CEA Insurers of Europe

Position Paper

CEA response to the European Commission's public consultation on Insurance Guarantee Schemes

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1. Introduction

The CEA welcomes the opportunity to respond to the European Commission's Consultation Paper on Insurance Guarantee Schemes (IGS). The CEA values positively the detailed and comprehensive consideration that the European Commission has given to this topic, demonstrating the Commission's commitment to Better Regulation. It therefore welcomes the present consultation, the Public Hearing on 2 June as well as the first thorough assessment of policy and design options made by Oxera.

The CEA agrees that policyholders and beneficiaries should be protected against the detrimental consequences of an insurer going insolvent and being unable to fulfill contractual commitments. In this respect, the CEA supports the Commission's objectives of ensuring a high level of consumer protection within the European Union.

The CEA believes that the most important protection for insurance consumers is an effective, efficient system of prudential regulation for insurers. Prudential solvency rules are already in place in Europe, providing a satisfactory level of prevention and protection for consumers and this will be enhanced by the forthcoming Solvency II regime. It would be reasonable to gain more experience with its functioning and await the effects these new rules will bring. However neither the current nor the future solvency regime create a zero-failure environment and it is therefore appropriate to consider the need for additional protection mechanisms.

This consideration must take into account the diversity of national insurance markets within the European Union, which differ in size, concentration and culture, and in the provision of mechanisms for protecting consumers, which are adapted to the particularities and the needs of individual national markets. The CEA considers that these factors make it particularly difficult to frame a European-wide legislative solution harmonising insurance guarantee schemes (IGS) in all member states. IGS might be an appropriate solution in some markets, while in others the objective of consumer protection might better be achieved via other arrangements.

The CEA considers that the Oxera report is a valuable contribution to this process, providing a detailed and comprehensive summary of existing IGS and of the issues that the Commission should consider before taking action. It notes, however, that there exist in some Member States alternative mechanisms that have proved to work effectively and to be suitable to provide an appropriate level of insurance consumers' protection. The CEA considers that these alternative mechanisms should also receive comprehensive assessment before the Commission decides on any additional steps. Further details are provided in this response.

If, further to this analysis, the Commission ultimately concludes that there is a need for Community harmonisation on IGS, then we are confident that any such initiative will:

- Be preceded by a serious economical impact assessment evaluating the probability of market failure and financial costs for the markets on one hand and justifying the feasibility, efficiency and utility of IGS on the other hand, with the aim to ensure that such an action would create added value for consumers.
- Provide Member States with sufficient flexibility to adapt solutions to the needs and traditions of their market.
- Provide for a sufficient transitional period.

2. Existing IGS in the EU

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

The CEA would like to bring to the Commission's attention arrangements in certain Member States that were not considered by the Oxera report:

- In Austria, **internal guarantee schemes** operated by insurance companies and the supervisory authority were introduced in 1978 and have been amended constantly since then. These internal schemes are an additional safety net on top of the solvency rules, ensuring that the insurer fulfils his obligations towards the policyholder at all times in a sustainable manner.
- In the Netherlands there is the **"Opvangregeling Leven"** (the Early Intervention Arrangement for Life Insurers). This arrangement is a preventive measure that makes it possible to guide a life insurer through a financially difficult period or at least to secure the continuity of the life insurer's portfolio. This arrangement is operated jointly by the Dutch Ministry of Finance, the Dutch supervisor (the Dutch Central Bank) and the Dutch insurance sector.
- According to Danish legislation, a life insurance company which is unable to meet its obligations may be taken under administration by the Danish Financial Supervisory Authority (Finanstilsynet). The first priority is to investigate whether another company is interested in taking over the suffering company. If efforts in that sense are failing, it is possible to set up a mutual company including all policyholders to run the business on in the best way. If necessary, the obligations of the company may be reduced proportionally.
- In Finland, the Insurance Company Act provides for consumer claims to have precedence over other insurance claims in the insolvency of a non-life insurance company. This provision significantly improves the position of the policyholder and thus reduces the need for an IGS.

These arrangements work efficiently. They are adapted to local market features, specificities and needs, such as the degree of concentration and the size of market and provide a high level of consumer protection. We believe these arrangements should be assessed by the European Commission in order to gain the comprehensive overview necessary to draw conclusions about the way forward.

The CEA also believes that it would be worth exploring further other solutions put forward by the market. The two-layer system of **reinsurance** proposed as another possible alternative to IGS at the Public Hearing on 2 June should be considered seriously and evaluated as well.

3. General policy options

Question 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

First and foremost, the CEA believes in the importance of effective insurer regulation, to minimise the possibility that an insurer is unable to meet its contractual commitments to policyholders. Insurance consumer protection depends mainly on the efficiency and appropriateness of prudential rules imposed on insurers and their effective and harmonised application by the competent national authorities. Existing arrangements for insurer supervision (eg rules on solvency, capital assessment, internal risk management, technical reserves, the re-organisation and winding-up of insurance undertakings and reinsurance) are the primary means of protecting insurance consumers.

The CEA does not agree with the Commission's description of the status quo as "adopting a caveat emptor approach" (see option a.). First of all, insurers are subject to stringent supervisory requirements to ensure that consumers are able to claim on their insurer contracts. Life and non-life insurance companies must hold sufficient own funds and maintain solvency margins as a buffer against unforeseen events such as higher than expected levels of claims or unfavourable investment results. This solvency margin is covered by assets and monitored by the supervisory authorities on a periodic basis. Secondly, the status quo includes a variety of IGS as well as other types of effective arrangements in Member States, which cannot be described as "caveat emptor" approaches.

We agree with the conclusion reached by Oxera in its report that the existing situation does not cause any particular problems since relevant cross-border business and insurance failures with cross-border implications are limited. Furthermore, we agree with the Oxera report conclusion that the establishment of a single EU-wide IGS is unlikely to be feasible and politically acceptable[1]. The CEA consequently does not support option d.

Moreover, although IGS might be a suitable solution in some markets, in others, **different arrangements** have proven to be efficient and well adapted to the local markets' specificities (see our response to question 1).

Policyholders' confidence in the market could also be achieved through **voluntary solutions** sought by the industry. They would offer the possibility for companies to assess and decide on their own the extent of their engagement and would avoid the potential negative impacts of IGS. In Greece, insurance legislation provides for the possibility that, subject to the prior approval of the Supervisory Authority, an insurance company undertakes the life portfolio of another company within thirty days from the withdrawal of the licence of the latter. This mechanism was successfully operated in the case of an insurer whose authorisation was withdrawn at the end of 1997 by a decision of the Ministry of Development. After intensive internal proceedings initiated

[1] Oxera report, p172

by the Hellenic Insurance Association, the life portfolio of said insurer was eventually transmitted on January 1998 to another insurance undertaking further to the approval of the Supervisory Authority.

Any legislative measures would discourage self-help efforts on the part of the industry.

4. The cost of IGS

Question 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?

The CEA shares the view presented in the Oxera report that scheme design can have a relevant impact on the costs of an IGS. The ability to adjust scheme design to keep costs under control does imply that, were the Commission to introduce any harmonisation provisions, Member States should retain a substantial degree of discretion to design schemes that are appropriate for national markets.

However, it is also fair to admit that those costs can be limited by the scheme design only to some extent, and, whatever the design options selected, since IGS are usually funded by levies on solvent insurers, the costs will always ultimately fall on insurance customers. IGS therefore entail additional costs for insurance consumers.

In addition, we would like to draw the Commission's attention to the following points:

- The CEA does have concerns about the ability of **concentrated national markets** to absorb the costs of the failure of an insurer with a substantial market share. It is difficult to envisage how this particular issue could be tackled through scheme design, unless an IGS has access to public funding. This is a particular issue that any proposals for harmonisation would have to address.
- IGS imply indirect costs through their negative market impact in the form of **moral hazard**. They involve the danger that badly managed undertakings are financed to the detriment of soundly managed companies which would be burdened with additional costs and weakened that way in their competitiveness.

On a competition point of view:

- As stressed by Oxera in its report, IGS might be a deterrent for insurance companies, which would not be able to enter the market because of higher market entry costs. Furthermore, there may also be distortion of competition if the policies offered in the same market are not subject to the same level of IGS protection[2].
- On the other hand, we note the Oxera report's arguments that IGS can be pro-competitive and improve the operation of markets[3].

Nevertheless, we would observe that IGS generally do not have a substantial impact on the operation of national insurance markets, and so are unlikely to have a significant pro- (or, indeed, anti-)competitive effect. It is clearly important that an IGS should not inhibit the efficient operation of an insurance market and this underlines the importance of ensuring that local consumer protection solutions are designed with local markets in mind.

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2 Oxera report, p58
3 Oxera report, p116

5. Operation of existing IGS in the cross-border context

Question 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?

Existing IGS provide limited coverage: for example they may cover life insurance or compulsory non-life insurance only, or the category of eligible claimants may be limited to individuals. Volumes of EU cross-border insurance business relating to these types of business are low. They are rather higher for business such as reinsurance or marine, aviation or large commercial insurance, which are unlikely to be covered by IGS. This suggests that the presence or absence of IGS has little or no impact on the development of cross-frontier insurance business in the single market.

As correctly noted in the Oxera report, other factors are likely to be more important determinants of consumer choice between financial products than the existence of IGS[4]. Factors such as the general strength of an insurance company and its presence in the market contribute more efficiently to the confidence of consumers. Consumers are also influenced by elements such local culture and language barriers, which play a vital role in consumers' willingness to buy insurance products from foreign insurance companies.

Many insurance consumers have limited awareness of the existence of IGS or the coverage they provide, so the presence or absence of IGS has little effect on their purchasing decisions.

6. Options: establishment and design of an IGS

6.1 Pros and cons of an IGS

Question 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?

The CEA considers that the consumer protection aspect should prevail over the other aspects. IGS can significantly reduce the risk that consumers suffer a loss in the case of an insurer going bankrupt but this is not the only way to achieve this goal. As set out in our response to question 1, other arrangements achieve similar goals in terms of consumer protection.

Most pros and cons of IGS have been extensively discussed in the Oxera report. At the same time, it is appropriate to take into account other considerations, such as:

- **Protecting policyholders of large insurance companies.** An IGS in a small and concentrated market may not be adapted to afford the insolvency of one of the largest insurers, ie to face high costs relative to the size of the market. This is particularly true in countries with high market concentration such as Austria, Belgium, the Czech Republic, Finland, Luxemburg, Slovakia or Sweden, where big insolvencies will not be covered by the fund capacity and remain under the responsibility of the supervisory authorities. For instance, in Finland, where a 29% increase in premiums would be needed to cover a

[4] Oxera report, p142

10% deficit in a large life company. 91% of the premium income of other life providers would be needed to cover a 30% deficit in the same large life company. Even in much less concentrated markets, like Germany, calculations show that an IGS would not be able to cover the insolvency of one of the major players.

We therefore recommend that the Commission conducts an additional economic study to assess the impact of an IGS in such a situation. Alternative mechanisms, which would be adjusted to the market's specificities and would lead to an equally high level of policyholders' protection, may be more appropriate. We deem it very important, before taking any decision on an EU initiative, to examine and find out if IGS is a fake or real consumer protection tool and to what extent it could ensure sufficient protection for all policyholders.

- **The dangers of moral hazard.** IGS entail a risk that the policyholders of soundly managed companies will pay for those insured by less well-run insurers. There is a risk that IGS can encourage less responsible conduct, whether on the part of **policyholders** who might be inclined to lose sight of the objective criteria of company financial solidity and favour those with the lowest rates; insurance company **directors and officers** who might be tempted by negligent and/or improvident behaviour; insurance **intermediaries** for whom the assessment of the undertaking's capacity to meet its commitments might no longer be a decisive element in selecting the insurance product; **supervisory authorities** whose responsibility in the last resort could be weakened, etc.

  As correctly noted in the Oxera report, 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[5], and moral hazard behaviour on the part of insurance undertakings can be contained through a risk-based approach to regulation, ie **risk-weighted contributions**[6]. However, risk-weighted contributions require an ex-ante financing, which subsequently would require increased administration and prudential management of assets. This would increase costs, impose the additional risk of bad management of assets, and have an impact on the competitive process and the stability of the insurance market.

6.2 Comparison with the banking sector

Question 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?

There are substantial differences between insurance and the banking and securities sectors, which make it difficult to draw comparisons. There are differences in the regulatory and risk environments, the nature of products, related timeframe and cost aspects.

Firstly, banking and securities sectors are regulated differently to insurance: insurance has an inversed production cycle and has less concern with liquidity management; insurance legislation's requirements are much more stringent than in the other two sectors. Secondly, the nature of insurance, ie insurance is based on the mutual solidarity between policyholders, has to be taken into account. Thirdly, the insurance sector has different risks, eg the contamination risk does not exist in the insurance and in the banking sectors to the same extent. In cases of insolvency, the losses could be much more severe and practically impossible to compensate

[5] "There are reasons to target IGS protection to retail consumers only. Larger commercial policyholders are in a better position to evaluate the soundness of the insurer and seek alternative protection. They may also be more likely to change their incentives and engage in moral hazard behavior". Oxera report, p144

[6] Oxera report, p vi

for, since insurance products are long-term oriented and spread over very long periods of time. We therefore deem the consideration of other possible solutions to be key.

6.3 Geographic scope: home/host state principle

Question 7: If an IGS were to be implemented in all Member States to address cross-border problems: 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?

If the establishment of IGS in all Member States were to be made mandatory, it would be desirable for them to be structured on the basis of the **home Member State principle** in order to be consistent with the EU supervisory framework. Basing mechanisms to protect policyholders on the home country principle is in line with the need for equal treatment of EEA nationals. If this principle is respected, there is no need for any further measures.

Nevertheless, a company should have the option to ask the host country (supervisory authority or scheme manager) for **coverage of its branch**. The authority or scheme manager for its part should have the option to accept this request or to reject it at will. This request must, however, not be equated to the Commission services' suggestion to provide for a supplementary guarantee in case of divergent levels of scope between the home and the host country fund.

6.4 Coverage of subsidiaries

Question 8: If an IGS were to be implemented in all Member States to address cross-border problems: 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?

The CEA does not believe that there is any connection between the provisions for group supervision in Solvency II and consideration of the introduction of IGS. As the details of group supervision have not yet been finalised, it is difficult to respond to this question. The results of the negotiations on group supervision and Solvency II should be awaited.

6.5 Degree of harmonisation

Question 9: If an IGS were to be implemented in all Member States to address cross-border problems: 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, riskweighted 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 the Commission decides to take action on IGS, the CEA's preference would be for a minimum harmonisation approach. It would allow Member States to adopt, for instance, a higher level of coverage if they believe this is necessary and appropriate for their market.

However, as a principle, if IGS were to be introduced, the Belgian, Italian and Swedish markets would only accept it if it were on the basis of full harmonisation in order 1) to ensure an identical level of consumer protection and therefore 2) not to distort competition.

Another solution would be to establish a set of minimum standards which the Member States would have to reach, with the freedom to select the most appropriate way, ie IGS or an alternative arrangement. This would avoid any disruptive impact on those existing alternative mechanisms which have proved to work effectively and to be suitable to provide an appropriate level of insurance consumers' protection.

a) Geographic scope

As already stated above, IGS should operate on the basis of the **home Member State principle**, ie they should cover all the activities of an insurer, be it national or cross-border, throughout the EU. This is in line with the home member state rule dominating insurance supervisory law.

b) Organisational structure

Member States should be free to decide on structural, financial and operational details of IGS, as well as on mechanisms that prevent one bankruptcy 'infecting' a whole market. If, for justified local conditions, a Member State envisaged the establishment of additional compensation mechanisms, it should be free to decide which instruments and schemes it deems appropriate to implement in order to guarantee the protection of policyholders in the most efficient way and to decide for which types of insurance they should be put in place. Any uniform pan-European solution disregarding the diversity of national situations would be ill-suited in this context.

c) Funding arrangements

Because of the differences between markets and market conditions, the **IGS funding method should be left to each Member State,** in consultation with local stakeholders. However, it would be desirable for the Member States to finance part of the compensation. Such an arrangement would help prevent moral hazard in the supervisory scheme, especially if the costs of compensation cannot be sustained by the market.

d) Policies covered

The CEA considers that further detailed consideration is necessary to determine the policies that should be included in any proposal for a harmonisation directive. The types of business covered should reflect the **necessities of consumer protection**.

The discussion should therefore be restricted to **life insurance policies**, since they involve large amounts and long-term commitments with insurers, often with a retirement objective. We nevertheless point out that a large insolvency could not be managed by any such IGS.

The need for IGS covering **non-life insurance** business should be questioned given the generally low impact of a failure by a non-life company. Only a minority of insureds would be hit by the failure of an insurer ie. those with a claim still unsettled. In any case, non-life insurance classes which do not involve consumers as policyholders

would have to be excluded. In addition, any discussion on IGS in the non-life area would have to be restricted to compulsory insurance, prescribed as such by an EU text.

Compulsory motor insurance and existing compulsory workmen's compensation schemes should be excluded from the discussion since they already exist. It is important to consider the correct functioning of the practical mechanisms in place. It would be counterproductive to interfere with them. In compulsory motor insurance, the present directive concerning motor guarantee funds does not consider the issue, but 1) Most markets have extended the role of motor guarantee funds to cover insolvency cases in their national law and 2) A market agreement prepared by CEA was signed in 1995 by all motor guarantee funds, apart from Luxemburg, to organise compensation for victims in cases of insolvency and recourse against the fund of the company's home country.

e) Claimant eligibility

Any directive on IGS should be restricted to contracts with **consumers** (policyholders, beneficiaries or insured persons who are individuals). Any reference to small businesses would remain open to various interpretations and as such would be likely to lead to misunderstanding regarding the scope of this concept. The exclusion of 'small business' claims from the scope of coverage should therefore be compulsory. In addition Member States should be allowed to exclude certain listed insurance claims from the scope.

f) Protection amounts and limits

Because insurers need certainty about the costs they have to face and because the source of the IGS financing is not infinite, an overall delay after which claims are no longer receivable should be fixed and **coverage must be limited**: i) minimum limit for IGS intervention (amount of the claim); ii) maximum limit for IGS intervention (amount of the claim); iii) within the maximum limit, maximum percentage of the insurance claim covered by the IGS; iv) a perennial maximum limit of intervention of the IGS ensuring the absence of any impact on the solvency of contributing companies. Considering the diversity of situations and differences between Member States, the amounts of compensation should be subject to the **competence of each national authority** which could take into account their economic environment. Coverage in the life insurance sector should further be limited to the guaranteed returns or main commitments of the contract and exclude features of the contract such as future profit sharing, the right to surrender or options.

g) Nature of intervention

If failures occur and following the application of stabilisation and winding-up procedures for undertakings, policies should either be transferred to other insurers, rescue devices specially designed for that purpose or contracts quickly terminated; in which case IGS should fund the payment of the insureds' rights as soon as their contract ceases to be effective. The double triggering mechanism involving either supervisory authorities or courts seems to be appropriate.

h) Payout timing and information to policyholders/beneficiaries

Member States should be allowed to regulate the timeframe for compensation themselves. For example, the compensation system could be left to the insolvency administrator and outstanding claims settled as part of the winding-up procedure. An overall delay after which claims are no longer receivable should be fixed. Insurers need certainty about the costs they have to face.

The question of minimum information on the existence and the essential characteristics of an IGS should be left entirely to Member States to deal with. Advertising about IGS should better be prohibited since its admittance would be dangerous given the moral hazard risk.

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Position Paper

About CEA

The CEA is the European insurance and reinsurance federation. Through its 33 member bodies, the national insurance associations, the CEA represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. The CEA represents undertakings that account for approximately 94% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 110bn, employ over one million people and invest more than €7 200bn in the economy.

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