider the issues now of a so called 'brexit'.

One further complication of the referendum on the insurance market is the affect it could have on insurance regulation.

According to Paul Clarke, PwC global insurance regulatory leader "Potentially the biggest impact on the insurance industry will be on regulation. The EU drives the regulatory environment, Solvency II being a classic example. Not being part of the EU would hand more discretion to domestic authorities over rule design. From a practical point of view, it is likely the UK would choose to pursue a Solvency II equivalent approach. Ironically, the risk would be a UK outside of the EU, unable to influence from within, yet still compelled to follow EU regulation to remain competitive." This is making the industry nervous in the UK and has the potential to damage its influence and input in regulatory decisions.

It is important to note that PWC, EY and AM Best are clear that EU reform is needed. It's also fair to say that the impact on the insurance industry should the UK decide to exit will be huge. However in the short term, the industry is being affected by the uncertainty surrounding the future. Although to what

extent is still uncertain, there will nevertheless be an impact.

A) Regulation

The Insurance Companies Act 1982 dealt with the regulation of insurers and was largely based on EU Directives. It has now been superseded by the Financial Services and Markets Act which is "An Act to make provision about the regulation of financial services and markets; to provide for the transfer of certain statutory functions relating to building societies, friendly societies, industrial and provident societies and certain other mutual societies; and for connected purposes". This act has many EU Directives and regulations affecting its content, for example The Insurance Accounts Directive and The European Communities (Lawyer's Practice) Regulations.

The *Solvency II* legislative programme is a new insurance regulatory regime that will apply to all 28 EU member states, coming into force from January 2016. Solvency II's key objectives are follows:

- i. "Improved consumer protection: It will ensure a uniform and enhanced level of policyholder protection across the EU. A more robust system will give policyholders greater confidence in the products of insurers.
- ii. Modernised supervision: The "Supervisory Review Process" will shift supervisors' focus from compliance monitoring and capital to evaluating insurers' risk profiles and the quality of their risk management and governance systems.
- iii. Deepened EU market integration: Through the harmonisation of supervisory regimes.
- iv. Increased international competitiveness of EU insurers

B) Insurance

Many of the issues explored above in relation to Passporting apply equally to the insurance sector, and UK firms currently relying on the Passporting regime may – if that system is not continued – have to rely instead on authorisation as a third country branch under Solvency II. A key question for the insurance sector will be whether the UK is granted provisional or formal equivalence under Solvency II. If it does not (which does not seem likely), then UK-headquartered European-wide groups may be subject to group supervision both under the UK regime and under Solvency II. Similarly, European-based groups with UK subsidiaries and European entities which transact reinsurance business with UK-based firms may worry that they will have to apply more onerous rules for capital purposes under Solvency II if the UK is not regarded as "equivalent". This will be less of a concern if the post-Brexit UK regime closely resembles Solvency II in its design.

The European Insurance and Occupational Pensions Authority (EIOPA) was set up following reforms required for the supervision and structure of the financial sector of the EU.

C) London as an insurance centre

A further issue that will affect business insurance and reinsurance going to other cities is the likely continuance of London as a global insurance centre. The UK is the world's third largest exporter of financial services and insurance products.

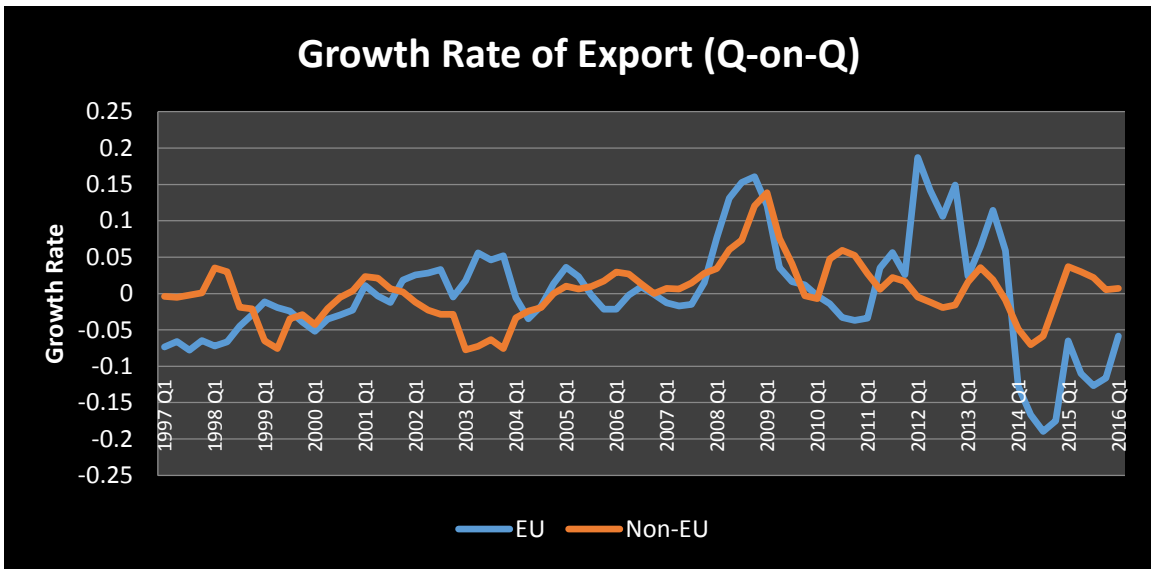


Fig 1: showing growth rate of exports for EU and Non EU countries.

The possible loss of insurance markets to other cities proved a divisive topic among our experts who held widely varying opinions. Andy Moore of PwC was one of several experts to question the future of London as a financial services centre outside of Europe “I think the future of the City of London does become questionable. It could well lose critical mass if we end up with another EU financial hub.” Most of the experts interviewed believed that such a loss of critical mass could see organizations moving people and/or companies out of the UK. The official word from Lloyd’s of London is that “in the event

of a vote to leave, we would work with the UK Government and EU Institutions during any negotiations to retain market access for Lloyd’s and the London Market and create as much regulatory certainty as possible.” Lloyd’s are clearly prepared to defend their patch, and Sean McGovern recently said “depending on the circumstances, Lloyd’s will need to take steps to secure the necessary access to EU member states and through our contingency planning work we have been undertaking the necessary research and planning to enable that to happen.

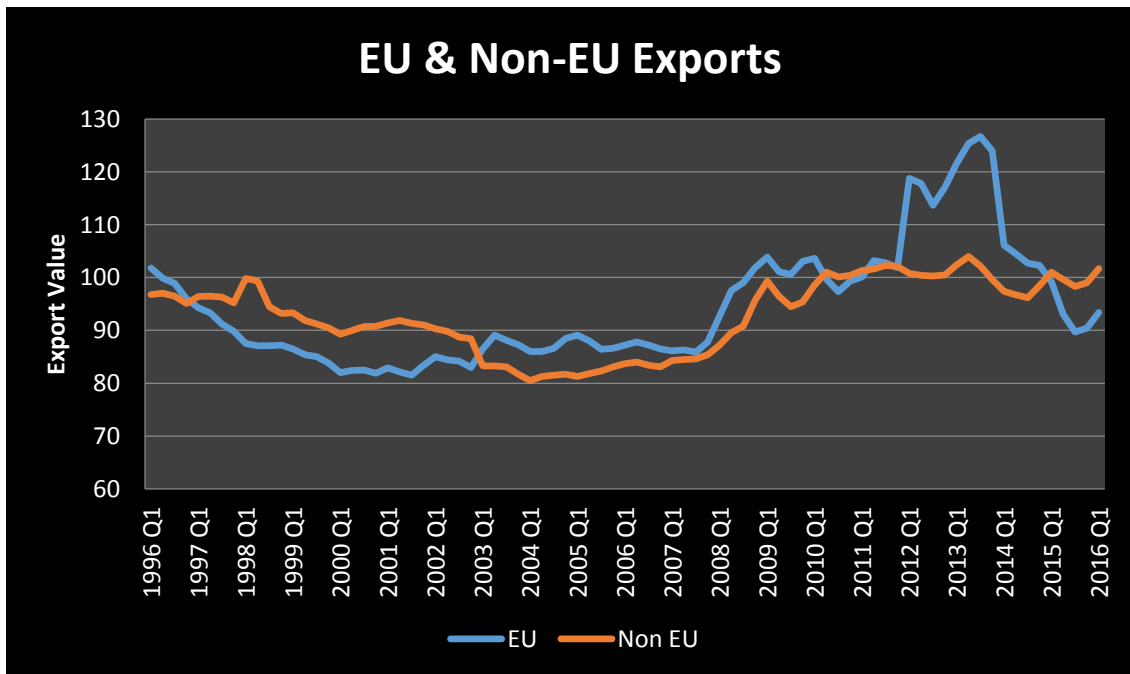


Fig 2: Showing EU and Non EU exports

Insurance Premium Tax (IPT): Mike Stalley of Fiscal Reps told us “Insurance Premium Tax rates are increasing globally.” Ian Smith also commented that the UK IPT rate has been low compared to the rest of the EU for some time, and while we remain within the EU we will feel pressure to trend upwards

towards the EU average. Outside the EU there may be less pressure to join the level playing field, and this could provide benefits for UK insurers that would be passed on to clients In conclusion, the loss of free trade access to the EU Is a worrying concept, let alone the wider implications of no longer

being part of the EU’s global FTAs. Whether it is a disaster or an economic inconvenience, divides opinion, but what is certain is that consumer costs will rise if free trade access is lost.

D) Claims

It is worth noting that none of our experts could find many significant impacts from Brexit on existing insurance claims, or on future claims from existing insurances. Andy Moore of PwC, (who have a claims consultancy practice), noted that there could be some individual impacts on long-running complex claims disputes with an international dimension, although he did point out that “one would hope that in most policies there would be a definition of where legal disputes would fall and be managed from.” Otherwise, it was the

conclusion of our experts that business insurance buyers can continue to have confidence in their ability to claim on existing and future policies, whether or not the UK votes for Brexit. In conclusion, as Clyde & Co told us, those who buy insurances with an international dimension need to plan for a more complex insurance-buying world post-Brexit, but whilst Brexit would be a complicating factor, insurance provision will continue to be available without significant interruption from experienced global insurers like QBE. For clients, yes “it does become... more messy for QBE’s clients because if they have UK businesses they will need a UK insurance company, if they have EU insurance businesses then they will need an EU insurer, and that applies to both commercial and retail. It is just another layer of problems.”

1.3 Probable matrix of the Brexit model

Table 1: Various models after Brexit

BREXIT MODEL		EU Member	EEA	FTA	MFN	CUS
Free movement of goods people and services		Yes	Yes	Yes*	No	Yes
Free to negotiate trade deals and set tariff levels with non EU countries		No	Yes	Yes	Yes	Yes
EU Laws	Influence	Yes	--	No	No	No
	Compliance	Yes	Yes	Yes*	No	Yes
Agri-policy		Yes	No	No	No	No
Freedom to impose immigration control		No	No	Yes	Yes	Yes

*Conditions Apply

i) EEA Agreement Model

The UK joins the European Economic Area (Norway, Iceland, Lichenstein) and maintains full access to the single market, but must conform to the standards of EU with very little influence over these. The UK still makes a substantial contribution to the EU budget and is unable to impose immigration restrictions.

Opinion: The very reason of the Brexit is not addressed with EU. Not likely

ii) FTA based approach Model

The UK is free to agree FTA’s (Free Trade Agreement) independently and the UK relationship with the EU is itself governed by FTA (Switzerland). Tariff barriers are unlikely, but as with all FTA’s the UK will need to trade off depth, which means agreeing common standards and regulation with independence.

Opinion: Likely model with some modifications

iii) MFN based model

Most Favoured Nations approach (Australia) where no need to agree common standards and regulation, but at the expense of facing the EUs common external tariff, which damages the UK trade with the EU in goods and services. Non-tariff barriers may emerge over time but it would be too late.

Opinion: Not likely as it is inconsistent with the UK’s liberal approach to trade.

iv) CUS Model

Customs Union Style Model (Turkey) where the major advantage is that the internal tariff barriers are avoided but total coverage is incomplete. The UK is required to implement EU external tariffs, without influence or guaranteed access to third markets.

Opinion: Not likely, it would be a bad compromise on the UK part.

v) Most likely model

Free movements of capital, labour, goods and services will be hampered and restricted severely after Brexit. It should work out a model *with bilateral accords and specific permission* on the following areas:

- Increased number of exporters/importers: Indigenous SMEs may be classed as importers/exporters and would be subject to European regulation. These SMEs are probably least equipped to deal with potential new resources, systems and procedures required
- Customs formalities: Trade with the UK and movement of people may face a border control with associated transactional costs (brokerage and bank guarantees) and time delays.
- Administrative and Regulatory burden: Specific paper work may be required similar to Turkey
- Revenue audits for non-established importers/exporters: All businesses or individuals whose trading activities include imports and /exports from or to a non-EC country may be subject to customs audit.
- Export: Export licensing and excise controls.

1.4 Shift of power and what it means for USA

British exit from the European Union could be disruptive for Britain and for the EU more generally. Even skeptics don’t expect a British exit to trigger a global recession, but turmoil in one of our most important trading partners can’t be good for the US economy.

But the more important issue from an American perspective is about geopolitics more than economics. Ever since World War II, the United States has been deeply invested in safeguarding

long-term peace and prosperity in Europe. We still have thousands of troops stationed in Germany to help maintain the status quo there, and we've worked to build a system of alliances that helps to minimize the possibility of conflict.

A British decision to leave the EU isn't going to pose an immediate threat to this political order. But it could signal growing dissatisfaction with the status quo among European voters. That could have unpredictable results.

1.5 Impact over 6 channels

S. No.	Factors	Impact on UK	Impact on EU
1.	Trade	Regulatory divergence grows over time increasing the cost of trade, impacting on volumes and the UK place in supply chains	EU trade matters more for the UK than the UK trade for the EU, but some states with big bilateral surpluses feel a macro chill from Brexit
2.	FDI	The UK is less attractive as a gateway to Europe, as a base for corporate HQs and as a location for investment from Europe	Businesses find it costly to relocate investment from the UK and there is a risk the UK attempts to undercut the EU on standards to attract FDI
3.	Liberalization and Regulation	The UK loses influence over EU regulation without gaining much freedom to regulate independently	The balance in the European Council shifts away from liberalisation and it becomes harder to form a blocking minority against illiberal measures.
4.	Immigration	Immigration is tightened, damaging competitiveness, particularly of London but how much depends on the terms of negotiation on the Brexit model.	Some countries are affected by the impact on the remittances or diverted migration, with the extent of political contagion a big unknown
5.	Financial Services	The UK retains a strong competitive edge, but most likely loses business as it becomes harder to provide certain services to EU markets.	One or two financial centres may benefit, but businesses and households suffer from the loss of liquidity and increased cost of financial services
6.	Budget	The UK gains financially over industrial policy, but much depends on the model and variation in the net impact across the UK regions complicates the Brexit policies	The EU loses a budget disciplinarian and a major net contributor, with the gap needing to be fulfilled by higher contributions or less spending. There could be weakening of competition policy.

1.6 Immigration and Brexit: trying to make sense of it?

The refugee crisis has nothing to do with EU membership. Refugees admitted to Germany have no right to live in the UK.

The UK is not in the *Schengen passport-free travel agreement* so there are border checks on migrants.

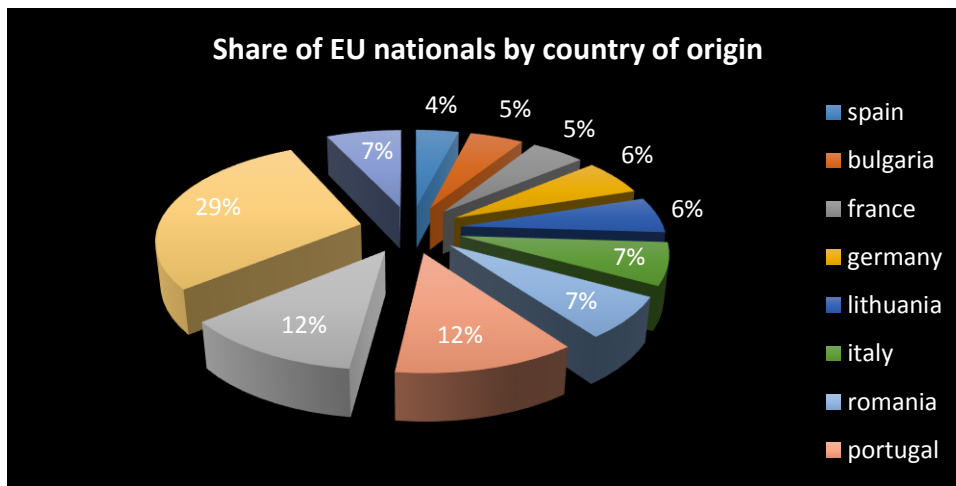


Fig 3: Graph showing the share of EU nationals by country of origin Data source: Labour Force Survey UK and ONS

Fig 5 plots the unemployment, employment and wage trends for individuals *born in the UK* alongside the trend in immigration from the EU. In Figure 4, at a time when EU

immigration has been rising sharply (after 2004), UK unemployment *for those born in the UK*

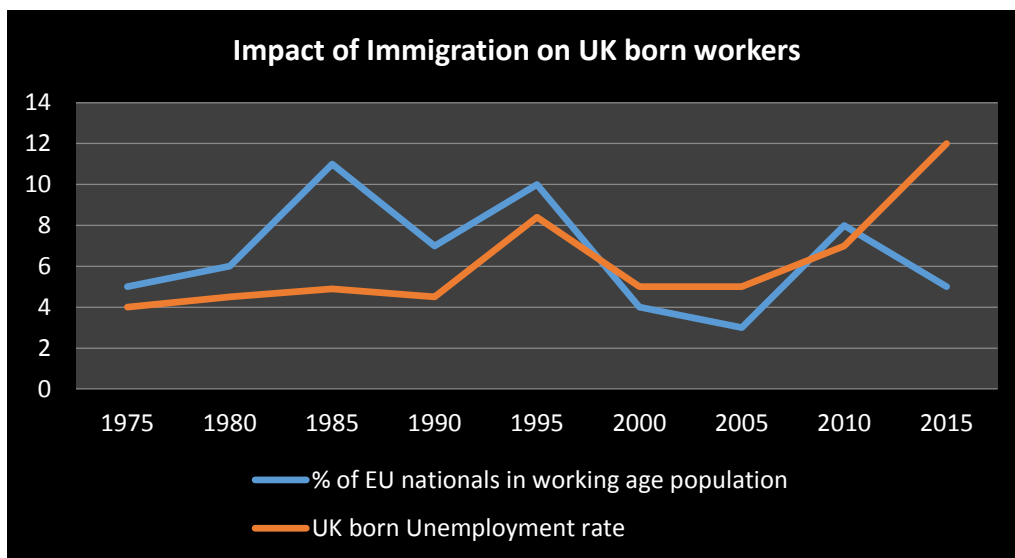
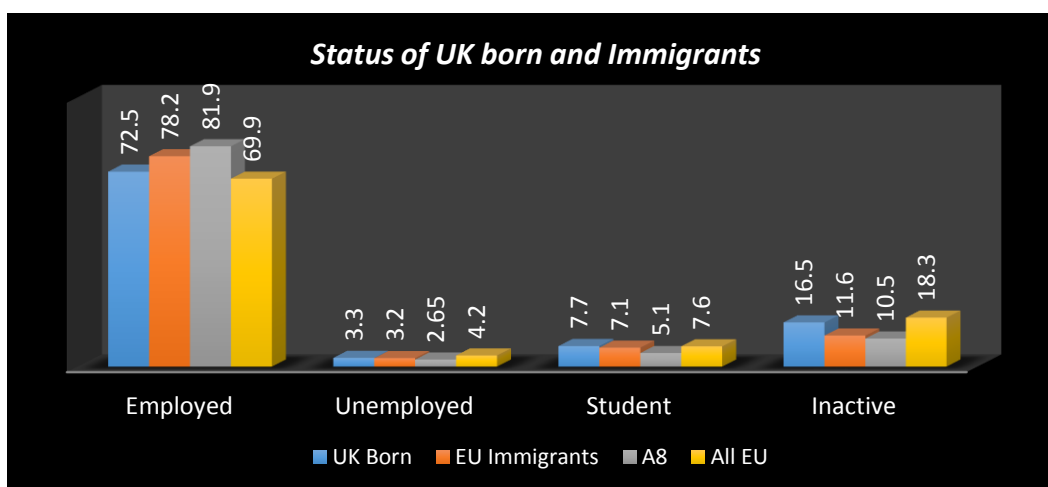


Fig 4: Unemployment of UK-born and EU immigration, 1975-2015

rose – but then fell back to a very low level, while EU immigration kept on rising. Indeed, despite the global crash, the rise in unemployment for UK-born workers was much less

than in previous downturns when EU immigration was much lower.



A8: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia. Data source: Labour Force Survey UK

Fig 5: The status of UK born and Immigrants with respect to Employment, Unemployment, Student and Inactive

Immigration has grown a lot in the last 20 years and a significant fraction of this growth has been from other EU countries, especially after 2004 and the accession of eight East European countries (the 'A8'). Between 1995 and 2015, the number of immigrants from other EU countries living in the UK tripled from 0.9 million to 3.3 million. The share of EU nationals grew from 1.5% to 5.3% of the total population and from 1.8% to 6.3% of the working age population (adults aged 16-64). Higher immigration has increased overall national income (more workers will generate more GDP) and has benefited the immigrants who have come to the UK since, by and large, they are better off than in their country of origin. But has it been economically harmful to people born in the UK. About 70% of EU immigrants say they come to the UK because

of work-related reasons, as opposed to study or joining their families (ONS, 2016). Since immigration increases the total number of people in work or looking for employment, does that mean that UK workers *must* have been harmed by this increased competition for jobs? The answer is 'no'. Believing otherwise is called the '*lump of labour fallacy*'. There would be harm only if the total number of jobs is *fixed* and only where immigrants *compete for a particular job*. But since immigrants also *consume local services and goods*, this increases demand and so raises job prospects of those who produce those goods and services. Adding an immigrant raises the population, just like a rise in the birth rate or a fall in the death rate. Over the last 100 years, the UK population has grown by around 50% but the unemployment rate has not trended inexorably upward.

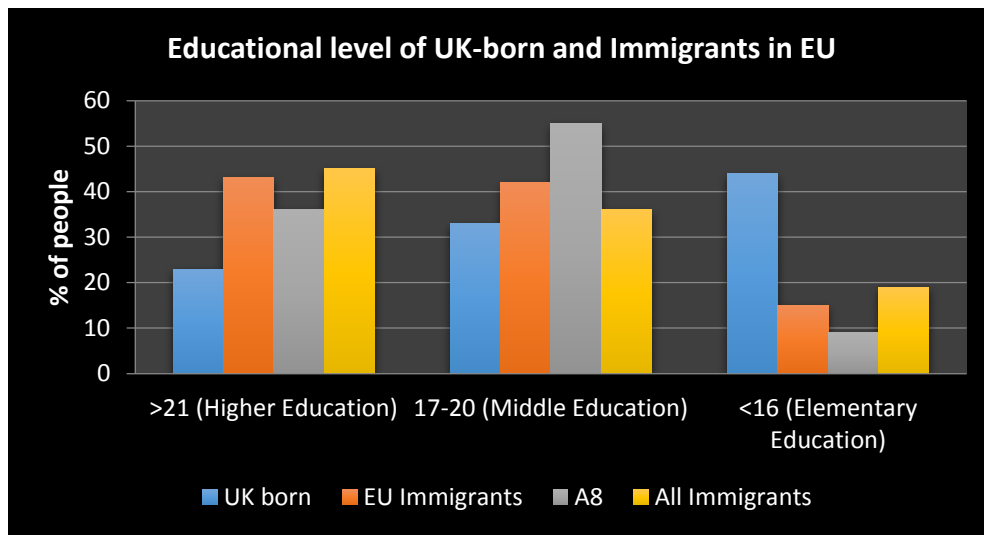


Fig 6: Showing educational levels of UK born and Immigrants higher, middle and elementary

The table above illustrates that EU immigrants are on an average more educated than UK born. Almost twice of them have some form of higher education (43% compared with 23% UK born) Only 15 % of the EU immigrants left school at 16 compared with 44% of the UK born. In the referendum debate about the UK’s membership of the European Union (EU), a

major argument of the Leave campaign is that Brexit would allow more control over the flow of immigrants to the UK from the rest of the EU. Many people are concerned that high levels of immigration may have hurt their jobs, wages and quality of life.

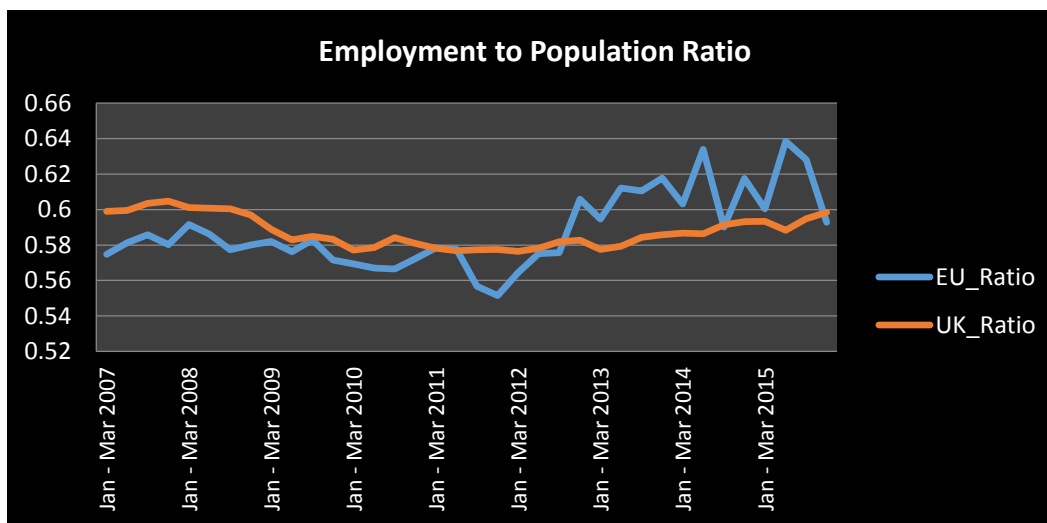


Fig 7: Showing the ratio of employment to population of EU

But even if there is no reason to think that immigration should increase unemployment, is it not obvious that an increase in the supply of workers must drive wages down? Again, it isn’t necessarily so. Alongside the increased demand that a rising population brings, greater *movement of labour allows countries to specialise in what they are best at*, just like increased trade. Firms will change the mix of their products to account for the new skills available to them. Immigrants, especially if they are more skilled, can boost productivity. All these effects will tend to *increase* wages.

Consequently, the impact of immigration on UK-born workers is an empirical question and not a foregone conclusion.

Conclusion

Pro-Brexiteers believe leaving the EU would benefit Britain because the country would be free to chart its own course,

unencumbered by EU law, and could strike new trading deals with quickly growing countries outside the EU, such as India and China.

There’s a perception among some in the "leave" campaign that immigrants to the country are taking jobs away from Britons. Additionally, they say, reducing immigration would relieve the pressure on public services and lessen competition for low-wage jobs. This is not actually the fact as corroborated by statistics.

Some small businesses in Britain say they are burdened by too much red tape and regulation from the EU. If Britain leaves, those businesses would be free from what they say is the over-regulation from Brussels bureaucrats.

The “remain” camp says London could lose its prominence as the center of European finance if Britain leaves the EU. Maintaining that dominance gives Britain a significant source

of revenue, so a vote to stay in the EU will secure those financial benefits for Britain.

What is clear however is that insurers would prefer the UK to remain in the EU in order to take advantage of the benefits, this offers and the stability of not having to consider or make any changes. Not having to make the decision of moving in the first place is definitely preferable. In the researcher's opinion though, having considered all the implications during this study, insurers are likely to choose to remain in the UK for the immediate future following a decision by the UK to leave the EU. It would be premature for insurers to relocate prior to this decision and would be far more prudent to remain in the UK until the actual implications are evaluated and they can determine what benefits they may receive as part of their decision to stay. The UK may offer incentives in order to entice insurers to remain based in the UK, which could be a more advantageous option than moving operations to another country.

From this review we can conclude that there are five major considerations that insurers will look at in order to make their location decision: *regulation, workforce and jobs, trade borders, currency and, lastly, stability*. It is the combination of these and how they weigh up for each individual insurer that will inform the decision for the insurer. Each insurer will have different requirements which will lead to an individual decision for each of them. Ultimately, it may be that whilst some companies decide to leave the UK, others may decide to relocate to the UK, thus balancing the market as a whole.

Consequently, the impact of immigration on UK-born workers is an empirical question and not a foregone conclusion. Overall the aftermath of the referendum is going to be a particularly uncertain time for the UK, the EU and insurers globally while the industry waits with bated breath for a decision one way or another. With this we can conclude that stability is currently the top priority for insurers with regard to how the UK's decision to remain in or leave the EU will affect them deciding where to base their operations.

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