ALLEN & OVERY

Impact of Brexit on Luxembourg life insurance companies – investments made by unit-linked life insurance products in UK external funds and in UK issuers may be subject to lower investment limits and/or changes in investment policies

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Whilst all our attention and energy are focused on Covid-19, other important developments continue that require attention.

On 8 April 2020 the Luxembourg *Commissariat aux Assurances* (the **CAA**) published a new information note (the **Information Note**) highlighting the impact of Brexit on the Luxembourg insurance sector[1], this time on the application of CAA circular letter 15/3 on investment rules for life insurance products linked to investments funds (the **Circular 15/3**).

As from 1 January 2021, investments into external funds domiciled in the UK or its dependent territories as well as financial instruments issued by issuers located in the UK or its dependent territories will need to take into account the rules applicable to the new classification of these countries pursuant to Circular 15/3. In particular, certain types of funds may be subject to lowered investment thresholds, while others may be required to adapt their investment policies.

The Information Note provides guidance on the impact of Brexit on investments of unit-linked life insurance products in external funds as well as internal collective, dedicated or specialized funds.

[1] For a summary of the information note of the CAA relating to the impact of Brexit on the deposit of matching assets by Luxembourg insurance companies with credit institutions and/or branches established in the United Kingdom, read our last e-alert here

1. External funds

As from 1 January 2021, investments into UK external funds are to be treated as investments in external funds from an OECD zone A country outside EEA within the meaning of Circular 15/3. Their use will therefore be limited to 25% for UCITS or open-ended alternative funds of funds, and to 0% for all other types of funds. The rule set out in Circular 15/3 of using up to the limit provided for by the local legislation of the policyholder can only be invoked (even for a UK policyholder) in limited circumstances (the CAA mentions open ended real estate funds), because for a number of other types of funds, the application of this rule is limited to funds domiciled in an EEA country.

The table below provides a comparison of the investment limits in UK external funds prior to and post-Brexit:

Investment limits in UK external funds prior to Brexit		**Investment limits in UK external funds post-Brexit**	
Type of fund	*General investment limit*	*Type of fund*	*General investment limit*
UCITS			
UCITS complying with amended directive 2009/65/EC	100%	UCITS from a zone A country outside EEA	25%
UCITS from an EEA country not complying with amended directive 2009/65/EC	25%		
ALTERNATIVE FUNDS			
Funds of alternative funds with enhanced guarantees	25%	Funds of alternative funds with enhanced guarantees	25%
Funds of alternative funds without enhanced guarantees	2,5%	Funds of alternative funds without enhanced guarantees	2,5%
Simple alternative funds with enhanced guarantees	0%	Simple alternative funds with enhanced guarantees	0%
Simple alternative funds with enhanced guarantees	0%	Simple alternative funds with enhanced guarantees	0%
UCIS OTHER THAN UCITS AND ALTERNATIVE FUNDS			
Open-ended real estate funds from a zone A country	2,5%	Open-ended real estate funds from a zone A country	2,5%

Furthermore, UK dependent territories will no longer be territories dependent on an EEA country and external funds domiciled in these territories, whether they are UCITS, alternative funds or any other type of funds, can no longer be used. The rule set out in Circular 15/3 of using up to the limit provided for by the local legislation of the policyholder cannot be invoked either (even in case of a UK policyholder), since such a rule is only provided for funds domiciled in territories dependent on an EEA country.

In practice, a distinction must be made between insurance contracts concluded prior to and post- Brexit:

- for contracts concluded after 1 January 2021, no investment in excess of the above limits is authorized;

- for contracts concluded before 1 January 2021, investment rules as they apply before 31 December 2020 should continue to apply to external funds serving as support for ongoing insurance contracts. The CAA nevertheless considers that the new classification of UK funds for new contracts with the resulting lowered investment thresholds constitutes for holders of existing contracts an important element for the assessment of investment risks and must therefore be brought to their attention. This communication should be accompanied by a proposal to switch to one or more other EEA supports presenting investment strategies similar to those of funds from the UK or its dependent territories in the portfolio. At the same time, it will be possible to propose a full application of the new post-Brexit investment rules taking into account the new status of the UK and its dependent territories as a non EEA country. In the event of non-response or refusal of these proposals, the CAA considers that pre-Brexit rules must continue to apply to existing contracts. In particular, the insurance company cannot refuse to maintain units in UK funds or acquire new ones on the sole grounds that the thresholds of the post-Brexit regime would be exceeded.

2. Internal collective funds

With respect to investments in internal collective funds, issuers located in the UK are to be treated as issuers from an OECD zone A country from 1 January 2021 and those from the UK dependent territories are to be treated as issuers outside zone A of the OECD within the meaning of Circular 15/3.

Collective internal funds created after 1 January 2021 will have to deal with financial instruments issued by issuers from the UK or one of its dependent territories, taking into account the new classification of these countries and territories.

According to the CAA, internal collective funds created before 31 December 2020 can continue to be managed with the pre-Brexit classification, but can then only be used as support for insurance contracts concluded before the aforementioned date. In the event that an internal collective fund created before 31 December 2020 also serves as support for contracts issued after this date, its investment policy must be adapted beforehand. The CAA envisages three scenarios:

- In the first case, the new policy remains compatible with the description previously provided to the policyholder. To avoid any subsequent dispute, the CAA recommends a communication both to the policyholders concerned and to the CAA.

- In the second case, the new policy is no longer compatible with the description previously provided to the policyholder, but changing the investment policy is conceivable by application of rule 5.1.4 in Circular 15/3 (setting forth the conditions for effecting substantial amendments to investment policies). Provisions of rule 5.1.4 must then be taken into account, including those relating to the notification of the change to the CAA.

- Finally, there may be a situation where the new policy is no longer compatible with the description previously provided to the policyholder and it is not possible to apply rule 5.1.4 of Circular 15/3. In this case the old fund will have to be maintained for the old policyholders and a new fund will have to be opened for the new contracts.

3. Internal dedicated or specialized funds

Concerning investments in internal dedicated funds and specialized funds (*fonds spécialisés*), issuers located in the UK are to be treated as issuers from an OECD zone A country from 1 January 2021 and those from the UK dependent territories are to be treated as issuers outside zone A of the OECD within the meaning of Circular 15/3.

Dedicated or specialized funds created after 1 January 2021 will have to deal with financial instruments issued by issuers from the UK or one of its dependent territories, taking into account the new classification of these countries and territories. This rule applies regardless of whether the dedicated fund is created for a contract concluded before or after 1 January 2021. In practice, the new status of the UK will only have an impact on dedicated funds of types A and B, funds of type C and D being allowed to invest without limitation in all the assets listed in annex 1 of Circular 15/3. For dependent territories, on the other hand, units of alternative funds issued by issuers established there can no longer be considered to be included in annex 1 of Circular 15/3 and are therefore no longer accessible to clients investing in a dedicated type C fund. Only dedicated type D funds can therefore still use it.

Dedicated funds created before 31 December 31 2020 must continue to be managed with the pre-Brexit classification, unless the client instructs otherwise. In this respect, the CAA considers that the new classification of UK financial instruments for new dedicated funds with the resulting lowered investment thresholds constitutes for holders of contracts invested in existing dedicated funds an important element for the assessment of investment risks and must therefore be brought to their attention as well as to their asset managers, if applicable. It will be up to the policyholder and his investment adviser to assess whether or not to modify the investment policy.

You can access the Information Note by clicking on this link (only available in French for the time being).

If you would like to discuss any of the issues raised in this paper in more detail, please reach out to any of our members indicated below or your usual Allen & Overy Luxembourg contact.

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