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Agenda

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Insurance guarantee schemes: a need for EU policy action?

Insurance guarantee schemes have been implemented in a number of EU Member States to provide last-resort protection to consumers in the event of failure of an insurance undertaking. However, there is no European requirement for Member States to establish an IGS, and no harmonisation of protection standards. With the European insurance industry moving towards a new common framework for prudential regulation (Solvency II), what is the case for implementing an EU-wide approach to IGS?

Insurance guarantee schemes (IGS) provide last-resort protection when insurers are unable to fulfil their contract commitments, offering protection against the risk that claims will not be met in the event of a failure of an insurance undertaking. IGS can offer protection by paying compensation to consumers, or by securing the continuation of their insurance contracts (eg, by facilitating the transfer of policies to a solvent insurer).

Last-resort protection schemes exist in other sectors of the financial services industry. In particular, there are deposit guarantee and investor compensation arrangements in all EU Member States, and minimum protection standards have been harmonised at the European level through implementation of the 1994 Deposit Guarantee Directive and the 1997 Investor Compensation Scheme Directive.[1] However, there is no such common European framework in the insurance sector.

Correspondingly, many Member States have no insurance guarantee arrangements in place, or have implemented IGS that cover only specific types of insurance. For countries that have implemented an IGS, the actual structure and operating arrangements of the schemes differ widely. This raises several important policy questions. In particular, is there a need for IGS to provide last-resort protection and, if so, how should they be designed? Is there a need for policy action at the EU level to ensure more harmonised consumer protection and to deliver conditions for effective competition and development of a single market for insurance? This article examines these questions, drawing on a recent Oxera report for DG Internal Market and Services.

Significant differences in national approaches to IGS

Of the 27 Member States, 13 operate at least one IGS.[2] Five countries have general schemes that 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).[3] In the other 14 Member States there are currently no explicit provisions for an IGS to be activated in the event of failure of an insurance undertaking.

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 that would have required 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.

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

– In the UK, a series of insurance failures led to the establishment in 1975 of the Policyholder Protection Board as the predecessor of the Financial Services Compensation Scheme to cover both life and non-life contracts.

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– In France, the establishment of the Fonds de garantie des assurances de personnes at the end of 1999 followed the failure of a life assurance company, Europavie, in the French market in 1998, Similarly, guarantee for compulsory non-life insurance was implemented in 2003 (Fonds de garantie des assurances obligatoires de dommage) as a result of several failures during 1998 and 2003, in which the new scheme was required to intervene retrospectively.

– In Germany, the insolvency of life assurer, Mannheimer Lebensversicherung, led to the 2002 establishment of Protektor, the industry scheme that preceded the implementation of a statutory life assurance guarantee scheme in Germany.

– In Denmark, a scheme for non-life insurance was established in 2003 following the bankruptcy of a non-life insurer one year earlier.

There are different ways of designing an IGS. The inventory of IGS currently established in the EU shows significant differences along virtually all dimensions of IGS design, including the following.

– **Scope of IGS protection**—the classes of insurance covered, restrictions on the type of claimant eligible to receive protection, the geographic scope (eg, whether cross-border business conducted via branches or insurers selling directly across borders under freedom of services provisions is protected), and the amount of protection provided, etc.

– **IGS operating arrangements**—governance, case handling procedures, etc.

– **Funding and the corresponding financial capacity of the IGS**—the timing and amount of levies imposed on insurance undertakings covered by the IGS (eg, pre-funding or post-funding), and the availability of other sources of funding (eg, borrowing with state guarantee).

From the perspective of consumers, these cross-country differences imply very different protection levels, depending on the place of residency in the EU and on whether policies are purchased from a domestic insurer or cross-border provider. From the industry perspective, the differences imply that policies written may or may not be covered by an IGS (and IGS levies need or need not be paid), depending on where in the EU the insurer is headquartered and what business is conducted.

The case for IGS

IGS provide last-resort protection in the event of an insurance failure. The risk of insurance companies failing is small because of the existence of other protection mechanisms, including a strict prudential framework, which in the EU is being further improved as part of the implementation of Solvency II. Nonetheless, insurance failures have occurred in the past and are likely to occur going forward, if at low frequency. Neither the current solvency regime nor Solvency II is a zero-failure regime—they reduce, but do not completely eliminate, the risk of failure.

In the event of failure, policyholders can incur losses if the insurer cannot meet the contractual obligations. This applies to life assurance as well as non-life insurance, although there are significant differences in loss exposure between the two types of insurance. Predicting failure or assessing the financial soundness of an insurance company is difficult, especially for retail consumers—the insurance business is technical in nature, and many insurance contracts are sold years before claims are settled. Moreover, losses may be incurred by consumers other than policyholders, such as injured third parties in the case of liability insurance, who have no influence over the choice of insurance provider. Thus, there are good reasons to introduce an IGS in the interest of consumer protection.

A second argument in support of setting up an IGS is that, in the absence of last-resort protection, consumers may lose confidence in insurance companies altogether. In addition to confidence losses, the failure of a larger insurer can disrupt market operations and have wider market impacts.

Thus, if the main evaluation criteria for policymakers are consumer protection and market confidence and stability, a case can be made for establishing an IGS. Consumer protection and market confidence/stability also provide the main reason why guarantee schemes have already been established in the investment and banking sector in all EU Member States.[4]

The case for establishing an IGS is strengthened by the fact that there are many examples of Member States having implemented an IGS after an insurance failure—ie, adopting a caveat emptor approach was not considered a viable policy option.

Thus, assuming that there is no zero-failure regime, the relevant question for those Member States that currently do not have an IGS is what the response will be if it comes to an insurance failure in the domestic market. If ‘do nothing’ is not an option, there may be an implicit guarantee that intervention will occur. Compared with operating an explicit IGS, such implicit guarantees have a number of disadvantages. First, they create uncertainty and may not allow intervention in a timely and cost-effective manner. Second, they may lead to concerns about fairness because the nature of intervention is discussed at a time when winners and losers can be identified. Third, to the extent that they may target the larger 'too-big-to-fail' companies, implicit guarantees can distort competition in the market.

However, while having significant advantages, establishing an IGS is not costless, so the policy decision to introduce one involves a trade-off between benefits and costs.

The case against IGS

IGS impose both direct and indirect costs. The former include those of operating an IGS, and the related concerns about administrative feasibility. While the costs are pure additional costs to be borne by the system, the evidence suggests that these are small, certainly compared with the other direct cost element—ie, the costs of providing the guarantee in the event of insurance failure (compensation payments or the costs of facilitating continuity of policies).

The guarantee costs are not costs to the system as a whole, but are largely distributional. The redistribution depends on the design of the IGS, but for industry-financed IGS it is in general the policyholders of the failed insurance company who benefit at the expense of solvent companies and their policyholders who finance the cost of protection. Given that the impact is largely distributional, the decision to establish an IGS depends on distributional preferences and notions of fairness and proportionality—eg, how much redistribution from the many (ie, consumers of solvent insurers) to the few (ie, individual consumers of insolvent insurers) is deemed necessary, acceptable or fair?

The evidence suggests that, for existing IGS, the level of direct guarantee costs, and hence the degree of redistribution, has been relatively small—usually below 0.1% of gross premiums—even in markets that have seen more frequent or larger failures. More generally, the direct costs of an IGS can, on aggregate, be relatively small if other protection mechanisms are effective in preventing insurance failures and where the IGS is introduced only to provide complementary last-resort protection. Costs can in principle also be contained through scheme design—ie, by limiting the scope of protection.

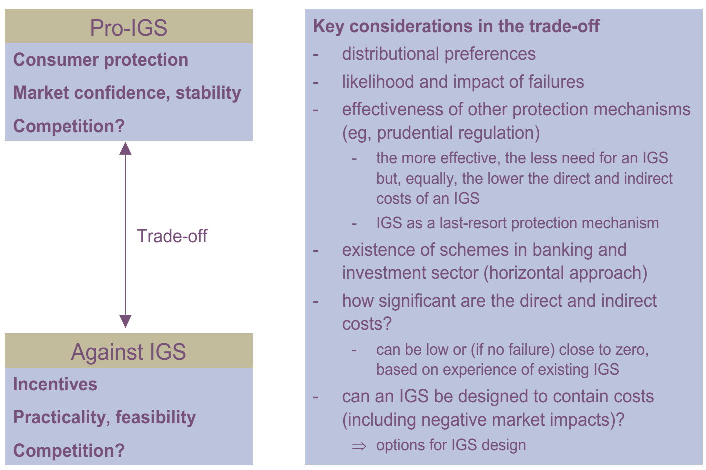
Clearly, large failures cannot be ruled out. Several insurance markets in the EU, particularly those in the new Member States, are relatively small and concentrated. The failure of the largest insurers (eg, those with a market share of 10% or more) would, depending on the asset shortfall and timing of 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

In terms of indirect costs, establishing an IGS may result in perverse incentives among market participants and, in particular, induce both policyholders and insurers to behave in a more risky manner (the 'moral hazard' problem). While important in theory, there is little evidence to empirically support the view that the introduction of IGS distorts market operations through incentive effects. In addition, moral hazard concerns are reduced through other protection mechanisms. These include prudential supervision; Solvency II may further reduce incentives for moral hazard behaviour on the part of industry because greater risk-taking will be penalised through higher capital requirements. Moral hazard concerns can also be reduced through scheme design.

Some argue that IGS may reduce competition in the insurance market—eg, by imposing IGS contributions that create barriers to entry and make it more difficult for firms to operate in the market. Poorly designed schemes may indeed have distortionary effects on the market. However, IGS are likely to be pro-competitive. They allow companies to exit the market efficiently without consequences for consumers (particularly where firms are otherwise regarded as 'too big to fail'), and they may promote entry of new firms that could benefit from enhanced consumer confidence.

Figure 1 summarises the trade-off involved in the decision to establish an IGS, as well as the key considerations influencing this trade-off.

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



Source: Oxera (2007), op. cit.

The introduction of an IGS depends to a large extent on distributional preferences and the weight attached to different criteria.

If policymakers have consumer protection and market confidence as their primary objectives, a strong case can be made for introducing an IGS. Nonetheless, even if consumer protection and market confidence are the primary objectives, these must be balanced against secondary objectives—ie, containing direct costs and limiting market distortions.

A matter of IGS design

Costs can be contained by limiting the scope of protection provided by the IGS. For example, protection can be targeted at specific classes of insurance, such as the following:

- 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;
- compulsory insurance, given the legal requirement on policyholders to purchase cover.

Protection can also be targeted at specific claimants, particularly retail consumers, for whom protection measures are generally considered 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 explicit 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 imposing risk-weighted levies on industry.

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 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 and the fund size is not in line with expected guarantee costs.

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.

A need for policy action at EU level?

The coexistence of the very different national approaches to IGS raises concerns at the EU level about consumer protection when it comes to insurance business provided across European borders. Insurance policies may or may not be protected (or may be protected to very different levels) depending on where in the EU the policy is issued, where the policyholder resides, what risk is protected, and whether the policy is purchased from a domestic insurer or cross-border provider. The different IGS protection levels and funding requirements also result in conditions that may distort cross-border competition—eg, by 'unlevelling' the playing field within Member States and influencing market entry decisions across Member States.

However, the problems with the status quo are limited for two reasons: first, the level of relevant cross-border insurance business (ie, retail business carried out via branches and freedom of services) remains low, with retail markets still being largely 'domestic'; 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 IGS differences would result in significant distortions in the competitive process within and across EU Member States—neither demand-side effects (ie, consumers making their choice on the basis of IGS protection) nor supply-side effects (ie, IGS-driven cost differences between firms operating in the same market) appear sufficiently strong to create such distortions.

To effectively address cross-border consumer protection problems, the EU policy response may be to impose a requirement to set 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.

A minimum level of harmonisation of national IGS would be required to deliver any 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 or funding arrangements across IGS as long as the resulting national IGS arrangements are such that the promised protection can actually be delivered.

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

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[1] Directive 94/19/EC on Deposit Guarantee Schemes and Directive 97/9/EC on Investor Compensation Schemes.
[2] Motor vehicle insurance and the guarantee funds established in the EU Member States were beyond the scope of the Oxera study.
[3] 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.
[4] See, for example, Oxera (2005), 'Description and Assessment of the National Investor Compensation Schemes Established in Accordance with Directive 97/9/EC', report prepared for DG Internal Market and Services, January.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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