Issues of Legal Uncertainty Arising in the Context of the Establishment of an E.U. Insurer in another Member State

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Financial Markets Law Committee

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TABLE OF CONTENTS

1. EXECUTIVE SUMMARY AND INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. In November 2016, the Committee established a Working Group to consider the distinction between becoming established in an E.U. Member State, by means of some form of presence in that State, and merely selling insurance into a Member State. The Working Group produced a paper considering this and related issues of legal uncertainty. That paper was not reviewed or adopted by the Committee and was published instead by the British Insurance Law Association (the "**BILA paper**").[2]

1.3. This FMLC paper was developed out of themes examined in the BILA paper. As the U.K. and E.U. continue to negotiate their relationship in the context of the U.K.'s impending withdrawal from the E.U. ("**Brexit**") and as U.K. insurers with clients in the E.U. begin to plan for the possibility that no deal is struck, it has become clear that the uncertainties in respect of the establishment of an insurer in an E.U. Member State will persist. In particular, Brexit will mean that U.K. (re)insurers may lose the right to insure clients resident in many E.U. Member States. They may also be legally unable to pay claims in respect of such business, including risks underwritten prior to Brexit. One of the ways in which U.K. (re)insurers are planning to continue to access the E.U. market is by establishing a subsidiary in an E.U. Member State which might then provide services to clients across the E.U. This paper examines the related issue of when an insurer is regarded as operating an establishment in a Member State as opposed to providing cross-border services into that Member State.

1.4. This paper proceeds in the following way: section 2 lays out the E.U. regulatory requirements which govern the freedom of establishment and the freedom to provide services in the case of insurers. Section 3 examines the questions which will arise in the provision of insurance services after Brexit. The FMLC's recommendations are laid out in section 4.

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[2] British Insurance Law Association, *Report on the Establishment of an EEA Insurer in another Member State*, (23 January 2018), available at: http://www.bila.org.uk/resources/Report%20on%20the%20Establishment%20of%20an%20EEA%20Insurer%20in%20another%20Member%20State.pdf.

2. BACKGROUND: FREEDOM OF ESTABLISHMENT AND FREEDOM TO PROVIDE SERVICES

2.1. The principles of freedom of establishment and freedom to provide services are derived from Articles 49 and 56 of the Treaty on the Functioning of the European Union (the "**TFEU**"). These rights, known collectively as "passporting" rights, are exercised where a (re)insurance policy is entered into by, or on behalf of, a (re)insurer incorporated and authorised in one member state (the "**Home Member State**") for the benefit of a policyholder who is resident in, or operating for purposes of the policy in, another member state (the "**Host Member State**").[3] Passporting rights are extended to the European Economic Area ("**E.E.A.**") by virtue of the Agreement on the European Economic Area 1994 (the "**E.E.A. Agreement**").[4]

2.2. The distinction between becoming established in another Member State of the E.U. by means of some form of presence in that state, and merely selling insurance into that state (i.e., exercising the right to provide services), is a fine one, although it remains important as the notification requirements and other formalities attached to each differ. Guidance on the freedom of services and freedom of establishment is set out in the European Commission's Interpretative Communication 2000/C 43/03 "Freedom to Provide Services and the General Good in the Insurance Sector" (the "**Insurance Interpretive Communication**").[5] Parallel guidance in respect of banking services was provided by the European Commission in Interpretative Communication SEC(97) 1193 "Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive" (the "**Banking Interpretative Communication**").[6]

2.3. The Insurance Interpretative Communication states that the "provision of services" (contrasted as it is here with doing business by way of establishment), involves either no presence in the relevant E.U. Member State or, at most, a temporary presence, while an establishment constitutes a permanent presence. The guidance given by the European

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[3] The Home Member State of a (re)insurance undertaking is defined in the Solvency II Directive (defined below) as the Member State in which the head office of the undertaking covering the risk (for non-life insurance) or the commitment (for life insurance) is located. Each other Member State into which the (re)insurance undertaking may wish to provide services is the Host Member State.

[4] The E.E.A. Agreement includes Iceland, Liechtenstein and Norway in addition to the E.U. Member States. Although this paper refers consistently to access by U.K. (re)insurers to E.U. markets under E.U. law, this should be understood to include, *mutatis mutandis*, access to E.E.A. markets by virtue of the provisions of the E.E.A. Agreement.

[5] European Commission, *Freedom to provide services and the general good in the insurance sector (2000/C 43/03)*, (16 February 2000), available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32000Y0216(01)&from=EN.

[6] European Commission, *Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive (SEC(97) 1193)*, (20 June 1997), available at: ec.europa.eu/internal_market/bank/docs/sec-1997-1193/sec-1997-1193_en.pdf.

Commission is subject to interpretation, however, and the distinction between freedom to provide services and freedom of establishment still remains, in many cases, a grey area. In particular, where an intermediary is used the distinction can be difficult to draw.

2.4. The passporting rights relevant to insurers—i.e., the freedom of establishment and the freedom to provide services—have since been consolidated and reaffirmed under Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (the "**Solvency II Directive**").[7] The Solvency II Directive provides that authorisation to take up the business of direct insurance or reinsurance is to be sought from an undertaking's Home Member State. Once received, such authorisation is valid for the entire Community and covers the "right of establishment" and the "freedom to provide services".[8]

2.5. Establishment in a Member State other than the Home Member State is done by establishing a branch.[9] The conditions for branch establishment, set out in Article 145 of the Solvency II Directive, provide that any permanent presence of an undertaking in a Member State is to be treated in the same way as a branch even where that presence does not take the form of a branch, but consists merely of an office managed by staff or by a person who is independent "but has permanent authority to act for the undertaking as an agency would".

2.6. A degree of uncertainty arises owing to the partial overlap between the Solvency II Directive and the Insurance Interpretive Communication. While the Solvency II Directive is broadly consistent with the European Commission's earlier guidance, there remain some differences in the conditions for distinguishing between the two freedoms. The Insurance Interpretive Communication provides that, for the links between an independent person and an insurance undertaking to have the effect that the (re)insurer

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7 The Solvency II Directive is not directly effective in E.U. Member States but has to be implemented by local law and regulation. For example, in the U.K., it is implemented largely through the provisions of the Financial Services and Markets Act 2000 (as amended) and rules made by the Prudential Regulation Authority and the Financial Conduct Authority. However, since the ultimate source of the law is the Solvency II Directive, it is helpful to refer directly to its provisions.

8 Articles 14 and 15 of the Solvency II Directive.

9 Articles 13(12) and 145(1) of the Solvency II Directive. According to Article 13(11) of the Solvency II Directive, a "branch" means "an agency or a branch of an insurance or reinsurance undertaking which is located in the territory of a Member State other than the home Member State".

falls within the freedom of establishment rules, the independent person must meet the following three cumulative conditions:[10]

a) he must be subject to the direction and control of the (re)insurer he represents;

b) he must be able to commit the (re)insurer; and

c) he must have received a permanent brief.

The Commission takes the view that it is only if these three conditions are met that a (re)insurer is to be treated as operating an establishment in the Host Member State, and must therefore comply with the relevant notification provisions.[11]

2.7. On the other hand, the conditions for branch establishment in the Solvency II Directive, set out in Article 145(1) of the Directive and described in paragraph 2.5 above, contain no express reference to the three-part test laid down by the Insurance Interpretive Communication. Article 145(1) broadly aligns with the Insurance Interpretive Communication insofar as it contemplates the possibility of an independent person being treated in the same way as a branch. It also includes the concept of a "permanent authority to act for the undertaking", perhaps reflecting the second and third parts of the test in the Insurance Interpretive Communication. Article 145(1) does not, however, appear to include the first part of the test—namely, the need for "direction and control" by the (re)insurer. It may be that this is captured by the words "as an agency would", on the basis that an agency may operate under the direction and control of its principal, but that is not certain, and certainly agency arrangements exist where the agent is relatively free of the direction and control of its principal.

2.8. It is unclear whether the Insurance Interpretive Communication, written in 2000, was intended to be overridden by the Solvency II Directive, which came into effect in 2009. It is possible that the branch establishment conditions in Article 145(1) were intended to reflect only as much of the Insurance Interpretive Communication as the E.U. wished to incorporate into the law in 2009. While the Insurance Interpretive Communication represents the views of the European Commission, and is to some extent based on prior case law, it is not binding. It has been broadly accepted by market participants in the

[10] These conditions are based on the European Commission's interpretation of the case law until that point. The meaning of each condition is elaborated in the text of the communication.

[11] It should be noted that the Insurance Interpretive Communication makes it clear that the independent person would not constitute a branch of the re(insurer) in the sense of being a legally dependent part of the insurance undertaking. It is therefore possible for a (re)insurer to be regarded as having a regulatory establishment in the Host Member State without having a branch of its company there.

U.K. and across much of the E.U. as effectively setting out the position on distinguishing the freedom to provide services as against the right of establishment. Regulators in E.U. Member States have adopted varying perspectives on it, however, as explained below, and none has wholeheartedly embraced it.[12]

3. BREXIT: IMPACT ON CROSS-BORDER INSURANCE PROVISION

3.1. The U.K.'s withdrawal from the E.U. will prevent U.K. (re)insurers and (re)insurance intermediaries from carrying on (re)insurance activities on an E.U.-wide scale on the basis of passporting rights. The precise terms on which U.K. (re)insurers will be able to access the E.U. market will depend on the outcome of negotiations between the U.K. and the E.U., on any requirements for reciprocity that may be agreed in that context or, failing this, on choices made by the U.K. government.[13] Accordingly, ahead of Brexit and immediately after withdrawal, one of the most significant features of the landscape is likely to be operational, practical, legal and regulatory uncertainty.

3.2. In the longer term, market participants in the U.K. face restrictions and limitations on doing business in the E.U. coupled with uncertainty as to both: (i) the availability and scope of authorisation in E.U. Member States; and (ii) the possibilities for conducting business in the E.U.—including legacy business—without authorisation. Further, it is not always clear whether the level of a firm's engagement with its clients amounts to "providing services" such that it needs to comply with notification requirements under the provision of services rules. For instance, it may be doubted whether the insurance of a policyholder in a Member State necessarily gives rise to the inference that the insurer in question is carrying on insurance business in that Member State. One factor which inevitably contributes to this ambiguity is the nature of financial services and activities themselves: they are often carried on remotely, on a cross-border basis and by

[12] There is no one common definitive test across the jurisdictions, in determining whether an insurer is deemed to be "established". Some jurisdictions have adopted positions that appear to differ from the Insurance Interpretative Communication, in that the "direction and control" criterion has not been specifically adopted.

[13] While commenting on policy is outside the FMLC's remit, the Committee has previously considered legal uncertainties in relation to the possible E.U.-U.K. relationship in the event it proceeds on the basis of equivalence provisions (see: FMLC, *Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the U.K. from the E.U.—the Provision and Application of Third Country Regimes in E.U. Legislation* (13 July 2017), available at http://fmlc.org/report-u-k-withdrawal-from-the-e-u-13-july-2017/.) and on the basis of World Trade Organization rules (see: FMLC, *Issues of Legal Uncertainty Arising in the Context of the U.K.'s Withdrawal from the E.U.—the Application and Impact of World Trade Organization Rules on Financial Services*, (22 December 2017), available at: http://fmlc.org/report-u-k-withdrawal-from-the-e-u-22-december-2017/).

means of electronic media, which means that identifying a *locus* for the provision of the service is challenging.[14]

3.3. In the event, however, that the U.K. and E.U. are unable to agree a new treaty setting out the conditions for the provision of services across the U.K.-E.U. border, U.K. insurers which conduct substantial levels of business in the E.U. have considered the establishment of a subsidiary in one E.U. Member State and the subsequent use of passporting as a possible way forward. The establishment of a subsidiary in the E.U. is already likely to entail significant cost for a U.K. (re)insurer. Additionally, there remain uncertainties about the requirements and timescale for gaining authorisation to establish the subsidiary.

3.4. A great degree of the uncertainty which relates to U.K. (re)insurers' future access to the E.U. concerns the Insurance Interpretive Communication. It is unclear to what extent the Insurance Interpretive Communication will be treated by Member States as representing the law, and to what extent (re)insurers can rely on it. For example, it appears that Germany and The Netherlands have not incorporated the "direction and control" test into their law, and regulators in other Member States have either not acknowledged the Insurance Interpretive Communication (Poland) or have acknowledged it but emphasised its non-binding effect (the U.K.). This demonstrates the range of views in different Member States about whether the Insurance Interpretive Communication may be relied on.

3.5. If the Insurance Interpretive Communication can be relied on as representing the law, the following uncertainties exist within it:

a) the amount of control that is necessary in order for an independent person to be treated as subject to the "direction and control" of the (re)insurer,[15] and whether there are any situations (such as where the companies are parent and subsidiary) where direction and control will be presumed or deemed;

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[14] The Insurance Interpretive Communication itself acknowledges that it may require revision in light of technological developments. See p. 2 of the Insurance Interpretive Communication (link, *supra*, at footnote n. 5).

[15] The relevant factor here will be whether, in the light of the links between the (re)insurer and the independent person, the latter has sufficient freedom to organise his activities, to decide how much time he will devote to the (re)insurer and, in particular, to represent competitors at the same time. For instance, a brief received by an independent person from a single (re)insurer requiring the independent person to act exclusively for the (re)insurer is an indication that the independent person is subject to the direction and control of that (re)insurer. The Insurance Interpretive Communication makes it clear that if the intermediary receives an exclusive brief from one insurer, that insurer may have a branch through that relationship even though the intermediary also works for other insurers.

b) what is meant by the independent person being able to "commit" the (re)insurer—in particular, whether actions that might have the practical effect of binding the (re)insurer would amount to a power to commit the (re)insurer; and

c) what is meant by the brief given to an independent person being "long-term" or "permanent"—in particular, where it is for a fixed period and capable of extension.

3.6. There also appears to be an inconsistency within the Solvency II Directive itself regarding when an E.U. (re)insurer will be regarded as having a branch in a Member State and when a non-E.U. (re)insurer will be regarded as having a branch in a Member State. It is useful to compare the concept of "branch" which applies for purposes of passporting, described in paragraph 2.5 above, with the definition of "branch" in Article 162 when determining whether an E.U. branch of a non-E.U. (re)insurer requires an authorisation. Article 162 states:

> "branch" means a permanent presence in the territory of a Member State of an undertaking [with a head office outside the E.E.A. which is accessing direct life and non-life insurance business in the E.E.A.], which receives authorisation in that Member State and which pursues insurance business.

Interestingly, there is no reference to "agency" or an independent person in this definition. On the other hand, there is a requirement that the branch "pursues insurance business", which is a phrase not included in the definition that applies for purposes of passporting. It is unclear whether this distinction is intended to make a difference, and therefore how far it may be relied upon in practice when the concept of a non-E.U. branch becomes relevant for the U.K. post-Brexit.

3.7. It remains equally unclear whether pure reinsurers would be treated as subject to a different standard than direct insurers in relation to carrying on business in other E.U. Member States, given the absence of a notification procedure for exercising passporting rights.

4. RECOMMENDATIONS

4.1. As described above, the complexities in determining whether (re)insurers need to follow notification requirements for the freedom of services or establishment will have substantial practical impact in the context of Brexit.

4.2. The FMLC considers that it might be helpful to receive firm guidance in respect of the continued relevance of the Insurance Interpretive Communication in light of the Solvency II Directive. The FMLC notes that the Banking Interpretive Communication (mentioned in paragraph 2.2 above), which addressed, *inter alia*, the question of when a Member State was entitled to prevent a firm from exercising the freedom to provide services from another Member State, was welcomed by the market. The analysis necessarily involved an assessment of when a credit institution would be considered to be providing services "within the territory of another Member State". The Commission's preferred approach relied on a concept of "characteristic performance", which led to the interesting observation that the provision of banking services through the internet "should not, in the Commission's view, require prior notification" to the host Member State.[16]

4.3. Although this analysis is dated by two decades and there remain questions about whether it would be applicable in the context of Brexit, the Banking Interpretive Communication at least provides a degree of predictability in determining what access rights are required. Similar guidance from the European Commission would greatly reduce the uncertainties faced by (re)insurers.

5. CONCLUSION

5.1. There has always been a degree of legal complexity involved in distinguishing between the provision of insurance services on a cross-border basis and the operation of an establishment in another Member State. Indeed, this complexity applies equally to other financial services. The distinction has increased significance, however, as the U.K. prepares to leave the E.U. and U.K. insurance undertakings prepare for the loss of their passporting rights, including by taking steps to establish a subsidiary in another Member State. This paper has identified particular areas of uncertainty in relation to branch establishment, especially relating to the use of intermediaries, and explored the applicability of the Insurance Interpretive Communication. Further clarity on this topic will assist both U.K. and other E.U. undertakings to ensure continued compliance with the regulatory framework post-Brexit.

[16] The Banking Interpretive Communication, at p. 7 (link, *supra*, at footnote n. 6).

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