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## **CONSULTATIVE DOCUMENT**

### **CONSULTATION PAPER ON INSURANCE GUARANTEE SCHEMES**

#### **Purpose of this document**

This document contains the consultation paper on insurance guarantee schemes. The purpose of this consultation is to provide stakeholders with the opportunity to comment on the main findings of the OXERA report and to make known their views on the desirability and feasibility of Community action in this area.

## Introduction

Insurance Guarantee Schemes (IGS) provide last resort to policyholders and beneficiaries when insurers are unable to fulfil their contract commitments. They protect against the risk that claims will not be met in the event of a failure of an insurance undertaking. An IGS can offer protection by paying compensation to policyholders or beneficiaries, or by securing the continuation of insurance contracts.

As set out in the cover note, the consultation paper is based on the main findings of the OXERA Report as set out in the Report's executive summary and asks a number of specific questions. When answering to the questions, please indicate the reasons for your response and specify if your response is valid for life or non-life insurance or both. For further details, please see the cover note to this consultation paper (MARKT/2509-08).

## Existing IGS in the EU

Of the 27 EU Member States, 13 operate one (or in some cases more than one) IGS. Five countries have general schemes which cover both life assurance and non-life insurance (Latvia, Malta, Romania, Spain and the UK); three countries have a general scheme for life assurance (France, Germany and Poland); and another three countries have a general scheme for non-life insurance (Denmark, France and Ireland). Finally, six countries have special schemes that cover very specific classes of non-life insurance (Belgium, Finland, Germany, Italy, Poland and Spain).<sup>1</sup>

The decision to establish an IGS has often been triggered by the occurrence of an insurance failure in the relevant markets, or by insurers experiencing severe financial difficulties.

The operation of the existing schemes has been limited to date in most countries, with some IGS not having dealt with a single case of insurer failure requiring intervention. However, there have been instances of more significant failures where claimants could have incurred sizeable losses had it not been for the existence of a scheme.

There are significant differences between the IGS established in the EU. While some countries have general schemes covering both life assurance and non-life insurance, other schemes cover only life assurance *or* non-life insurance, and within the latter may restrict coverage to specific (often compulsory) classes of non-life insurance. Significant differences also relate to other dimensions of IGS design that are relevant to determining the scope of protection (eg, eligibility restrictions and protection limits), operational procedures (eg, nature of intervention), and the funding arrangements and corresponding financial capacity of the schemes.

### *1. Have new insurance guarantee scheme arrangements been introduced in your Member State or is the situation currently under review?*

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<sup>1</sup> In addition, the Netherlands and France have put in place specific arrangements relating to health insurance, which, at the time of writing, were in the process of being finalised.

## Framework for the analysis and evaluation of options

The analysis was approached in terms of the risks and consequences of insurance failure, which may require an IGS to be established as a last-resort protection mechanism to complement other protection mechanisms available that mitigate the risks of failure, or to reduce the consequences for policyholders if the risks materialise. It considers what market outcomes could be expected to improve through IGS establishment, and what the corresponding desired design features are for an IGS to be effective, taking into account the fact that establishment of an IGS, like any type of market intervention, will also impose costs.

In addition to evaluating the general options concerning IGS establishment and scheme design, the study also looks at the key question at the EU level—ie, whether policy action is required to remedy any problems identified with the current coexistence of different national approaches to IGS. The main options evaluated include:

- preserving the status quo—ie, it is left up to individual Member States to decide whether to introduce an IGS, with no harmonisation across the EU;
- introducing an EU-wide approach to IGS—this includes options that differ in:
  - the degree of harmonisation and the aspects to be harmonised across national IGS rather than being left to individual Member States;
  - the structure of the national IGS adopted, particularly with respect to geographical reach in terms of scheme participation and coverage (home state versus host state).

The evaluation of different options, both in the single-country and EU (cross-border) context, is carried out against a set of criteria to allow a systematic analysis of each option. The selected criteria include the following.

- **Consumer protection.** One of the main objectives of an IGS is mitigating financial losses for policyholders in the event of insurance failure.
- **Market confidence and stability.** By increasing consumer confidence in insurance providers and products, an IGS may promote consumer demand and enhance the stability of the system. At the same time, however, IGS funding requirements may jeopardise the financial position of insurance undertakings.
- **Incentives.** The introduction of an IGS may have an adverse effect on the behaviour of players in the market (moral hazard). The IGS should be structured to minimise excessive risk-taking behaviour or other distortions in incentives.
- **Competition.** IGS may influence the competitive conditions between insurers active in a given market as well as new entrants. For example, efficient entry may be deterred if an IGS raises market entry costs; alternatively, competition may be distorted if the policies offered in the same market are not subject to the same level of IGS protection.
- **Fairness/proportionality.** IGS intervention redistributes funds from solvent insurers (and their customers) to the policyholders of insolvent insurers. While it is difficult to objectively define what constitutes fair redistribution, some IGS structures may be considered fairer or more proportionate than others.

- **Practicality/feasibility.** This criterion relates to the administrative burden associated with an IGS and the ease with which it can be implemented and operated. At the EU level, a relevant question is how the IGS structure fits in with the wider supervisory framework and the allocation of responsibilities between home and host state.

No single option meets all evaluation criteria, and the ultimate choice depends on trade-offs between policy objectives and the weight given to the different, and often conflicting, criteria.

### **Risks and consequences of insurance failure: the role of IGS**

Insurance undertakings are exposed to a range of risks, which can lead to failure if inadequately managed and controlled. Insurance failures in the EU have been infrequent owing to, among other factors, internal risk management practices and the prudential supervision framework. Solvency II (and accompanying changes in the market) may further reduce the incidence of failures going forward. However, neither the current nor the future solvency regime creates a zero-failure environment. Insurance failures have occurred, and are likely to occur going forward, even if very infrequently.

IGS are mechanisms to provide last-resort protection, being triggered only when other protection mechanisms fail. In those circumstances, IGS can provide (and have provided) important protection to claimants who would otherwise experience losses as a result of insurance failure. In addition to protecting individual consumers, an IGS may have wider positive market impacts if it preserves consumer confidence or prevents disruption in the market if a larger insurer fails.

Many EU Member States have not yet established an IGS. If insurance failures in these markets cannot be ruled out, the question is what will happen if a failure does occur? Adopting a caveat emptor approach may not be acceptable, especially when larger losses or a large number of claimants are involved, and if there is the expectation of an implicit guarantee. Resolution on a case-by-case basis may raise concerns about transparency and timeliness of response. Hence, establishing an IGS to provide explicit guarantee may be the preferred outcome if the policy objective is to protect individual consumers and preserve market confidence. For several Member States, it was the occurrence of a failure (or failures) that led to the establishment of an IGS in the first place.

The nature of risks and the consequences of failure differ between life assurance and non-life insurance, but IGS can play, and have played, a role in protecting (retail) consumers from losses in relation to both types of insurance. The evidence suggests that failures on the non-life side tend to be more frequent, and although the average loss may be smaller, there are instances where the loss exposure of individual policyholders (and, importantly, third-party claimants) can well exceed that of typical life assurance policies.

*2. Given that neither the current nor the future solvency regime create a zero-failure environment and that many MS have not established IGS, which is your preferred option?*

- a. The status quo, i.e. adopting a caveat emptor approach possibly linked with enhanced policyholder information*
- b. Case-by-case intervention as and when problems arise*
- c. Mandating the establishment of IGS in all Member States*

- d. Introducing a single EU-wide IGS that covers all relevant policies written and purchased within the EU*
- e. other options*

## **The cost of IGS**

IGS incur direct costs (ie, payments made to provide the guarantee and administration costs), as well as indirect costs (ie, negative market impacts). These costs must be weighed against the benefits that an IGS is expected to deliver in terms of consumer protection and market confidence.

In the absence of failure, administrative costs associated with running the scheme can be minimal. Where failures occur, administrative costs are small compared with the actual costs of providing the guarantee.

Guarantee costs have not been significant in the past—in general below 0.1% of gross premiums, even in markets that have seen relatively frequent or larger failures. Given the low rate of insurance failure and other factors, the expected guarantee costs are also comparatively small. With a more sophisticated regulatory regime (Solvency II) to be implemented, the expected rate of failure may be even smaller.

Clearly, larger failures cannot be ruled out and costs would be correspondingly higher, increasing IGS funding requirements. Several insurance markets in the EU, particularly those in the new Member States, are relatively small and concentrated. The failure of the largest insurers (eg, those with a market share of 10% or more) would, depending on the asset shortfall and timing of claims against the failed institution, be difficult to finance by the remaining firms in the market. IGS can best deal with failures that do not involve potential costs that are large relative to the size of the market—large failures may need to be dealt with through other mechanisms.

From a societal point of view, the direct costs associated with an IGS are largely distributional. In the case of a failure, the losses are distributed from the failed insurer to the solvent insurers remaining in the market. If insurers pass through their costs to customers, as can be expected under competitive market conditions, the distribution of losses is ultimately from the customers of insolvent insurers to the customers of solvent firms. Weighing the direct costs of an IGS against the benefits therefore depends to a large extent on distributional preferences.

The distributional impact, as well as the level of direct costs, can be adjusted to some extent through scheme design. Scheme design can also seek to address the two main types of negative market impact that may arise as a result of an IGS. First, the existence of an IGS may lead to adverse behaviour of the relevant parties, changing their incentives and thereby exacerbating the risk of failures in the market (moral hazard). Second, an IGS and the associated direct costs may have an adverse effect on the structure, competitive process and indeed the stability of the insurance market. There is little evidence available to support the empirical significance of these effects. In principle, if properly designed, introducing an IGS can be pro-competitive and improve the operation of the market.

*3. Do you agree with the conclusion that, costs can to a certain extent be adjusted through scheme design and that if properly designed, introducing an IGS can be pro-competitive and improve the operation of the market?*

### **Operation of existing IGS in the cross-border context**

Lack of IGS coverage and differences in the level and scope of coverage result in varying degrees of consumer protection *across* Member States, also giving rise to the possibility that the failure of a single insurer operating in different countries has different loss consequences for consumers depending on their country of residence. In addition, the current IGS arrangements imply that (except for countries operating an IGS on a host-state basis) consumers *within* a given country may or may not be protected by an IGS, depending on whether they have purchased the insurance policy from a domestic insurer or an incoming EU firm providing under freedom of services or via branches. To date, however, failures of insurers with significant cross-border operations have been rare.

When it comes to the operation of IGS in some markets, asymmetries in the treatment of domestic and incoming EU insurers can also distort the level playing field. On the one hand, there may be a demand-side effect in that consumers prefer to buy policies that are covered by an IGS to the detriment of insurers offering policies that are not covered and where the insurers do not have the option to seek coverage from the IGS. On the other hand, there may be a supply-side effect which places firms required to contribute to an IGS at a competitive disadvantage compared with those that are not. There is no direct evidence available to suggest that the impact on cross-border competition, either from the demand- or the supply side, is significant.

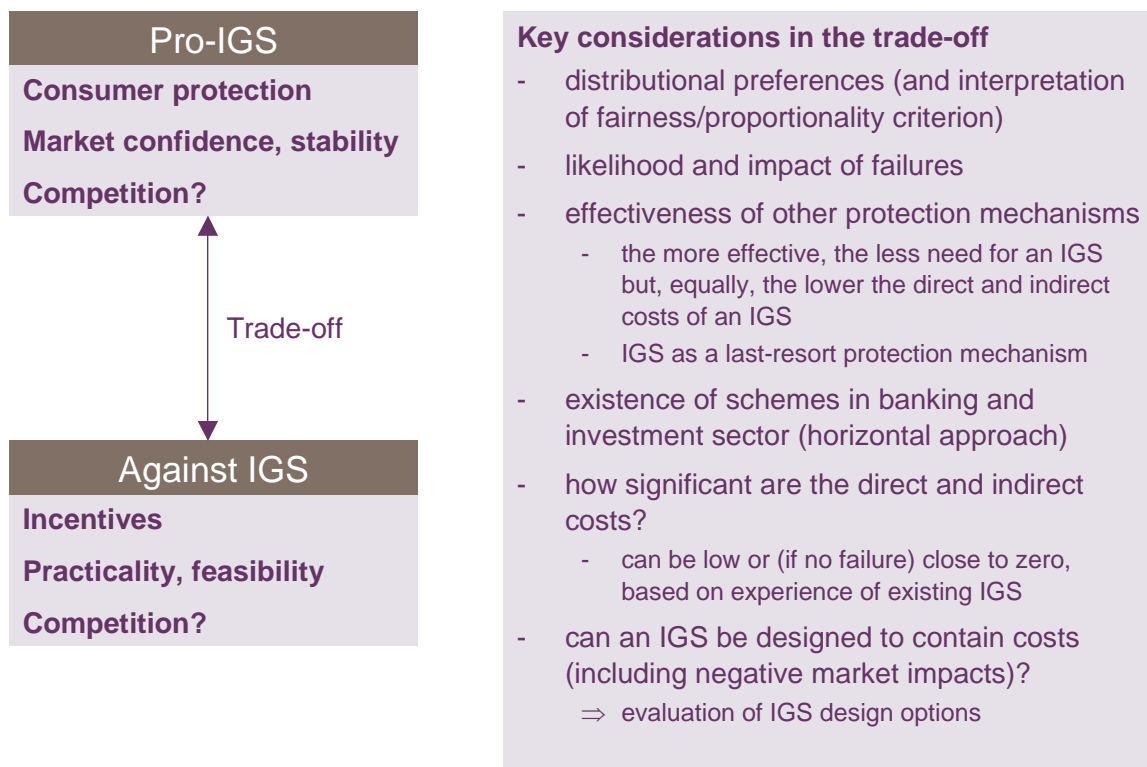
The potential impacts on cross-border consumer protection and competition must be considered in the broader context of the EU (retail) insurance market and, in particular, the fact that cross-border activity (in the form of branches and freedom of services) remains limited. Thus, while the lack of harmonised IGS arrangements raises concerns with respect to the protection of individual consumers, wider impacts on the market are not evident, given the current volume of cross-border operations. This may change in the future as cross-border activity increases. The effects may also become more pronounced in the event of a large failure of an insurer with significant cross-border operations, which could adversely affect confidence in the EU insurance markets.

*4. Do you consider the presence or absence of IGS to be an important factor in the development of cross-frontier insurance business in the single market and, in your view, which aspects of the current uncoordinated situation already or potentially constitute obstacles to the further development of the single insurance market?*

## Options: establishment and design of an IGS

The decision to establish an IGS depends ultimately on the value of the benefits of enhanced consumer protection and market confidence/stability, compared with the costs (both the direct costs of running the scheme and providing the guarantee, and the indirect costs in terms of negative market impacts).

**Figure 1 The trade-off in the decision to establish an IGS**



Source: Oxera

The comparison of benefits and costs is not straightforward for at least two reasons.

- There are many ways in which an IGS can be designed. Different scheme designs provide different levels of protection and can also have significant implications for the direct and indirect costs of an IGS. The question of whether to introduce an IGS is therefore closely related to the choice of scheme design.
- The operation of an IGS always triggers redistribution of funds from one part of the market to another. Decisions concerning the establishment of IGS and scheme design therefore depend on distributional preferences and are ultimately a matter for policy.

If the primary objectives are consumer protection and market confidence/stability, there is a case for establishing an IGS. Failures of insurance companies have been infrequent, and may become even more infrequent with improvements in the solvency regime and other protection mechanisms. However, as long as failures cannot be ruled out (ie, there is no zero-failure guarantee), IGS have a role in providing last-resort protection. Although the nature of risks and consequences of failure differ, this applies to both life and non-life insurance.

Several Member States have responded to insurance failures by implementing an IGS. Moreover, guarantee schemes are the norm in all Member States in other financial sectors. Although there are significant differences between sectors, in terms of risks and regulation, if guarantee schemes are accepted as important last-resort protection mechanisms in the deposit-taking and investment sectors, it may be challenging to argue against the introduction of similar arrangements in the insurance sector.

Nonetheless, even if consumer protection and market confidence were the primary objectives, these would still need to be balanced against secondary objectives—ie, containing direct costs and limiting market distortions. There are different options available for IGS design to contain direct and indirect costs.

Direct costs and the degree of redistribution can be contained by limiting the scope of protection provided by the IGS. For example, protection can be targeted at specific classes of insurance—eg, life assurance, given the long-term nature of policies and their importance as a savings and protection vehicle for households; liability insurance, given the potentially large loss consequences for injured third parties; or compulsory insurance, given the legal requirement on policyholders to purchase cover. It can also be targeted at specific claimants, particularly retail consumers, for whom protection measures are generally more justified.

Limiting the scope of protection not only reduces direct costs, but can also reduce any perverse incentive effects that may be triggered by the establishment of an IGS. Moral hazard on the part of policyholders can be contained by imposing eligibility restrictions on those who are more likely to engage in such behaviours (eg, the more informed larger commercial policyholders or persons connected to the failed insurer). It can also be contained by imposing limits on the amount of protection available from the IGS. Moral hazard behaviours on the part of insurance undertakings can be contained through a risk-based approach to regulation, which in the IGS context could be achieved by levying risk-weighted contributions.

The structure of IGS funding can have important implications for the cost to industry, bearing in mind that the levies imposed on industry can be expected to be passed on to, and ultimately borne by, customers. In particular, ex post-funded schemes can be operated at virtually no direct cost to the industry, at least up to the point of an insurance failure occurring. Building up a large ex ante fund may enhance the speed and certainty of access to funds for the IGS, but it may impose disproportionate costs if the frequency and size of failures are expected to be small. The choice between ex ante and ex post funding largely depends on the timing and level of expected IGS costs, the financial capacity of insurers in the market, and the availability of alternative sources of funding.

There is no single IGS design option that fits all criteria and objectives. The most economically efficient options are often not the most practical, and the options that are cheapest to operate may not deliver the desired protection or distributional objectives. The decision concerning IGS establishment and scheme design depends on the weight attached to the different criteria, and is therefore a matter for policy.

### **Options: status quo or EU-wide approach to IGS**

The coexistence of national approaches to IGS raises concerns about consumer protection in insurance business provided across borders; it also results in conditions that may distort cross-border competition. The problems with the status quo are limited for

two reasons: first, the level of relevant cross-border business (ie, retail business carried out via branches and freedom of services) remains low; second, few insurance failures with cross-border implications have occurred.

Based on the evidence available, the case for changing the status quo depends on the weight attached to the objective of protecting individual consumers (and related market confidence objectives, depending on the scale of future failures). It also depends on the weight attached to the fact that the conditions for a single market in insurance are not met by existing IGS arrangements (as opposed to evidence of actual distortions in cross-border competition). The relevant cross-border business is expected to grow, but even then it is not clear whether this would result in significant distortions in the competitive process within and across Member States.

Certain intervention measures (such as requiring existing IGS not to discriminate in the protection they provide on the basis of country of residency of policyholders or location of risk) may close some gaps in consumer protection that currently arise in the cross-border context. However, if the objective is to address the problems on a comprehensive and consistent basis across the EU, an EU-wide approach to IGS would be required.

Given that the establishment of a single EU-wide IGS (covering insurance business written or purchased anywhere in the EU) is unlikely to be feasible or politically acceptable, this could instead involve setting up national IGS in all Member States, as with the requirements that already exist in the banking and investment sectors as a result of EU Directives.

In order to effectively address cross-border problems, the geographic scope of national IGS would need to be structured consistently on the basis of either the host or the home state principle. Adopting the host state principle would deliver equal levels of consumer protection within Member States, without the need to harmonise IGS across countries; it would also ensure level playing field conditions between domestic and incoming EU insurers operating in the same jurisdiction. However, the host state structure would not fit well with the EU supervisory framework, and gives rise to a number of related problems in terms of both practicality/feasibility of IGS operation and political acceptance, particularly if there is reluctance in the host state to fund those IGS costs that are perceived to be the result of (supervisory or industry) mistakes in the home state. For these reasons, the home state principle may be preferred.

A move to lead (or group) supervision under Solvency II may give rise to new issues about the geographic scope of IGS. While there are advantages of structuring the IGS in accordance with the geographic responsibilities of the lead supervisor (ie, subsidiaries would be covered by the home state IGS of the parent company), there are also important arguments for not changing IGS participation requirements for subsidiaries, and retaining the current practice of their participation in the local IGS. These arguments relate to the objective of ensuring equivalent consumer protection and a level playing field between subsidiaries and domestic insurers within a jurisdiction; the administrative feasibility of the IGS process; and the IGS funding implications, both for countries with a large number of insurance group headquarters and for countries with a large number of foreign subsidiaries.

Structuring national IGS around the home state principle would require a minimum level of harmonisation to deliver the desired improvements in market outcomes compared with the status quo. If the objective is to improve consumer protection in cross-border business, harmonisation is required only with respect to the scope of protection afforded

by IGS in different countries. There is no need to harmonise operating arrangements across IGS as long as the resulting national IGS arrangements are such that the promised protection can actually be delivered.

While harmonisation of IGS funding may be required to improve level playing field conditions, this may be considered secondary given the lack of evidence of actual distortions in cross-border competition, and given that even the most harmonised funding arrangements cannot eliminate cost differentials resulting from differences in the (actual or expected) guarantee costs of IGS across jurisdictions. Allowing flexibility in funding may also enhance the political acceptance of an EU-wide approach to IGS.

The relevant IGS design dimensions to consider when deciding on the degree of harmonisation in the scope of IGS protection include: the classes of insurance policy that should be covered; claimant eligibility; protection amounts and limits; and, depending on the degree and consistency of consumer protection desired, the nature of IGS intervention. There are arguments for targeting IGS protection at specific policies and claimants, and for imposing limits on the level of protection available from the IGS. These could serve as a basis for defining minimum protection standards.

The decision concerning whether to implement minimum harmonised IGS across Member States, and where to set the minimum protection standards, depends on preferences at the EU level overall and the weight of preferences between individual countries. As such, it is a matter for policy.

*5. Which are the key considerations (for and against) in the trade-off involved in the decision on whether or not to establish an IGS and what relative weight do you attach to these key considerations ?*

*6. Is the case for establishing an insurance guarantee scheme in insurance weaker than in the banking and securities sectors and which lessons, if any, can be learned from the banking and securities sectors?*

**If an IGS were to be implemented in all Member States to address cross-border problems, the following questions would have to be addressed:**

*7. What should be the geographic scope of the IGS – i.e. should the national IGS be based on the home or the host state principle?*

*8. Should subsidiaries participate in and be covered by the IGS of the Member State in which the group supervisor is located under the group support regime under Solvency II?*

*9. What degree of harmonisation across Member States would be required between national IGS and which features of IGS should be harmonised? Should they be harmonised, please indicate your preferred approach.*

- a. Geographic scope (home v host state principle)*
- b. Organisational structure (single or multiple IGS, cooperation with insolvency practitioners and supervisory authority, staffing arrangements/outsourcing)*
- c. Funding arrangements (in particular ex ante or ex post funding, risk-weighted contributions and contribution limits))*

- d. *Policies covered - What classes of insurance should be covered by the IGS and which insurance classes could be excluded?*
- e. *Claimant eligibility - Which claimants should benefit from the IGS, and which claimants could be excluded?*
- f. *Protection amounts and limits (caps or maximum compensation levels, deductibles, etc.)*
- g. *Nature of intervention (in particular the payment of compensation or portfolio transfer)*
- h. *Payout timing and information to policyholders/beneficiaries*

**If you wish to submit any additional documents which are of relevance in this context, please send them to stefana.vella@ec.europa.eu by 07 July 2008.**