

Insurance guarantee schemes in the EU

**Comparative analysis of existing
schemes, analysis of problems and
evaluation of options**

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Executive summary

This report sets out Oxera's main findings on the study 'Insurance Guarantee Schemes in the EU: Comparative Analysis of Existing Schemes, Analysis of Problems and Evaluation of Options', commissioned by the European Commission (DG Internal Market and Services).

Insurance guarantee schemes (IGS) provide last-resort protection to policyholders and beneficiaries 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. An IGS can offer protection by paying compensation to policyholders or beneficiaries, or by securing the continuation of insurance contracts.

Last-resort protection schemes exist in other sectors of the financial services industry. In particular, deposit guarantee and investor compensation arrangements exist 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. However, there is no such common European framework in the insurance sector.

The main objective of this report is to inform the policy debate on IGS in the EU. The report provides a detailed description and comparative analysis of the existing EU IGS for life assurance and non-life insurance.¹ In addition, it examines the need for, and role of, an IGS as a last-resort protection mechanism, and the cost of establishing such a scheme. Based on an assessment of the current situation and the potential problems arising from the coexistence of different national approaches to IGS, the report also presents an evaluation of the options available to improve on the status quo, at both the national and EU (cross-border) levels.

Existing IGS in the EU (section 2)

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).²

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

¹ Motor insurance and the guarantee funds established in Member States in accordance with the EU Motor Directives are beyond the scope of this study.

² 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.

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.

Framework for the analysis and evaluation of options (section 3)

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 (section 4)

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.

The cost of IGS (section 5)

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.

Operation of existing IGS in the cross-border context (section 6)

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.

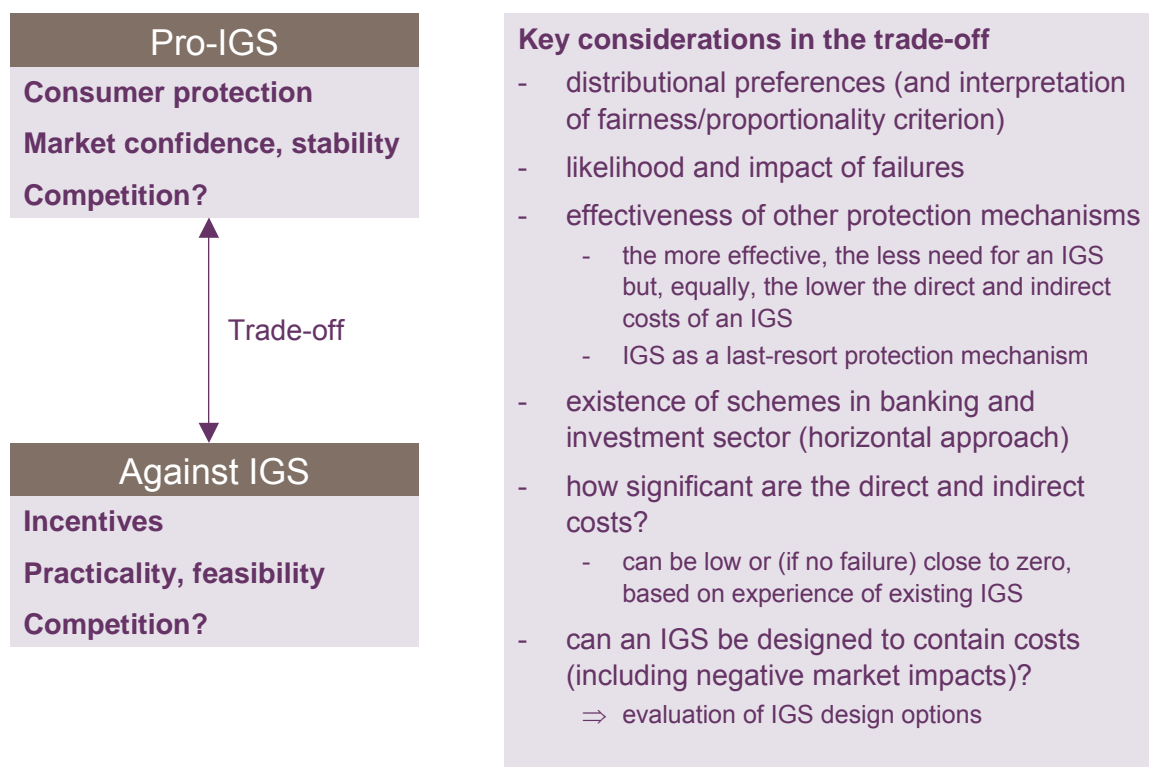
The potential impacts on cross-border consumer protection and competition must be considered in the broader context of the EU (retail) insurance market and, in particular, the fact that cross-border activity (in the form of branches and freedom of services) remains limited. Thus, while the lack of harmonised 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.

Options: establishment and design of an IGS (section 7)

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 assurance 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 (section 8)

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.

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1 Introduction

This report sets out Oxera's main findings on the study 'Insurance Guarantee Schemes in the EU: Comparative Analysis of Existing Schemes, Analysis of Problems and Evaluation of Options', commissioned by the European Commission (DG Internal Market and Services).³

1.1 Content and objectives of study

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.

Similar last-resort protection schemes exist in other sectors of the financial services industry. In particular, deposit guarantee and investor compensation arrangements exist 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, respectively.⁴ However, no such common European framework exists in the insurance sector.

The market for life assurance and non-life insurance has grown substantially over the past few years in all EU Member States. Cross-border business has also grown significantly, with increased sales through foreign branches and subsidiaries, or directly under the freedom to provide services. The largest European insurance firms are progressively becoming pan-European groups.

In an expanding and increasingly integrated insurance market, there is likely to be a growing need for a common prudential framework to protect customers and ensure a level playing field for competition. EU Directives concerning the solvency requirements of insurance undertakings have improved the level of harmonisation of prudential regulation, and Solvency II, which will eventually replace the present solvency regime, will result in further improvements. However, although these EU measures and corresponding national rules reduce the risk of default of insurance undertakings, it is not possible (and in some cases not desirable) to eliminate altogether the possibility of failure. Recent failures (or near-failures) of insurance companies could be seen as indicative of the importance of last-resort protection and orderly arrangements to deal with claims by policyholders and beneficiaries in the event of insurance failure.

Many EU Member States have no insurance guarantee arrangements in place, or have implemented schemes 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 a number of key policy questions.

- What are the principal risks to policyholders, and is there a need for IGS to provide last-resort protection?

³ Contract ETD/2006/IM/H2/113.

⁴ Directive 94/19/EC on Deposit Guarantee Schemes and Directive 97/9/EC on Investor Compensation Schemes.

- To what extent do existing IGS in the EU provide adequate consumer protection and ensure that confidence remains high in insurance markets in the event of an insurance company failure (within and across borders)?
- What is the impact of existing IGS arrangements on competition and market development (within and across borders)?
- What options are available to improve upon the status quo, in terms of the design of individual schemes at the national level as well as the implementation of minimum protection standards and harmonisation at the European level?

The aim of this report is to inform policy decisions in relation to these questions. It therefore provides a detailed analysis of the existing IGS in the EU for life assurance and non-life insurance. In addition, the report examines the role of IGS and the cost of establishing one. Based on an assessment of the current situation and potential problems arising from the coexistence of different national approaches to IGS, the report also presents an evaluation of the options available to remedy any identified issues at the national and EU (cross-border) levels. It considers how the design of IGS can mitigate identified problems.

Motor vehicle insurance and the guarantee funds established in the EU Member States are beyond the scope of this study. In accordance with the EU Motor Directives, Member States have to set up or authorise a body with the task of providing compensation for damage to property or personal injury caused by an unidentified vehicle or a vehicle for which the insurance obligation provided for in the Directives has not been satisfied. The Motor Directives do not state that the motor guarantee funds should also ensure payment of compensation in the event of the insolvency of the insurance undertakings. The IGS established in some Member States also assume responsibility for motor insurance, while in others, motor guarantee funds are separate and have no relationship with the IGS. Although motor insurance was specified as being outside the scope of this study, for the IGS that also cover motor insurance, the relevant information was not always available to exclude motor insurance, and for these schemes motor insurance is included in the description and analysis.

1.2 Structure of report

This report is structured as follows.

- Section 2 presents an inventory of the IGS currently observed in Europe. It draws from the more detailed scheme descriptions contained in Appendix 1, and provides a comparative summary of the main features of the schemes. The objective is to describe existing IGS and highlight the main differences in the scheme structures and operating arrangements.
- Section 3 sets out the conceptual framework developed to conduct the analysis of the role of IGS in the market, the potential problems with the current situation, and the options available to introduce and structure IGS in the EU going forward.
- Section 4 examines the risks and consequences of insurance failures and the potential need for, and role of, IGS as a protection mechanism.
- Section 5 presents an analysis of the costs of IGS, focusing on both the direct costs (ie, payments made to provide the guarantee as well as administration costs) and the indirect costs (ie, negative market impacts).
- Section 6 examines the problems associated with the operation of existing IGS in the EU cross-border context, from the point of view of consumer protection and competition.

- Sections 7 and 8 present the evaluation of options. This includes both general options concerning the introduction of an IGS and scheme design (section 7), as well as specific options in the EU cross-border context (section 8).
- Appendix 1 provides the country-specific descriptions of insurance guarantee arrangements in place in the EU Member States (this is background information to support the inventory contained in section 2).
- Appendix 2 contains the questionnaire that was circulated to each IGS for the purpose of obtaining detailed information about scheme structure and design.
- Appendix 3 provides a list of abbreviations and acronyms used in the report.

1.3 Methodology

The completion of this report required extensive information gathering and research.

- **Identification of relevant schemes.** In each Member State, Oxera contacted the national insurance association, as well as the relevant supervisory authority and/or ministry, with a view to: a) informing the stakeholders about Oxera's research; b) requesting their assistance with the identification of IGS in their country and provision of contact details; and c) inviting them to participate and submit information to aid the study. The responses received provided Oxera with a complete list of IGS and the relevant contact details. The list was cross-checked with existing information, including the information previously gathered by the Commission.
- **Questionnaire design and analysis.** Information requirements were met in part by the review of published documentation. However, it was also necessary to design a detailed questionnaire in order to fill any information gaps and obtain details in a harmonised format for all countries. A copy of the questionnaire is provided in Appendix 2.

In designing the questionnaire, Oxera considered existing research into IGS and the information already available to the Commission. A number of interviews were conducted to identify the key issues to be addressed and the optimal phrasing of questions. Prior to circulation to scheme operators, the questionnaire was also shown to the Commission for comment.

- **Review of laws, regulations and other publications.** The relevant national laws and regulations governing insurance guarantee arrangements, as well as any other relevant published documentation (eg, annual reports), were consulted for each scheme with a view to gaining a comprehensive understanding of structure and operation. Responses to previous Commission questionnaires on IGS were also reviewed.
- **Interviews.** The questionnaire analysis was complemented by in-depth interviews with operators of EU IGS.

The interviews with scheme operators were critical to the information-gathering exercise, and contributed significantly to the understanding of insurance guarantee arrangements in the different countries. The interviews also gave the scheme operators the opportunity to express their views on, and influence, the research. The scheme operators provided comments and checked the factual correctness of the country-specific descriptions contained in Appendix 1.

In addition to the scheme operators, interviews were conducted with supervisory authorities or ministries, industry associations and individual insurance undertakings in selected Member States.

In addition to collecting country-specific information, Oxera reviewed the existing academic literature and research studies to examine the generic issues addressed in this research, including studies on guarantee schemes, the risks of insurance failures, the regulatory framework of insurance undertakings, and developments in the EU market for life assurance and non-life insurance.

2 Description of existing IGS

This section provides an inventory of insurance guarantee arrangements in place in the EU Member States, covering life assurance and non-life insurance. It draws from the more detailed descriptions contained in Appendix 1, and summarises the main features of the schemes and the ways in which they differ across countries.

The inventory starts with an overview of IGS established in the EU, summarising those countries that have established an IGS and those that have not. For the countries with existing schemes, it describes the type of scheme in place; date of implementation; relevant national laws and regulations; structure and governance arrangements; participation requirements for insurance undertakings; nature of the intervention; scope of coverage in terms of protected policies, eligible claimants and protection limits; cross-border arrangements; and funding provisions. The inventory also provides an overview of the cases dealt with by the schemes to date.

2.1 Summary of existing schemes

When an insurance company becomes insolvent, policyholders and beneficiaries can face financial losses if their claims cannot be met by the company. IGS are arrangements that protect claimants against such losses (either partially or in full) and ensure that claims held against the company are met in one form or another. This protection can be provided by paying compensation to claimants after the insurance company has been declared insolvent, or by securing continuation of the insurance policies through transfer of the insolvent insurer's portfolio or other means.

Among the 27 EU Member States, 13 countries have put in place insurance guarantee arrangements and set up one (or in some cases more than one) IGS.⁵ The countries are reported in Table 2.1, which further distinguishes between different types of scheme. One distinction is drawn between schemes covering life assurance and non-life insurance. The other distinction further divides non-life insurance schemes, separating special schemes that apply to only one or a few branches or classes of (compulsory) insurance from schemes that cover non-life insurance contracts subscribed to by participating insurers on a more general basis.

Overall, IGS in life assurance have been established in eight countries. Thirteen countries have guarantee arrangements in the non-life sector, many of which provide coverage for only very specific types of insurance, such as workers' accidents insurance, hunting insurance, or supplementary health insurance.

Structure and coverage differs significantly across countries. Key differences are as follows.

- In some countries, there is **one scheme that covers both life and non-life insurance** (Latvia, Malta, Romania, Spain and the UK), although the scheme may be further divided into sub-schemes or sub-funds. Poland also has a scheme for both life and non-life insurance, but the latter applies only to a few specific classes of compulsory insurance.
- In other countries, **separate schemes operate for life assurance and non-life insurance** (France and Germany), and there can also be **separate schemes for**

⁵ This excludes motor guarantee funds established in the EU, which are outside the scope of this study.

different classes of non-life insurance. For example, in Spain, the Consorcio de Compensación de Seguros (CCS) operates a general winding-up scheme for both life and non-life insurers, as well as two special schemes covering hunting liability and travellers' insurance (in addition to motor insurance).

- Some countries have implemented arrangements that provide insurance guarantee only for non-life insurance. Denmark and Ireland have a **single scheme that covers non-life insurance on a general basis**. In other Member States (Belgium, Finland and Italy) the schemes **apply only to specific classes of non-life insurance**. In Belgium and Italy, a single scheme has been set up which applies to one class of insurance only (workers' accidents and hunting liability, respectively). In Finland, there are two separate schemes covering employment accident insurance and patient insurance. These insurance classes are compulsory in the respective countries and, for Belgium and Finland, they are considered a part of social security that is provided by private insurers.

Broadly speaking, and as discussed in more detail below, the most comprehensive insurance guarantee arrangements are observed in the UK—the Financial Services Compensation Scheme (FSCS) covers both life assurance and non-life insurance on a general basis, with a scope of coverage that is broader than in other countries that also have in place arrangements to guarantee life and non-life insurance claims.

Table 2.1 Existence and type of scheme

	General schemes for life and non- life insurance	General schemes for life assurance	General schemes for non-life insurance	Special schemes for non-life insurance
Austria				
Belgium				✓ ¹
Bulgaria				
Cyprus				
Czech Republic				
Denmark			✓	
Estonia				
Finland				✓ ²
France		✓	✓ ³	
Germany		✓		✓ ⁴
Greece				
Hungary				
Ireland			✓	
Italy				✓ ⁵
Latvia	✓ ⁶			
Lithuania				
Luxembourg				
Malta	✓			
Netherlands				
Poland		✓ ⁷		✓ ⁷
Portugal				
Romania	✓			
Slovenia				
Slovak Republic				
Spain	✓ ⁸			✓ ⁸
Sweden				
UK	✓			

Notes: ¹ Covers compulsory workers' accidents insurance only. ² Scheme for statutory employment accident insurance, and scheme for statutory patient insurance. ³ Scheme covers only compulsory non-life insurance, but is classified as a general scheme because of the number of compulsory insurances in France and to distinguish it from the special schemes that cover only one insurance class. ⁴ Covers substitutive private health insurance only. ⁵ Covers hunting liability insurance only. ⁶ Several classes of non-life insurance excluded, but classified as a general scheme to distinguish it from the special schemes that cover only one insurance class. ⁷ One scheme that covers life and non-life insurance, but not classified as a general scheme because only specific classes of non-life insurance are covered (farmers, farm buildings, professional and motor third-party liability). ⁸ General winding-up scheme for life and non-life insurers as well as special schemes for travellers' accident and hunting liability insurance.

Source: Oxera.

The relevant schemes were identified with the help of the national supervisory authorities, ministries, or industry associations in the EU Member States, as well as information previously collected by the European Commission as part of the Working Group on IGS.

The following arrangements have been excluded from subsequent descriptions.

- **Early Intervention Arrangement for Life Insurers in the Netherlands (EIALA)**—in the Netherlands, there is no life assurance IGS as such. The Early Intervention Arrangement for Life Insurers (Opvangregeling Leven) is in place to protect consumers. The EIALA makes it possible to guide a life insurer through a financially difficult period and secure continuity of its portfolio. The arrangement applies only if the portfolio of the insurer is still viable (ie, there are sufficient assets to cover the technical provisions). The intervention takes the form of entering reinsurance agreements with a special entity, formed by the Dutch insurance association, or a portfolio transfer to such a special entity (which then seeks to transfer the portfolio to another insurer). Although similar in effect to some IGS that have the role of facilitating portfolio transfer or otherwise secure contract continuity, the arrangements are preventative in nature—they take effect to prevent insolvency and apply only if the portfolio of the life insurer is still viable.⁶
- **Workers' compensation fund in Portugal**—Portugal has established a Workers' Accidents Compensation Fund (Fundo de Acidentes de Trabalho, FAT). The FAT provides protection in the event of non-insurance of a worker by their employer. Whether the FAT covers the compensation in the event of a winding-up of one insurance company providing workplace accident insurance remains a matter of legal interpretation. Since there have not been any cases that have required the courts to make a clear interpretation of the law in this matter, there is no legal certainty of the interpretation. This is unlike other countries (eg, Belgium and Finland) where workers' compensation funds are required by law to operate not only in cases of non-insurance, but also when the insurer providing the insurance is insolvent. Given the legal uncertainty and the fact that the FAT in Portugal may not operate in cases of insolvency, this scheme is not considered further.
- **Specific arrangements concerning health insurance in France and the Netherlands**—France has established two main IGS that protect against failures in the life assurance and compulsory non-life insurance market. In addition to these main IGS, there are separate funds for the mutuals operating in France (Fonds de garantie des mutuelles du code de la mutualité) and for paritarian institutions of social protection (Fonds de garantie des institutions de prévoyance du code de la Sécurité Sociale). The funds apply to a specific segment of the market only and the main type of insurance covered is health insurance. The description for France focuses on the two main IGS.

In the Netherlands, a new insurance system for curative healthcare came into force in 2006. All Dutch residents are obliged to take out health insurance, and insurance companies are not permitted to preclude anyone or charge different premiums for different risks. A risk equalisation system protects health insurers from financial losses arising from an unequal distribution of risks. Compensation arrangements are part of the system. In the event of failure of an insurer, policyholders are compensated by the Health Care Insurance Board (CVZ) for unsettled claims. The costs are first recovered on the estate of the bankrupt insurer by the CVZ, with any deficits borne by the state. Given the special nature of the system and the fact that the arrangements were in the process of being finalised at the time of writing, this system is not considered further in the description provided in the report, although a short summary is provided in Appendix 1.

2.2 Scheme name, establishment and legal/regulatory framework

Table 2.2 provides details of the scheme established in each country, distinguishing between the four different types of scheme listed in Table 2.1. It also refers to the date at which the scheme was established, the principal legislation governing the scheme as well as further

⁶ A general description of the EIALA is included in Appendix 1.

regulations, and the competent supervisory authority for insurance undertakings in the relevant country.

Insurance guarantee arrangements in some countries date back many years. For example, although the general scheme that currently covers both life and non-life insurance in the UK (FSCS) was established in 2001, comprehensive guarantee arrangements existed in the UK as early as 1975.

IGS are often established as a result of an insurance failure in the relevant market. This was the case in the UK when a series of insurance failures led to the establishment in 1975 of the Policyholder Protection Board as the predecessor of the FSCS to cover both life and non-life contracts. The establishment of the Fonds de garantie des assurances de personnes (FGAP) in France 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, FGAO) as a result of several failures during 1998 and 2003, in which the new scheme was required to intervene retrospectively.

The general scheme for non-life insurance in Denmark was established in 2003 following the bankruptcy of a non-life insurer one year earlier. The corresponding scheme in Ireland, the Insurance Compensation Fund, was introduced in 1964 to assist with the liquidation of an insolvent non-life insurer; the implementing legislation was further amended in 1983 and 1985 to facilitate the administration of further cases of non-life insurer failures.

In Germany, the implementation of legislation to create two statutory guarantee schemes in 2004 followed private initiatives by the insurance industry, which had already established voluntary funds to protect policyholders in the event of failures of life insurers and private health insurers (Protektor Lebensversicherungs AG and Medicator AG, respectively).

In the new Member States, insurance guarantee arrangements have been implemented in Latvia, Malta, Poland and Romania, covering life assurance as well as (certain classes of) non-life insurance. Some of these schemes date back to well before accession to the EU. For example, the Maltese scheme was originally set up in 1986; the Polish scheme in 1991; and the Latvian scheme in 1993, although there have been changes to the legal framework since. Table 2.2 reports the principal legislation that currently applies.

Table 2.2 Establishment of schemes and legal/regulatory framework

	Name of scheme	Principal legislation	Other regulation	Established	Supervisory authority
General schemes covering both life and non-life insurance					
Latvia	Fund for the Protection of the Insured (Apdrošināto aizsardzības fonds)	Law on Insurance Companies and Supervision thereof (Apdrošināšanas sabiedrību un to uzraudzības likums)	Regulations of the Financial and Capital Market Commission on the Payment Procedures of the Fund for the Protection of the Insured	September 1st 1998	Financial and Capital Market Commission
Malta	Protection and Compensation Fund	Insurance Business Act		January 1st 2004, taking over the functions of the Insurance Security Fund (implemented 1986)	Malta Financial Services Authority
Romania	Guarantee Fund (Fondul de Garantare)	Law 136/1995 regarding insurance and reinsurance in Romania (privind asigurările si reasigurările in Romania); Law 503/1004 regarding financial recovery and the winding-up of insurance undertakings; Law 32/2000 regarding insurance business and insurance supervision	Order 3115/2005 to enact the regulations regarding the Guarantee Fund	January 1st 2005 (date of full implementation of legislation)	Insurance Supervisory Commission (Comisia de Supraveghere a Asiguratorilor)
Spain	Consortio de Compensación de Seguros (CCS), which is the body in charge of the general and the special schemes (see below)	Royal Decree 6/2004 (rules regarding CCS functions in relation to winding up). Royal Order in Council 10/1984 of July 11th	Royal Decree-Law of 1940, Act of December 16th 1954, and revised text by the Royal Legislative Decree 7/2004 of October 29th Law 21/1990, Law 30/1995, Law 44/2002, Law 22/2003, and Law 34/2003	Guarantee arrangements since 1984, but CCS assumed responsibilities in 2002 from its predecessor (CLEA)	Dirección General de Seguros y Pensiones, which is part of the Ministry of Economy and Finance

	Name of scheme	Principal legislation	Other regulation	Established	Supervisory authority
UK	Financial Services Compensation Scheme (FSCS)	Financial Services and Markets Act 2000	Financial Services Authority Handbook of Rules and Guidance ('Compensation')	December 1st 2001, taking over the function of the Policyholder Protection Board (implemented in 1975)	Financial Services Authority (FSA)
General schemes covering life assurance					
France	Guarantee Fund for Life Insurance (Fonds de garantie des assurances de personnes, FGAP)	Law of June 25th 1999 (loi no. 99-532 due 25 juin 1999 relative à l'épargne et à la sécurité financière)	Décret no. 99-688 due 3 août 1999	Legal implementation in June 1999; established end 1999	Autorité de contrôle des assurances et des mutuelles (ACAM)
Germany	Guarantee Fund for Life Insurers (Sicherungsfonds für die Lebensversicherer) ¹	Insurance Supervision Law amended on December 15th 2004 (Versicherungsaufsichtsgesetz, VAG)	Decree concerning the funding of the guarantee fund for life insurers (Sicherungsfonds-Finanzierungs-Verordnung (Leben))	Legal implementation in December 2004; statutory scheme established in May 2006	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)
Poland	Insurance Guarantee Fund (IGF, Ubezpieczeniowy Fundusz Gwarancyjny)—also in charge of special schemes (see below)	Act on insurance activity of July 28th 1990	Act of May 22nd 2003 on Compulsory Insurance, Insurance Guarantee Fund and Polish Motor Insurers' Bureau Articles of Association of Insurance Guarantee Fund approved in 2004	January 1st 1991. However, until 1995 the protection functions in the event of bankruptcies were performed by the Insurance Protection Fund. In 1995, the IGF took over these responsibilities	Financial Supervisory Commission, Ministry of Finance
General schemes covering non-life insurance					
Denmark	Guarantee Fund for Non-life Insurance Companies (Garantifonden for Skadesforsikringselskaber)	Guarantee Fund for Non-life Insurance Companies Act (Consolidated Act no. 457 of June 10th 2003)		2003	Danish Financial Supervisory Authority
France	Guarantee Fund for Compulsory Non-life Insurance (Fonds de garantie des assurances obligatoires de dommages, FGAO)	Law of August 1st 2003 (Loi no. 203-706 due 1er août 2003)		Legal implementation in August 2003	ACAM
Ireland	Insurance Compensation Fund	The Insurance Act 1964 (dated July 7th 1964) with amendments since		1964 (with amendments since)	Irish Financial Services Regulatory Authority

	Name of scheme	Principal legislation	Other regulation	Established	Supervisory authority
Special schemes covering one or a few branches of (compulsory) non-life insurance					
Belgium	Fonds voor Arbeidsongevallen/Fonds des Accidents du Travail (FAO/FAT)	Article 58 of Law of April 10th 1971		1971	Commission Bancaire, Financiere et des Assurances (CBFA)
Finland	Joint guarantee for statutory employment accident insurance (Lakisääteisen tapaturmavakuutuksen yhteistakuu) Statutory patient insurance scheme (Potilasvakuutuksen yhteistakuu)	Employment Accident Insurance Act Act on patient injuries insurance		January 1st 1997	Ministry of Social Affairs and Health
Germany	Guarantee Fund for Private Health Insurers (Sicherungsfonds für die privaten Krankenversicherer) ¹	Insurance Supervision Law amended on December 15th 2004 (VAG)	Decree concerning the transfer of functions of the health insurance guarantee fund to Medicator AG	Legal implementation on December 2004; statutory scheme established in May 2006	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)
Italy	Guarantee Fund for Hunting Victims (Fondo di garanzia per le vittime della caccia – organismo di indennizzo)	Law 157 of 1992	Codice delle Assicurazioni Private – Decreto legislativo n. 209 del 5/9/2005 (Private Insurance Code – decree law no. 209 of 5/9/2005)	1992 (but Fund assumed functions relating to insolvencies only in 2000)	Ministro dello sviluppo economico (Ministry of Economic Development)
Poland	Insurance Guarantee Fund (IGF, Ubezpieczeniowy Fundusz Gwarancyjny)—also in charge of general scheme for life assurance (see above)	Act on insurance activity of July 28th 1990	Act of May 22nd 2003 on Compulsory Insurance, Insurance Guarantee Fund and Polish Motor Insurers' Bureau Articles of the Association of Insurance Guarantee Fund approved in 2004	Since 1991: farmers' third-party liability (TPL) and farm buildings insurance Since 2004: professional TPL insurance	Financial Supervisory Commission, Ministry of Finance
Spain	Travellers' insurance scheme and hunters' liability insurance scheme, which are both operated by CCS	Travellers' insurance: Royal Decree 1575/1989 December 22nd Hunters' liability insurance: Ministerial Order of July 20th 1971		Travellers' insurance—1989. Hunters' liability insurance—1971	Dirección General de Seguros y Pensiones, which is part of the Ministry of Economy and Finance

Note: ¹ Private initiatives preceded the statutory schemes for life and health insurance, namely the Protektor Lebensversicherungs-AG (established 2002) and the Medicator AG (established 2003). These bodies now operate the statutory guarantee schemes.

Source: Oxaera.

2.3 Ownership, management and administration

The institutional structure and set-up of the IGS differ considerably across countries. As already discussed, schemes may cover both life assurance and non-life insurance, or only life assurance or non-life insurance, either on a general basis or for specific branches of insurance.

In the UK, the FSCS is the last-resort protection scheme for insurance, but also provides guarantee or compensation in the event of failures in other parts of the financial services industry, including deposits and investments. In all other countries, IGS are organised separately from deposit guarantee schemes (DGS) and investor compensation schemes (ICS).

All EU Member States have implemented motor guarantee funds to compensate damage to property or personal injury caused by an unidentified vehicle or a vehicle for which the insurance obligation has not been satisfied, in line with EU Motor Directives. The general IGS established in some countries also assume responsibilities for motor insurance (eg, France, Malta and Poland), while in other countries motor guarantee funds are separate and have no relationship with the IGS (eg, Denmark, Germany, Ireland and Latvia). Motor insurance is outside the scope of this study, and is therefore not discussed.⁷

Table 2.3 summarises the institutional structures of IGS that concern the ownership, management and administration arrangements of the schemes.

While some countries have opted to operate IGS by way of a public body, others have implemented a model of private ownership and management. Some of the public schemes are operated by, or from within, the financial services supervisory authority (eg, Latvia and Romania), while others are administered by a separate public entity (eg, Belgium, Ireland, Italy and Malta). Although essentially public, some of the schemes have in place some form of involvement by, or representation of, the participating firms. For example, the schemes in Italy and Malta are under the general control of a committee that also includes industry representatives.

Among the private schemes, some are set up as limited companies, while others are private trusts or foundations. One model of private management is for the trade association representing the participating firms to be responsible for the daily management of the IGS (eg, Denmark).

Although most are independent, the schemes maintain a close relationship with, and are accountable and subject to, the supervision of the financial services supervisory authority—eg, schemes are often required to submit annual reports to the supervisor. The supervisor is in some cases the competent authority that declares that an insurer is unable to meet its obligations, and thereby triggers the operation of the IGS in the first place. The scheme and supervisor generally cooperate in terms of information sharing, for example, with the supervisor informing the scheme in advance of cases that may require IGS intervention or providing data on scheme participants.

Table 2.2 also reports estimates of the number of staff employed to administer the IGS, as well as the administration expenses. These estimates differ markedly between schemes and are largely a function of:

⁷ For some IGS that also cover motor insurance, it was not always possible to obtain the information required to exclude motor insurance. Motor insurance is therefore included for these schemes.

- the number and nature of failures dealt with by the scheme (see section 2.10);
- the nature of intervention by the scheme and the scope of coverage (see in particular sections 2.5 and 2.6); and
- the tasks carried out by the scheme as opposed to being outsourced to a third party.

In relation to the last point, an IGS may itself be in charge of processing claims for compensation or securing continuation of portfolios (eg, Spain). Alternatively, these tasks may be performed by a third party. In particular, the insolvency practitioner assigned to the estate of the insolvent insurer plays a key role in establishing claims for most schemes (eg, France and the UK). In other cases, the scheme has concluded agreements with other insurers established in the market to handle claims and administer payments (eg, Denmark and Italy), with the functions of the scheme being largely reduced to collecting and providing the supporting funds to meet the costs. Table 2.3 provides a summary of who is responsible for handling cases and administering claims, with further details provided in Appendix 1.

Table 2.3 Ownership, management and administration

	Ownership and management	Claims handling, case administration	Number of staff (full-time equivalent, FTE)	Operating costs in 2006
General schemes covering life and non-life insurance				
Latvia	The scheme is under public ownership, with public management. It is operated by the national supervisory authority (Financial and Capital Market Commission)	The scheme relies on the insolvency practitioner to establish claims, which are then paid by the scheme	0.2 (two members of staff at the supervisory authority carry out IGS related work 10% of their time)	€4,250 in administration costs
Malta	The Fund is under the general control of the Management Committee. It is accountable to the national supervisory authority (Malta Financial Services Authority), which also provides the staff if required in the event of failure	The Management Committee is responsible for the claims being established	No staff	€18,111 in administration costs
Romania	The Fund is operated by a specialised department (Departamentul Fond de Garantare) within the supervisory authority, the Comisia de Supraveghere a Asigurarilor	Claims process is administered by the Fund, with a special commission of internal experts created to decide on all details	28 (carrying out Guarantee Fund functions and certain related functions)	RON2.472.061 (€647,560) in administration costs
Spain	The CCS is a legal entity under public ownership and management, but it has its own capital (independent from the state) and is governed by the rules applying to private companies (código de derecho privado). CCS performs functions other than operating the general and special schemes	CCS, as the body in charge of winding up proceedings in Spain, administers claims	The CCS employs 366 in total, of which 40 are fully dedicated to the general winding-up scheme	€2.9m in costs to administer the winding-up proceedings
UK	<p>The FSCS is a privately owned and managed company ('company limited by guarantee') with a board of directors who are appointed by the regulator</p> <p>The FSCS provides not only insurance guarantee, but also operates sub-schemes for deposits, investment, mortgage advice and insurance intermediation. The insurance sub-scheme is divided into life and non-life insurance</p>	The FSCS relies on the insolvency practitioner assigned to the estate of the insolvent insurer to establish claims and amounts, but evaluates itself whether the claims are eligible for protection	16 (total FSCS staff is 211, but most staff time is devoted to investor compensation cases)	<p>In 2005/06, basic administration costs for life and non-life schemes: £488k (€721k)</p> <p>Additional compensation-specific costs for non-life scheme of £1,436k (€2,121k)</p>

Ownership and management		Claims handling, case administration	Number of staff (full-time equivalent, FTE)	Operating costs in 2006
General schemes covering life assurance				
France	The FGAP is a legal entity under private law, managed under the control of a board that constitutes 12 industry representatives elected by participating life assurers	The liquidator assigned by the ACAM to the case processes claims and establishes the amount of compensation due (if no portfolio transfer)	0.66 (two persons working 20% and 46%, respectively, on FGAP functions) Any case work arising is outsourced to service providers	€144,000 in administration costs
Germany	The guarantee scheme is operated by Protektor AG, a private company which has a licence to undertake life assurance business and is owned by participating life assurers. Protektor AG was established as a private initiative to provide insurance guarantee by the German insurance industry before creating the statutory scheme	Protektor AG takes over the portfolio of the insolvent insurer and continues the contracts until termination (or sale to another insurer)	Fewer than 2 members of staff required to carry out the functions of the statutory scheme (no cases) Protektor has 107 members of staff	€153,000 in the first half year of operation of the statutory scheme Protektor incurs additional operating costs (related to run-off of Mannheimer case, which occurred prior to establishment of statutory scheme)
Poland	The IGF is a private body under the control of a Council comprising 9 members (one from the Ministry of Finance, one from the Financial Supervisory Commission, and 7 from insurers)	IGF handles claims itself, but may also rely on the receiver in the bankruptcy proceedings to establish claims	IGF has total staff of 155, but at present around 2 are responsible for claims handling in life and non-life insolvency cases (varies significantly with case load)	Difficult to estimate since IGF performs other functions (including motor guarantee) not related to insolvency cases
General schemes covering non-life insurance				
Denmark	Scheme is managed by a board of directors consisting of 5 members appointed by the Minister for Economic and Business Affairs. The daily management of the scheme is undertaken by the Danish Insurance Association	There is an agreement with established insurance undertakings to handle claims in the event of failure	Approximately 2 people work half-a-day each for the scheme, giving the equivalent of one full-time staff member	€115,733 in administration costs In addition, the scheme paid €7,333 to an insurer in 2006 for claims handling
France	The FGAO is a legal entity under private law. Originally established to deal with motor liability and hunting insurance, its statutes were amended and board expanded when it assumed functions to provide guarantee for other classes of compulsory insurance	FGAO staff handle the claims and payment process	FGAO can draw from a total staff of 227, which have other functions (motor guarantee, fund for terrorism, etc). Staff time devoted to insurance guarantee is small (about 2 FTE) and case-dependent	Around €250,000 of FGAO operating costs can be attributed to functions relating to insolvencies (excluding motor)
Ireland	The Fund is maintained and administered under the control of the President of the High Court, acting through the Accountant (of the High Court). As such, it is under public ownership, with public management	The liquidator or administrator assigned to the estate deals with claims. The Fund has a payment function	No staff	Minimal (no cases)

	Ownership and management	Claims handling, case administration	Number of staff (full-time equivalent, FTE)	Operating costs in 2006
Special schemes covering one or a few branches of (compulsory) non-life insurance				
Belgium	The scheme for workers' accidents insurance is operated by the FAO/FAT, which is part of the Belgian Federal Public Service Social Security—hence, it is under public ownership and management	FAO/FAT	No winding-ups since 1975, so the FAO/FAT does not have any employees dealing with liquidation-related matters. Only cases of non-insurance	No operating costs specific to IGS function (no cases)
Finland	The schemes for employment accident insurance and for patient insurance constitute provisions in law to provide guarantee (ex post), and as such are not separate legal entities. In the case of an insurance company failure, the Federation of Accident Insurance Institutions (FAII) or the Finnish Patient Insurance Centre (FPIC) would be managing the respective schemes	FAII and FPIC would be handling the claims, as well as the liquidator assigned to the estate	No staff Functions would be assumed by staff of the FAII and FPIC	Minimal (no cases)
Germany	The guarantee scheme is operated by Medikator AG, a private company initially established by German private health insurers as a private initiative to provide insurance guarantee before creation of the statutory scheme. The industry association (PKV) is the single shareholder of Medikator and carries out the relevant functions	Medikator AG facilitates portfolio transfer to another health insurer active in the market	No staff Management functions are carried out from within the association for private health insurers, and outsourcing agreements with insurers exist if failure occurs	Minimal (no cases)
Italy	The Agency for public insurance services, Concessionaria Servizi Assicurativi Pubblici (Consap), is the organisation that runs the Fund. The Ministry of Economics (Ministero dell'economia) is the sole shareholder of Consap	The supervisory authority over the Italian insurance system (ISVAP) designates a number of insurance companies (between 6 and 10), each responsible for a different region(s). These verify and quantify the claim, and pay compensation, and then get reimbursed from Consap	One Consap employee and one employee of the designated insurance companies deal with liquidations	€80,000 in administration costs In addition €34,000 were paid by Consap as fees to the designated insurance companies
Poland	The IGF operates the special schemes, as well as the general scheme covering life assurance. See above	IGF. As per scheme for life assurance. See above	As per scheme for life assurance. See above	As per scheme for life assurance. See above
Spain	CCS operates the special schemes, as well as the general winding-up scheme. See above	CCS, as the body in charge of winding-up proceedings in Spain, administers claims	Schemes not activated, so no CCS staff time	Schemes not activated, so costs insignificant compared with total CCS budget (see general scheme above)

Source: Oxera.

2.4 Scheme participation

Table 2.4 provides an overview of the main participation requirements for the different schemes. These requirements are defined according to the classes of insurance protected by the scheme—ie, all insurance undertakings licensed by the competent supervisory authority to provide insurance in the relevant classes are required to participate in the scheme.

Schemes that cover both life and non-life insurance distinguish between the two types of insurer, and allocate life and non-life insurers to different sub-schemes or sub-funds that are separate for funding purposes.

The reported numbers of insurance undertakings participating in the schemes (usually as of end-2006) partly reflect the size of the relevant insurance markets. For example, the FSCS in the UK, which covers both life and non-life insurance, is the largest scheme, with 288 life assurers and 258 non-life insurers participating. This contrasts with the scheme in Latvia, which also covers life and non-life insurance but in a significantly smaller market, where participation is limited to only six life assurers and 13 non-life insurers. Similarly, the schemes covering only specific types of insurance are smaller in terms of number of participants than schemes that cover insurance on a more general basis—eg, the Belgian workers' accidents fund has 17 participants compared with the general non-life scheme in Denmark, which has 51 participants.

The question of cross-border participation is particularly relevant in an increasingly integrated EU insurance market. In all countries, there is a requirement for subsidiaries of EU insurance groups to participate in the IGS, since they are authorised by the same competent supervisory authority and subject to the same regulatory framework as any other domestic insurer. Similar participation requirements also apply to non-EU insurers.

The difference in participation requirements concerns incoming firms under the EU passport. As further discussed in section 2.8, business conducted by incoming firms under freedom of services or freedom of establishment is excluded in those schemes that are structured around the home state principle.⁸ This applies to a number of schemes (eg, Denmark, France, Germany and Romania).

In contrast, branches of incoming insurers are required to participate—for example, in the UK FSCS, the Irish and Polish guarantee funds and the special schemes in Belgium, Finland and Italy. Similarly, the Latvian and Maltese schemes require EU branches to participate unless the establishments are covered by a home state scheme that affords protection equivalent to the protection that would apply if they were members of the host state scheme. The participation requirement in the host state scheme may also be extended to insurance undertakings operating under freedom of services provisions (eg, Latvia).

In most Member States, the insurers whose policies are protected by the scheme are those that are required to contribute to it. For example, if domestic firms and branches of EU undertakings pay a levy to the scheme, their policyholders and beneficiaries would be covered by the scheme. One exception to this rule is Spain, where branches have to contribute to the general scheme, but their business is not protected; equally, life assurance policies are protected although contributions are raised only with respect to non-life insurance. Another exception is the Irish Compensation Fund, which supports only insurance liquidations and administrations under Irish law, but with incoming firms expected to contribute to meeting the costs of the support provided.

⁸ Under the home state principle, the IGS covers policies issued by domestic insurers as well as by the branches of domestic insurers established in other EU Member States. In contrast, under the host state principle, the policies issued by branches of incoming EU insurers are covered by the local IGS.

Cross-border arrangements are further described in section 2.8, with respect to the scope of scheme coverage concerning location of risk and residency of claimants (within and outside the EU).

Table 2.4 Scheme participation

	General participation requirement	Number of participants	Participation of EU branches required?
General schemes covering life and non-life insurance			
Latvia	All insurance undertakings registered in Latvia, as well as EU insurance undertakings operating in Latvia via branches or under the freedom to provide services, are required to participate ¹	Life assurance: 7 General insurance: 13	Yes, unless they are branches of EU insurers protected by their home state scheme to a level equivalent to that of Latvia
Malta	All insurers that require formal authorisation to operate in Malta are required to participate in the scheme. Branches from EU Member States which either do not have a scheme, or where the protection offered by the scheme is inferior to that of Malta, also need to participate	Life assurance: 7 General insurance: 13	Yes, unless they are branches of EU insurers protected by their home state scheme to a level equivalent to that of Malta
Romania	All insurance undertakings authorised to operate in Romania are required to participate in the Guarantee Fund	40 (8 life, 21 non-life and 11 both life and non-life)	No (neither required nor permitted)
Spain	There are differences between the insurers that: <ul style="list-style-type: none"> – are protected by the general and special schemes—only life and non-life insurers with headquarters in Spain – have to contribute to the general and special schemes—all undertakings that issue contracts in Spain (except life assurance and State-managed export credit insurance) 	Protected by scheme: 364 domestic insurers (27 life, 337 non-life) and 2 non-EU insurers. Contributing to the scheme in addition to the above: 51 EU branches	Business of EU branches is not protected by the scheme but EU branches have to contribute to it with respect to non-life contracts covering risks located in Spain
UK	All FSA-authorised life and non-life insurance undertakings that carry out regulated insurance business that falls under the scope of FSCS protection. Firms without protected business are not required to participate. Incoming EU firms are required to participate	Life assurance (contribution group A4): 288 firms General insurance (A3): 258 firms	Yes

	General participation requirement	Number of participants	Participation of EU branches required?
General schemes covering life assurance			
France	All life assurance undertakings established in France that adhere to the French insurance law (code des assurances) and are under the control and supervision of the ACAM	128 life assurers (in 2005)	No
Germany	All insurers licensed to carry out life assurance activities in Germany under the VAG Voluntary participation of Pensionskassen	128 life assurers (and voluntary participation of 23 Pensionskassen)	No (neither required nor possible)
Poland	All life assurers operating in Poland would need to contribute (ex post) in the event of a failure of another life assurer	Around 35 life assurers are operating in Poland, but with no participation/contribution because there has not been a failure since 1995	Yes, EU branches would be required to contribute to the scheme in the event of a failure
General schemes covering non-life insurance			
Denmark	All non-life insurers that are authorised by the Danish FSA	51 non-life insurers	No
France	All insurers subject to French insurance law and supervised by ACAM if they provide non-life insurance that is compulsory by law or regulation	127 non-life insurers	Yes, but only for insurers providing motor and hunting liability insurance.
Ireland	All domestic insurance undertakings, as well as EU branches and non-EU undertakings, providing non-life insurance in Ireland would be required to contribute to the scheme in the event of a failure. Protection applies only to insurers that would be wound up under Irish law	There is no participation model as such. Contributions would be raised from all non-life insurers operating in Ireland in the event of failure, but this has not been the case since the 1980s	EU branches would be required to contribute to the scheme in the event of a failure, but their business would not be protected if not wound up under Irish law

	General participation requirement	Number of participants	Participation of EU branches required?
Special schemes covering one or a few branches of (compulsory) non-life insurance			
Belgium	All insurance companies offering workers' accidents insurance are required to participate in the scheme	17 domestic insurers offering workers' accidents policies	Yes (if they provide the relevant insurance)
Finland	All insurance companies providing employment accident insurance or statutory private patient insurance are required to participate in the schemes	Scheme for employment accident insurance: 13 Scheme for patient insurance: 10	Yes (if they provide the relevant insurance)
Germany	All insurers licensed to carry out private health insurance business in Germany under the VAG	48 private health insurers	No
Italy	All insurance undertakings that provide hunting insurance cover in Italy must participate	53 companies	Yes (if they provide the relevant insurance)
Poland	<ul style="list-style-type: none"> – Motor and farmers' TPL—all insurance companies providing these two types of insurance policy are required to participate (with regular contributions) in the scheme – Farm buildings, and professional TPL—all insurers providing the insurance in Poland would be required to contribute (ex post) in the event of failure 	30 insurers providing motor and farmers' TPL insurance are participating in the scheme (with regular contributions) These and other insurers providing farm buildings and professional TPL insurance would be required to participate/contribute in the event of failure involving such insurances	Yes (if they provide the relevant insurance)
Spain	As for general scheme above	n/a	Yes (if they provide the relevant insurance)

Note: ¹ However, the provisions of the Latvian scheme are not binding on branches of foreign insurers if the regulatory enactments of those states provide for the protection of the insured in their branches in Latvia and cover all the cases provided for in the Latvian law. In addition, the guaranteed insurance indemnity must be at least as high as the one prescribed by the Latvian law.

Source: Oxera.

2.5 Nature of scheme intervention

The IGS observed in the EU Member States assume different functions. Two main functions can be distinguished:

- to compensate losses of policyholders or beneficiaries in the event of insolvency of an insurance undertaking;
- to secure continuity of the insurance contracts.

In the case of life assurance, owing to the long-term nature of the products, policyholders are often considered better off if their contracts are continued, rather than having contracts immediately terminated and receiving compensation in cash. Most non-life insurance contracts, on the other hand, are more short-term in nature, so the continuation of contracts is considered less important than the efficient handling of the insolvency cases; the claims for events before the insolvency date or for a certain period afterwards are covered by the IGS, but the remaining contracts at the end of the period are terminated, and policyholders are required to make similar insurance arrangements with other companies if they want to be continuously insured.⁹

The statutory guarantee schemes for life insurers and private health insurers in Germany have the exclusive function of securing continuity of insurance contracts; the payment of compensation is not envisaged by law. The operator of the scheme for life insurers (Protektor AG), which in itself was granted a licence to operate as a life insurer, assumes the insurance contracts of the insolvent insurer and administers those contracts until termination (or until the portfolio can be transferred to another insurer). The scheme for health insurers would secure continuity through portfolio transfer.

The rules governing the operation of the FSCS in the UK also specify that the scheme should aim to secure continuity of long-term policies, but (unlike in Germany) leave the payment of compensation as the alternative procedure. The chosen procedure depends on cost-effectiveness. Continuity of contracts must be secured if it is 'reasonably practicable' to do so and if, in the opinion of the FSCS, this would be beneficial for the generality of eligible claimants. Rather than assuming the administration of contracts itself, the FSCS would make payment either to the insolvency practitioner or to the insurer receiving the portfolio transfer or issuing substitute policies for facilitating the deal.

The life assurance scheme in France (FGAP) provides compensation payments for claims established by the liquidator assigned to the estate, but would also make available the funds to facilitate portfolio transfer if this were decided by the supervisory authority and liquidator.

The schemes covering life assurance in Latvia, Malta, Poland and Romania, on the other hand, have as their main function the payment of compensation to policyholders (in full or up to certain limits).¹⁰

In the case of non-life insurance, the established schemes (other than the German scheme for health insurance) pay compensation to cover losses of policyholders (and third parties) in the event of insolvency.

The nature of intervention of the different schemes is summarised in Table 2.5. The table also describes the provisions in place relating to what triggers the intervention of the scheme and when this occurs. In most cases, IGS operation starts following the determination by the

⁹ See Yasui, T. (2001), 'Policyholder Protection Funds: Rationale and Structure', Insurance and Private Pensions Compendium for Emerging Economies, Book 1, Part 1:2b, OECD.

¹⁰ In the case of farmers' third-party liability insurance (and motor), but not life assurance (and other classes of insurance covered by the scheme), the Polish Insurance Guarantee Fund can intervene to avoid the possible bankruptcy of an insurer. The preventative function consists of it being authorised to grant repayable loans to insurers taking over the portfolio.

supervisory authority that an insurance undertaking is unable to meet its obligations. Formal insolvency is not always required to trigger operation. For example, the statutory guarantee schemes in Germany are activated prior to the start of formal insolvency proceedings, in order to ensure that the contracts can be continued and the portfolios transferred; the contracts are terminated on formal declaration of insolvency.

In the UK, the FSCS is activated if an insurer has been declared ‘in default’ for the purposes of the scheme. This may follow a court order or appointment of a liquidator, but it may also apply in cases of voluntary winding-up or the regulator’s decision that the firm appears to be unable to meet claims against it.

One of the advantages of having an IGS (in addition to covering losses that may arise from a shortfall of assets) is to speed up the reimbursement of funds to policyholders or beneficiaries compared with winding-up proceedings. However, not all IGS offer such timing advantages—eg, in Malta, the payment of compensation follows only after the termination of the winding-up proceedings.

In various other countries, the guarantee process is also dependent on the liquidator assigned to the insurance estate, but payment usually is not deferred until the end of the liquidation proceedings. Rather, the IGS pays compensation once the claims have been established (by the IGS, the liquidator or another party), and the rights of the claimants in the insolvency proceedings are assigned to the IGS (at least up to the amount of compensation paid).

The general winding-up scheme in Spain (CCS) provides a different type of intervention and protection (for life and non-life), which does not fit into either of the two categories described above—ie, compensation payment or securing continuity of contract. If an insurer is insolvent, the scheme itself becomes the body in charge of administering the winding-up proceedings. From the perspective of policyholders, the scheme speeds up the proceedings by anticipating the amounts that would be recovered and paying policyholders accordingly following a short period of evaluation. The scheme may uplift the payment by an amount that depends on the decision of the scheme and the financial situation of the insurer in question (ie, there is no guarantee of compensation).

Table 2.5 Start and nature of intervention

What triggers intervention?		Nature of intervention
General schemes covering life and non-life insurance		
Latvia	Decision taken by the meeting of creditors to initiate bankruptcy proceedings, which has been confirmed by a court	Payment of compensation
Malta	When the insolvent insurer has been struck off the register or the insolvent insurer has been wound up	Payment of compensation
Romania	Declaration of insolvency and withdrawal of authorisation by the Insurance Supervisory Authority at the beginning of the winding-up proceedings	Payment of compensation
Spain	Declaration by the Insurance and Pensions Unit of the Ministry of Economy and Finance that the company is winding up	CCS is in charge of the winding-up proceedings. It facilitates portfolio transfer, and, where that fails, makes payments to claimants following a short period of evaluation. The CCS can uplift payments so that, in many instances, claimants receive considerably higher payments compared with what they would receive after liquidation
UK	Determination by FSCS that a firm is in default because firm is subject to one or more of the following: voluntary winding up; regulator determines that firm appears to be unable to meet claims against it; appointment of liquidator or administrator; court order; approval of a company voluntary arrangement	Payment of compensation In the case of long-term life assurance, scheme must aim to make arrangements to secure continuation of contracts (eg, portfolio transfer to, or issue of substitute policies by, another insurer)
General schemes covering life assurance		
France	Determination by the ACAM that an insurance undertaking is no longer able to meet its obligations	Payment of compensation and/or facilitation of portfolio transfer (depending on decision of ACAM and liquidator assigned to case)
Germany	Decision by BaFin that the insurer is unable to meet its obligation and that no other policy measure is effective	Continuation of policies. Statutory scheme takes over the portfolio and continues contracts until termination (or sale to another insurer)
Poland	The IGF must intervene in three cases <ul style="list-style-type: none"> – bankruptcy declaration of an insurer – when the application to be declared bankrupt is dismissed or the bankruptcy proceedings have been stopped because the assets are insufficient to cover the costs of the proceedings – in the event of ordering compulsory liquidation, if the entitled claims are not covered by assets as the back-up for technical and insurance reserves 	Payment of compensation
General schemes covering non-life insurance		
Denmark	Declaration of bankruptcy by a court	Payment of compensation
France	Determination by the ACAM that an insurance undertaking is no longer able to meet its obligations	Payment of compensation and/or facilitation of portfolio transfer (depending on decision of ACAM and liquidator assigned to case)
Ireland	Formal start of proceedings for liquidation or administration	Payment of compensation or supporting the administration of a failed company on a going-concern basis

	What triggers intervention?	Nature of intervention
Special schemes covering one or a few branches of (compulsory) non-life insurance		
Belgium	Declaration of insolvency by CBFA	Payment of compensation or transfer of portfolio
Finland	Liquidation, or bankruptcy, of a participating insurance company where a part or the whole compensation to be paid remains unsecured	Payment of compensation or transfer of portfolio
Germany	Decision by BaFin that the insurer is unable to meet its obligation and that no other policy measure is effective	Continuation of policies. Statutory scheme secures transfer of policies to another insurer
Italy	Formal start of winding-up procedures	Payment of compensation
Poland	The IGF starts operation and pays compensation under the three conditions set out above for the scheme on life assurance In addition, for motor and farmers' TPL, since 2004, the IGF can take preventative measures (prior to bankruptcy) (ie, not for professional TPL, farm buildings and life assurance)	Payment of compensation Since 2004, the preventative function consists of the IGF facilitating portfolio transfer and granting repayable loans to insurers taking over the portfolio of the firm in difficulties. It applies only to motor and farmers' TPL. The preventative function has not yet been activated
Spain	As per general scheme. See above	As per general scheme. See above

Source: Oxaera.

2.6 Protected policies and eligible claimants

Table 2.6 summarises for each IGS the policies that are covered, as well as the claimants entitled to protection by the schemes. Which policies are protected depends on the type of scheme concerned.

- The general schemes covering life assurance usually protect all classes of life assurance.
- The general schemes covering non-life insurance tend to restrict protection for certain classes of insurances (eg, excluding maritime, aviation and transport or other professional risks). Although it covers compulsory insurance only, the French scheme (FGAO) was classified as a general scheme because of the high number of insurances that are compulsory in France, and to distinguish the scheme from special schemes that cover only one or very few branches of non-life insurance.
- Among the specific schemes, many cover only one class of non-life insurance (eg, workers' accidents insurance in Belgium, private health insurance in Germany, and hunting liability insurance in Italy). In Spain, hunting liability and compulsory travellers' insurance is covered (the schemes are operated by the same body as the general winding-up scheme), and in Poland the scheme covers professional third-party liability (TPL), farmers' TPL and compulsory insurance for farm buildings (in addition to motor insurance).
- Contracts of reinsurance are not covered by any IGS.

Further exclusions may apply depending on the geographic location of the risks, as discussed in section 2.8.

Potential claimants are policyholders themselves (or their direct beneficiaries) and, in the case of non-life insurance, third parties who may seek compensation from an IGS for any injuries or losses incurred when the insurer is no longer in a position to provide the compensation.

Many IGS (but not all) restrict the type of claimant entitled to receive protection from the scheme to retail consumers, usually private individuals, although small or medium-sized businesses may also fall in this category. The rationale is that other policyholders may be in a better position than retail consumers to assess the financial risk of particular firms, or have a greater capacity to reduce risk (eg, through diversification).

Limiting the scheme to certain claimants also substantially reduces the cost of the scheme and/or increases the funds available to protect eligible claimants.

In addition to excluding non-retail claimants or professionals from protection, many schemes impose eligibility restrictions on individuals who are connected with the defaulting insurer, or who have been responsible for, or have profited from, the financial difficulties of the relevant insurer.

Further restrictions may apply depending on the geographic location of residency of the claimant (or where legal persons are protected, the place of establishment of the claimant), although such restrictions are not common, at least in terms of claimants within the EU. The geographic scope is further described in section 2.8.

Table 2.6 Protected policies and eligible claimants

	Protected policies	Eligible claimants
General schemes covering life and non-life insurance		
Latvia	All life assurance policies are covered Non-life insurance policies covered are: accident insurance; health (sickness) insurance; land vehicle (except railway rolling-stock) insurance; insurance of property against fire and natural elements; insurance of property against other damage to property; motor vehicle liability insurance; general liability insurance; and assistance insurance	Natural persons only
Malta	Life assurance policies covered are: life and annuity; marriage and birth; permanent health; pension fund management; and social insurance Non-life insurance policies covered are: accident (where the insured is an individual); sickness; land vehicles; fire and natural forces; other damage to property; motor vehicle liability; general liability; miscellaneous financial loss; legal expenses; and assistance	In the case of life assurance, payment is made to all policyholders or beneficiaries In the case of non-life insurance, payment is made only to private individuals and non-corporate bodies or associations of persons if all such persons are individuals
Romania	All classes of life and non-life insurance, without exclusions	Natural and legal persons
Spain	All life and non-life insurance contracts are, in principle, covered, except for state-managed or state-supported export credit insurance	Natural and legal persons, except when the policyholder is another insurance undertaking
UK	All life and non-life insurance contracts are, in principle, covered, except for reinsurance and certain non-life contracts (maritime, aviation, credit). Further restrictions apply to the geographic location of the risk (see below)	In general, protection is provided only to retail claimants (private individuals and small businesses). Large businesses may claim only in the case of compulsory (employers') liability insurance Specific exclusions apply to individuals responsible for, or connected to, the firm in default
General schemes covering life assurance		
France	All classes of life assurance are covered	All natural and legal persons, but excluding other insurers, credit institutions, collective investment schemes and retirement schemes as well as certain individuals professionally connected to the insolvent insurer or responsible for the insolvency
Germany	All classes of life assurance are covered, without exclusions	Scheme provides continuation of all contracts, without exclusion of policyholders
Poland	All classes of life assurance are covered, without exclusions	Natural persons only

Protected policies		Eligible claimants
General schemes covering non-life insurance		
Denmark	Non-life scheme covers: policyholders with private consumer insurances (consumer policies); third parties insured against personal injury and damage to property under third-party motor liability insurances; third parties insured against personal injury under other third-party liability insurances; collective insurances to the extent that an insurance corresponds to the individual insurances covered; damage done to property caused by fire	Natural persons, as well as small and medium-sized companies in some cases (mainly for third-party liability insurance)
France	Classes of non-life insurance that are compulsory in France are covered, which includes construction liability, professional liability, workplace accidents, etc There is a list of specifically excluded risks, such as maritime, fluvial, air transport, financial guarantees, and nuclear	Policyholders (natural and legal persons), unless the policy is underwritten in a professional capacity Third parties resident within the EU that are not contractually connected to the insurer, or if connected, are connected only in a non-professional capacity Otherwise as for French life assurance scheme above
Ireland	The scheme covers all classes of non-life insurance	The scheme pays compensation only to natural persons. Where the scheme supports administration as a going-concern, all claimants are protected
Special schemes covering one or a few branches of (compulsory) non-life insurance		
Belgium	The scheme covers only workers' accidents insurance policies, which are compulsory for all employees	Employees and their direct beneficiaries (ie, only natural persons)
Finland	The scheme for employment accident insurance covers only the statutory employees' accident insurance policies The scheme for patient insurance covers only the statutory patient insurance policies	Both schemes cover natural persons only
Germany	Only private health insurance policies are covered	Policyholders are private individuals, and all are protected
Italy	Only hunting liability insurance policies	Natural persons only
Poland	Policies covering motorcar, farmers' and professional TPL insurance, and insurance for farm buildings, which are compulsory classes of insurance in Poland	Natural persons only
Spain	Hunting and travellers' insurance policies	Natural persons only

Source: Oxera.

2.7 Compensation limits and other reductions in benefits

For IGS that pay compensation (rather than, or in addition to, aiming for continuity of contract), the question that arises is: how much compensation should be paid to eligible claimants? As summarised in Table 2.7, many schemes provide potentially unlimited compensation.

In France, the compensation amount is limited for the life assurance scheme (€70,000 or €90,000, depending on type of benefit), but unlimited compensation is offered by the scheme for compulsory non-life insurance. Limits also apply to the schemes in the new EU Member States, but are set at comparatively low levels—eg, just under €3,000 in Latvia for life and

non-life insurance, and around €23,000 in Malta (excluding compulsory non-life insurance, for which compensation is unlimited).

A separate issue is whether the schemes provide 100% cover or instead require claimants to bear a share of any loss, with a view to avoiding moral hazard behaviours on the part of policyholders. Moral hazard is not an issue for third-party claimants.

As shown in Table 2.7, the percentage cover differs between schemes. While some schemes provide 100% protection for all claimants, others offer less—eg, only 65% of the claim is compensated in Ireland. Some schemes set different levels by type of insurance (eg, Latvia compensates 100% for life but only 50% for non-life policies). The UK provides 100% protection for the first £2,000 (around €3,000), but 90% for any amounts above this level. The French scheme for non-life insurance distinguishes between policyholders and third-party claimants, with the former receiving 90% but the latter 100%.

In addition to limits per claim, more general payout limits may be specified, such as in Malta, where the total compensation capacity per case of insolvent insurer is limited to around €2.3m.

What is important is not just the limit to any compensation paid, but also how the compensation amount is calculated. In relation to non-life insurance, the entitlement for compensation covers outstanding claims; premiums paid are not usually covered, although there are exceptions—eg, the UK FSCS covers premiums in addition to outstanding claims. For life contracts, the entitlement normally relates to contractual benefits or the totality of the mathematical provisions covering the contracts; any bonuses or unexpired premiums would therefore not be taken into account.

No compensation is paid if the schemes secure continuity of contracts either by facilitating portfolio transfer to another insurer, or by assuming the contract administration responsibilities themselves. The relevant question here is whether contracts are continued but with a reduction in benefit.

Table 2.7 summarises the main provisions relating to the ability of the scheme (or supervisory authority) to reduce benefits in order to secure contract continuity. For example, in Germany, the supervisory authority may cut contractual benefits by 5%, but only if the scheme for life assurers has insufficient funds available. There are also provisions that allow an adjustment of contractual terms if this facilitates the transfer of the portfolio to another insurer. The UK FSCS must ensure that at least 90% of contractual benefits are preserved under portfolio transfer, and that any reductions in benefits are compensated by future reductions in premiums.

In Spain, the CCS has a special role. As the body administering the winding-up proceedings of insurance companies, it pays (but does not guarantee) policyholders and beneficiaries a percentage of the value of their policies and claims, and also provides them with upfront liquidity. When taking over the contractual obligation of an insurer, the CCS applies a value that is higher than the liquidation value of the insurer's assets and liabilities (eg, through excluding certain provisions from the liabilities). The difference between the amount paid to claimants and the amount recovered by the CCS from the subsequent liquidation of the insurer in question is the extra coverage provided by the CCS to claimants. The uplift of payments to claimants depends on the specific financial circumstances of the insurance undertaking in winding up.

Table 2.7 Compensation limits and other reductions in benefits

Compensation limit			
	Maximum amount	Level of coverage	Other reductions in benefits
General schemes covering life and non-life insurance			
Latvia	LAT2,000 (around €2,833)	For life assurance, 100%. For non-life insurance, 50%	–
Malta	Unlimited for compulsory insurance MTL10,000 (around €23,294) for life and non-life insurance that is not compulsory	For compulsory insurance, 100% For non-compulsory life and non-life insurance, 75%	The total amount of payments with respect to any one insolvent insurer cannot exceed MTL1,000,000 (around €2,329,373)
Romania	Unlimited (except for motor vehicle)	100%	–
Spain	n/a	n/a	Uplift of payments to claimants made by CCS compared with liquidation value varies by case (could be full reimbursement or zero)
UK	Unlimited	For compulsory insurance, 100% Otherwise, 100% of first £2,000 (around €3,000) and 90% of remainder	When securing continuation of contracts, FSCS must ensure that claimant receives at least 90% of any benefit compared with original contract; if benefit is less than 100%, future premiums must be reduced
General schemes covering life assurance			
France	€90,000 on policies in the event of death or invalidity; otherwise €70,000	100%	–
Germany	No compensation (continuation of policies)	No compensation (continuation of policies)	BaFin can cut contractual benefits by 5% if funds are insufficient
Poland	€30,000	50%	–
General schemes covering non-life insurance			
Denmark	Unlimited	100%	Premium paid for the period after the date of bankruptcy is reimbursed subject to a deductible of DKK1,000 (around €134) per policy
France	Unlimited ¹	90% (policyholders) or 100% (third-party claimants)	—
Ireland	€825,000 ²	65% ²	–
Special schemes covering one or a few branches of (compulsory) non-life insurance			
Belgium	Unlimited	100%	
Finland	Unlimited for both schemes	100% for both schemes	
Germany	No compensation (continuation of policies)	No compensation (continuation of policies)	Contracts can be modified to facilitate portfolio transfer, subject to this being acceptable to policyholders and approved by independent trustee

Compensation limit			
	Maximum amount	Level of coverage	Other reductions in benefits
Italy	For personal damage: €387,342.67 (plus interest) For material damage: €129,114.22 (plus interest)	100%	— ³
Poland	<ul style="list-style-type: none"> – Motorcar and farmers' TPL: up to €1.5m for personal injuries and €300,000 for material damages – Farm buildings: unlimited – Professional TPL: up to €30,000 	<ul style="list-style-type: none"> – Motorcar and farmers' TPL insurance: 100% – Farm buildings insurance: 100% – Professional TPL: 50% 	—
Spain	Limits vary depending on the type of insurance and damage ⁴	100% (additional funds might result from CCS's uplift of undertaking's assets and liabilities)	—

Notes: ¹ Where the Fund supports administration on a going-concern basis (as has been the case in two out of three failures), no compensation is paid and all claims are met in full. ² Individual claims are unlimited, but there is a total payout limit of €700m (cumulative). ³ The first €500 is to be paid by the damaging party (hunter). ⁴ For example, in the case of travellers' insurance the law specifies limits for 14 different types of damage, including death (covers up to €56,000) and serious disability (around €60,000). In relation to hunters' insurance, the limits are around €36,000. CCS may further uplift payments, as it does for the general life and non-life winding-up scheme.

Source: Oxera.

2.8 Cross-border arrangements

Table 2.8 summarises the main EU cross-border arrangements of the IGS in terms of participation as well as coverage of risks. Some schemes are organised around the home state principle—they cover policies issued by domestic insurance undertakings that participate in the scheme, including policies issued by the companies' branches established in other EU Member States or provided under freedom of services. In turn, they do not require incoming EU firms to participate in the scheme. For example, in Germany, branches of incoming EU insurers are not required to participate in the schemes for life insurers; neither is it possible for them to seek participation. Similarly, the Romanian Guarantee Fund does not allow participation of incoming insurers. In other countries, participation of branches is allowed in principle under legal provisions (eg, France), but in practice branches do not participate in the scheme, as there is no requirement for them to do so.

In some countries (eg, Malta and Latvia), the home state principle also applies, but additional provisions have been implemented requiring incoming insurers and their branches (and in some cases also insurers providing under freedom of services) to participate in the host state scheme to the extent that their policies are not covered at all or to the same degree by their home state scheme. This ensures that all policies issued in the host state are protected by insurance guarantee. As such, these countries operate a combination of home and host state arrangements when it comes to cross-border business.

A pure host state principle features in a number of schemes listed in Table 2.8—particularly for the schemes that cover special types of compulsory insurance.

The UK requires all incoming insurers to participate in the FSCS (host state principle). In turn, the FSCS does not typically cover contracts of insurance issued by UK firms through their branches established in other Member States (or outside the EU). If issued by an

establishment in another EEA Member State, the FSCS covers only the contract for risks located in the UK. For example, if the contract were issued by a branch of a UK firm established in Germany, policyholders resident in the UK would be eligible for FSCS protection, but the protection would not apply to German policyholders. It is the place of issue that determines whether the contracts are protected by the FSCS—a contract sold by a UK branch in another Member State (but issued in the UK) would be covered, but a contract sold and issued in another Member State would not be covered unless the risk is located in the UK.

Although all claimants, irrespective of their place of residency, are in general covered by the schemes with respect to policies issued by a participating insurer, there may be eligibility restrictions depending on the location of the risk. An example is the restriction described above for the UK FSCS. Another example is the Protection and Compensation Fund in Malta, which covers only risks located in Malta or commitments where Malta is the country of commitment. The scheme for hunting liability insurance in Italy is also an example, where compensation is paid only if the risk materialises in Italy; in one case, the scheme required a reimbursement of sums initially paid to a claimant after it was established that the accident had taken place outside Italy. Special provisions apply in some countries with respect to business outside Europe. In particular, risks located outside Europe may not be protected, which is the case, for example, with the UK FSCS and the French scheme for non-life insurance, the FGAO.

Table 2.8 Cross-border participation and protection

	Home versus host state	Scheme participation	Eligibility restrictions within EU	Special provisions for non-EU
General schemes covering life and non-life insurance				
Latvia	Combination	EU branches of insurance companies, as well as EU insurance undertakings operating in Latvia under freedom to provide services are required to participate in the scheme, unless the business is covered by a home state scheme	Branches of Latvian companies in other EU countries are covered and there are no restrictions with respect to location of risk	No
Malta	Largely host state	EU branches of insurance companies are required to participate in the scheme, unless the business is covered by a home state scheme	The Fund covers claims arising under a contract covering a protected risk situated in Malta or a protected commitment where Malta is the country of the commitment	No
Romania	Home state	EU branches are not required (nor allowed) to participate	Branches of Romanian companies in other EU Member States are covered, and there are no restrictions with respect to location of risk	No
Spain	Home state for protection and host state for contribution	No protection for the business of EU branches (and non-EU insurers), but they have to contribute to the scheme	All business of insurers with headquarters in Spain are covered, irrespective of location of risks, but incoming business is not covered	No
UK	Largely host state, but additional provisions	EU branches are required to participate, so contracts issued by incoming firms are covered	Branches of UK firms in other EU countries are not covered unless a) the contract is issued in the UK or b) the risk is situated in the UK	Risks located outside the EU are not covered
General schemes covering life assurance				
France	Home state	EU branches are not required to participate	Branches of French companies in other EU Member States are covered and there are no restrictions with respect to location of risk	No
Germany	Home state	EU branches are not required (nor allowed) to participate	Branches of German companies in other EU Member States are covered and there are no restrictions with respect to location of risk	No
Poland	Host state	All life assurers operating in Poland, including EU branches, are required to participate	Only policies issued by insurance undertakings in Poland are covered. Branches of Polish firms in other EU countries are not covered	No

	Home versus host state	Scheme participation	Eligibility restrictions within EU	Special provisions for non-EU
General schemes covering non-life insurance				
Denmark	Home state	EU branches are not required to participate	Branches of Danish companies in other EU countries are covered and there are no restrictions with respect to location of risk	No
France	Home state	EU branches are not required to participate (except for motor and hunting liability insurance)	Branches of French companies in other EU Member States are covered and there are no restrictions with respect to location of risk	Risks located outside the EU are not covered. Third-party claimants who are not EU residents are not covered
Ireland	Home state for protection and host state for contribution	EU branches (and non-EU undertakings) would be required to contribute in the case of a failure, but their business is not protected by the scheme	Protection applies only to firms in liquidation or administration under Irish law. No restrictions with respect to location of risk	No
Special schemes covering one or a few branches of (compulsory) non-life insurance				
Belgium	Host state	All insurers providing the insurance, including EU branches, are required to participate	All claims under the workers' accidents insurance contracts are covered	n/a
Finland	Host state for both schemes	All insurers providing the insurance, including EU branches, are required to participate	All claims under the employment accident or patient insurance contracts are covered	n/a
Germany	Home state	EU branches are not required to participate	All claims under the private health insurance contracts are covered	n/a (private health insurance contracts are terminated if place of residency is moved outside EU)
Italy	Host state	All insurers providing the insurance, including EU branches, are required to participate	The risk (accident/damage) must be located in Italy	No
Poland	Host state	All insurers providing the insurance, including EU branches, are required to participate	Only policies issued by insurance undertakings in Poland are covered. Risks must be located in Poland	No
Spain	As per general scheme	As per general scheme	As per general scheme	No

Source: Oxaera.

2.9 Funding

2.9.1 Contributions from participants

Although alternative financing approaches are available, the IGS raise their funding mainly or exclusively through contributions from participating insurers. However, there are considerable differences across schemes, particularly in terms of when contributions are collected, the extent to which funds are pooled between different types of business, how contributions are calculated, and whether there are any limits on the amount that can be collected from firms for a given period.

The following summarises the main features that characterise the funding of the different schemes, with details contained in the country-specific descriptions in Appendix 1.

Ex ante and ex post funding

Schemes can raise their funds by collecting contributions to build up a reserve in anticipation of future liabilities (ex ante funding), or by levying contributions when required to cover the costs of failures that have occurred (ex post funding). The main advantage of ex ante funding is that money is readily available in a fund to compensate claimants should a failure occur. It also offers the benefit of smoothing firm contributions over time. However, ex ante funding may raise issues relating to fund management—levies collected ex ante will rarely be equal to losses ex post, such that a fund will always be in a situation of surplus or deficit. Moreover, if funds are invested in safe and liquid assets, participating firms suffer opportunity costs relative to their cost of capital. Scheme operators will therefore face important decisions about how to invest funds and incur further costs (eg, of outsourcing the function to professional fund managers).

As reported in Table 2.9, the majority of schemes are funded ex ante or involve a sizeable element of ex ante funding. Firms make annual contributions to allow the schemes to build up a standing fund or reserve to finance any future guarantee costs. Ex ante schemes may have the power to levy additional contributions if the built-up reserve is insufficient to cover the costs.

Of the countries with general schemes covering both life and non-life insurance, Latvia, Malta and Spain have opted for ex ante funding. By contrast, the UK FSCS is essentially ex post-funded with levies raised to cover the compensation payments foreseen over the forthcoming 12-month period.

In Germany, the scheme for life assurers is funded ex ante, but the scheme for private health insurers is funded ex post. For the Polish guarantee scheme, ex ante levies apply to farmers' TPL insurance (as well as motor TPL), whereas ex post levies are raised from insurers to meet the cost of failures relating to life assurance, professional TPL and compulsory insurance for farm buildings.

The French scheme for life assurers (FGAP) is funded ex ante, but half of the industry funding takes the form of cash contributions, whereas the other half takes the form of guarantees—the funds stay in the books of the insurer but, by making pledges, firms guarantee payment in the event of a failure.

Similarly, the Finish scheme for employment accident insurance has an ex ante component that takes the form of balance sheet provisions in the books of participating insurers, with additional levies raised ex post. The requirement to make balance sheet provisions applies only to domestic insurers, and not to incoming EU insurers, which are required to contribute on an ex post basis only. The patient accident insurance scheme in Finland, on the other hand, is purely ex post-financed.

The statutory scheme for life insurers in Germany collects annual contributions from insurers on an ex ante basis. In addition to the statutory contributions, the German life assurance industry has pledged to make additional contributions in the event of large failures where normal funding proves insufficient. This guarantee applied under the voluntary insurance guarantee arrangements (Protektor AG) that were implemented in a private initiative by German life insurers prior to the establishment of the statutory scheme, and continues to apply. In addition to the statutory scheme for private health insurers, which is ex post-funded, industry participants continue to pledge the amount they guaranteed under the previous guarantee arrangements established by private initiative (Medicator AG).

Pooling of funds

A further funding issue relates to the extent to which funds are pooled between different types of insurance business. Schemes that cover both life and non-life insurance do not pool between the two types of business and raise separate funds to cover the costs of life and non-life failures. For example, the UK FSCS operates different contribution groups for life and non-life insurance. Similarly, Malta, Latvia and Romania have separate sub-funds for life and non-life insurance. The exception is the general winding-up scheme in Spain, which raises ex ante funds from insurance undertakings with respect to non-life policies; these funds can also be used to cover costs arising from a life assurance failure. However, Spain does separate the funding of the general winding-up scheme from the special schemes for hunting liability and travellers' insurance.

In the other countries, where separate schemes have been established for different types of insurance, there is no relationship between the different schemes when it comes to funding.

With the exception of the UK FSCS, the IGS have no relationship with the DGS and ICS established in accordance with the EU Directives. The FSCS operates guarantee arrangements for deposits and investments (as well as mortgage advice and insurance intermediation), but for funding purposes has created different sub-schemes and contribution groups to avoid cross-subsidy. There is, however, a possibility of borrowing funds between the sub-schemes and contribution groups. In addition, the UK Financial Services Authority (FSA) has been consulting about policy proposals to implement a wider pooling of funds across all FSCS-protected sectors in the financial services industry in the event of very large failures. In a policy statement issued in November 2007, it announced its intention to go ahead with these proposals.¹¹

Calculation of contributions

The basis on which annual contributions are calculated (either ex ante or ex post) varies. As summarised in Table 2.9, the schemes adopt various approaches to calculating the level of contributions, using the following main bases of assessment.

- **Provisions or reserves.** Under this method, contributions are allocated to participating firms in proportion to each participant's share of the protected technical provisions or a similar balance sheet measure. For example, this method is used for life insurers in France and Germany. Net reserves also form the basis for calculating contributions in the German scheme for private health insurance. Similarly, in the Finnish scheme for employment accident insurance, domestic undertakings are required to set aside a percentage of the relevant technical provisions.
- **Premiums.** In contrast to a stock measure of the size of participating insurers, the majority of schemes raise funds on the basis of gross or net premium income as a flow measure of business volume. For example, the UK FSCS levy is allocated on the basis

¹¹ FSA (2007), 'Financial Services Compensation Scheme: Funding Review', Consultation Paper 07/5, March; and FSA (2007), 'FSCS Funding Review: Feedback on CP07/5 and Made Text', Policy Statement 07/19, November.

of relevant net premium income. Similarly, premiums (gross or net) form the calculation basis in Finland, Ireland, Italy, Latvia, Malta, Spain, Poland and Romania. However, the definition of what constitutes premium income does differ between countries and schemes.

- **Number of policies.** In Denmark, the non-life insurance scheme raises contributions on the basis of the number of policies. For each policy, insurers pass on a fixed amount per policy to the scheme (DKK10 (€1.3) in 2006).

Some of the guarantee schemes that are funded on an ex ante basis require minimum levels of annual contributions from participating firms. For example, in Malta, once the target amount of the Protection and Compensation Fund has been reached, regular annual contributions cease, but the Fund continues to collect an annual payment of MTL300 (around €700) from participating insurers to cover expenses incurred by the administration of the Fund. In Belgium, insurers providing workers' accidents insurance are required to make an initial one-off deposit that provides a source of funding to the Workers' Accident Fund, with additional funds being raised ex post.

An important issue on which the national schemes diverge is the extent to which they adopt an explicit risk weighting in the calculation of contributions. The German scheme for life insurers adopts such a risk weighting by aiming to take into account explicitly the likelihood of the default of a firm when setting the level of contribution that the insurer is required to make. Specifically, when calculating the level of contributions of an insurer, the assessment base (life insurance net reserves) is multiplied by an individual firm risk-adjustment factor that depends on the firm's equity capital relative to its solvency margin. Using this metric, firms are ranked from lowest risk to highest risk and classified into three risk categories: For firms in category 1 (low risk), a risk factor of 0.75 is applied to the net reserves; for firms in category 3 (high risk), the risk factor is 1.25; and for firms in category 2 (medium), the risk factor is adjusted from firm to firm on a linear basis to range between 0.75 and 1.25.

No other scheme adopts a similarly explicit risk-weighting. Rather, the contributions depend on the size or volume of the relevant insurance business of participating insurers, without further taking account of risks.

Limits on contributions

Some schemes have the power to levy additional contributions from participating insurers in the event of large or unexpected failures. This may raise the concern that participating firms effectively have an open-ended liability to fund the scheme through annual and additional contributions. In particular, in the event of a substantial failure, contributions could be so large that the resulting costs to firms could have a significant impact on their ability to continue operating in the industry. Given these concerns, most countries have adopted an overriding limit on the amount that can be levied in a given year.

If a scheme includes a contribution limit, it is usually expressed as a percentage of the assessment base for calculating contributions—eg, 0.5% of relevant gross premium income in Denmark; 0.8% of relevant net premium income in the UK; 2% of relevant premiums in Ireland; and 0.2% of the relevant net reserves in Germany.

Instead of putting a cap on contributions, there may be a cap on the aggregate amount of payment that a scheme can make. For example, intervention of the French non-life insurance scheme, the FGAO, is limited to €700m.

Table 2.9 Type of firm contributions and calculation method

	Ex ante or ex post	Different pools of funds by type of business	Calculation of contributions	Risk-weighting	Annual limit on contributions
General schemes covering life and non-life insurance					
Latvia	Ex ante	Separate sub-funds for life and non-life insurance	Firms pay 1%pa of relevant gross premiums from natural persons for the classes of life and non-life insurance covered by the scheme	No	1% of relevant gross insurance premiums In 2006 this totalled around €818,800
Malta	Ex ante (with power to levy additional contributions)	Separate sub-funds for life and non-life insurance	Firms pay 0.125% of relevant gross premiums. In 2005 the total levy amounted to around €283,600	No	Not specified in rules
Romania	Ex ante (but annual contributions adjusted in line with funding requirements)	Separate sub-funds for life and non-life insurance	Annual contribution rate (based on gross premiums on relevant direct business) established by the Insurance Supervisory Commission. In 2006, the rate was 0.3% for life and 0.8% for non-life insurance	No	10% of gross direct premiums
Spain	Ex ante (with power to levy additional contributions)	No—single fund to cover interventions in life and non-life failures	Contributions raised as a proportion of premiums (on non-life policies only). In 2006, rate set at 0.3% of premiums, with €94.1m raised	No	Not specified
UK	Ex post (levies raised for costs expected during next 12 months)	FSCS maintains two separate contribution groups for claims relating to life assurance (A4) and non-life insurance (A3)	The cost of meeting claims is allocated to firms according to relevant net premium income on life or general insurance business, respectively All firms contribute to the basic costs of running the FSCS, in proportion to the periodic fees they pay to the FSA	No	0.8% of relevant net premium income For 2006/07, this amounts to £544m (€803m) for life assurers and £267m (€394m) for general insurers

	Ex ante or ex post	Different pools of funds by type of business	Calculation of contributions	Risk-weighting	Annual limit on contributions
General schemes covering life assurance					
France	Combination—ex ante cash contributions and guarantee to make additional payment ex post	No	0.05% of mathematical provisions of life assurers, of which half is contributed to the FGAP and half remains as a guarantee in the insurers' books	No	0.05% of mathematical provisions (although scheme can also borrow up to the same amount from participating firms)
Germany	Ex ante (with power to levy additional contributions)	No	0.02% of life assurance net reserves is yearly contribution until target is reached (amounted to €123m in 2006)	Yes. Firms are ranked according to their financial capacity (equity relative to solvency margin), and contributions are weighted accordingly	Target capital is 0.1% of life assurance net reserves (€615m based on 2006 net reserves). Extraordinary levies can amount to a further 0.1% of net reserves
Poland	Ex post	No	Contributions are allocated on the basis of gross premiums	No	Not specified in the rules
General schemes covering non-life insurance					
Denmark	Ex ante (with power to levy additional contributions)	No	Levies allocated on the basis of number of insurance policies. The amount is fixed by the Danish FSA on an annual basis (DKK10 or €1.3 per policy in 2006)	No	0.5% of relevant gross premium income
France	Ex ante (with power to levy additional contributions)	No (but funding of insolvency cases is, at least in part, separated from other FGAO functions)	Firm contributions are only one source of funding. Currently set at 1% of FGAO costs concerning insolvency cases, but extraordinary contributions are raised if reserves drop below €250m	No	Intervention limit for the FGAO is €700m
Ireland	Ex post	No	Costs allocated on the basis of premium income, at a rate specified by the Central Bank	No	2% of relevant aggregate premium income

	Ex ante or ex post	Different pools of funds by type of business	Calculation of contributions	Risk-weighting	Annual limit on contributions
Special schemes covering one or a few branches of (compulsory) non-life insurance					
Belgium	Combination—initial deposit and ex post levies	–	<ul style="list-style-type: none"> – Ex ante: fixed entry fee of €1.4m for each insurer offering workers' accidents insurance – Ex post: not specified in the rules how this would be structured 	No	Not specified in the rules
Finland	<p>Scheme for employment accident insurance: combination—balance sheet provisions and ex post levies</p> <p>Scheme for patient insurance: ex post</p>	–	<p>Ex post levies are allocated on the basis of gross premium for both schemes</p> <p>Regarding ex ante funding, Finnish and non-EU undertakings form, as a part of the technical provisions, a provision for the scheme, which should be accumulated at 4% p.a. with a maximum of 3% of technical provisions relating to the statutory employment accident insurance. The ex ante element does not apply to incoming EU insurers</p>	No	2% of relevant gross premiums for both schemes
Germany	Ex post	–	Ex post levies allocated in proportion to the net reserves of participating private health insurers	Envisaged, but no details specified in the rules	0.2% of net reserves
Italy	Ex ante	–	5% of premium paid for each hunting liability insurance policy (amounts to €0.5 per policy). Includes levies to cover claims in the event of unidentified or uninsured hunter	No	5% of relevant premiums

	Ex ante or ex post	Different pools of funds by type of business	Calculation of contributions	Risk-weighting	Annual limit on contributions
Poland	<ul style="list-style-type: none"> – Motorcar and farmers' TPL insurance—ex ante (with power to raise additional contributions) – Professional TPL and farm buildings—ex post 	Yes. Separate funding pools for the different types of non-life insurance, with firms contributing only if they provide the relevant insurance	<p>All contributions based on gross premiums for relevant insurance</p> <p>For motor and farmers' TPL, levy rate was 1% in 2006, of which 0.8% used to meet current costs and 0.2% to accumulate in fund designated for preventative action ('aid fund')</p>	No	Not specified in rules
Spain	Ex ante (with power to levy additional contributions)	No	Levies raised in proportion to premiums paid on hunters' liability and travellers' insurance. 3% in 2006	No	Not specified

Source: Oxera.

2.9.2 Other sources of funding

In addition to differences in the contributions of participating insurers (direct levies on policies), the funding arrangements of the IGS in the Member States also differ with regard to the aspects outlined below and summarised in Table 2.10.

- **Standing fund and minimum capital requirements.** Schemes that are funded on an ex ante basis aim to build up a reserve or standing fund that enables them to deal with intervention cases in the future. As noted above, ex ante funding is observed for many schemes. However, not all countries have imposed explicit provisions that set out the minimum size of the fund (or that determine its target size).

Explicit capital requirements are observed, for example, for the life assurance schemes in France and Germany. In France, the fund size is set at 0.05% of aggregate mathematical provisions; in Germany, contributions are accumulated to achieve the fund size of 0.1% of aggregate life assurance net reserves. In both schemes, the share of each participating insurer in the fund is reallocated every year, with additional contributions or reimbursements of previous contributions, depending on whether a firm has increased or reduced the relative volume of its business compared with the preceding year.

Among the ex ante schemes, the general scheme in Malta and the non-life insurance scheme in Denmark also have an explicit fund size target, and will cease to collect regular contributions once the target has been reached. Without such provisions, annual cash contributions by firms imply that, in principle, the size of the standing fund can continue to increase in the absence of intervention.

Table 2.10 shows that the size of the standing fund, as well as the size of the minimum or target fund, differ considerably among schemes.

Note that in Germany, the IGS arrangements established under private initiative by life assurers and private health insurers preceded the implementation of the statutory schemes, and involved guarantees amounting to €5 billion and €1 billion, respectively. These guarantees continue to apply following implementation of the statutory schemes in the event of very large failures, and provide the two schemes with a guarantee for industry funding that is significantly higher than in other countries.

- **Borrowing power.** Guarantee schemes could fill any funding gaps by borrowing, and many (but not all) schemes have been granted some borrowing powers. However, this may be restricted to particular forms of borrowing. For example, the French life assurance scheme can only borrow from participating insurers an amount equal to the normal annual funding. The special scheme in Italy can seek advances from the insurance undertakings that have been designated to handle insurance claims relating to an insolvent insurer, and reimburse the firms at a later stage.

The UK FSCS is the only statutory scheme that has arranged a binding agreement with a commercial bank to obtain credit if required. The credit facility of around €74m applies not just to the insurance sub-scheme, but also to the deposit, investment and other sub-schemes operated by the FSCS. The sub-schemes can also borrow funds from each other.

- **State funding.** State funding of guarantee schemes could take different forms: the state could make direct contributions to the scheme, offer low-interest or interest-free loans, or otherwise guarantee the long-term financial viability of the scheme. However, explicit involvement of the state is rare across the EU Member States. Regular state contributions are not observed (except for part or all of the administration costs where the scheme is operated from within a public body that is funded from the general budget—eg, the workers' accidents fund in Belgium). Only for the non-life insurance

guarantee funds in Denmark and Ireland are there provisions to enable the schemes to borrow directly from the state, or with state guarantee from other credit providers. None of the other countries explicitly provides for borrowing or guarantees from the state.

- **Reinsurance.** Schemes may also take out insurance cover to meet their funding requirements and to cap the exposure of participating firms. However, insurance cover of this kind is not observed, although the possibility of taking out such cover has been considered by some schemes.¹²
- **Recoveries.** Additional funding is available to the schemes as a result of recoveries of assets in the winding-up proceedings. There may also be recoveries through legal proceedings against those responsible for the failure or, in the case of liability insurance, those responsible for any damage caused.
- **Investment income.** The reserves or standing funds accumulated from contributions may deliver schemes with additional cash inflows from the returns of invested assets. Schemes often outsource the fund management function through mandates to external fund managers, but retain control over the asset allocation. Accumulated funds are usually invested in safe and liquid assets (eg, treasury bills) with corresponding modest returns.

¹² One exception is the voluntary scheme for life assurers in Germany (Protektor aG), which preceded the statutory scheme and which took over the obligations of Mannheimer Lebensversicherung. It continues to handle those policies until run-off and has reinsured a part of the portfolio.

Table 2.10 Other sources of funding

	Standing fund and capital requirements	Borrowing power	External credit facility in place	State funding	Other
General schemes covering life and non-life insurance					
Latvia	The scheme has a standing fund (around €3.56m in 2006). There is no target amount or minimum requirement	No	No	No	No
Malta	Both the life and non-life sub-funds have the same target size of around €2.33m	Yes	No	No	No
Romania	The accumulated reserves in 2006 were €58.9m (life) and €14.4m (non-life). There is no target amount or minimum requirement	No	No	No	No
Spain	The scheme has a standing fund (€1,099.3m in 2006). There is no target amount or minimum requirement	No	No	No	No
UK	No (although there may be funding surpluses; the scheme is largely ex post-financed)	Yes	Yes, external credit facility in place of £50m (around €74m) for all sub-schemes of the FSCS	No	No

	Standing fund and capital requirements	Borrowing power	External credit facility in place	State funding	Other
General schemes covering life assurance					
France	Fund size is 0.05% of mathematical provisions (€480m in 2006)—half of the fund is a guarantee in the books of insurers. Contributions are adjusted to ensure that each participant's share reflects its relative net reserves	Yes	FGAP can borrow from participating life insurers an amount equal to the normal annual funding (0.05% of mathematical provisions). The borrowed amount must be repaid over a three-year period	No	No
Germany	Target capital is 0.1% of life assurance net reserves (€615m based on 2006 data). Annual contributions are raised until target is met. Contributions are adjusted to ensure that each participant's share reflects its relative net reserves (and risk)	Yes	No	No	Additional guarantees in the event of large failures were given as part of the private initiative that preceded the statutory scheme and continue to apply (€6 billion including the contributions) Protektor has reinsured part of the life portfolio it has taken over
Poland	No (ex post-financed)	No	No	No	No
General schemes covering non-life insurance					
Denmark	Target fund size is DKK300m (around €40.3 m)	Yes	No	The scheme can borrow with state guarantee	No
France	Minimum reserves for cases of insolvency (including motor) cannot fall below €250m. If they do, extraordinary contributions from firms are required	No	No	No	To be provided
Ireland	No (ex post-financed)	Yes	No	The scheme can borrow funds with state guarantee. The Minister for Finance may, on the recommendation of the Central Bank, make repayable advances to the Fund to enable payments to be made expeditiously	No

	Standing fund and capital requirements	Borrowing power	External credit facility in place	State funding	Other
Special schemes covering one or a few branches of (compulsory) non-life insurance					
Belgium	There is a reserve resulting from the fixed entry fee (€1.4m) paid by each insurer providing workers' accidents insurance policies, but the reserve can only be used to meet costs of failures of the insurer making the deposit	No	No	No explicit state involvement (although staff and admin expenses are covered by the general budget)	No
Finland	Scheme for employment accident insurance: no standing fund as such, but scheme can draw from the balance sheet provisions set aside ex ante by Finnish and non-EU undertakings (€61m in 2006) Scheme for patient insurance: no (ex post-financed)	No	No	No	No
Germany	No (ex post-financed)	Yes	No	No	Additional guarantees in the event of large failures were given as part of the private initiative that preceded the statutory scheme and continue to apply (€1billion)
Italy	The scheme has a standing fund (€60,000 in 2006). There is no target amount or minimum requirement	No	The compensation is initially paid by the insurance companies designated by ISVAP (see Table 2.3). If Consap does not have the funds to reimburse them, Consap reimburses them at a later stage with interest	No	No

	Standing fund and capital requirements	Borrowing power	External credit facility in place	State funding	Other
Poland	An aid fund has been accumulating since 2004 for motor and farmers' TPL insurance (€8.8m in 2006), to facilitate preventive function No fund for professional TPL and farm buildings insurance (ex post financed)	No	No	No	No
Spain	Not available	No	No	No	No

Source: Oxera.

2.10 Past and ongoing cases of intervention

Table 2.11 summarises the intervention experience of the IGS currently in place in the EU Member States.

Notably, a number of schemes have not had a single case of insurance failure that would have triggered intervention by the scheme. This applies to the general scheme in Malta, which, since 1986 when its predecessor scheme was established, has not dealt with any cases of life or non-life insurance failure. It also applies to most of the special schemes that cover only one or a few branches of non-life insurance (Belgium, Finland, Germany and Spain), which have not yet been triggered as a result of an insolvency of an insurer providing the specific insurance. The special schemes established to cover employment accidents or hunting liability insurance provide compensation not only in the event of insolvencies of insurers, but also for cases of non-insurance—ie, victims of work accidents where there is no insurance cover, or victims of hunting accidents where the hunter is unidentified or uninsured. The schemes have been active in dealing with these cases of non-insurance, but not with cases of insolvencies. For example, the Workers' Accidents Fund in Belgium has provided compensation for cases of non-insurance, but has not intervened thus far as a result of insolvency of an insurer providing workers' accidents cover.

The one case of a life assurance failure in Germany was dealt with by the scheme established under private initiative (Protector), but there has been no failure since the implementation of the statutory scheme.

Where intervention of statutory schemes is observed, this has been limited for most of the schemes in terms of numbers of insolvencies dealt with or claims and costs arising. In France, the life assurance scheme (FGAP) has dealt with one failure, but the only costs incurred were administrative in nature—sufficient assets were ultimately available to meet all contractual obligations of the insurer and no compensation costs were imposed on the scheme.

The last intervention of the Irish scheme for non-life insurance dates back to a failure in 1985, and there have been no failures since. The one failure of a non-life insurer dealt with by the Latvian scheme was small and has triggered only 40 claims to date with compensation costs of just over €12,000.

The Danish scheme was established as a result of a failure of a non-life insurer in 2002. This failure has remained the only case of intervention to date, and is expected to require a total payment of just over €13m. The Italian scheme for hunting liability insurance has paid a total of €1m to seven claimants in relation to the failure of an insurer providing this type of insurance.

The scheme with a comparatively high degree of activity is the general winding-up scheme operated by CCS in Spain. For example, the CCS has assumed responsibilities for the winding-up of 259 insurers since establishment in 1984 (including those relating to motor cover). Most of these failures occurred in the 1980s and involved small companies only. There have been no failures in the five years up to 2006, but during this period the CCS paid a total of €69.2m mainly in relation to non-life insurance claims. The largest case dealt with to date concerns the insolvency of Reunión in 1992, with costs to the CCS due to payments to policyholders of the non-life insurer amounting to €35.4m by 2006 (including motor).

The UK FSCS has dealt (and continues to deal) with fewer failures, but given the more comprehensive protection provided by the scheme, has paid out more significant amounts. In the five years up to 2005/06, the FSCS paid out nearly €500m, virtually all in relation to non-life insurance claims. According to the FSCS, the largest case of failure handled to date relates to the default of Independent Insurance in 2001; the case is ongoing and total costs are expected to reach £500m (around €738m).

The French scheme for compulsory non-life insurance is supporting claimants in relation to five liquidations of non-life insurers (excluding motor) that were declared insolvent before establishment of the FGAO in 2003.

The Polish scheme for life and specific classes of non-life insurance (and its predecessor) has dealt with a total of seven bankruptcies since 1993, with the last case occurring in 2000—one life insurer, and six non-life insurers. The non-life insurance cases involved payment of compensation in relation to motor and farmers' TPL insurance. The total compensation cost for the largest case (failure of a non-life insurer in 1993) amounted to €18.7m, but this includes the cost of motor claims and is therefore not directly comparable with other numbers reported in Table 2.11.

The Romanian scheme for all classes of life and non-life insurance has dealt with three bankruptcies of composite insurers, the largest being a default costing around €1.7m in relation to 1,250 claims paid to date, with more claims to be paid going forward.

Table 2.11 Past and ongoing cases of intervention

	Total number of insurance failures handled	Total costs of protection during 2002–06	Largest case handled
General schemes covering life and non-life insurance			
Latvia	One failure since 1998	LAT8,000 (around €11,333)	Alianse (non-life) in 2002 was the only failure. LAT8,000 paid in relation to 40 claims for compensation by 2006
Malta	None	0	–
Romania	Three failures of composite insurers since establishment	RON12,414,831 (€3,473,652)	Grup AS (composite) in 2003. RON5,999,580 (€1,678,674) paid to date in relation to 1,250 claims. 10,000 claims remain to be paid
Spain	Since 1984, 259 insurance companies have been wound-up by CCS and predecessor—mostly during 1980s and concerning smaller companies	€69.2m, mostly in relation to non-life insurance claims Breakdown by year: 2001/02: €14.7m 2002/03: €16.4m 2003/04: €21.3m 2004/05: €2.5m 2005/06: €14.3m	Reunión (non-life) in 1992. By 2006, this had cost the CCS €35.4m
UK	One small default since establishment of FSCS in 2001, but FSCS is involved in the ongoing winding-up of 25 general insurers and two life assurers that defaulted before scheme establishment	£500m (€738m), almost all in relation to non-life insurance claims Breakdown by year: 2001/02: £26.4m 2002/03: £131.3m 2003/04: £131.4m 2004/05: £112.9m 2005/06: £93.1m	Independent Insurance (non-life) in 2001. Around 190,000 policyholders. By 2007, £330m (€487m) had been paid, but case is ongoing and total payment expected to reach £500m (€738m)
General schemes covering life assurance			
France	One failure since establishment in 1999 (insolvency of Europavie in 2000)	€423,000	Europavie is only case handled to date. No compensation was ultimately required since assets were sufficient and most of portfolio was transferred. Case handling cost of €423,000
Germany	No failure since implementation of the statutory scheme, but Protektor continues to handle the run-off of Mannheimer Lebensversicherung as part of a private initiative (since 2003)	Participating insurers made one-off contribution of €240m in 2003 to recapitalise Mannheimer, but actual cost was only €100m	Mannheimer is only case handled to date. 344,000 life contracts were transferred to Protektor, and total cost was €100m
Poland	One failure since establishment in 1991	0 (during 2002–06)	The only failure (Westa Life SA) dates back to 1993, so no information on costs and number of claims handled is available

	Total number of insurance failures handled	Total costs of protection during 2002–06	Largest case handled
General schemes covering non-life insurance			
Denmark	None since establishment of scheme in 2003. However, the scheme was set up after the 2002 bankruptcy of Plus Forsikring A/S, for which the scheme assumed responsibility	DKK91m (around €12.2m)	Plus Forsikring A/S in 2002 was the only failure. Case is ongoing and total payment expected to reach around DKK97.5m (around €13.1m)
France	When established in 2003, FGAO was required to take on responsibilities in the ongoing liquidation of five companies declared insolvent during 1998–2003 (excludes motor)	€20.3m paid between 2003 and 2006 in relation to five cases of insolvency (excludes motor)	International Claims Services SA—winding up started in 1999 and FGAO intervention in 2003. By end 2006, 260 claims handled at a total cost of €10.2m (excluding motor cover)
Ireland	1 liquidation (1964) and 2 administrations (1983 and 1985)	Not available	ICI/ICAROM administration, for which payment of €315m was made through the Fund
Special schemes covering one or a few branches of (compulsory) non-life insurance			
Belgium	None	0	–
Finland	None	0	–
Germany	None	0	–
Italy	One failure in 1998 (Consap intervened in 2000)	€1m since 2000 ²	Failure of insurance company FIRS in 1998, with cost of €1m arising from compensation of seven claims ²
Poland	Six failures since 1991 (all involving motorcar and farmers' TPL insurance). No intervention with respect to professional TPL, which is only covered since 2004	Around €55m (but most of these costs relate to motor) ¹	Tur Polisa SA (went into liquidation in 2000) with cost of €20m arising from compensation of nearly 13,000 claims, again, mostly in relation to motor cover
Spain	None	0	–

Note: ¹ The costs relate to the period 1993–2006. Most of the costs would have been incurred prior to 2002. ² One claim paid was subsequently challenged, and €120,000 recovered by Consap as a result.
Source: Oxera.

2.11 Summary

Of the 27 EU Member States, 13 have established insurance guarantee arrangements that offer protection in the event of insolvency of an insurance undertaking. The decision to establish an IGS has often been triggered by the occurrence of insolvencies, or by insurers experiencing severe financial difficulties.

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

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

3 Overview of framework for the analysis

The differences in national approaches to IGS across EU Member States raise the general question about the need for, and role of, an IGS as a protection mechanism. Similarly, the differences in the structure of existing IGS raise questions about the optimal design of a scheme. The lack of harmonised arrangements also raises particular questions when it comes to cross-border insurance business within the EU, both in terms of consumer protection and competition. These questions are examined in the remainder of this report.

This section provides an overview of the framework that was applied to conduct the analysis, and sets out the structure for the subsequent sections.

The analysis is approached in terms of the risks and consequences of insurance failure, which may require an IGS to be established in the first place. 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 any type of market intervention is also likely to impose costs. This framework is useful for assessing the status quo and evaluating the policy options available to improve on the status quo if required.

3.1 Risks and consequences of insurance failures: the role of an IGS

The need for, and role of, an IGS depends on the risk of insurance company failures and the potential impact that these could have on consumers and the wider market. The analysis was conducted in this context, taking account of the following.

- There are other protection mechanisms available to mitigate the risk of insurance failure (eg, internal risk management, prudential regulation) or reduce the consequences for policyholders if the risk materialises (eg, preferential treatment of policyholders in winding-up proceedings). The question is whether these other protection mechanisms are effective or whether a case can be made for an IGS to provide last-resort protection.
- Should a failure occur, policyholders (or beneficiaries) may be exposed to losses if there is a lack of available funds to meet valid claims on insurance policies for which premiums have previously been paid.
- Policyholders cannot instantly and costlessly switch to a new supplier in the event of the collapse of their own insurance provider. They may have outstanding claims that they had made prior to the collapse of the provider as they had imperfect knowledge concerning the provider's ability to meet these claims. In addition, even if they are aware that the provider is in financial difficulty, they may have imperfect knowledge about the precise nature of these difficulties and may delay their transfer of the policy to another provider. These informational problems are generally considered to be more severe in the retail market.
- Policyholders may be left without cover in the case of both life- and non-life business; in terms of the former, they may also lose access to the savings that they have built up over time. Again, such savings may not be immediately and costlessly transferable to an alternative savings scheme.
- Furthermore, in the case of the life market, there are externalities present in that the beneficiaries of the savings scheme will not be the policyholder in the event of the latter's death. Similarly, in the case of the non-life market, there are externalities to the

extent that, in the event of collapse of the insurer, the damaged party may not be the policyholder, but a third party.

- The portfolio of the failed insurer may be transferable to another insurer in the market. However, there may be informational problems, such that it may take time for other insurers to assess the risks of the failed insurer's portfolio before deciding whether to take on the potential claims and to price them accordingly. In the meantime, policyholders may be left without cover and may not be able to claim against existing policies.
- In the absence of an IGS, policyholders would have to rely on the winding-up process of the insolvent insurer in order to obtain compensation for claims previously made but still unsettled, or for new claims that emerge during the process. This can create uncertainty for policyholders, which, in turn, may adversely affect confidence in the market as a whole. In addition, the winding-up process may not provide sufficient funds to enable claims to be met in full and, again, this may have an adverse impact on confidence.

3.2 Desired market outcomes from an IGS

A key objective of an IGS can therefore be to ensure that the insurance market continues to operate effectively, and that market confidence is maintained following a failure of an insurer—as a last-resort means when other protection mechanisms fail. In addition, there may be further (distributional) objectives such as avoiding financial hardship for individual consumers.

Having identified those objectives, it is then possible to define the desired market outcomes that an IGS may be expected to help deliver. The main outcomes include the following.

- Ensuring that coverage for policyholders is maintained by continuing to pay out on claims made prior to the failure of the insurance firm, and ensuring that claims made during the winding-up process are also met.
- Maintaining the value of long-term contracts (particularly in the life assurance market) that policyholders may have entered into. Holders of such contracts may prefer cover to be maintained rather than compensation. Therefore, it may be necessary for the IGS to facilitate the transfer of an existing life assurance portfolio to another provider if appropriate.
- Ensuring that there is no wider collapse in the insurance market. In the event of failure of one firm, consumers need to be reassured about the soundness of the rest of the system, and confidence in insurance products and their providers needs to be maintained.
- Related to the consumer protection outcomes above, ensuring that policyholders are compensated adequately and that there is equitable treatment for all policyholders. For example, more informed policyholders may be able to transfer their policies or seek new cover in the event of failure relatively quickly and at low cost, but less capable consumers may not. Hence, an IGS may be required to ensure adequate and equitable treatment. However, what constitutes adequate and equitable largely depends on the chosen distributional/social justice objectives.

These desired market outcomes are applicable in the case of a single-country IGS. However, the analysis can be equally extended to desired market outcomes at the EU level.

3.3 Negative market outcomes and other costs

While an IGS can deliver positive market outcomes, its establishment also imposes costs. To a large extent, the impact is distributional in nature, with the costs that arise to some parties (contributing insurance firms and, if the costs associated with contributions are passed on, their customers) being matched by benefits to other parties (claimants receiving protection). Put differently, the decision to introduce an IGS will always depend on distributional preferences.

In addition, there may be costs that are ‘true’ costs to society as a whole. These arise if the introduction of an IGS has unintended, negative impacts on market outcomes, including distortions in the decision-making of individual players in the market (moral hazard) and in the competitive process in the market as a whole.

The decision to introduce an IGS then depends on the significance of these adverse effects. It also depends on whether it is possible to limit such effects through effective IGS design, structuring the IGS in a way that preserves competitive neutrality and does not distort the incentives of individual players in the market.

3.4 Impact of current arrangements in the wider EU market context

The desired market outcomes are applicable in the case of a single-country IGS, but the analysis can be equally extended to desired market outcomes from an EU internal market point of view.

In particular, the coexistence of different systems of IGS, coupled with the creation of new schemes in some Member States, may give rise to concerns about the coherent protection of policyholders as well as the functioning of the internal market. A large number of policyholders in the EU are not protected by an IGS in the event of insurance failure, and given the current structure of national arrangements, if an insurance company with cross-border operations fails, some policyholders may be covered by an IGS, whereas others with an identical contract may not, or may only be protected at a lower level. From a cross-border competition angle, there are concerns about the lack of a level playing field between insurance companies operating in the same market if some companies are participating in an IGS and others are not, depending on the existence and scope of geographical coverage of IGS in the relevant home or host countries.

At the EU level, the desired market outcomes that may be expected to result from an EU-wide approach to IGS may therefore be defined as:

- equitable treatment of policyholders (or beneficiaries) residing in different EU Member States and/or purchasing policies across borders;
- confidence in, and stability of, the wider operation of the EU insurance market through equivalent protection of insurance policies in the EU irrespective of where they are issued or bought; and
- a level playing field between insurance companies and competitive neutrality of business conducted by domestic undertakings and incoming EU insurers, including those operating under freedom of services or providing insurance via branches.

3.5 Evaluation of options

The evaluation of the options conducted as part of this study focuses on remedies to any problems identified with the current situation, including options concerning specific aspects of scheme design.

To give a structure to the evaluation, a distinction is made between the options concerning the introduction of an IGS and scheme design at the general level and the options that are of specific relevance at the EU level.

3.5.1 Establishment of an IGS and options for scheme design

The most fundamental question is whether the benefits of having an IGS outweigh the costs and, hence, whether a case can be made for introducing an IGS. This is a key question, at both European and national levels, particularly for those countries that do not currently have an IGS. The first high-level option to be evaluated therefore relates to the establishment of an IGS (as opposed to not having an IGS).

Guarantee schemes are observed in other sectors of the financial services industry, so the evaluation also considers a benchmarking of the case for and against an IGS compared with DGS and ICS.

If the policy decision is to introduce an IGS, the question is how to design the scheme. In addition, different scheme designs are associated with different costs and benefits such that the choice of IGS structure may in itself influence the decision to introduce an IGS.

The inventory and cross-country comparison in section 2 has highlighted the diverse set of actual IGS structures observed in the EU and the differences that exist along virtually all dimensions of scheme design. The main dimensions are repeated in Table 3.1, and options are evaluated in each design dimension.

Table 3.1 Dimension of IGS design and main options evaluated

Main dimensions	Options
Scope of protection—insurance class	Life and/or non-life Focus on specific insurance branches
Scope of protection—claimant eligibility	Policyholders and/or third parties Natural persons or more comprehensive coverage
Scope of protection—amounts and limits	Calculation of guaranteed amount Compensation limits or deductions
Nature of intervention	Payment of compensation Continuity of policies (eg, portfolio transfer)
Organisational structure	Single or multiple IGS for different classes of insurance Private versus public management Relationship with supervisory authority Outsourcing, staffing
Funding	Ex ante or ex post funding Pooling (or not) of funding between insurance classes Calculation of industry contributions (including risk-weighting) Contribution limits Alternative funding sources

Source: Oxera.

3.5.2 Options at the EU level

The key question at the EU level is whether policy action is required to remedy any problems identified with the current coexistence of different national approaches to IGS. The main options evaluated therefore include:

- preserving the status quo;
- introducing an EU-wide approach to IGS—this includes options that differ in:
 - the degree of harmonisation and the aspects to be harmonised rather than being left to individual Member States; and
 - the structure of the IGS adopted, particularly with respect to geographical reach in terms of scheme participation and coverage (home state versus host state).

Other policy measures, such as enhanced policyholder information on the existence (and main features) of an IGS, or case-by-case intervention such as launching infringement proceedings in the event of discriminatory treatment of non-domestic policies or policyholders, are also briefly considered. However, the different modes of implementing EU policy action (eg, non-binding action versus Directive) are not evaluated.

3.5.3 Evaluation criteria

The evaluation of different options is carried out against a set of criteria to allow a systematic analysis of each option. The selected criteria include the following.

- **Consumer protection.** Mitigating financial losses for policyholders or beneficiaries in the event of insurance failure is one of the main objectives of an IGS. Different IGS designs will offer different degrees of consumer protection, both for a single-country IGS and at the EU level.
- **Market confidence and stability.** This criterion is closely linked to consumer protection, since loss events or any uncertainty about potential losses may have an adverse impact on confidence in the market. By increasing consumer confidence in insurance products, an IGS may promote consumer demand and enhance the stability of the system, bringing benefits for the industry as a whole. However, at the same time, the introduction of an IGS may be destabilising—eg, if the funding requirements jeopardise the financial stability of insurance undertakings required to provide the funds.
- **Incentives.** The introduction of an IGS may have an adverse effect on the behaviour of players in the market (moral hazard). The implications for scheme design are that the IGS should be structured to minimise excessive risk-taking behaviour or other distortions in incentives, or indeed provide incentives for better behaviour.
- **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 to a level such that some insurers (domestic or incoming EU firms) find it difficult to compete. Alternatively, if the policies offered by different firms operating in the same market are not subject to the same level of IGS protection, this may put the policies of less protected firms at a competitive disadvantage compared with protected (but otherwise equally efficient) firms. For an IGS to be neutral with respect to competition, it should be such that a level playing field between providers in the market is maintained, efficient entry not deterred, and inefficient entry not promoted.
- **Fairness/proportionality.** This is a broad criterion related to the distributional impact of an IGS. For example, IGS intervention in the first instance redistributes funds from solvent insurers (and their customers) to policyholders of insolvent insurers. The extent of the redistribution may give rise to concerns about notions of ‘fairness’. There is inevitably a degree of unfairness implicit in the nature of IGS, precisely because the

‘good’ firms will have to pay for the mistakes of the ‘bad’ ones. While it is difficult to objectively define what constitutes fair redistribution, some IGS structures may be considered fairer or more proportionate than others. For example, when it comes to IGS funding, a system in which firms make contributions in proportion to the risks or expected costs they impose on the system may be considered more proportionate than a system where this does not happen.

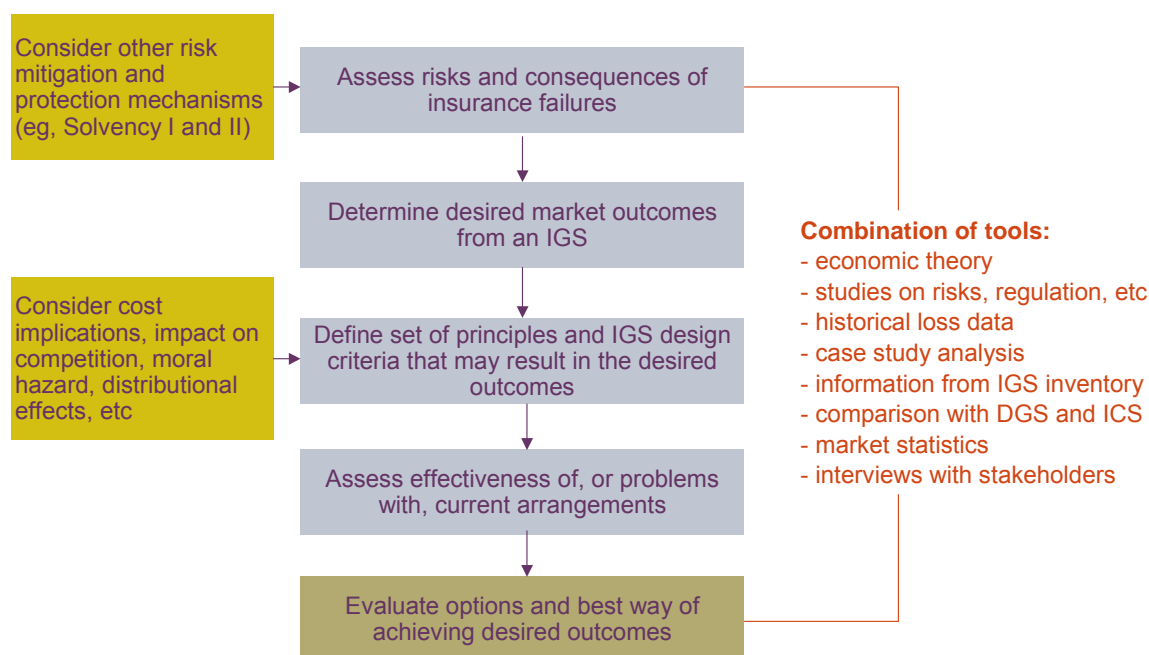
- **Practicality/feasibility.** This criterion relates to the administrative burden associated with an IGS and the ease with which it can be implemented and operated, both at the national level and in the EU cross-border context. For example, at the national level, comprehensive pre-funded IGS are likely to involve greater administrative costs than more limited IGS that are triggered only in the event of specific insurance failures. 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. For example, it may be considered less feasible to operate IGS in the EU around the host state principle if supervisory powers and information rights lie with the home state regulator. This may be for legal and practical reasons, or because it may not be considered acceptable—eg, if domestic firms are reluctant to contribute to a scheme that they feel is funding the failures of incoming firms that are subject to different, and potentially less stringent, regulatory requirements.

No single option is likely to meet 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. For example, the economically most efficient option may not be feasible to implement, and the most feasible option may not comply with notions of fairness or other distributional objectives. Deciding on the optimal balance between the criteria is ultimately a matter for policy.

3.6 Summary of conceptual framework

Figure 3.1 summarises the overall framework of analysis resulting from the above considerations.

Figure 3.1 Overview of framework of analysis



Source: Oxera.

3.7 Structure of the remaining report

The subsequent sections report the results of the analysis conducted, using the framework described above. The presentation of results is structured as follows.

- Section 4 examines the risks and consequences of insurance failures and presents evidence to assess the need for, and role of, an IGS.
- Section 5 describes the costs of an IGS, in terms of the direct costs of administering a scheme and providing the guarantee, and the negative market impacts.
- Section 6 assesses the effectiveness of, or problems with, current IGS arrangements in the EU cross-border context, focusing on implications for consumer protection and competition in the EU insurance markets.
- Section 7 contains the evaluation of options concerning the introduction of an IGS, including specific options for scheme design.
- Section 8 evaluates the main options available at the EU-level to address any problems identified with the coexistence of different systems of IGS across EU Member States.

4 Risks and consequences of insurance failures: the role of IGS

IGS provide last-resort protection in the event that an insurance company fails and cannot meet its contractual obligations to policyholders. The need for, and role of, an IGS therefore depends on the risk of insurance failures occurring and the consequences such failures have on policyholders and the wider market.

This section reviews the evidence available on the causes and incidence of insurance failures (section 4.1) and their potential impact (section 4.2). This evidence should be understood in the context of the range of existing protection mechanisms, which aim to prevent insurance failures or limit the consequences if failures occur (section 4.3).

IGS have a role only in those cases where other protection mechanisms are insufficient to prevent failures or to limit their consequences. This is discussed at the general level in section 4.4, with examples of the role played by the IGS established in the EU presented in section 4.5. Further examples of IGS intervention are provided for the US markets in section 4.6. The main findings are summarised in section 4.7.

4.1 Causes and incidence of insurance failures

There are a range of risks that can impact on the financial position of insurance companies and, if not adequately managed, may result in financial difficulties and ultimately insolvency. The following provides a summary of the main risks faced by insurance undertakings and the causes of failure, drawing on the growing body of literature in this area.

What matters when it comes to assessing the need for an IGS is not so much *why* insurance companies fail, but *whether* they do (or will) fail and the frequency of such failures. Evidence is therefore presented on the incidence of failures in the EU; this complements the evidence reported in section 2.10 (also further discussed below) on those failures that have triggered intervention by the IGS established in the EU.

4.1.1 Risks faced by insurance undertakings

The nature of an insurance undertaking is to take over the risk from policyholders in exchange for a premium. By definition, therefore, insurance is a risk business. Different taxonomies have been developed to describe the main risks faced by insurance companies. For example, in a report for the European Commission, KPMG (2002) categorises these risks into three broad groups.¹³

- **Idiosyncratic risks.** The risks faced by insurers at individual entity level. This includes those risks that relate to the design of the insurance policy (underwriting risk), including underpricing the policy; mis-evaluating the size or the frequency of claims; and designing contracts that encourage policyholders to behave in a more risky manner. There are also operational risks relating to IT systems problems, management failures, etc. On the asset side of the balance sheet, investments are subject to credit risks. On the liability side, insurance companies need to pay claims when they occur. To do this they have to reserve appropriately and keep some assets liquid, which places further constraints on the way assets are managed. The related risks are usually referred to as liquidity, provisioning and matching risks.

¹³ KPMG (2002), 'Study into the Methodologies to Assess the Overall Financial Position of an Insurance Undertaking from the Perspective of Prudential Supervision', report prepared for the European Commission, May.

- **Systematic risks.** The risks faced by insurers as a result of external factors that affect the entire insurance industry. These comprise changes in insurance market conditions that affect all insurers alike—eg, due to changing consumer attitudes or preferences, or reforms in national or supra-national legislation.
- **Systemic risks.** The risks linked to the wider economy. Systemic risks involve political and environmental risks as well as economic risks. Because one of the main tasks of insurance companies is to invest the funds received in the form of premiums before they are paid out as claims, insurers are exposed to market value fluctuations of investments, interests rates and, more generally, to the economic cycle. For example, during financial market downturns, insurers will see their capital surpluses shrink and, for solvency reasons, may need to continue selling assets into the falling market.

A summary of the risks identified in these three categories is provided in Table 4.1, distinguishing between life assurance and non-life insurance.

Table 4.1 Risks faced by insurance companies

Risk	Life	Non-life
Idiosyncratic risks		
Pure underwriting	Severity and frequency of claims due to changes in anticipated mortality, morbidity and longevity	Severity and frequency of claims due to random effects such as natural perils, fire, pollution, crime, war and terrorism
Underwriting management	Poor underwriting through selection of bad risks and inappropriate product design	Poor underwriting through selection of bad risks and inappropriate product design. Losses due to underpricing and under-provisioning, management decisions to expand, inexperience and accumulation and concentration of large losses
Credit	Default risk on investment and premium debts from intermediaries	Default risk on investments and premium debts from intermediaries Reinsurance default is the main driver of credit risk. Failure of major reinsurers will have a high-risk financial impact in the overall loss experience for insurance companies
Reinsurance	The reinsurance programme is generally of less importance in life than in non-life	The purchase of insufficient cover can lead to financial difficulties in the event of unexpected claims or major loss. Failure of reinsurers to respond as anticipated
Operational	Fraud, mis-selling, IT issues, systems and control failures and management failures are the main drivers of operational losses Process failures in key business cycles	Fraud, inadequate reinsurance programme, IT issues, systems and control failures and management failures are the main drivers of operational losses Process failures in key business cycles
Investment	Poor investment resulting from inappropriate mix of investments, overvaluation of assets, excessive concentration of assets in investment-type products. A significant proportion of the investment risk is borne by the policyholder	Poor investment performance resulting from inappropriate mix of investments, overvaluation of assets, and excessive concentration of assets. A far greater proportion of investment risk is borne by the shareholder compared with life assurance
Liquidity	Inability to liquidate assets when needed or having to accept a lower price	Inability to liquidate assets when needed or having to accept a lower price
Matching	Mismatch of assets and liabilities due to cash-flow, currency and timing risks	Matching risk is not usually a major issue for non-life insurers due to the shorter duration of the contracts. For long-tail business the claims profile may need to be matched. Matching is required where there is exposure to different currencies
Expenses	Expense overruns more likely with longer-term contracts	There is normally less risk of expense overruns due to the short-term nature of contracts. However, the company may be exposed to higher claims settlement expenses, such as legal costs
Lapses	Lower level of policies in force results in lower recovery of fixed costs. Where upfront commission is paid, it may be difficult to recover with respect to lapses	Less of an issue than for life due to the short duration of contract. Lower than budgeted level of premiums will impact on profitability. Where upfront commission is paid it may be difficult to recover with respect to lapses
Provisioning	Inadequate levels of provision could lead to the company's financial position being presented in a better light than it actually is. This could result in inappropriate underwriting and other management decisions being made	Inadequate levels of provision could lead to the company's financial position being presented in a better light than it actually is. This could result in inappropriate underwriting and other management decisions being made

Risk	Life	Non-life
Systematic risks		
Jurisdictional and legal change	Implications of court decisions affecting policyholder liabilities	Legal risk has had a high impact for non-life insurers due to court decisions with respect to liability claims
Market changes	Implications of changes in consumers' attitudes and competitor behaviour	Implications of changes in consumers' attitudes and competitor behaviour Implications of the insurance cycle. When premiums rates are low there is a higher risk of insurers entering into uncompetitive contracts
Systemic risks		
Market value fluctuation of investments	Variability in the market value of investments, particularly depreciation of investments due to market conditions. In investment-type products a significant proportion of the investment risk is borne by the policyholder	Variability in the market value of investments, particularly depreciation of investments due to market conditions. Unlike life assurance, all investment risk is borne by the shareholder
Environmental changes	Death and health-related claims as a result of natural perils (eg, floods) increase mortality and morbidity experience	Increased frequency and severity of losses due to natural perils (eg, floods)
Social/political changes	Increased longevity has negative implications for the cost of annuities, but positive implications for term assurance	Increased losses due to social behaviour (eg, crime and theft). Change in attitude of the insured party to making compensation claims from liability insurers
Economic cycle	Downturns in the economic cycle will increase the number of contract terminations (surrenders and lapses) due to inability to pay premiums Impact on investments	Rise in the unemployment rate will increase the number of losses due to theft and crime. Recession will reduce the levels of premium income due to insurance cycle Impact on investments
Inflation rate	Increase in the inflation rate will directly affect the payments for long-term contracts if benefits are linked to inflation. It will also increase medical expenses claims for certain policies Impact on expense base	Inflation will have a high financial impact in losses related to long-tail claims (eg, legal cost for claim settlement) and claims inflation (eg, motor insurance) Impact on expense base
Interest rate	Interest rate is a key risk driver in life assurance since it affects the valuation of assets and liabilities	Short-term changes in interest rate will impact the rate of return on investments if they are not held to maturity. Due to the short duration of non-life insurance contracts, interest rate is not a major risk driver
Exchange rate	Potential losses where there are significant foreign liabilities, which are not matched by investments in the same currency. In investment-type products a significant proportion of the exchange rate risk is borne by the policyholder	Potential losses where there are significant foreign liabilities that are not matched by investments in the same currency. This risk is more significant in non-life insurance than in life assurance
Technological changes	Higher payment experience as a result of increases in longevity as a result of curing of diseases. Higher claims due to health hazards (critical illness) Impact on operational risk if IT systems fail	New technologies increase the number of losses due to system failures (eg, IT systems), health hazards and employers' liabilities claims, and development of new cars, ships and aircraft. It also impacts on the efficiency of distribution channels Impact on operational risk if IT systems fail

Source: KPMG (2002), 'Study into the Methodologies to Assess the Overall Financial Position of an Insurance Undertaking from the Perspective of Prudential Supervision', report commissioned by the European Commission, May.

4.1.2 Incidence and causes of insurance failures

The solvency of an insurance undertaking depends on the extent to which the main risks are managed by the company's internal risk-management process. Key elements of this process include, for example, pooling and diversifying the risks, controlling exposures and obtaining appropriate reinsurance protection.

Failures in the process can occur, and even the best process may not be able to deal with certain risks if they materialise. This can jeopardise the solvency of an insurer and lead to insolvency if the position cannot be restored. Various studies have been undertaken into the incidence and main causes of insurance failure; three such studies for the European insurance market are summarised below.¹⁴

The studies clearly show that, overall, there have been few cases of insurance failure compared with the total number of insurance companies operating in the market—well over 3,000 insurers were operating in the EU25 in 2005 (national enterprises only).¹⁵ Although infrequent, failures have occurred due to a combination of internal and external factors resulting in financial difficulties that, where not possible to correct, have triggered insolvency.

Sharma (2002)¹⁶

In 2001, the EU Insurance Supervisors Conference created a Working Group of insurance supervisors to look at the practical lessons from the past for the risks faced by insurance companies and causes of insurance failure. The conclusions of this Group are presented in the Sharma Report (2002).

The study examines insurance failures in Europe between 1996 and 2001. It finds that restoration plans and short-term finance schemes were applied to 70 insurers in Europe, and a further 15 companies have undergone a withdrawal of authorisation—ie, a total of 85 insurance companies are classified as failing companies.

As summarised in Table 4.2, in 65 of those cases, policyholders' rights were safeguarded despite failure, because either the portfolios of the insurance companies were taken over by another company (29 cases), there was an increase in the capital by a third party, which was often the parent company (32 cases), or the company was able to recover alone (three cases).

Of the 20 insurance companies that were wound up, 17 were non-life companies. For those, Sharma (2002) further analyses the causes of failure. Technical imbalances due to underpricing or mispricing were the most frequent cause, followed by problems on the asset side and inadequate reinsurance.

¹⁴ Additional evidence is available, for example, in Massey, R. (2002), 'Insurance Company Failure', a report prepared for The Actuarial Profession, General Insurance Research Organising Committee.

¹⁵ Committee of European Insurance and Occupational Pensions Supervisors (2006), 'Financial Conditions and Financial Stability in the European Insurance and Occupational Pension Fund Sector 2005–2006: Risk Outlook', December.

¹⁶ Sharma, P. (2002), 'Prudential Supervision of Insurance Undertakings', report prepared for the Conference of Insurance Supervisory Services of the Member States of the European Union.

Table 4.2 Incidence and causes of insurance failures in Sharma (2002)

	Number of failing companies
Failures where rights of policyholders were ultimately safeguarded through:	65
portfolio transfer or takeover	29
capital increase (eg, capital injection by parent company)	32
own recovery by the insurer	3
Failures resulting in withdrawal of authorisation and winding-up, of which:	20
life	3
non-life	17
Main cause underlying the failure of the 17 non-life insurers that were wound up:	
technical imbalance (underpricing, mispricing)	8
asset problems	2
inadequate reinsurance	1
multiple causes	6

Source: Based on Sharma, P. (2002), 'Prudential Supervision of Insurance Undertakings', report prepared for the Conference of Insurance Supervisory Services of the Member States of the European Union.

Sharma (2002) also analyses 155 'near-misses' between 1996 and 2001, which are defined as 'cases in which the EU solvency requirements were not breached but where the supervisor felt it necessary to intervene or to place the company under some form of special measures'. The main two causes for supervisory intervention (before the solvency margins were breached) are incorrect evaluation of financial outcomes (in particular, the technical provisions), and inappropriate risk decisions by management. Inappropriate risk decisions by management are reported to take many forms, but business risk, whether due to rapid growth, over-concentration of risk or lack of expense control, is shown to play a significant part.

CEIOPS (2005)¹⁷

In an exercise similar to that conducted by Sharma (2002), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) analysed insurance failures over the period 2001–04.

As summarised in Table 4.3, during the period, a total of 48 insurers (31 non-life, 14 life, and three composite) suffered actual failure. The number of near-misses (defined as companies that were still solvent but that had problems that could have resulted in failure) was substantially higher (152).

¹⁷ CEIOPS (2005), 'Consultation Paper No. 7, Draft Answers to the European Commission on the "Second Wave" of Calls for Advice in the Framework of the Solvency II Project'.

Table 4.3 Incidence of insurance failures in CEIOPS (2005)

	Number of actual failures	Number of near-misses
Non-life	31	56
Life	14	39
Composite	3	57
Total	48	152

Source: CEIOPS (2005), 'Consultation Paper No. 7, Draft Answers to the European Commission on the "Second Wave" of Calls for Advice in the framework of the Solvency II Project'.

Information on the outcome of the actual failures is available for 45 companies. In the majority of cases, the insurer continued its business as a reduced entity, or its portfolio was taken over or transferred. Withdrawal of the authorisation to conduct business applied in 11 cases. The report concludes that, in general, there was no single cause of failure. Frequent causes of failure were related to underpricing, excessive overheads, investment depreciation, and management and other operational problems (Table 4.4).

Table 4.4 Outcome and causes of insurance failures in CEIOPS (2005)

Outcome of failures	
Portfolio transfer or takeover	4
Continuation of business as a reduced entity	30
Authorisation by supervisory authority was withdrawn	11
Causes of failures	
Technical imbalance	
Underpricing	10
Mispricing	5
Excessive overhead	10
Inadequate reinsurance	5
Losses on assets	
Default by reinsurers	4
Bad debts on the part of insured parties and intermediaries	1
Losses of intra-group assets	4
Investment depreciation	14
Other	3
Mismatched assets and liabilities	4
Management causes	11
Other operational causes	7
Lack of liquidity	2
Other causes	12

Note: Multiple causes of failure are possible.

Source: CEIOPS (2005), 'Consultation Paper No. 7, Draft Answers to the European Commission on the "Second Wave" of Calls for Advice in the Framework of the Solvency II project'.

Plantin and Rochet (2007)¹⁸

Plantin and Rochet (2007) suggest that, in insurance more than in other businesses, a failure is likely to be large in scale, that insurance companies should be regulated, and that a guarantee scheme should be set up, providing policyholders with insurance against their insurer's default. The authors start from the result of the corporate governance literature (see Dewatripont and Tirole, 1994¹⁹) that if control rights (ie, the power to make decisions) and the rights on income streams differ, decisions may not be appropriate. This is particularly the case when companies have a low solvency, because the management and shareholders are protected by limited liability, and they take decisions that may adversely affect creditors' stream of revenue. They may then engage in risky business because limited liability protects them from bad outcomes, whereas good outcomes increase their own stream of revenues—ie, when things go wrong, instead of cutting their losses, they 'gamble for resurrection'.

As argued by Plantin and Rochet (2007), the insurance sector may be more subject to 'gambling for resurrection', mainly because, given the nature of the business, it is easier for management to conceal difficulties while taking risky bets. In particular, unlike most other goods and services, insurance services are produced only after they are purchased by policyholders. Premiums are collected in many cases long before claims are paid out. This means that it is not possible to know immediately whether the policy that has been underwritten is profitable; in some cases, this is known only several years after the business has been underwritten and premiums cashed in. Moreover, the final losses depend heavily on the insurers' ability and efforts to mitigate losses during the run-off period.

The authors confirm this intuition with case studies of recent insurance incidents, each caused by the (quasi-) failure of an insurance company—Independent Insurance and Equitable Life in the UK, and Groupe des Assurances Nationales (GAN) and Europavie in France. The authors analyse what these cases have in common: after an initial unexpected shock on assets or liabilities, the net wealth of the companies decreases. Only company insiders appear to react in the first instance, and the failures may become excessively large due to 'gambling for resurrection'. Indeed, excessively risky strategy may worsen the situation of a company.

4.1.3 Likelihood of failure based on credit ratings of EU insurers

The above evidence of past insurance failures in the EU suggests that insurance company failures are infrequent—they can and do occur, but with low frequency.

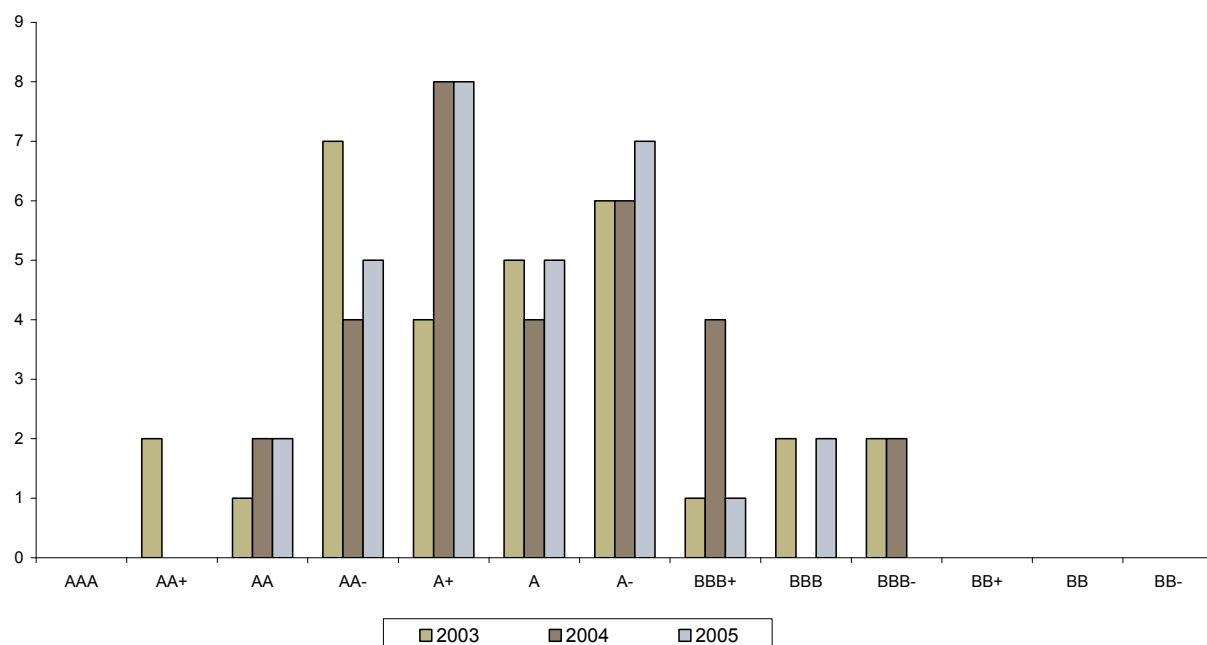
Information about the probability of failure on a more forward-looking basis can be inferred from the credit ratings of insurance companies. Credit ratings measure the financial strength and creditworthiness of a company. Although credit ratings are imperfect predictors of insurers' likelihood of defaulting on their debt and obligations, studies show that they provide an indication of future default probabilities.

Figure 4.1 presents the distribution of long-term credit ratings of European insurers, as rated by Standard & Poor's (S&P). The sample of insurers for which a rating was available is small, but some of the largest EU insurers are captured in the ratings distribution. While very high ratings are rare, most insurers are rated A- or higher.

¹⁸ Plantin, G. and Rochet, J.-C. (2007), *When Insurers Go Bust: An Economic Analysis of the Role and Design of Prudential Regulation*, Princeton University Press.

¹⁹ Dewatripont, M. and Tirole, J. (1994), *The Prudential Regulation of Banks*, The MIT Press.

Figure 4.1 Distribution of credit ratings for European insurers



Source: CEIOPS (2006), 'Spring 2006 Report on Financial Conditions and Financial Stability in the European Insurance and Occupational Pension Fund Sector', May.

In their annual default studies, rating agencies examine the relationship between credit ratings and default rates. The results of S&P's 2006 study are reported in Table 4.5. For example, the one-year default rate for a corporate issuer rated AA is 0% during 1981–2006, whereas that for a BBB-rated issuer is 0.25%. Default rates over a five- and ten-year period are also reported.

Table 4.5 Default rates by credit rating

	1-year default rate (%)	5-year default rate (%)	10-year default rate (%)
AAA	0	0.29	0.7
AA+	0	0.21	0.37
AA	0	0.21	0.78
AA–	0.02	0.48	1.2
A+	0.05	0.63	1.57
A	0.07	0.63	1.85
A–	0.06	0.79	2.33
BBB+	0.16	1.92	4.14
BBB	0.25	2.14	4.9
BBB–	0.33	4.07	7.67
BB+	0.57	5.94	11.18
BB	0.86	9.02	15.7
BB–	1.54	13.39	22.57
B+	2.7	18.75	27.41
B	7.1	25.77	32.48
B–	10.11	32.2	38.94
CCC	26.29	46.22	51.83

Note: Default rates by rating class calculated over the period 1981–2006.

Source: Standard & Poor's (2007), 'Annual 2006 Global Corporate Default Study And Rating Transitions'.

These default rates apply to the overall market and not to insurers specifically. It has been shown that insurers have tended to default on their debt less frequently than other firms. For example, among the companies for which S&P rates bonds, S&P reported an average of 1.45% for all companies during 1981–2002, compared with just 0.61% for insurers; similar average insolvency rates are reported by rating agencies Moody's and A.M. Best for US insurers.²⁰

With these caveats in mind, it is possible to draw some inferences about the default probabilities of European insurers. In particular, the ratings that apply to the sample of European insurers suggest that the market does not consider the sector to be failure-free. Based on credit ratings as a measure of financial strength, the probability of default is low but not zero. For the sample of European insurers considered in Figure 4.1 (for 2005), the probability of default implied by the ratings and calculated default rates ranges between 0% to 0.25%, with an (unweighted) average probability of 0.065%. A higher default probability is likely to apply if the sample of rated insurers were larger and smaller unrated companies are included.

Thus, the market-based assessment based on credit ratings supports the historical evidence in concluding that, although small, the risk of an insurance company failing is not zero—failures have occurred and are likely to continue to occur, albeit infrequently.

²⁰ Swiss Re (2003), 'Insurance Company Ratings', Sigma, No. 4/2003.

4.2 Consequences of insurance failures

The failure of an insurance company can expose policyholders or beneficiaries to losses if the failed insurer cannot meet its liabilities. Moreover, insurance company failure may have wider impacts on the market. The following sets out the potential impact on individual policyholders and beneficiaries as well as the possible wider market impacts.

4.2.1 Potential impact on individual policyholders or beneficiaries

The risks faced by insurance undertakings and the incidence of insurance failure vary between the life and the non-life markets. Similarly, the consequences of failure from the perspective of policyholders and beneficiaries also varies depending on the type of policy. The following therefore sets out the potential consequences separately for life assurance and non-life insurance.

The actual consequences are likely to be case-specific, and depend on the magnitude of failure (eg, asset shortfall at the level of the insurer) and how the failure is resolved (eg, through formal winding-up proceedings).

The following examines the potential consequences in terms of the significance of insurance for individual policyholders (or beneficiaries) and the types of loss they could incur in the event of failure, bearing in mind that the level of exposures generally exceeds actual losses if it comes to insolvency. Evidence on the size of actual losses incurred is presented in section 4.5 with respect to failures that triggered the operation of the IGS.

Life insurance

Life insurance is a contract between the insurer and the insured whereby a benefit is paid to the beneficiary if an insured event occurs which is covered by the policy or, in some cases, at the expiry of the policy term. Life assurance policies tend to fall into two main categories.

- **Risk protection products** are designed to provide a benefit in the event of a specified occurrence, which typically is the death of the insured, but may also include, for example, the insured reaching a certain age. In general, the benefit will be paid to the insured, or in the case of death, their beneficiaries, in a lump-sum payment, although this may vary according to the terms of the insurance policy.
- **Savings and investment products** are those in which the main objective is to facilitate the growth of the capital contributed by regular or single premiums (eg, unit-linked insurance policies).

Life insurance can therefore be used for protection purposes and, because of its long-term nature, as a means of investment and savings. Some life contracts combine both elements.

The failure of an insurance company can lead policyholders or beneficiaries to lose a sizeable part of the expected policy benefits. Financial hardship may be particularly severe in life assurance because the expected benefit of policyholders is their future income. Even if the benefits can be recovered at a later date (eg, as part of winding-up proceedings of the failed insurer), the recovery may not be in full and policyholders suffer from uncertainty during the period.²¹

Where protection products are concerned, in addition to the potential loss of the expected policy benefit, policyholders may incur losses for the unexpired portion of a policy for which a premium has been paid in advance. The monetary loss may not be significant, but

²¹ For a further discussion on the consequences of life assurance failures, see Davis, K. (2004), 'Study of Financial System Guarantees', a report prepared for the Commonwealth Government of Australia, March.

policyholders may need time to arrange suitable replacement cover. In addition, replacement cover may not be available at the same price, or at all—for example, because the policyholder has aged or has experienced a deterioration in health.

For savings and investment products, policyholders and their beneficiaries are exposed to losses on their savings and investment. Some insurance products may entail a guarantee on the part of the life insurer. Failure of the insurer may result in the guarantee not being honoured, resulting in wealth losses for policyholders or beneficiaries that can be significant, particularly where the life policy was purchased to provide for retirement income. For other products (eg, unit-linked insurance), the value of the policy benefit fluctuates due to exposure to investment risk, as with other investment products (eg, mutual funds). While there is no risk of loss relative to a guaranteed amount, policyholders may nonetheless be exposed to losses in the event of failure if the underlying investments are not properly segregated and cannot be returned to policyholders (eg, in cases involving fraud).

One way to reduce the risk of loss as a result of life assurance failure is to choose a financially sound life insurer. For life policies, this can be a difficult task even for the most financially sophisticated of individuals because of the long-term and very technical nature of the products, as well as the complexity of both the risks involved and the means used to manage those risks. Moreover, for group insurance contracts (eg, concluded by employers on behalf of their employees), those who may incur financial hardship are usually not those who select the insurer, in which case there is little that can be done by the final beneficiary of the policy to reduce risk.

Aggregate statistics for the life assurance industry give an indication of the importance of life policies for individuals. Table 4.6 shows the volume of premiums as well as the investments made by insurers in relation to life policies in the EU. Premiums paid in relation to life policies represents more than 5% of GDP in the EU.

Penetration of life assurance policies (as well as the type of product) varies considerably between Member States, depending on the use of life assurance for supplementary pension provision, the existence of favourable tax incentives for savings via life assurance, household wealth, savings attitudes, and a range of other factors.

Table 4.6 shows that life policies are more important for households in Belgium, Denmark, Finland, France, the Netherlands, Sweden and the UK.²² In these countries, aggregate life investments are greater than or equal to 50% of GDP. The investment per-capita figures (on average, almost €11,000, but with significant variations across countries) underestimate the amounts invested for policyholders, given that not all inhabitants are covered by life assurance policies.

²² The high numbers reported for Luxembourg are misleading as a sizeable part of the policies is written for foreign households.

Table 4.6 Life insurance premiums and investments, 2006

Country	Premium (€m)	Investments (€m)	Premium to GDP (%)	Investments to GDP (%)	Premium per capita (€)	Investments per capita (€)
Austria	7,181	47,304	2.8	18.5	869	5,723
Belgium	20,634	154,086	6.6	49.2	1,963	14,659
Bulgaria	82		0.3		11	
Cyprus	287	1,794	2.0	12.4	375	2,342
Czech Republic	1,661		1.5		162	
Denmark	12,334	175,624	5.6	80.0	2,272	32,355
Estonia	36		0.3		27	
Finland	11,803	98,897	7.0	58.9	2,246	18,816
France	141,180	1,247,200	7.9	70.0	2,245	19,833
Germany	74,700	670,000	3.2	29.0	906	8,127
Greece	2,274	7,570	1.2	3.9	204	680
Hungary	1,592		1.8		158	
Ireland	11,000	69,000	6.3	39.7	2,613	16,393
Italy	69,377	401,313	4.7	27.2	1,181	6,831
Latvia	23	68	0.1	0.4	10	30
Lithuania	131	162	0.6	0.7	38	48
Luxembourg	11,500	42,307	34.8	128.0	25,000	91,972
Malta	171	988	3.5	20.2	423	2,446
Netherlands	25,000	287,660	4.7	54.5	1,531	17,611
Poland	5,416	16,697	2.0	6.2	142	438
Portugal	8,762	38,000	5.6	24.5	829	3,595
Romania	252	333	0.3	0.3	12	15
Slovakia	684	1,577	1.6	3.6	127	293
Slovenia	542	2,505	1.8	8.4	271	1,251
Spain	22,472	138,717	2.3	14.2	514	3,170
Sweden	15,452	213,913	5.0	69.7	1,708	23,642
UK	183,357	1,760,228	9.7	93.0	3,036	29,146
EU	627,567	5,375,608	5.4	46.7	1,273	10,907

Source: Based on CEA (2007), 'European Insurance in Figures', August 2007 and Eurostat data.

Some data was also available on the average amount of the sum insured per life assurance policy—for example, in 2005, the sum insured per policy amounted to €17,462 in Austria, €24,865 in Germany and €17,251 in the UK; in Estonia and Latvia, the amounts were €6,517 and €3,108, respectively.²³

However, detailed data allowing the evaluation of the average value (and the distribution of this value) of the expected policy benefits from different life assurance policies held by households in the EU, and hence of the potential exposure in the event of failure, was not available on a consistent and comprehensive basis.

²³ Data made available by the CEA.

Non-life insurance

As with life assurance protection products, the loss for policyholders from the failure of an insurer can be divided into the non-payment of expected policy benefits and the loss of insurance cover (as well as any prepaid premiums).

In the event of failure of a non-life insurer, there can be a loss for those policyholders with outstanding or incurred but not reported claims against the insurer. The size of loss depends on the level of assets available to cover the claim and the amount of the claim—the latter may range from very minor to severe, depending on the event triggering the claim.

There are different types of insurance policy, all covering events during a certain period of time. However, some claims can arise long after the policy expires. For these long-tail classes of insurance, the full consequences of an insurance failure may be difficult to evaluate, as claims may continue to arise for many years.

The consequences of the failure of an insurance undertaking may not only affect policyholders but also third parties, as is the case for classes of liability insurance. Failure of the insurer may lead to non-payment of claims, which will leave the injuring party exposed to the liability and the injured third party without compensation.

Risks are generally insured on a short-term basis, with premiums paid for a one-year period. Loss of pre-paid premiums is likely to be small compared with the loss of expected policy benefit. Additional costs arise from the need to arrange suitable replacement cover, which may be available but may take time to obtain. Lack of insurance cover can be disruptive—eg, for businesses, when it becomes illegal or too risky to operate without insurance.

As in the case of life assurance, policyholders may not be well placed to assess whether a non-life insurer will be able to pay its claims. This is particularly the case for retail policyholders—they are less capable of making informed decisions. Furthermore, they may not have the same access to brokers or the internal risk management resources available to commercial policyholders. Even if policyholders' claims are ultimately met after the company has been wound up, non-payment of claims may lead to financial hardship for a potentially long period for some policyholders and third-party claimants.

Table 4.7 presents the non-life premiums and investments of EU insurers. The data includes all classes of non-life insurance, and does not distinguish between commercial and retail policies.

Total non-life premiums in the EU amount to, on average, 3.3% of GDP in 2006. The average amounts invested are just under 10% of GDP. Table 4.7 also presents premiums and investments in relation to the number of individuals. However, to the extent that policies covering large risks constitute a significant part of the market, the data does not give an indication of the level of non-life insurance premiums and investments for households.

Table 4.7 Non-life premiums and investments

Country	Premium (€n)	Investments (€n)	Premium to GDP (%)	Investments to GDP (%)	Premium per household (€)	Investments per household (€)
Austria	8,401	18,464	3.3	7.2	1,016	2,234
Belgium	8,999	38,562	2.9	12.3	856	3,669
Bulgaria	490		2.0		63	
Cyprus	342	208	2.4	1.4	446	272
Czech Republic	2,568		2.3		251	
Denmark	6,324	17,965	2.9	8.2	1,165	3,310
Estonia	200		1.5		149	
Finland	3,150	10,065	1.9	6.0	599	1,915
France	56,980	163,800	3.2	9.2	906	2,605
Germany	86,900	520,000	3.8	22.5	1,054	6,308
Greece	2,060		1.1		185	
Hungary	1,550		1.7		154	
Ireland	3,904	10,000	2.2	5.8	928	2,376
Italy	37,184	77,812	2.5	5.3	633	1,324
Latvia	270	195	1.7	1.2	118	85
Lithuania	288	260	1.2	1.1	85	76
Luxembourg	1423	2,666	4.3	8.1	3,093	5,796
Malta	119	648	2.4	13.2	295	1,604
Netherlands	39,691	37,270	7.5	7.1	2,430	2,282
Poland	4,213	8,981	1.6	3.3	110	235
Portugal	4,360	7,000	2.8	4.5	412	662
Romania	1,024	107	1.1	0.1	47	5
Slovakia	758	593	1.7	1.3	141	110
Slovenia	1,185	1,670	4.0	5.6	592	834
Spain	30,112	34,606	3.1	3.5	688	791
Sweden	7,696	45,083	2.5	14.7	851	4,983
UK	72,071	132,017	3.8	7.0	1,193	2,186
EU	380,749	1,127,863	3.3	9.8	773	2,288

Notes: Premiums and investments relate to both retail and commercial policies; hence, the per-capita figures are therefore not a useful indicator of the average premiums paid by, or investments made in relation to, policies purchased by households.

Source: Based on CEA (2007), 'European Insurance in Figures', August 2007 and Eurostat data.

While giving an indication of the economic importance of non-life insurance in the economy, the data in Table 4.7 is of limited use in assessing the consequences of insurance failures for policyholders or beneficiaries.

As outlined above, for the majority of policyholders or beneficiaries, the impact of an insolvency of a non-life insurer is likely to be limited. This is because, in general, only a fraction of claims is outstanding (or incurred but not reported) at any point in time. Thus, only those with claims outstanding at the time of insolvency could be exposed to significant losses. For the majority of policyholders, the consequence of an insurance failure is limited to the amount of prepaid but unused premiums, which in most cases will be small, at least compared with the size of potential claims.

An assessment of the potential consequences of non-life insurance failure for individual policyholders or beneficiaries would require data on the number of claims outstanding relative to the total number of policies, and on the size of those claims. Moreover, to obtain information about the ‘typical’ size of unearned premiums, data would be required on, for example, the number of policies and the unearned premiums provision. Such data was not readily available from cross-country statistics for the 27 EU Member States.

Nonetheless, it was possible to obtain at least some information on the size of claims for selected branches of non-life insurance. Table 4.8 contains claims data for personal lines of insurance in the German non-life market, provided by the German industry association, Gesamtverband der deutschen Versicherungswirtschaft (GDV). The data shows the number and average size of claims for general liability insurance and private property insurance (home contents and building) during 2000 and 2005.

Table 4.8 Number of claims and average claim (selected branches of private non-life insurance in Germany, 2000–05)

	General liability		Home contents		Building	
	Number of claims (m)	Average claim (€)	Number of claims (m)	Average claim (€)	Number of claims (m)	Average claim (€)
2000	1.69	383	–	–	–	–
2001	1.73	390	1.38	901	1.48	1,647
2002	1.64	399	1.75	846	3.09	1,354
2003	1.70	398	1.53	853	1.88	1,551
2004	1.71	417	1.43	860	2.09	1,442
2005	–	–	1.34	878	1.98	1,515
5 years	8.47	397	7.42	866	10.52	1,478

Note: ‘5 years’ refers to 2000–04 for private general liability insurance claims, and 2001–05 for private home contents and building insurance claims.

Source: Statistics provided by the GDV.

It is evident from the table that the average size of claims is relatively small (eg, compared with the income and wealth of the average German household)—over a five-year period, individual claims amounted to €397 for general liability insurance, €866 for home contents insurance, and €1,478 for private building insurance. Put differently, the average exposure of individuals in the event of failure of a non-life insurer is relatively small, and losses materialise only for those claims outstanding at the time of insolvency.

The conclusion is supported by data on the average cost of claims for select branches of non-life insurance in a few other EU Member States, made available by the CEA. For example, in 2005, for accident insurance, the average cost was €2,533 in Austria and €2,454 in Finland; for general liability insurance, the amounts were €2,143 and €5,010, respectively.²⁴

While the amount is small on average, the distribution of claims is markedly skewed, with some claims significantly exceeding the average. Table 4.9 provides an illustration, again using data from the German non-life insurance market.

²⁴ Data made available by the CEA.

Table 4.9 Distribution of claims by size (selected branches of private non-life insurance in Germany, 2000–05)

Size of claim	General liability		Buildings	
	Number of claims during 2000–04	% of total	Number of claims during 2001–05	% of total
< €1,000	7,979,079	94.2	7,376,747	70.1
> €1,000	491,281	5.8	3,020,152	28.7
> €10,000	17,110	0.202	115,755	1.1
> €100,000	813	0.0096	7,366	0.07
> €1m	15	0.00018	42	0.0004

Note: Distribution based on total number of claims during 2000–04 for private general liability insurance claims, and 2001–05 for private building insurance claims.

Source: Statistics provided by the GDV, and Oxera calculations.

More than 94% (70%) of claims relating to general liability (residential buildings) insurance during the five-year period considered were less than €1,000, supporting the above conclusion that, for the majority of individuals, the failure of a non-life insurer is unlikely to be significant, even if they have claims outstanding at the time of insolvency.

Nonetheless, for a few individuals, claims reach a significant size and non-payment could have financial consequences as severe, or indeed more severe, than losses that could be incurred with typical life assurance policies. For example, 0.2% of general liability insurance claims amounted to more than €10,000, and for 15 claimants (during the five-year period) liability insurance claims exceeded €1m. These very large claims are clearly exceptional, but would be significant if outstanding and not paid in the event of failure.

Overall, the financial consequences of non-life insurance failures are likely to be comparatively small for the majority of individual policyholders and beneficiaries—or at least less significant for individual policyholders or beneficiaries than failures in the life assurance market. However, even if infrequent, large claims can occur and can expose the affected policyholders or beneficiaries to significant losses if unprotected in the event of failure. Section 4.5 describes examples of where IGS have intervened to protect claimants who would otherwise have incurred significant losses.

4.2.2 Potential wider market impacts

The potential loss exposures for policyholders in the event of insurance failure may raise concerns from an individual policyholder protection perspective. In addition, there may be concerns about wider market impacts. In particular, any losses incurred following the failure of an insurer may result in policyholders losing confidence in the insurance market as a whole.

While it seems plausible to assume that policyholders may become uncertain and be more reluctant to enter insurance contracts after they have experienced a loss due to the failure of an insurer (or because they have learned that other policyholders have experienced losses), there is no direct evidence available to quantify the strength of the possible adverse effect on market confidence.

Wider market impacts are most likely to be observable only in the event of major insurance failures. One example from outside Europe comes from the 2001 insolvency of the HIH Group, which was the second largest non-life insurance group in Australia. It has been reported that, following the failure, many small businesses and community organisations were unable to obtain insurance cover (or experienced significant premium increases);

without the cover, they were unable to continue operating.²⁵ Such business disruption has a direct adverse effect on the wider economy, over and above the market confidence effect.

Similar large-scale effects could have arisen in Ireland after the second largest non-life insurance company in the country, the Insurance Corporation of Ireland (ICI), failed in 1985. The government chose to step in and took the company over. It was said that:

the alternative to a rescue was unthinkable—the liquidation of ICI, a company which held 120,000 insurance policies in Ireland, including 30,000 motor insurance policies as well as a 25% share of the employers' liability and public liabilities insurance market.²⁶

The government set up a special fund and required the last owner of ICI to lend €89m, and the Central Bank €38m, to the fund over 15 years at low interest rates, with the owner contributing €7m per year and the other banks €2m to the interest on that €127m loan.

Less than two years prior to this, in 1983, the Irish Parliament passed an emergency insurance bill aimed at preventing the collapse of the Private Motorists' Protection Association (PMPA) and protecting its 400,000 policyholders, which included over 50% of Ireland's private motorists.²⁷ The High Court placed the company under management of an administrator and, as part of the insurance guarantee arrangements for non-life insurance in Ireland, the Irish authorities placed a 2% levy on all non-life premiums to contribute to the cost of the administration. Given the company's significant market share, there could have been difficulties for the remaining companies to offer substitute policies, resulting in supply shortages in the market. The intervention prevented liquidation of the company and ensured the continuation of policies under administration.

However, major insurance failures have been rare in the EU, and there is no evidence of significant losses as a result of failure. As further discussed below, other mechanisms have assisted in either preventing losses or compensating policyholders for losses incurred—including the IGS already in existence or established in response to failures.

4.3 Protection mechanisms

There is a range of mechanisms in place aimed at preventing insurance company failure or mitigating the impact should failure occur.

- **Internal risk management.** The processes introduced by the insurance industry to internally manage or transfer the risks that may jeopardise the solvency of an insurer.
- **Prudential supervision framework.** The additional requirements introduced as part of a stringent prudential framework applying to insurers—the framework comprises different elements:
 - standards-setting to define what constitutes minimum acceptable behaviour and promote sound risk-management practices among insurers;
 - supervision to facilitate early detection of financial difficulties and to monitor and enforce compliance with prudential standards;
 - early intervention and resolution strategies to deal with insurers in financial difficulty, including the ability to issue directions to the insurer, to replace management and to effect a merger or a portfolio transfer from the failing insurer to a solvent one;

²⁵ See Massey, R. (2002), 'Insurance Company Failure', a report prepared for The Actuarial Profession, General Insurance Research Organising Committee.

²⁶ *Irish Times*, (1992), 'Taxpayer Forced to Pick up Tab for AIB Failure', December 11th.

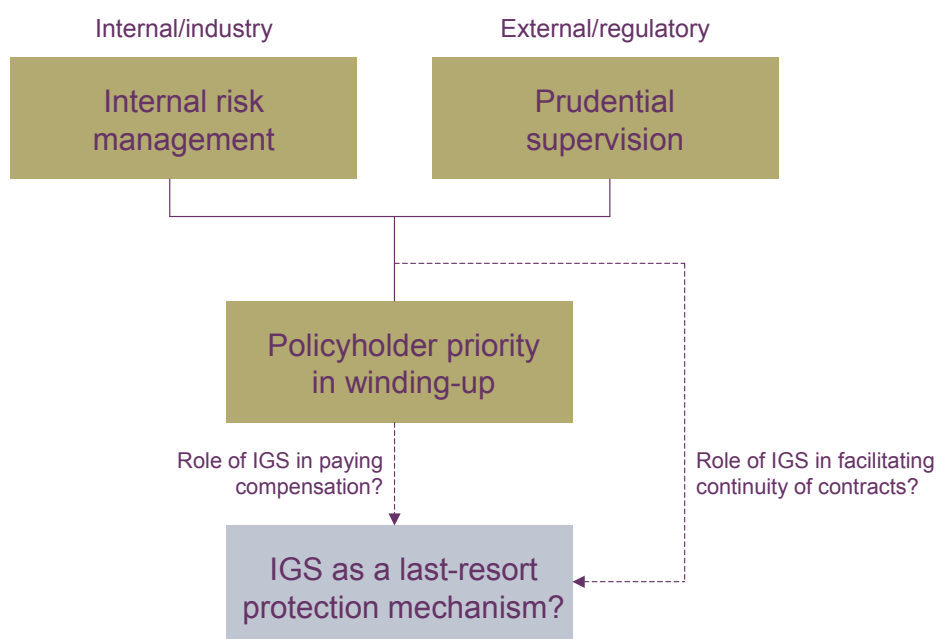
²⁷ ReActions (1989), 'Prospects for PMPA?', March 13th.

- **Priority treatment of policyholders in winding-up proceedings.** Where a winding-up process is initiated because other resolution strategies were not possible or effective, this involves provisions for the priority treatment of policyholders over other creditors of the insurer in liquidation.

The comparatively low failure rate and absence of significant loss events for policyholders can be taken as evidence that the existing preventative mechanisms have worked effectively, and are likely to continue to do so going forward, especially as further advances are made in understanding and responding to the risks inherent in the insurance industry, both at industry level and through the supervisory framework as part of the implementation of Solvency II.

The need for an IGS as a protection mechanism can only be evaluated in the context of these other protection mechanisms. Where other protection mechanisms fail or are considered unable to provide adequate protection, an IGS may have a role in either making compensation payments (typically after the start of the formal winding-up proceedings) or facilitating the continuity of policies (which may be before the start of insolvency proceedings—eg, if the IGS takes over the portfolio or makes available the funds required to allow portfolio transfer to another insurance company in the market). Figure 4.2 provides an illustrative summary of the role of an IGS in the context of the other main protection mechanisms.

Figure 4.2 Overview of main alternative protection mechanisms



Source: Oxera.

In this framework, an IGS is not interpreted as an alternative or substitute form of protection. Indeed, if internal risk-management practices and the supervisory framework were weak, the introduction of a comprehensive guarantee would undermine market operations—it could then have an adverse impact on the incentives of the participants in the market and create costs at levels that would be difficult to finance. Rather, an IGS is a last-resort protection mechanism. In this role, it complements existing arrangements and serves as a safety net should the main protection mechanisms in the market fail.

The following provides a brief overview of the main mechanisms in place to prevent insurance failure or mitigate the impact should a failure occur. An assessment of their effectiveness is beyond the scope of this study. The more effective the other protection mechanisms, the less need there is to introduce an IGS—but as long as the other mechanisms do not eliminate the risk of failure completely (ie, create a no-failure

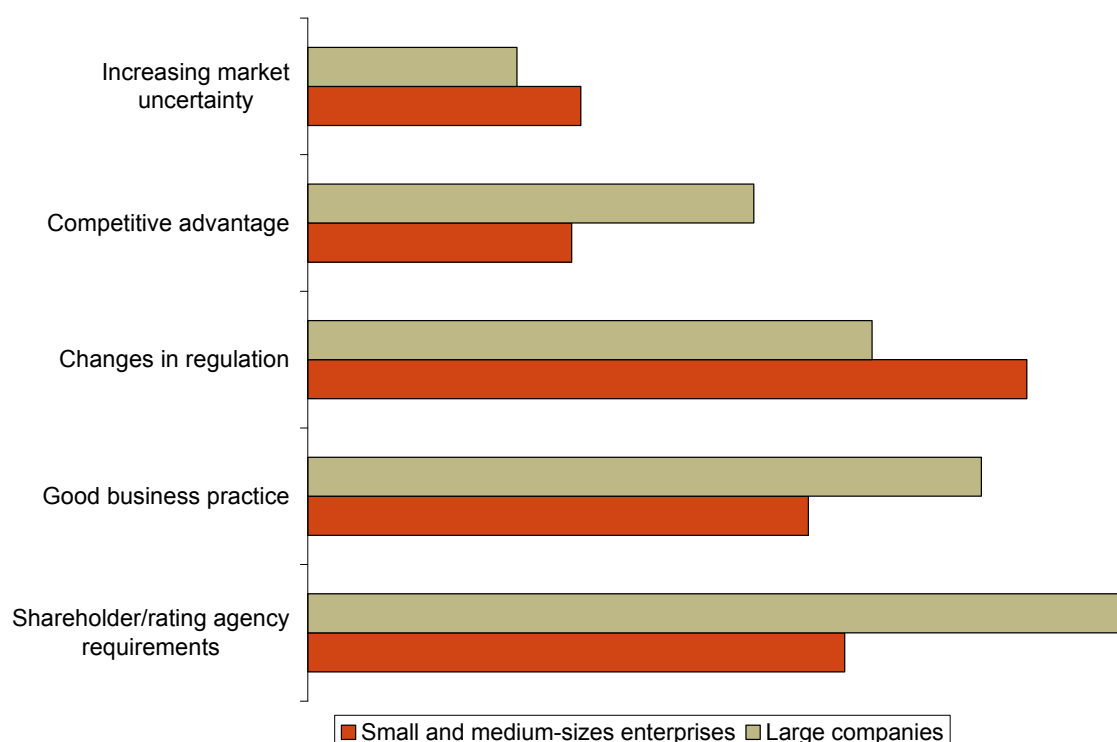
environment), there is a potential role for an IGS to provide last-resort protection. In this case, arguments against an IGS largely relate to the costs of introducing and operating a scheme and how these costs are distributed (see section 5).

4.3.1 Protection through internal risk management, reinsurance and other forms of risk transfer

Internal risk management is a core process in any insurance business. It involves an internal assessment of financial resources and ensuring that the insurance undertaking has sufficient capital to mitigate the risk of financial difficulties and insolvency. In recent years, risk management has gained momentum among European insurance companies, spurred on by the proposed new framework for a more risk-based prudential regulation (Solvency II).²⁸

A survey of European insurers conducted by the CEA in 2007 shows that, although there are differences in approaches between countries and insurers, the majority of insurers—particularly the larger ones—have either already implemented a risk-management framework or are currently in the process of improving their risk-management tools, consistent with regulatory proposals. Changes in regulation are not the only, or indeed the main, driver for internal risk management. Rather, as summarised in Figure 4.3, risk management is seen as good business practice, or as required by the market, both in light of increasing market uncertainty and to maintain a competitive advantage.

Figure 4.3 Motivations for internal risk management



Source: CEA (2007), 'Results and Discussions on the Impact Assessment of the Future Solvency II Framework on Insurance Products and Markets', March.

One of the specific risk-management tools in insurance is reinsurance. While used less in life assurance, reinsurance is a commonly used tool in non-life insurance as a way of reducing the risk exposure of insurance undertakings. A reinsurance contract allows the transfer of

²⁸ For a review of developments and methods, see Filipovic, D. and Rost, D. (2004), 'Benchmarking Study of Internal Models', The Chief Risk Officer Forum, and CEPS (2006), 'The Future of Insurance Regulation and Supervision in the EU', Centre for European Policy Studies, November.

risk to a reinsurer. It can offer protection against single extreme events and reduce volatility at the level of individual insurers.

Alternative methods for transferring insurance risks have also been developed, including, for example, self-insurance through captives and transfers of insurance risks to the capital markets.²⁹ On the financial side, risks can be mitigated through hedging transactions, whereby the insurer assumes an offsetting risk to the one it currently holds. Hedging is becoming increasingly important, notably in life assurance.

While they help to mitigate risk exposures, these tools do not eliminate all risks. For example, traditional reinsurance contracts are used to reinsure precisely defined portfolios, typically leaving part of the risk with the insurer. Moreover, the presence of reinsurance introduces the insurer to a new potential source of risk—ie, the risk of counterparty default. Counterparty risk can also arise from hedging transactions, depending on the type of hedge used. In addition, hedging against some risks may not be possible—for example, because the market for the relevant hedging instruments is insufficiently developed. Insurance hedging policies could lead to losses when there is insufficient capital to cover the probabilities of default arising from their market exposures.

More generally, insurance undertakings have incentives to engage in risk management and maintain the levels of capital sufficient to mitigate the risk of financial difficulties and insolvency. However, it is commonly recognised that private incentives to implement potentially costly risk management techniques are not always sufficiently strong, and that the risk tolerance of an individual insurer exceeds the insolvency tolerance in the market as a whole. Hence, internal market-based protection is supported by an externally imposed supervisory framework.

4.3.2 Protection through the prudential framework

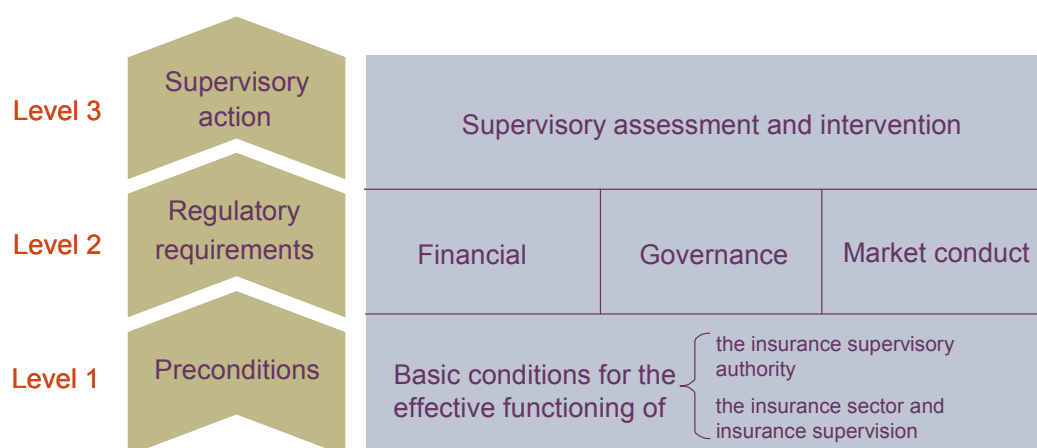
There are three broad levels in the supervisory framework—preconditions for effective insurance supervision, regulatory requirements and supervisory action (see Figure 4.4).³⁰

The first level relies on the observation that effective insurance supervision needs efficient financial markets, where the relevant information is available. Effective insurance supervision also requires legislation setting clear objectives, and an independent but accountable supervisory authority with adequate powers. The second level is often referred to as prudential regulation. The supervisory authority sets standards, defines what is minimum acceptable behaviour, and requires insurers to comply with a certain number of rules, including solvency requirements. The third level comprises supervision (ie, the supervisory authority monitors insurers' compliance with the rules) and, ultimately, intervention (ie, the supervisory authority takes some remedial actions when the insurers repeatedly fail to meet requirements).

²⁹ The role of reinsurance and other risk-mitigating mechanisms is reviewed in CEPS (2006), *op. cit.*

³⁰ For a discussion, see CEPS (2006), 'The Future of Insurance Regulation and Supervision in the EU', Centre for European Policy Studies, November, based on International Association of Insurance Supervisors (2005), 'A New Framework for Insurance Supervision: Towards a Common Structure and Common Standards for the Assessment of Insurer Solvency', October.

Figure 4.4 The three levels of insurance supervision



Source: CEPS (2006), 'The Future of Insurance Regulation and Supervision in the EU', Centre for European Policy Studies, November.

Regulatory requirements: Solvency I and II

The supervisory framework includes a range of regulatory requirements with which insurers are required to comply, including solvency standards. The EU's solvency regime dates from the first insurance Directives in 1973 (non-life) and 1979 (life). The solvency requirements were modified in a reform, referred to as the Solvency I regime.

The rules cover the way in which an insurer's assets and liabilities are to be valued and the available and required solvency margin (SM). They specify, using fixed ratios, the minimum excess of assets over liabilities for both life and non-life business. This provides an extra source of capital to help insurers meet unexpected events, thereby reducing the risk of failure and protecting policyholders.

The current EU solvency requirements have worked reasonably well over many years, as indicated by the relatively low number of insurance insolvencies. However, the need for a fundamental review has been apparent for some time.³¹

The European Commission has adopted a Directive, which at the time of writing is being negotiated by the Council and Parliament. The Directive defines a new solvency framework, referred to as Solvency II, for insurance companies, which is to be implemented in 2012.³² The main objectives of the new framework (based around three 'pillars', see Figure 4.5) are the following.

- **Improve capital allocation.** Solvency II (first pillar) sets financial requirements. It contains the technical provisions and two capital requirements: the solvency capital requirement (SCR, the level of capital required to enable an institution to absorb significant losses) and the minimal capital requirement (MCR, the level of capital below which ultimate supervisory action would be triggered). The financial requirements reflect the quantifiable risks to which an undertaking is exposed, thereby requiring insurers to hold capital commensurate to their risk and, overall, leading to a more efficient use of capital.
- **Improve risk assessment by companies themselves.** Solvency II (second pillar) involves supervisory authorities identifying institutions with features that may produce a

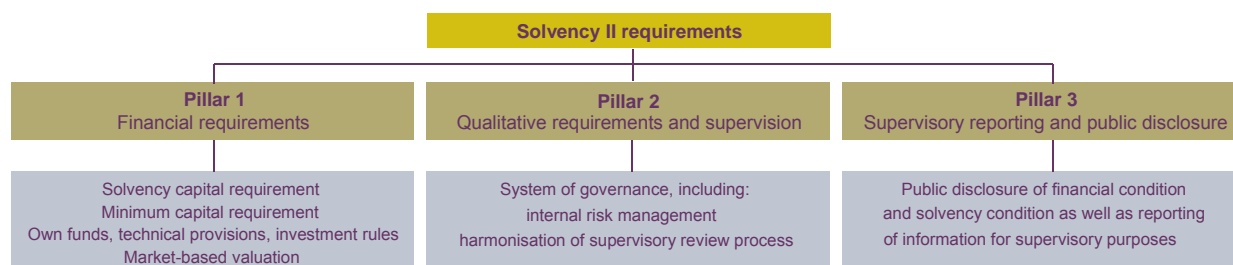
³¹ See, for example, Müller, H. (1997), 'Solvency of Insurance Undertakings', report by the Conference of Insurance Supervisory Authorities of the Member States of the European Union.

³² Commission of the European Communities (2007), 'Proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance, July.

higher-risk profile, and promoting better use of systems, processes and controls for risk management among insurers.

- **Increase transparency and market discipline.** Solvency II (third pillar) requires that insurance undertakings report to the supervisory authority and publicly disclose both financial and organisational features, thereby reinforcing market mechanisms and discipline.

Figure 4.5 The three pillars of Solvency II

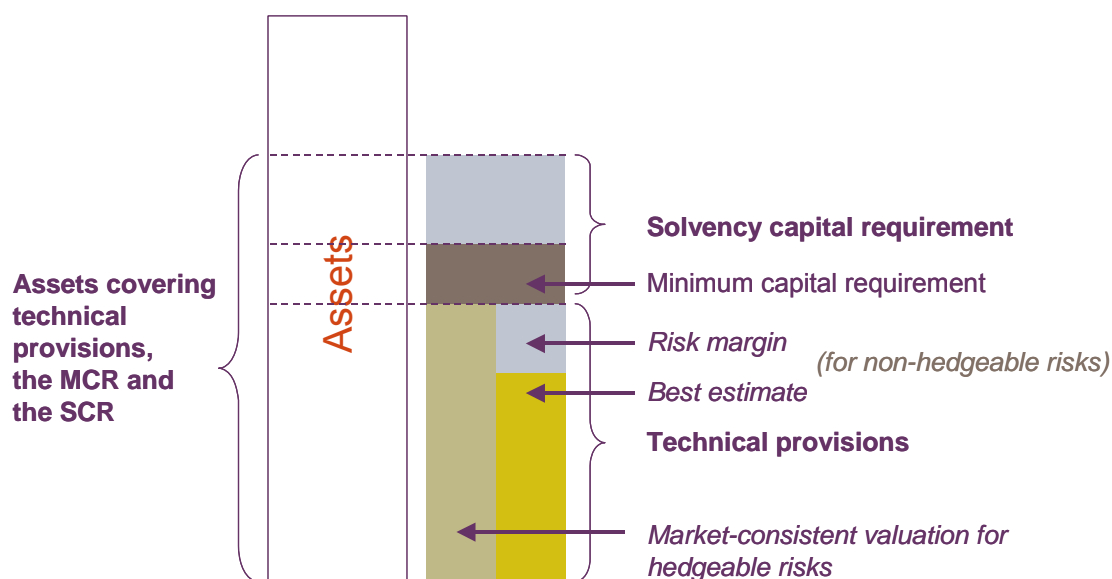


Source: Adapted from various studies.

One of the most discussed issues relates to financial requirements. The objective of the reforms is to improve on the current solvency regime by introducing a risk-based economic approach to align capital requirements with the underlying risks of an insurance company. This will be done, whenever possible, by valuing both assets and liabilities' risks at reliable market prices (marked-to-market). The aim is to provide policyholder protection and encourage efficient operations by aligning regulatory capital requirements with best practice in internal risk-management processes.

Figure 4.6 summarises the current proposals. Assets will have to cover technical provisions, the MCR and the SCR. These requirements are estimated following the market price of liabilities. When hedgeable, risks are valued in a market-consistent manner. When risks are not hedgeable, requirements are based on the best estimate of the company to which a risk margin is added.

Figure 4.6 First pillar: financial requirements



Source: Committee of European Insurance and Occupational Pensions Supervisors (2007), 'Advice to the European Commission in the Framework of the Solvency II Project on Pillar I Issues: Further Advice', March.

The SCR, which is envisaged to be the level of capital that enables an insurance undertaking to absorb significant unforeseen losses, is to be calibrated such that the quantifiable risks to which an institution is exposed are taken into account and based on an amount of capital corresponding to a ruin probability of 0.5% over a one-year time horizon. This can be translated in two ways:

- one company will experience losses in excess of its capital once in 200 years; or
- one in 200 companies will experience losses in excess of its capital base each year.

The SCR is above the MCR, acting as an alarm bell and allowing supervisors sufficient time to take action so as to ensure that the assets do not fall below the level required to meet policyholder and other liabilities—ie, it is the MCR that presents the level of capital of which a breach could not be tolerated by supervisors. This framework provides a ladder of supervisory actions and interventions.

The benefits of two levels of capital requirements have also been examined in the academic literature. Plantin and Rochet (2007) argue that this reduces the cost of regulation for well-capitalised companies, while allowing close tracking and special supervisory actions for low-capitalised firms that may otherwise ‘gamble for resurrection’ (see section 4.1.2).³³

Supervisory action and early interventions

It is the role of the supervisory authority to check whether individual insurers comply with the capital requirements, and whether there are any wider risks for insurance companies. The supervisory authority can monitor insurers off-site and engage in on-site inspections. Should an insurer fail to meet supervisory requirements, the supervisory authority can intervene using a range of intervention tools to prevent failure and protect policyholders’ interests.

Depending on the nature of the problem detected, the supervisory authority can take actions of varying degrees of formality. For example, supervisors have the capacity to issue directions, which allow them to effectively influence the operations of a financially stressed company with the objective of returning to a prudentially sound position. In more severe circumstances, the supervisory authority can assume control of the company, temporarily replacing the board and management. A summary list of enforcement actions and sanctions available to supervisors is summarised in Table 4.10.

³³ Plantin, G. and Rochet, J.-C. (2007), *When Insurers Go Bust: An Economic Analysis of the Role and Design of Prudential Regulation*, Princeton University Press.

Table 4.10 Enforcement and sanctions

	Enforcement or sanctions
Restrictions on business activities	Direct the insurer to cease practices that are unsafe or unsound Withhold approval for new activities Stop the writing of new business Revoke the licence of an insurer
Financial restrictions	Require increase in capital levels Restrict asset transfers Restrict or suspend dividend or other payments to shareholders Restrict an insurer's purchase of its own shares Put insurer's assets in trust or restrict disposal of assets
Power on management	Restrict power on directors and managers Remove/replace directors and managers Prohibit individuals from participating in the business of insurance

Source: Based on CEIOPS (2005), 'Consultation Paper No. 7: Draft Answers to the European Commission on the "Second Wave" of Calls for Advice in the Framework of the Solvency II Project'.

It is only at the stage where early intervention tools turn out to be ineffective that supervisory authorities are likely to take further action. This may involve, in particular, withdrawing the insurer's licence in order to prevent new business; to run off all contracts; or to facilitate transfer of the portfolio and policy obligations of a failing insurer to another insurer that is willing to accept this transfer.

Solvency II introduces two capital requirements (SCR and MCR), which is expected to establish more effective early warning mechanisms and thereby allow more time for supervisory intervention. If an insurer's available resources fall below the SCR, supervisors will take action with the aim of restoring the insurer's finances back into the level of the SCR as soon as possible. If, however, the financial situation of the insurer continues to deteriorate, the level of supervisory intervention will be progressively intensified. The aim of this 'supervisory ladder' of intervention is to capture any ailing insurers before a serious threat to policyholders' interests materialises.

If, despite supervisory intervention, the available resources of the insurer fall below the MCR, then 'ultimate supervisory action' will be triggered. In other words, the insurer's liabilities will be transferred to another insurer and the licence of the insurer will be withdrawn or the insurer will be closed to new business, and its in-force business will be liquidated.

No zero-failure policy

There would be no role for an IGS if the supervisory framework were designed to strictly adhere to a zero-failure principle. Although harmonised to a minimum standard, different supervisory frameworks have been implemented in the EU, with specificities in the national regulations and supervisory practices. Solvency II is expected to provide greater harmonisation of supervision between the EU Member States, but some differences between national approaches are likely to remain.

Put differently, the tolerance to insurance failure may differ between countries, and the approach taken in some countries may be closer to a zero-failure regime than in others. It is beyond the scope of this study to review national supervisory frameworks or, more generally, highlight differences between countries in the risk of insurance companies failing.

Rather, it is assumed that supervisors aim to prevent financial institution failure and have a wide range of tools available to achieve their objective, but that this does not involve a zero-failure approach in the strict sense—ie, taking preventative measures at all costs.

Under the current solvency regime, insurance failures have been rare—indeed some countries have not experienced a single case of insurer insolvency. Solvency II is expected to further improve on the current regime, by aiming to better match solvency requirements to the true risk encountered by an insurance undertaking, and also by encouraging insurers to improve their measurement and monitoring of the risks they incur.

The level of the SCR under the new framework ensures that the likelihood of an insurer being ruined during the year is no more than 1 in 200. However, in practice, the likelihood of failure occurring is expected to be much lower than this, because as soon as the SCR is breached, supervisors will intervene and take action to restore the financial position of the insurer. Furthermore, even in the rare event that an insurer gets into financial difficulties, the requirement for supervisors to take ultimate supervisory action once the MCR has been breached should ensure that, in most of these cases, an insurer's business can be liquidated, or that its insurance obligations are transferred to another insurer, thus minimising any disruption or loss to its policyholders.

Despite the many safeguards in the new solvency framework, which are designed to minimise the likelihood of insurance failure and the costs to policyholders in the event of failure, Solvency II is not a 'zero-failure' regime. It is widely acknowledged that it is too costly—or even not possible—to build a viable system that fully guarantees that no insurer will ever fail, as also discussed in the literature (see, for example, Yasui 2001 and Davis 2004³⁴).

4.3.3 Protection in winding-up proceedings

In the event that an insurance company is to be wound up because no other action is available, and to ensure the distribution of assets before the potential losses become too great, provisions have been introduced to protect policyholder rights in the proceedings. Directive 2001/17/EC specifies that policyholders are given preferential treatment over other creditors in the winding-up proceedings.³⁵ The Directive gives Member States a choice between two alternatives for implementing the preferential treatment in national law:

- grant insurance claims absolute precedence over any other claim with respect to assets representing the technical provisions; or
- grant insurance claims a special rank, which may only be preceded by claims on salaries, social security, taxes and rights over the whole assets of the insurance undertaking.

While providing important policyholder protection in winding-up proceedings, there are limitations. First, even if policyholders precede other creditors in the distribution of assets, the assets may be insufficient to cover claims. The degree of insolvency (ie, the asset shortfall) varies from case to case, and there can be insolvencies that are so significant that insufficient assets are available for distribution to policyholders. Moreover, the outcome of the proceedings may be unclear. This creates uncertainty for policyholders who have outstanding claims for which they do not know whether they will be compensated.

³⁴ Yasui, T. (2001), 'Insurance and Private Pensions Compendium for Emerging Economies,' OECD; and Davis, K. (2004), 'Study of Financial System Guarantees', Canberra, Australia.

³⁵ Directive 2001/17/EC defines winding-up proceedings as collective proceedings involving realising the assets of an insurance undertaking and distributing the proceeds among the creditors, shareholders or members as appropriate. The Directive also sets standards for the protection of policyholder rights when reorganisation measures are taken; these are defined as measures to preserve or restore the financial situation of an insurance undertaking, which affect pre-existing rights of parties.

Second, winding-up proceedings of insurance undertakings are not only complex and expensive, they are also lengthy. The length of the proceedings varies according to national insolvency frameworks as well as case-specific facts such as the size of the insurer, the volume and nature of policies written, fraud suspicion, etc. The evidence obtained suggests that the proceedings can take up to 10–12 years, sometimes more, depending on the nature of the failure and claims. During the proceedings, policyholders with outstanding claims at the time of insolvency (or with claims emerging during the proceedings) are likely to suffer from a shortage of liquidity if claims cannot be paid for many years.

4.4 The role of IGS as a last-resort protection mechanism

As emphasised above, there is a range of mechanisms in place to prevent insurance company failures, and the low failure rate experienced to date suggests that these mechanisms have, in general, been effective. Should failure occur, there are further mechanisms in place to protect the rights of policyholders.

However, failures cannot be ruled out (even if protection mechanisms are being improved to minimise their frequency and impact). The question then arises of how to respond if failure (with loss implications for policyholders) occurs. The two main alternatives to an explicit IGS are as follows.

- **Adopting a caveat emptor approach.** One option is to accept losses if they arise and not provide compensation. However, such an approach may be difficult to pursue on a consistent basis, especially when larger losses or a large number of policyholders are involved, and if market participants have an expectation that there are implicit guarantees. In those cases, there are likely to be expectations and strong pressure on governments to resolve the situation—eg, by underwriting at least some of the commitments of the failed insurer. For example, when the Australian government was confronted with the insolvency of a large non-life insurer in 2001 (HIH Group); the Australian states and territories assumed responsibility for certain classes of claims, and the HIH Claims Support Scheme was established to support policyholders suffering financial hardship as a result of the HIH collapse.³⁶ In Europe, the publicity and inquiries around the failure of Equitable Life are another case in point, even though insolvency in this case was ultimately prevented.³⁷
- **Case-by-case intervention.** Loss events may be resolved on a case-by-case basis—eg, through ex post intervention by the government (as in the HIH example above). This gives flexibility, but is associated with several problems. For example, the response may be delayed as decisions regarding the appropriate form of intervention need to be made and cleared. In addition, such interventions may appear non-transparent and unfair, as compensation decisions are made on an ad hoc basis rather than according to a set of pre-designed rules. For example, case-by-case interventions may give better protection for policyholders of large companies. They may also bring uncertainty both to policyholders and, depending on the financing, taxpayers or the industry.

Establishing an IGS can therefore be seen as an alternative to the caveat emptor approach or the case-by-case intervention—ie, as a last resort when other protection mechanisms have failed to prevent or mitigate the impact of insurance company failure.

³⁶ See Davis, K. (2004), 'Study on Financial System Guarantees', a report prepared for the Commonwealth Government of Australia, March, and HIH Royal Commission (2003), 'The Failure of HIH Insurance, Volume 1: A Corporate Collapse and its Lessons', a report prepared for the Commonwealth of Australia, April.

³⁷ See European Parliament (2007), 'Report on the Crisis of the Equitable Life Assurance Society' a report prepared by the Committee of Inquiry into the crisis of the Equitable Life Assurance Society, May.

As further described in section 4.5, there are examples of EU Member States where an IGS has been established in direct response to a failure or, more generally, where existing IGS have operated to provide last-resort protection in cases that were not prevented or addressed with other actions.

The role of many IGS in Europe is to provide compensation to policyholders for losses incurred in the event of insolvency of an insurer. That is, the IGS is activated after the insurer is declared insolvent. The main benefits this brings to policyholders or beneficiaries are derived from addressing the shortcomings of the winding-up proceedings described above.

- **Upfront liquidity.** Claims can be adjusted and payments made to policyholders regardless of delays associated with winding-up proceedings. The process required to establish whether a claim is eligible for compensation by the IGS and to initiate payment typically requires less than six months.³⁸ The winding-up proceedings, on the other hand, can last for several years.
- **Compensation amount.** Claimants receive compensation—up to the full claim or a fixed or proportionate amount—that they may not have received following the winding-up proceedings if there is a shortfall of assets to meet policyholder claims.
- **Certainty.** The uncertainty associated with the timing of the winding-up proceedings and the level of funds ultimately available to make payment is removed.

However, IGS can also intervene to provide the guarantee before an insurance undertaking is declared insolvent—ie, where the role of the IGS is to secure continuation of the insurance policies. This can bring benefits to policyholders—particularly in life assurance where policies are long-term—since these policyholders are better off if their contracts are continued rather than having contracts immediately terminated and receiving compensation in cash.

Securing the continuation of contracts can take the form of the IGS assuming responsibilities for the contracts of the failed insurer, administering those contracts and paying claims up to the covered amounts when due. Alternatively, the IGS can make payments to ensure that the portfolio is transferred to another insurer in the market. The nature of intervention and the outcome in those cases is similar to the supervisory authority taking action to arrange portfolio transfer and policy obligations to another insurer which is willing to take on the liabilities (see section 4.3 above).

However, the IGS is activated where a transfer of business to another insurer in the market is not possible, eg, because the portfolio is not attractive or liabilities are too large, or because a transfer can only be effected at well below market price. In those cases, the IGS provides an explicit means of facilitating the transfer, making the financial resources available as required.

In this context, it is worth referring to the Early Intervention Arrangement for Life Insurers in the Netherlands (EIALA), described in section 2.1 and Appendix 1. The EIALA has been set up to guide a life insurer through a financially difficult period and secure continuity of the life insurer's portfolio. The intervention can take the form of a portfolio transfer to a special entity, formed by the Dutch insurance association, which then seeks to transfer the portfolio to another insurer. As with some IGS, EIALA also provides an explicit means of facilitating portfolio transfer. However, unlike an IGS, the arrangement applies only if the portfolio of the insurer is still viable (ie, there are sufficient assets to cover the technical provisions). Thus, the EIALA does not have the guarantee function of an IGS. An IGS with responsibility to facilitate portfolio transfer, on the other hand, makes available the funds required to cover the shortfall of assets and restore the solvency position if this were required to effect the transfer.

³⁸ New claims may arise after the start of the proceedings (eg, in the case of long-tail classes of insurance), meaning that an IGS can be involved in paying compensation as claims arise for a long period of time.

4.5 Past and ongoing cases of intervention of existing IGS in the EU

The role of IGS in providing last-resort protection is evidenced by the experience of existing IGS in the EU. Section 2.10 provided an overview of past and ongoing cases of IGS intervention. It showed that, overall, the number of cases dealt with has been limited, and in fact some IGS have to date not experienced any cases that would have triggered the operation of the schemes.

Nonetheless, where failures have occurred, IGS have provided important protection to claimants who would otherwise have experienced losses in relation to both life and non-life business. Moreover, in some countries, it was the occurrence of a failure (or failures) that led to the establishment of an IGS. The following provides examples illustrating these points.

Establishment of an IGS as a result of insurance failures

There are a number of examples where IGS have been established as a consequence of insurance failure(s) in the relevant market. Three examples, two in the life market and one in the non-life market, are provided below; further examples are listed in section 2.2.

- **Mannheimer Lebensversicherung.** The insolvency of life insurer, Mannheimer Lebensversicherung, led to the establishment of Protektor, the industry scheme that preceded the implementation of a statutory life assurance guarantee scheme in Germany. The portfolio of Mannheimer (344,000 life contracts) was transferred to Protektor in 2003, and Protektor continues to be in charge of the run-off of the business. The 104 life insurers participating in Protektor at the time made a one-off contribution of €240m in 2003 to cover the shortfall in assets and meet solvency margin requirements. The actual cost turned out to be lower than expected, resulting in a cost to Protektor of around €100m, with a refund of the excess contributions made by industry. Attempts were made to find an alternative solution and transfer the business to another insurer in the market. However, such attempts failed, partly because of the reluctance on the part of a few larger foreign insurers operating in the German market.³⁹ The solution effectively also involved a portfolio transfer and continuation of the policies, but it entailed the establishment of a specially created company (ie, Protektor) and granting it a licence to pursue life assurance business. Future cases of life assurance failure will also be handled by Protektor, subject to the rules of the statutory guarantee scheme.
- **Plus Forsikring A/S.** The Danish Guarantee Fund for non-life insurance was initially established as a consequence of the bankruptcy of insurer Plus Forsikring A/S in 2002. As a result of the bankruptcy, both policyholders and third-party claimants were left without insurance coverage, so following negotiation between the industry association, the Danish Ministry of Finance and the Danish Financial Supervisory Authority, the association agreed to cover the cost arising from certain insurance claims which had occurred before December 1st 2002. As a part of the agreement, the association's expenses were refunded by the scheme after the Guarantee Fund for Non-life Insurance Companies Act was passed by Parliament and had come into force. In total, the bankruptcy is expected to have cost approximately DKK97.5m (around €13.1m). The majority of claims were processed and settled within the first two years following the bankruptcy in October 2002. However, the winding-up proceedings of the company are ongoing and not expected to be finalised for another few years.

³⁹ See Fromme, H. (2003), 'Mannheimer kurz vor dem Ende', *Financial Times Deutschland*, June 26th and, for a detailed summary of Protektor and the statutory guarantee scheme in Germany, see Müller, H. (2006), 'Insurance Guarantee Schemes— Entwicklung eines Insolvenzversicherungssystems für die Kunden von Lebensversicherern auf Basis einer kritischen Analyse international bestehender Systeme', Dissertation (to be published), University of Basle, Switzerland.

- **Europavie.**⁴⁰ Europavie was created in 1987 by a group of brokers, and specialised in unit-linked contracts backed by real estate. Europavie guaranteed a high interest rate—8%—on premiums invested in these contracts. The company found itself in difficulties in the early 1990s when the French real estate bubble burst. The company was taken over by a conglomerate, Thinet, which continued to develop unit-linked contracts backed by real estate. In 1997, BVH, a German bank subsidiary of Thinet, in which part of Europavie's assets were deposited, became insolvent, and the insolvency of the entire group followed as a consequence. The shortage of Europavie's assets over liabilities was estimated to be one-third. The company was rather small (liabilities were around Fr350m), but the shock that followed the failure was sufficiently important to create a guarantee scheme for life assurance in France—the Fonds de garantie des assurances de personnes, FGAP. Although the failure triggered the creation of the FGAP, the scheme was ultimately not required to intervene to protect policyholders.

Case experience of the FSCS in the UK

Insurance guarantee arrangements in the UK were also first implemented in the 1970s as a result of a series of insurance failures. The FSCS took over responsibilities as the relevant IGS in December 2001. In early 2007, the FSCS was involved in the insolvencies of 25 non-life insurers and two life insurers that occurred prior to FSCS establishment, and one small default of an insurer after establishment. The scheme has the highest activity among EU IGS in terms of claims processed and paid in recent years, mainly in relation to non-life insurance.

Table 4.11 reports the total number of payments made to claimants as well as the total and average value of those payments since 2002/03.

Table 4.11 Compensation paid by FSCS in relation to insurance failures

	Total number of payments	Total payments (€m)	Average payment (€)
2002/03	44,245	190.2	4,299
2003/04	94,106	191.4	2,034
2004/05	41,104	169.2	4,117
2005/06	40,817	135.3	3,314
2006/07	16,844	97.0	5,760
Total	237,116	783.1	3,303

Note: £1 = €1.47678. Exchange rate as of April 3rd 2007 from www.oanda.com.
Source: FSCS and Oxera calculations.

In the five years shown, FSCS made a total of nearly 240,000 payments to policyholders or beneficiaries to compensate them for losses related to insurance failures. Total payments over the period amounted to €783m, with the average payment amounting to €3,303.

The number of payments is an overestimate of the number of claimants who have benefited from the existence of the scheme, since more than one payment can be made in relation to a single claim. Correspondingly, however, the average payment underestimates the average amount of compensation received by claimants.

Importantly, the distribution of payments is markedly skewed—while average payments during the period were €3,303, the FSCS has made some significantly higher payments to individual claimants. According to the FSCS, the single highest compensatory payment made in relation to a non-life claim amounted to more than £3m (around €4.4m).

⁴⁰ This description is largely based on Plantin, G. and Rochet, J-C. (2007), *When Insurers Go Bust: An Economic Analysis of the Role and Design of Prudential Regulation*, Princeton University Press.

The amounts paid are gross of recoveries. The amount that is recovered by the FSCS varies on a case-by-case basis, but full recovery of the amounts paid is possible for some insurance estates. In the absence of compensation by the FSCS, claimants would still have received funds in relation to their claims, depending on the outcome of the winding-up proceedings and with a delay. The benefits to individual claimants is therefore the upfront liquidity provided by the FSCS and the uplift in the amount compensated if there is an asset shortfall; in addition, uncertainty associated with the winding-up proceedings and the level and timing of payment is eliminated.

Examples of two major (non-life) insurance failures dealt with by the FSCS include the following.⁴¹ Payment details are reported in Table 4.12.

- **Independent Insurance.** The largest single failure was due to the default of Independent Insurance in 2001. At the time of appointment of the provisional liquidators, there were around 190,000 policyholders and in excess of 50,000 outstanding insurance claims. A further 41,000 insurance claims were received during the provisional liquidation.⁴² In the five years up to 2006/07, the FSCS had made a total of 193,324 payments, amounting to nearly €500m (see Table 4.12). The proceedings are ongoing, and the total payout is expected to reach about £500m (around €738m).
- **Chester Street.** In 2001 provisional liquidators were appointed for Chester Street after the directors received preliminary information from the company's actuary that led them to conclude that the company was insolvent. The company was exposed to a large number of asbestos-related claims, and considerable publicity was generated because it was feared that claimants suffering from asbestos-related diseases would not be fully or promptly compensated.⁴³ The claims compensated by the FSCS in the five years up to 2006/07 amount to €146.5m, with over 17,000 payments made at an average value of €8,504 (see Table 4.12). However, due to the long-tail nature of the claims, the process is ongoing, and new claims resulting from certain types of lung cancer are not expected to peak before 2015–20.

Table 4.12 FSCS payments made in relation to specific large failures

	Independent Insurance			Chester Street		
	Total number of payments	Total payments (€m)	Average payment (€)	Total number of payments	Total payments (€m)	Average payment (€)
2002/03	27,966	116.4	4,161	1,342	18.9	14,086
2003/04	84,161	134.5	1,599	2,783	23.8	8,543
2004/05	34,798	101.8	2,924	4,335	40.8	9,402
2005/06	34,659	90.1	2,599	4,380	28.6	6,541
2006/07	11,740	47.3	4,025	4,387	34.4	7,843
Total	193,324	490.0	2,535	17,227	146.5	8,504

Note: £1 = €1.47678. Exchange rate as of April 3rd 2007 from www.oanda.com.
Source: FSCS and Oxera calculations.

⁴¹ The failures occurred prior to the December 2001 establishment of the FSCS as the single compensation scheme for the UK financial services industry, but the FSCS assumed responsibility for the cases from its predecessor scheme.

⁴² Oxera (2006), op. cit.

⁴³ For more details on the case, Massey, R. (2002), 'Insurance Company Failure', report prepared for The Actuarial Profession, General Insurance Research Organising Committee.

Case experience of other EU IGS

Summaries of the cases of insurance failure dealt with by other IGS in the EU Member States are provided in section 2.10, with further descriptions contained in Appendix 1. The following provides illustrations of the role that IGS have played in providing last-resort protection.

- **FGAO in France.** The FGAO pays compensation for losses in the event of insolvencies of insurers providing compulsory classes of non-life insurance. When established to carry out this function in 2003, the FGAO took over responsibilities regarding five insurers with compulsory insurance that were already in the liquidation process. Other than motor vehicle insurance, the policies covered guarantees, work accidents, construction liabilities and other classes of liability insurance. Table 4.13 summarises the number of claims received to date by the FGAO in relation to those failures, and the total cost incurred due to compensation payments. Claims and payments made in relation to motor vehicle insurance are excluded.⁴⁴ Total costs up to end-2006 in relation to the five failures amounted to €20.3m. Only 884 of the claims concerning the relevant classes of compulsory insurance were received. The average amount of claims was comparatively large—just under €23,000 across the five failures. Thus, although the number of claimants was small, the benefit they received from the existence of the FGAO was sizeable, even for the average claimant.

Table 4.13 Costs and claims handled by the FGAO

	Year of insolvency	Total compensation cost (€000s)	Number of claims	Average cost per claim (€)
International Claims Services SA	1999	10,238	260	39,377
Groupement d'Assurances Européennes	2000	1,466	27	54,296
Independent Insurance	2000	209	3	69,667
Compagnie Internationale De Caution Pour le Développement	2001	5,770	187	30,856
Caisse Générale d'Assurances	2003	2,638	407	6,482
Total		20,321	884	22,988

Note: Costs and claims are the total up to end-2006. Motor vehicle insurance claims are excluded.
Source: FGAO and Oxera calculations.

- **Guarantee Fund in Romania.** The Fund, which has been set up to provide compensation in the event of failure of insurers in both the life or non-life market, has dealt with three main cases of insolvency in recent years. The insurers provided both life and non-life insurance policies; no breakdown is available for claims and payment made by class of insurance. As summarised in Table 4.14, to date, the Guarantee Fund has dealt with 2,508 claims for compensation relating to those failures at a cost of more than €3.4m. The calculated average cost per claim was comparatively small. However, some claimants received significant amounts of compensation. Data on the full distribution of payments is not available, but the single largest claim paid in 2006 (2005) was €44,234 (€144,450). The cases are ongoing and further claims are likely to be paid.

⁴⁴ For example, the failure of Independent Insurance resulted in 4,137 claims relating to motor vehicle insurance, at a total cost of €34.3m (up to end-2006). Similarly, the failures of Groupement d'Assurance Européennes and Caisse Générale d'Assurances also triggered motor-related claims—5,202 (€22.6m) and 5,671 (€49.2m) in terms of number (cost), respectively.

Table 4.14 Costs and claims handled by the Guarantee Fund in Romania

	Year of insolvency	Total compensation cost (€000s)	Number of claims paid	Average cost per claim (€)
Metropol SA	2003	155.5	1,114	1,396
Grup AS	2003	1,678.7	1,250	1,343
Croma	2005	240.3	144	1,669
Total		3,473.7	2,508	1,385

Note: Costs and claims are the total up to mid-July 2007.

Source: Guarantee Fund and Oxera calculations.

Summary

IGS in the EU have played an important role in providing last-resort protection in the event of failures of insurers in both the life and non-life markets. The cases of intervention have been small in number compared with the total of insurance undertakings operating in the market and participating in the IGS. Guarantee payments made (and the number of claimants protected) have also been small compared with the volume of total insurance business written (and number of policyholders). Nonetheless, where IGS have intervened, a non-negligible number of individual claimants have benefited from the existence of the IGS. Although the average benefit may be considered relatively small (eg, compared with household income or wealth), some claimants would have sustained sizeable losses had it not been for the guarantee payments made by the IGS.

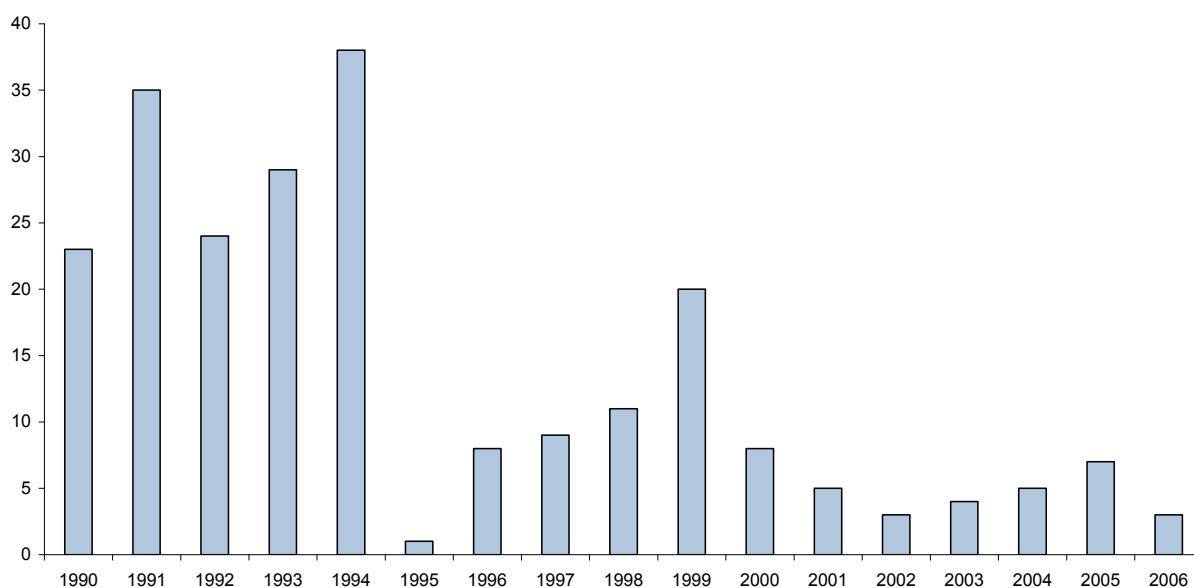
4.6 IGS outside the EU

The debate about the need for an IGS to provide protection against failures in the life and non-life insurance market is not restricted to the EU, and a number of countries outside the EU have established IGS. For example, within Europe, Norway has created a scheme for non-life insurance companies. In the Asia-Pacific region, both Japan and Korea have established schemes covering life and non-life insurance policies. In Australia, there has been extensive debate about the need to create a guarantee scheme, particularly following the failure of the HIH Insurance Group in 2001, although no scheme has yet been established. In North America, schemes for life and non-life insurance have been established in Canada and the USA.

Focusing on the USA as an example, failures of insurance companies have been relatively frequent in the US markets, for both life assurance and non-life insurance. Figures 4.7 and 4.8 show the number of failures during the period 1990 to 2006, based on information gathered by TheStreet.com Ratings.⁴⁵

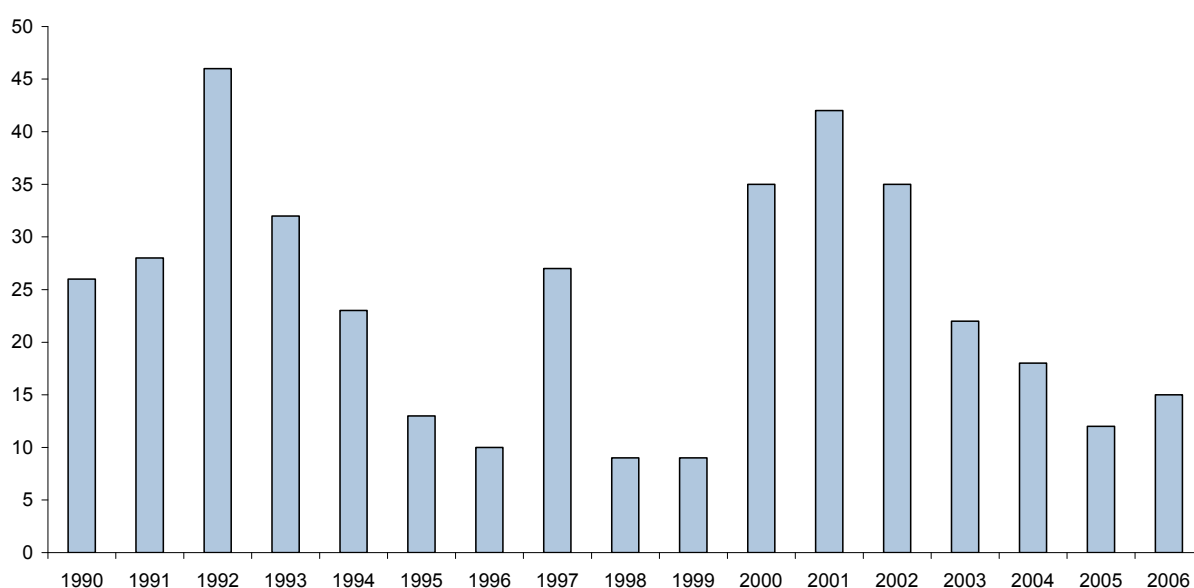
⁴⁵ TheStreet.com Ratings, Inc. (<http://www.weissratings.com/>).

Figure 4.7 Number of failures of life and health insurers in the USA, 1990–2005



Source: TheStreet.com Ratings.

Figure 4.8 Number of failures of property and casualty insurers in the USA, 1990–2005



Source: TheStreet.com Ratings, Inc.

All states as well as the District of Columbia and Puerto Rico have established IGS, one for life and health insurance and one for property and casualty insurance, to protect policyholders from losses as a result of the insurance failures. Before doing business in another state, insurance companies must be licensed in that state and must belong to its IGS.

All licensed life and health insurance companies must belong to the guarantee scheme of each state in which they are licensed. With the exception of the New York scheme, all schemes are funded ex post after a failure has occurred: if an insurer fails, all insurers doing business in a particular state have to pay a fixed percentage of their premiums to meet the

claims of policyholders. Limits on the benefits and coverage of the schemes are established by the states. Typically, there is an overall cap on coverage for any individual of \$300,000, although the cap in some states exceeds this.

When an insolvency involves more than three states, the state schemes are supported by the National Organization of Life and Health Insurance Guaranty Association (NOLHGA). NOLHGA then arranges transfers of policies to a financially sound insurer, ensures that outstanding claims are paid, and allocates any shortfall in assets across the relevant state schemes. NOLHGA has provided protection to more than 2.2m policyholders in more than 60 multi-state insolvencies since its creation in 1983. It has guaranteed more than \$21.2 billion in coverage benefits, and it has contributed \$4.4 billion to ensure that policyholders received their benefits.⁴⁶

A similar system exists for property and casualty insurance. In case of a multiple state insolvency, state schemes are supported by the National Conference of Insurance Guaranty Funds (NCIGF) for property and casualty insurance (set up in 1989). In 2003, the total cost amounted to €2.7 billion.⁴⁷

There have been discussions to curb the costs of providing the guarantees through changes in scheme design. For example, suggestions have been made to exclude high net worth policyholders, such as commercial enterprises, from protection, the argument being that given the internal risk-management resources available and access to national brokers, these policyholders can make fully informed choices about insurers based on careful review of financial strength.⁴⁸

4.7 Summary

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 reasons, 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, if 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.

As described in section 2.1, 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 an expectation of an implicit guarantee. A case-by-case resolution may raise concerns about transparency and timeliness of response. Establishing an IGS to provide explicit guarantee may be the preferred outcome. For several EU Member States, it was the occurrence of a failure (or failures) that led to the establishment of an IGS in the first place.

⁴⁶ See <http://www.nolhga.com/factsandfigures/main.cfm>.

⁴⁷ American Insurance Association (2005), 'Guaranty Fund Reform: Protecting the Most Vulnerable Insurance Consumers', in *Advocate*, September 6th.

⁴⁸ *Ibid.*, p. 2.

The nature of risks and the consequences of failure differs between life and non-life insurance, but IGS have played a role in protecting 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) well exceeds that of typical life assurance policies.

5 The cost of insurance guarantee schemes

This section examines the costs of IGS, focusing on both the direct and indirect costs. Direct costs cover the compensation paid to eligible claimants in the event of an insurance company failure or, depending on the nature of scheme intervention, the costs of facilitating the continuation of contracts, as well as the administration costs incurred by the scheme in the process (section 5.1). Indirect costs cover the potential negative market impacts resulting from the existence of a scheme (section 5.2).

The section also explains how the distribution, as well as the level, of the direct and indirect costs incurred depends to a large extent on how the IGS is designed—particularly in terms of scope of coverage and funding structure. This is further discussed in section 7 as part of the evaluation of specific options for IGS design.

5.1 Direct costs

The following outlines the main direct costs that will be incurred by any IGS: guarantee costs and administration costs. The guarantee costs incurred (eg, compensation payments) are largely distributional in nature, presenting transfers to policyholders or other claimants benefiting from the intervention of the IGS. Administrative costs, on the other hand, are pure expenses arising from the existence of the scheme and present additional costs to the system.

Although these costs will be incurred by all IGS, their magnitude will depend on the incidence and size of failure and, importantly, on the design of each scheme—the schemes can be designed such that guarantee and administration costs are minimised. Different options for scheme design are further discussed in section 7.

5.1.1 Insurance guarantee costs

Insurance guarantee costs include the aggregate amount of compensation paid to eligible claimants in the event of an insurance company failure. However, IGS can recover a proportion (and in some cases most or all) of these costs in insolvency proceedings. Thus, the actual cost incurred by the scheme (and ultimately participants of the scheme) will be lower than the amount of payment to claimants.

However, insolvency proceedings can last for several years, so even though (some) costs can be recovered, this can happen some time after the scheme has paid compensation to claimants. Thus, at least in the short run, the IGS (and ultimately participants of the scheme) ends up bearing the full compensation costs. Therefore, this section focuses on guarantee (or compensation) costs in full, rather than just the proportion of these costs that could not be recovered in insolvency proceedings.

Not all schemes provide protection (only) through payment of compensation. Instead, they aim to secure continuation of policies, either by keeping the insolvent insurer in administration until all policies have expired, or through portfolio transfer to another insurer in the market. Thus, insurance guarantee costs cover the costs related to the transfer of the portfolio in the event of a failure, or alternatively, the costs of keeping a company in administration.

Determinants of the size of insurance guarantee costs

Several factors will affect the size of guarantee costs incurred by a scheme once a failure has occurred. These are discussed below. Clearly if no insurers fail, the insurance guarantee costs could be zero (as has indeed been the experience of some EU IGS).

- **Extent of insolvency.** By definition, when an insurer becomes insolvent, its assets fall short of its liabilities. However, this shortfall between assets and liabilities can be of varying magnitude. The smaller the shortfall, the lower the guarantee costs incurred by the scheme. This is because the insurer itself would be able to cover most of the claims, thus leaving a small proportion to be covered by the scheme. This factor is independent of the choice of scheme design.
- **Market share of the failed company.** This will have a direct effect on the total loss in insolvency, and thus on the guarantee costs. An insurer with a higher market share has by definition more customers and/or more policies than an insurer with a low market share. Thus, if the insurer with a higher market share fails, more claims would need to be compensated, and therefore the guarantee costs incurred by the scheme would be higher. This factor is independent of the choice of scheme design.
- **Nature and scope of coverage.** The rules adopted by the scheme, in relation to the level of compensation provided, will affect the total amount to be paid by the scheme in compensation. In addition, the coverage rules relating to the eligibility of claimants will determine how many claims are eligible for compensation. Similarly, for schemes seeking to ensure the continuation of policies through portfolio transfer, costs are lower if policy benefits can be reduced to facilitate the transfer.

Historical evidence of insurance guarantee costs

As discussed in sections 2.10 and 4.5, several insurer failures in the EU have triggered the operation of the IGS. The relevant IGS have paid compensation, or have sought the continuation of insurance contracts at a cost to the scheme. Table 5.1 shows the annual guarantee costs incurred by schemes in Spain, the UK, Germany, France, Ireland, Italy, Finland and Malta over the period 2002–06.⁴⁹

As can be seen from the table, the guarantee costs are significantly higher in Spain and the UK, where the schemes cover both life and non-life insurance, and where the schemes have dealt with a relatively high number of failures.⁵⁰ The guarantee costs are lower in Italy, where the scheme covers only one class of non-life insurance: hunters' liability. The costs reported in Table 5.1 overestimate guarantee costs resulting from insurance insolvencies, as they include also costs incurred in relation to claims paid in the event of an unidentified or uninsured hunter—the total cost paid for insolvencies amounts to €1m paid over the period in relation to one insolvency. The Finnish schemes, which cover specific types of non-life insurance, and the Maltese scheme, which covers both life and non-life insurance, have not yet dealt with any failures, and thus have not incurred any guarantee costs.

⁴⁹ A time series of data was not available for all IGS.

⁵⁰ The figures for Spain relate to the general winding-up scheme covering life assurance and non-life insurance. The special schemes for compulsory insurance have not yet been activated.

Table 5.1 Past guarantee costs in a sample of EU countries, 2002–06 (€)

	2002	2003	2004	2005	2006
General schemes covering life and non-life insurance					
Spain¹	14,700,000	16,400,000	21,300,000	2,500,000	14,300,000
UK²	38,986,992	193,901,214	194,048,892	166,728,462	137,488,218
Malta³	0	0	0	0	0
General schemes covering life assurance					
Germany⁴	–	100,000,000	0	0	0
France⁵	0	0	0	0	0
General schemes covering non-life insurance					
Ireland³	0	0	0	0	0
Special schemes covering one or a few branches of (compulsory) non-life insurance					
Italy⁶	282,900	598,800	512,000	780,000	567,500
Finland³	0	0	0	0	0

Note: ¹ The figures relate to the general winding-up scheme covering life assurance and non-life insurance from 2001/02 to 2005/06. ² The figures relate to years 2001/02 to 2005/06. ³ No failures have occurred. ⁴ Cost incurred by the voluntary scheme for life assurance (Protektor) that existed prior to the establishment of the statutory scheme. ⁵ Figures relate to scheme for life assurance, FGAP. There was one failure, which incurred administration costs, but sufficient assets were available to meet policyholder claims and no compensation costs were borne by the scheme. ⁶ Figures also include costs in relation to claims when the damaging party is not insured or not identified.

Source: Oxera, based on questionnaire responses or annual reports of IGS.

Table 5.2 shows the past guarantee costs as a proportion of gross direct premiums for life and/or non-life schemes in Spain, the UK and Germany, over the period 2003–05.⁵¹ The premiums relate to total premiums, and not necessarily premiums on policies that are protected by the relevant schemes; data on premiums on protected policies was not available on a consistent basis.

In 2005, the guarantee costs in Spain (relating to the general scheme covering both life and non-life insurance) were 0.005% of the total gross insurance premiums earned nationally. In the UK the guarantee costs relating to both life and non-life insurance were 0.084% of total gross premiums in the same year. In Germany the guarantee costs were zero in 2005; however, in 2003 they were 0.15% of total life assurance gross premiums.

Overall, expressed as a percentage of total premiums, the guarantee costs of the selected schemes appear small. If measured against premiums on protected policies, the percentages would be somewhat higher, particularly for the UK scheme, which does not protect certain types of non-life insurance (eg, marine, aviation and transport) and generally excludes claimants that are not retail consumers. However, even if measured against ‘relevant’ premiums, costs incurred to date are relatively small.

⁵¹ Premiums include all life and/or non-life business, including that which may not be protected by the relevant guarantee scheme. Put differently, the guarantee costs relative to ‘protected’ premiums may be underestimated.

Table 5.2 Past guarantee costs as a proportion of gross premiums in a sample of EU countries that have had insurer failures, 2003–05 (%)

	2003	2004	2005
Spain¹	0.039	0.046	0.005
UK¹	0.094	0.098	0.084
Germany²	0.149	0	0

Note: Gross premiums include policies not protected by the relevant schemes. The compensation figures for Spain and the UK relate to years 2003/04, 2004/05 and 2005/06. The figures for Spain relate to the general scheme covering life assurance and non-life insurance. ¹ Guarantee costs from Table 5.1 divided by the total gross premiums on life and non-life insurance. ² Guarantee costs from Table 5.1 divided by the total life assurance gross premiums.

Source: Oxera calculations.

Table 5.3 shows the costs incurred by the schemes in the EU in relation to the largest case handled. Where the case is still ongoing, the cost is up to 2006, rather than total. As the table shows, the costs vary significantly from scheme to scheme. This will be due to insurer-specific factors—such as the size of the failed company—as well as scheme design.

Up to 2007, the highest guarantee cost incurred was in the UK, where the scheme paid nearly €500m in relation to a non-life insurer (Independent Insurance); however, compared with the total UK market, this cost is relatively small. Overall, no significant single failure costs have been incurred in the EU to date.

Table 5.3 Largest cases handled in EU countries that have had insurer failures

Country	Total cost ¹	Description of largest case
General schemes covering life and non-life insurance		
Latvia	€0.011m	Alianse (non-life) in 2002 was the only failure. LAT8,000 (around €11,333) paid in relation to 40 claims for compensation by 2006
Romania	€1.7m	Grup AS (composite) in 2003. RON5,999,580 (around € 1,678,674) paid in relation to 1,250 claims by mid-2007
Spain	€35.4m	Reunión (non-life) in 1992. By 2006, this has cost the CCS €35.4m
UK	€487m	Independent Insurance (non-life) in 2001. Around 190,000 policyholders. By 2007, £330m (€487m) paid, but case is ongoing and total payment expected to reach £500m (€738m)
General schemes covering life assurance		
France	€0.423m	Europavie is the only case handled to date. No compensation was ultimately required since assets were sufficient and most of the portfolio was transferred. Case-handling cost of €423,000
Germany	€100m	Mannheimer is the only case handled to date. 344,000 life contracts were transferred to Protektor, and total cost was €100m
Poland	n/a	The only failure (Westa Life SA) dates back to 1993, so no information on costs and number of claims handled is available
General schemes covering non-life insurance		
Denmark	€12.2m	Plus Forsikring A/S in 2002 was the only failure. Case is ongoing and total payment to date is DKK91m (around €12.2m)
France	€10.2m	International Claims Services SA—winding up started in 1999 and FGAO intervention in 2003. By the end of 2006, 260 claims were handled at a total cost of €10.2m (excluding motor)
Ireland	n/a	ICI/ICAROM administration in 1980s
Special schemes covering one or a few branches of (compulsory) non-life insurance		
Italy	€1m ²	Failure of insurance company FIRS in 1998, with cost of €1m arising from compensation of seven claims ²
Poland	€20m	Tur Polisa SA (went into liquidation in 2000) with a cost of €20m arising from compensation of almost 13,000 claims, mostly in relation to motor

Note: ¹ The cost is up to 2006 or later where the case is still ongoing. ² One claim was subsequently challenged and €120,000 recovered.

Source: Oxera based on questionnaire responses.

Expected future insurance guarantee costs

Expected guarantee costs are difficult to assess. First, they depend on the expected loss to policyholders from the possible failure of a particular institution. Second, expected costs also depend on the scheme design (eg, on the monetary thresholds for payouts and other claim eligibility restrictions). It is beyond the scope of this study to examine in any detail the expected losses arising from insurance failure and to quantify the resulting guarantee costs. Methods for calculating expected costs of guarantee schemes have been proposed, and are discussed—eg, in Davis (2004).⁵²

The illustration considered below focuses on expected losses to policyholders in the event of insolvency of an insurer, as determined by the following three factors.

⁵² Davis, K. (2004), 'Study of Financial System Guarantees', a report prepared for the Commonwealth Government of Australia, March. A modelling approach is applied from Müller (2006), who estimates guarantee costs for the German scheme of life insurers and also provides simulations to assess unexpected costs. Müller, H. (2006), 'Insurance Guarantee Schemes—Entwicklung eines Insolvenzversicherungssystems für die Kunden von Lebensversicherern auf Basis einer kritischen Analyse international bestehender Systeme', Dissertation (to be published), University of Basle, Switzerland.

- **Probability of insolvency.** A probability of 0.1% is used for the illustration. Under Solvency II, the ruin probability is higher at 0.5%, but this is likely to overestimate the frequency at which an IGS may be triggered—as discussed in section 4.3.2, supervisory actions and interventions could stop, or at least significantly limit, the deterioration in the financial position of insurers, thereby reducing the actual probability of ruin below the theoretical level of 0.5% (and hence reducing the probability of an IGS being called on). The probability of a company defaulting on its debt estimated on the basis of the credit ratings of a sample of large EU insurers is 0.065% (see section 4.1.3). The illustration is based on a probability that is lower than the ruin probability envisaged in Solvency II, but somewhat higher than that implied by the ratings analysis.
- **Shortfall of assets over liabilities.** An asset–liability ratio of 85% is assumed in the example (ie, an asset shortfall of 15%). While there may be instances where the asset shortfall is significantly greater—particularly in the event of failure of a non-life insurer—the size of an insolvency and losses at any point in time are usually contained. This is also due to regular checks by the relevant supervisory authority.
- **Exposure at default** (or size of institution failing as measured by the liabilities to policyholders). It is assumed that technical provisions fully capture policyholders' claims against insurance companies.

The following factors, which would influence the expected guarantee costs, are disregarded.

- Scheme design features that may reduce the scheme's payout (ie, all policies covered, no compensation limits or reductions in benefits, etc).
- Timing (or the fact that costs are spread out, and that some costs can be recovered by an IGS on initial payment to policyholders).
- Differences in default rates and default consequences between countries.

With these simplifying assumptions, it is possible to calculate the expected loss (and if it is assumed that the loss is fully covered by a guarantee scheme, the expected guarantee cost) in different EU insurance markets.

The resulting estimates of expected costs are presented in Table 5.4, along with the expected costs as a proportion of gross premiums.

Table 5.4 Illustration of expected guarantee costs in different EU markets

	Life assurance			Non-life insurance		
	Total gross technical provisions, 2005 (€m)	Expected costs (€m)	Expected costs (% of gross premiums)	Total gross technical provisions, 2005 (€m)	Expected costs (€m)	Expected costs (% of gross premiums)
Germany	641,078	96.16	0.13	221,248	33.19	0.04
Spain	124,941	18.74	0.09	31,281	4.69	0.02
UK	1,313,373	197.01	0.14	n/a	n/a	n/a
Poland	11,418	1.71	0.05	5,329	0.8	0.02
Italy	354,928	53.24	0.07	62,444	9.37	0.03
France	946,844	142.03	0.12	98,916	14.84	0.03
Malta	828	0.12	0.10	352	0.05	0.03

Note: Expected cost = 0.1% * 15% * total gross technical provisions, where 0.1% is the assumed probability of default, and 15% is the assumed shortfall of assets over liabilities.

Source: CEIOPS data and Oxera analysis.

As shown in Table 5.5, the overall expected costs obtained based on the set of simplifying assumptions appear relatively small when compared against premiums in the relevant markets, making up 0.05–0.14% of gross premiums in life assurance, and 0.02–0.04% in non-life insurance.

As well as considering the expected costs in a given year, it is also worth looking at the loss were a failure to occur. As mentioned above, the probability of such an event occurring is very small—eg, the annual default probability implied by the ratings of the sample of large European insurers is on average 0.065%. However, depending on the market share of the failed insurer, and the shortfall of assets to liabilities in the particular failure, the losses could potentially be significant. Put differently, what would be the cost for IGS if a larger-scale failure occurred?

Table 5.5 illustrates the loss as a proportion of the remaining insurers' gross premiums for various market shares of the failed company, as well as for various shortfalls of assets to policyholder liabilities of the failed insurer. The illustrations are shown using data for the non-life insurance market in three countries—France, Malta and Denmark.

Table 5.5 Loss given failure as a proportion of remaining insurers' gross premiums, for various market shares and asset shortfalls (non-life insurance, %)

	France			Malta			Denmark		
Shortfall	5%	10%	15%	5%	10%	15%	5%	10%	15%
5%	0.5	1.0	1.6	0.5	1.0	1.5	0.4	0.8	1.3
10%	1.0	2.1	3.3	0.9	1.9	3.1	0.8	1.7	2.7
15%	1.5	3.1	4.9	1.4	2.9	4.6	1.2	2.5	4.0
20%	2.0	4.1	6.6	1.8	3.9	6.2	1.6	3.4	5.4
30%	2.9	6.2	9.9	2.8	5.8	9.2	2.4	5.1	8.0
40%	3.9	8.3	13.1	3.7	7.7	12.3	3.2	6.8	10.7
50%	4.9	10.3	16.4	4.6	9.7	15.4	4.0	8.4	13.4

Note: Calculations based on 2005 data on technical provisions and gross premiums. Three market shares are shown for each country, 5%, 10% and 15%. This can be the assumed market share of one failed insurer, or a number of failed insurers that combined have that market share.

Source: CEIOPS data and Oxera analysis.

For example, if a French non-life insurer (or several insurers) with a (combined) market share of 5% fails, assuming an asset-to-liability shortfall of 15%, the loss would amount to 1.5% of the remaining non-life insurers' gross premiums in that year.

The higher the asset shortfall and the larger the company failing (or the greater the market share of the failed company or group of companies), the greater the losses. The table shows that losses can be significant as a percentage of premium income of the insurers remaining in the market. For example, for an asset shortfall of 20%, the loss would amount to around 6% of the remaining insurers' premium income if the market share of the failed undertaking were 15%.

Several countries in the EU have insurance markets that are small and concentrated, raising particular concerns about the financeability of an IGS. Having a small and concentrated market may not present a particular problem per se, as the costs resulting from failure vary with market size and, if industry-financed, can be shared among firms remaining in the market on a proportionate basis. However, problems can arise if the failure involves an insurer with a disproportionately large market size (or, equally, in the event of a series of failures of smaller insurers with a large combined market share).

Table 5.6 shows the market share of the top five insurers, in terms of non-life technical provisions, for a sample of Member States, using data collected by the European Commission from Member States in 2004. Market shares in life assurance are omitted, but display a similar pattern and hence result in similar (qualitative) conclusions.

The data shows that the largest five companies often have a combined market share of 50% or more. Concentration is particularly high in most of the new Member States, where the combined market share of the top five insurers can exceed 80%. In those countries, the single largest insurer has more than half of the market alone. The second to fifth largest insurers have correspondingly lower shares.

Table 5.6 Share of technical provisions of largest five insurers in a sample of EU Member States

	Top 5 combined	Company 1	Company 2	Company 3	Company 4	Company 5
Austria	56	16	15	9	8	8
Belgium	50	16	11	9	8	7
Finland	83	31	23	17	10	3
France	36	11	10	6	4	4
Ireland	51	18	13	7	7	6
Italy	39	11	9	8	6	5
Netherlands	27	8	8	6	3	3
Portugal	57	21	14	9	8	6
Spain	28	7	7	6	5	4
Sweden	59	35	10	7	3	3
UK	53	17	13	9	8	6
Cyprus	53	24	9	9	6	4
Hungary	93	51	16	14	6	5
Lithuania	74	52	11	5	3	2
Slovakia	86	51	17	11	4	2
Slovenia	95	66	11	7	6	5

Notes: Reported market shares are subject to error due to rounding in the original data and after the calculations. Source: Calculations based on data in European Commission (2004), 'Working Paper on Insurance Guarantee Schemes', Annex 1 on MARKT/2501/04, March.

Comparing these market shares with the loss illustrations in Table 5.5 suggests that the impact of a failure of one of the largest companies could be significant. This is particularly the case in some of the new Member States if the failure involved the largest insurer covering more than half of the market—the impact here could be significant, even for small asset shortfalls.

The fourth and fifth largest companies in all countries considered have an individual market share of less than 10%, and for some countries, the market share is less than 5%. Based on the illustrations in Table 5.5, the losses, given the failure of a company with a 5% (10%) market share, would correspond to around (1.5%) 3% of premiums of the remaining non-life insurers in the market, if the shortfall of assets over policyholder liabilities were 15%. More severe failures with higher asset shortfalls would imply greater losses.

The actual cost to the IGS could be much lower, for two main reasons.

- The costs can be contained through scheme design—eg, imposing limits on the amount of compensation paid or introducing other forms of co-insurance whereby claimants are protected for only part of the loss.
- The costs to the guarantee scheme of an insurance failure is often spread over many years, particularly in relation to long-tail classes of non-life insurance where claims can occur several years after the insurer has failed. Thus, the losses resulting from the failure of an insurer would not need to be met in one year.

Nonetheless, it is clear that the cost to an IGS of a large failure can be significant, with implications for scheme financing. As further discussed below, to limit the impact on industry, many IGS have been designed with a cap on the amount of contributions that can be raised from industry in any year. Where the cap is set at, for example, 1–2% of premiums, the illustrations in Table 5.5 would suggest that a failure of a non-life insurer with a market share of 5% (eg, the fourth or fifth largest insurer in the market) could be financed by the IGS in any year if the asset shortfall of the insurer were 20% or less. Larger failures could also be financed within these contribution limits if the scope of protection afforded by the IGS were limited (eg, capped compensation), if the claims against the insurer were spread over several years, and/or if alternative funding sources were available to the IGS. The larger the failure, the greater the costs for the IGS and resulting funding requirements. Very large failures may be difficult to finance with industry funding alone, and some failures (eg, insolvency of the largest insurance undertakings in the market) may not be financeable by normal IGS arrangements at all. IGS can best deal with failures which do not involve potential costs that are very large relative to the size of the market—those failures may be better dealt with in other ways.

5.1.2 Administration costs

The administration costs of an IGS include the initial set-up costs, as well as the costs associated with the running of the scheme (ie, staff costs, claims handling costs and office costs).

Table 5.7 presents the 2006 administration costs for the schemes currently in place in the EU.

Table 5.7 Operating costs in 2006

General schemes covering life and non-life insurance	
Latvia	€4,250
Malta	€18,111
Romania	€647,560
Spain	€2,900,000 This includes the costs incurred by the CCS to administer the winding-up proceedings
UK	In 2005/06, basic running costs for life and non-life scheme of €720,670 Additional compensation-specific administration costs (relating to assessment of claims and making payments) for non-life scheme of €2,120,660
General schemes covering life assurance	
France	€144,000
Germany	€153,000 in the first half-year of operation of the statutory scheme Protector itself incurs additional operating costs (related to run-off of Mannheimer case, which occurred prior to the establishment of a statutory scheme)
Poland	Difficult to estimate since IGF performs other functions (including motor guarantee) not related to insolvency cases
General schemes covering non-life insurance	
Denmark	€115,733 In addition, the scheme paid €7,333 to an insurer in 2006 for claims handling
France	Around €250,000 of FGAO operating costs can be attributed to functions relating to insolvencies (excluding motor)
Ireland	Minimal (no cases)
Special schemes covering one or a few branches of (compulsory) non-life insurance	
Belgium	No operating costs specific to IGS function (no cases)
Finland	Minimal (no cases)
Germany	Minimal (no cases)
Italy	€80,000 In addition, €34,000 paid by Consap as fees to the designated insurance companies
Poland	As per scheme for life assurance. See above
Spain	Schemes not activated, so costs insignificant compared with CCS budget

Source: Oxera based on questionnaire responses or annual reports of IGS.

The administration costs vary significantly between the schemes. Part of this variation can be explained by the differences in scheme design. In particular, as a result of their respective operating arrangements, several IGS have incurred minimal administration costs in the absence of failures.

Differences in administration costs are to a large extent related to differences in the case volume handled by the schemes—administration costs are small and in many cases negligible for those schemes that have not dealt with any failures. Schemes with a higher case volume necessarily incur higher administration costs, such as the general schemes in the UK and Spain. But even there, the administrative costs of providing the guarantee are small when compared with the compensation costs (or other guarantee costs). For example, in the UK, administration costs amount to around 0.5% of compensation costs.⁵³

⁵³ The administration costs of the Spanish scheme (CCS) are significantly higher (around 20% of the guarantee costs), but this is due to the fact that the CCS is in charge of the winding-up proceedings—ie, the reported administrative costs include the

5.1.3 Impact on industry

The costs of the IGS are mainly or exclusively funded by levies raised from insurance undertakings participating in the schemes. As set out in section 2.9, there are considerable funding differences between IGS.

One key difference relates to the timing of levies—while some schemes raise levies irrespective of the incidence and cost of intervention to build up reserves in anticipation of future liabilities (ex ante funding), others raise levies to cover the cost of failures that have occurred (ex post funding). Therefore, depending on the nature of failures, the impact on the industry differs according to the type of funding mechanism implemented.

Table 5.8 summarises the annual levies and the accumulated funds of those IGS that are funded on an ex ante basis. Focus is on general schemes for life and non-life insurance, leaving aside the specific schemes that are also funded on an ex ante basis.⁵⁴

Table 5.8 Ex ante levies and size of fund for IGS in selected EU countries, 2006 (€m)

	Annual levy paid in 2006 (€m)	Calculation of levy	Size of IGS fund in 2006 (€m)	Comment
Paid by life assurers				
Latvia	0.2	1% of relevant gross premiums	0.8	No target fund size
Malta¹	0.1	0.125% of relevant gross premiums	0.2	Target fund size: around €2.33m
France	n/a	Annual levy adjusted to maintain insurer's share in IGS fund	480	Fund size is 0.05% of life technical provisions; half is paid to fund and half remains as guarantee in books of insurers
Germany	123	0.02% of life assurance net reserves until target fund size is reached; risk-weighting	615 (target)	Target fund size is 0.1% of life assurance net reserves
Paid by non-life insurers				
Latvia	0.6	1% of relevant gross premiums	2.8	No target fund size
Malta¹	0.1	0.125% of relevant gross premiums	0.2	Target fund size: around €2.33m
Spain²	94.1	0.3% of non-life premiums	1,099	No target fund size
Denmark	7.8	DKK10 (€1.3) per policy	11.6	Target fund size: €40.3m

Note: ¹ Applies to 2005 levy. ² Relates to general winding-up scheme rather than specific schemes; levies pay for functions that the scheme performs in winding up insurers (over and above any guarantee costs). Source: Questionnaires to IGS operators.

The annual ex ante levies for participating insurers in Malta and Spain amount to 0.125% and 0.3% of premiums. The higher rate of 1% of premiums applies to participating life and non-life insurers in Latvia.

In Latvia and Spain, the annual levies to industry could in principle continue even if no failure were to occur—there is no target or maximum fund size beyond which levies would cease to

winding-up costs. Moreover, the guarantee costs are small given the nature of the protection provided by the scheme (see section 2.5).

⁵⁴ The Finnish scheme for employment accident insurance combines ex ante and ex post funding; insurers make balance sheet provisions (equivalent to 3% of relevant gross technical provisions), with cash levies raised ex post. The Italian scheme for hunting liability insurance charges 5% of relevant premiums (amounting to about €0.5 per policy).

be raised. In Malta, on the other hand, the target size is MTL1m (around €2.33m) for each of the life and non-life fund. Once reached, the Maltese FSA could decide to suspend the collection of the regular levy.

In Denmark, the ex ante levies take the form of a fixed amount per policy. In 2006, the rate was DKK10 (€1.3) per policy, and participating non-life insurers paid a total of €7.8m. Measured against total gross non-life premiums in Denmark (including non-protected policies), the impact translates to around 0.14% of premiums.⁵⁵

The levies paid by participating insurers to the life assurance schemes in France and Germany depend on the size of their balance sheets.

In France, the available funds of the FGAP per year amount to 0.05% of the relevant technical provisions or, in 2006, €480m. However, the impact on individual insurers is limited by requiring only half of the amount to be paid in cash, with the remainder retained as a guarantee on the insurers' balance sheets. Dividing the total funds of €480m among the 128 participating insurers means that the average insurer had a stake of €3.8m in the fund—€1.9m in cash and €1.9m in terms of guarantees. Each insurer's stake is rebalanced every year (through additional contributions or refunds) to reflect its size. Total direct gross premiums earned on life business in the French market amounted to around €118 billion in 2005,⁵⁶ so the total funds (cash and guarantees) made available by industry as a proportion of direct premiums amount to around 0.4% in a year.

In Germany, participating life insurers make an annual aggregate cash contribution of 0.02% of life net reserves to the statutory guarantee fund; the contributions will cease once the target of 0.1% of net reserves is achieved. In 2006, the aggregate contribution amounted to €123m. The average insurer among the 127 participants would pay just under €1m, but the actual amount paid depends also on a firm's relative risk (balance sheet strength)—the lowest-risk firms receive a discount due to a risk factor of 0.75 being applied to net reserves, with the net reserves of the highest-risk firms being increased by a risk factor of 1.25. Total gross direct premiums written with respect to life assurance amounted to €72 billion in 2005,⁵⁷ so the impact of the 2006 levy of €123m amounts to around 0.2% of premiums.

In the absence of failures, the annual levy will cease once the target of 0.1% of net reserves is reached (€615m based on 2006 data), and additional payments would only be required from those firms that experience a growth in net reserves relative to the aggregate (with refunds to those experiencing a decline in relative terms). However, should failures turn out to be greater than expected, an extraordinary levy can be raised up to an extra 0.1% of net reserves—measured against total gross direct premiums written as above, this amounts to around 0.8% of premiums.

Furthermore, the German life assurance industry has committed to financing failures on a voluntary basis, raising the total statutory and voluntary industry funding to around €6 billion. Measured against total direct gross premiums in 2005, as above, this amounts to as much as 8%.

Overall, and disregarding the voluntary industry funding in the German life industry, the burden imposed by the ex ante schemes described above varies, but annual levies do not exceed 1% of premiums and, in general, are well below this level.

Where there are no or limited failures, the burden on industry is generally lower in ex post-funded schemes. The most comprehensive scheme in terms of coverage—the UK FSCS—is essentially ex post-funded: levies are raised based on cost estimates for the next 12 months.

⁵⁵ Based on total non-life gross premium income in 2005, as recorded by CEIOPS (2005), op. cit.

⁵⁶ CEIOPS (2005), op. cit.

⁵⁷ Ibid.

As shown in Table 5.9, in the five years up to 2006/07, insurers participating in the FSCS paid a total of £296m (around €437m). Due to the absence of life assurance failures, levies were exclusively paid by non-life insurers (258 participants in 2006/07).

The FSCS received significant recoveries, such that a refund was paid to the industry in 2005/06 and no levy was imposed in 2006/07. Levies are allocated among participants on the basis of protected net premium income. Aggregate protected net premium income amounted to around £33 billion (€49 billion) in 2006/07; thus, measured against relevant premiums in that year, the annual impact on the industry ranged between 0% and 0.4% (or less if measured against total premiums, including business not protected by the FSCS).⁵⁸

Table 5.9 Ex post levies for IGS in selected EU countries, 2002–06 (€m)

		2002	2003	2004	2005	2006
General schemes						
UK	Life	0	0	0	0	0
UK¹	Non-life	215.2	0	0	206.9	15.2
Poland	Life	0	0	0	0	0
Ireland	Non-life	0	0	0	0	0
Specific schemes						
Belgium²	Workers' accident	0	0	0	0	0
Finland	Patient insurance	0	0	0	0	0
Germany	Private health insurance	–	0	0	0	0

Note: ¹ Data for 2001/02–2005/06. The 2004/05 figure is net of a £42m (€62m) refund paid in March 2006 as a result of recoveries. ² No ex post levies in relation to insolvencies; insurers need to make an initial deposit of €1.4m, which can only be used to settle the cost of failures of the insurer making the deposit.

Source: Oxera, based on questionnaires to IGS operators, and IGS annual reports.

For all other ex post schemes reported in Table 5.10, no levy was required given the absence of failures that would have needed to be financed. Thus, where there are no failures, the impact on the industry can be zero if ex post funding is implemented. More generally, the impact on the industry depends on the incidence and severity of failures. Where small, the industry impact will be small where the scheme is ex post-funded.

Failures dealt with by existing IGS have been rare and relatively small, but there remains the possibility of larger failures. Even in those cases, the impact on the industry may be limited depending on scheme design. In particular, most schemes have introduced a cap on the amount of levy that can be raised from industry in any given year.

Table 5.10 summarises the caps on levies that have been introduced for the existing IGS in the EU, focusing on general life and non-life schemes only. For the specific schemes, the information is contained in section 2.9 (Table 2.9).

⁵⁸ Oxera (2007), 'Funding the Financial Services Compensation Scheme', prepared for the Financial Services Authority, March.

Table 5.10 Caps on industry levies for general IGS in selected EU countries

Ex ante funded IGS		Ex post funded IGS	
	Annual cap on industry levies		Annual cap on industry levies
Latvia: life and non-life	1% of relevant gross premium income	UK—life and non-life	0.8% of relevant net premium income
Malta: life and non-life	No cap specified	Poland—life	No cap specified
Spain: life and non-life¹	No cap specified	Ireland—non-life	2% of relevant premium income
France: life	0.05% of life technical provisions is annual capital of scheme ²		
France: non-life	€700m is intervention limit ³		
Germany: life	0.1% of life net reserves is target capital of scheme; same amount can be levied as extraordinary contributions		
Denmark: non-life	0.5% of relevant gross premium income		

Notes: ¹ Levies imposed on life policies only, but funds can be used to facilitate winding-up and provide guarantee for non-life failures. ² Scheme can borrow funds from firms up to same amount. ³ Compared with total gross direct premiums earned (including unprotected non-life business), which were around €53 billion in 2005, the limit corresponds to around 1.3%.

Source: Oxera, based on questionnaire responses, and the relevant laws and regulations.

With the exceptions of the IGS in Malta, Spain and Poland, where no specific cap is defined in the rules, potential costs on industry are contained. For example, annual levies are capped at between 0.5% and 2% of relevant (gross or net) premiums in Latvia, Denmark, the UK and Ireland.

Caps on industry levies raise the question of how to fund the excess cost of large failures. However, at least from the perspective of the industry, they work to limit potential liabilities. Put differently, concerns about excessive costs on the industry can be contained through scheme design—ie, by setting limits on the levy that can be raised from industry in any given time period, and by introducing alternative funding sources if the financial capacity of the industry is overstretched.

5.1.4 Distributional effects

IGS are often seen as entailing an additional cost to consumers and to an insurance company's shareholders. This may be the case for the administrative costs required to set up and run the IGS, which, as shown above, tend to be small. However, when it comes to the potentially more significant guarantee costs, taken from a societal point of view, the main effect of an IGS is to simply alter the distribution of the losses associated with insolvencies.

The immediate distributional implication of a failure is the distribution of the losses from the poorly managed insurer, which has failed, to the well-managed insurers that contribute to the IGS. However, in competitive markets, insurers would pass through costs to their customers. If this is the case, the distribution of losses is ultimately from the customers of insolvent insurers to the consumers of solvent firms.

The cost to policyholders is, in many cases, rather small. In Denmark, every policyholder is levied DKr10 (around €1.3) as a contribution to the IGS. In Italy, where there is an IGS for hunting liabilities, hunters are charged 5% of the compulsory hunting liabilities insurance as a contribution to the fund. Since the policy costs around €10, the contribution to the scheme is

around €0.5 per insurance policy; this also includes coverage of claims arising when the damaging party (hunter) is uninsured or unidentified (ie, not just claims relating to insolvencies). In Spain, the absolute value of the burden on policyholders depends on the size of the policy. Each customer of a new policy has to pay an extra 0.3% on the value of the gross premium as a contribution to the IGS. If the average home insurance premium in Spain was €163 in May 2006, the additional cost to the average policyholder with home insurance would be $0.3\% * €163 = €0.49$. In the case of life assurance, where the average premium was €543 in May 2006, the cost to the average policyholder would be $0.3\% * €543 = €1.63$.⁵⁹

It is important to stress two further points. First, the cost of an IGS can, in principle, be close to zero. The IGS is usually a residual claimant on the assets of a liquidated company. Therefore, the scheme can recover a part, or in some cases most or all, of the money it has spent compensating policyholders. If the assets of the insolvent insurer are sufficient to cover the entirety of the claims paid, the distributional impact occurs mainly over time. For example, the impact on the industry could be limited if levies were paid to fund the initial payment by the IGS and then refunded as amounts are recovered by the scheme. The recovery rate varies significantly between insurance estates, but many IGS indicated that they can recover up to 80% (or more) during the insolvency proceedings on some estates. Even when there is only partial recovery of funds from the liquidated assets, the distributional effects of an IGS are lower than those implied when looking only at the initial payments made by the scheme.

Second, the distributional effects depend on the design of the IGS. The effect of scheme design on distributional effects is summarised below, with scheme design being discussed in more detail in section 7.

- **Ex ante versus ex post funding.** In principle, a scheme designed with ex ante funding has smaller distributional effects than one characterised by ex post funding. This is because, in the former case, the failed insurer, and consequently its policyholders, will have made some prior contribution to the scheme. However, in the absence of failures, ex post-funded schemes require no levies, thus avoiding any payment and redistribution altogether.
- **Caps on contributions.** As discussed, most schemes have implemented a cap on the amount of contributions that can be raised from industry in any year. This limits adverse effects for the industry, but with implications for other parties if guarantee costs exceed the contribution cap: The costs will either be borne by consumers (eg, non-payment by the scheme), by tax payers (if the government steps in to pick up the excess cost), or by firms and consumers over time (eg, if funds are initially borrowed or if payments are spread over time).
- **Allocation of contributions (including risk-weighting).** How much an individual insurer pays depends on the mechanism used to allocate total contributions among firms. For example, new and rapidly growing firms in the market will pay relatively more in a system that is funded on the basis of premiums earned on new business than in a system that allocates funds on technical provisions; the reverse is the case for insurers with significant old business but little new business. Furthermore, the assessment of contributions owed by each insurance company to the IGS may take risk into account (as is the case in the German scheme for life assurers, for example). Risk-weighting will shift a larger proportion of the distributional cost of the scheme onto riskier insurance companies.

⁵⁹ Information taken from Egg TM, <http://journalist.egg.com/aboutegg/newsreleases/news2006/2006-06-21/>; data provided by Datamonitor.

- **Limitations on coverage.** Limitations on the compensation that policyholders are awarded by the IGS are present in a number of countries. These can take two forms: payment ceilings and partial payments. Both limit the redistribution of the cost of a failure from solvent insurers (and their policyholders) to policyholders of the failing company.
- **Government intervention.** IGS may redistribute from general taxpayers to policyholders of the failed firm if the government decides to support funding of the scheme. Such direct government funding is not commonly observed among existing IGS in the EU.

5.2 Indirect costs

In addition to the direct costs, IGS may impose indirect costs in the form of negatively impacting on market outcomes. There are two main categories of potentially negative market outcomes. 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 in particular the associated costs—may have an adverse effect on the structure, competitive process and indeed the stability of the insurance market. The costs associated with moral hazard and the impact on competition and market structure are discussed below.

5.2.1 Moral hazard

One main concern with the establishment of an IGS is the potential that it has to create moral hazard—ie, the tendency of a decision-maker, once insured against some contingency, to behave so as to make that contingency more likely. The potential moral hazard may occur at different levels (these are discussed in more detail below):

- policyholders;
- insurance undertakings; and
- supervisory authorities.

The significance of these concerns has already been discussed in many studies.⁶⁰ Overall, there is limited evidence to support the view that the problem of moral hazard is sufficiently severe to make the case against establishing an IGS per se; rather, the concerns about moral hazard indicate the importance of adjusting scheme design to minimise distortionary effects.

Even in the absence of an IGS there could be moral hazard behaviours—eg, on the part of insurers, at the time when they face financial difficulties and ‘gamble for resurrection’, and policyholders, when they rely on supervision or believe in the existence of implicit guarantees. For example, an insurer may be tempted to ‘gamble for resurrection’ by underwriting risky policies in a last attempt to resurrect its financial position. Similarly, a policyholder may rely on the existence of supervisory bodies and not seek adequate information on the soundness of the company with which they hold a policy; they may also believe in the existence of implicit guarantees. The relevant question is therefore whether an IGS further increases moral hazard problems, and how these problems can be minimised through appropriate design of the IGS.

⁶⁰ For a review, see Yasui, T. (2001), ‘Policyholder Protection Funds: Rationale and Structure’, in OECD (2001), ‘Insurance and Private Pensions Compendium for Emerging Economies’, Book 1, Part 1:2b, and Davis (2004), op. cit.

Policyholders

When moral hazard is present, policyholders may be less inclined to assess the financial situation of the insurer they contract with and to make a prudent selection. This is because they would be covered by the scheme, even in the event of failure of their chosen insurer. As a result, consumers may decide to purchase the cheapest product, regardless of the risk associated with the insurer, because of the belief that they will not suffer from an eventual bankruptcy of that insurer. This behaviour on the part of policyholders may result in a ‘race to the bottom’, with insurers under pressure to respond with reducing prices and taking on more risk.

However, moral hazard on the part of policyholders relies on two crucial assumptions:

- policyholders have to be well informed about the existence of a guarantee scheme and understand the implications; and
- they would have to adjust their behaviour as a result of their knowledge.

These conditions are most likely to be met in the case of commercial policyholders insuring large risks—they (or their brokers) are more likely to be in the position to understand and act upon the knowledge that an IGS exists to insure losses irrespective of their decisions. Although no evidence is available to assess the significance of this effect, it is for this reason that a case could be made to exclude such policyholders from the coverage of an IGS.

These conditions are not likely to be met for many retail consumers. Although consumer understanding and behaviour are generally not well researched in this area, there is some evidence to suggest that consumers are not well informed about the existence of guarantee schemes. For example, consumer research conducted by the FSA in the UK has shown that consumer awareness of the FSCS (and the regulatory structure more generally) is very low. For those consumers who are aware of the existence of a compensation scheme, its existence is not a determining factor when making a financial decision. The financial security of the institution they are investing with is considered far more important than the existence of a safety net should a firm fail. Brand recognition and reputation seem to be the most important indicators of financial security. Consumers are happy to know that a compensation scheme exists, but do not appear to make financial decisions on the basis of its existence.⁶¹

If moral hazard were present for policyholders, there are options to adjust scheme design to minimise these effects—eg, by introducing coinsurance and imposing limits on the amount of compensation paid by the IGS. Such options have been implemented by many IGS in the EU. The options available for reducing moral hazard on the part of policyholders are further addressed in section 7.2.

Insurance undertakings

The existence of an IGS may also act as a disincentive for firms to behave appropriately. Some firms may gain a competitive advantage by relying on the scheme to meet their liabilities in the event of default. For example, an insurer, particularly a weak insurer, may be encouraged to compete on price if consumers pay less attention than they otherwise might to an insurer’s financial position and reputation. As such, the introduction of an IGS may increase risk-taking and exacerbate the likelihood of insolvencies.

Empirical evidence on this effect is limited, and only a few studies in the academic literature have aimed to test its importance. Munch and Smallwood (1980) examine insolvencies among property and liability insurers around the establishment of IGS in different US states.⁶² They conclude that, rather than increasing risk-taking behaviour, the introduction of IGS

⁶¹ Financial Services Authority (2000), ‘Financial Services Compensation Scheme Draft Rules’, Consultation Paper 58.

⁶² Munch, P. and Smallwood, D.E. (1980), ‘Solvency Regulation in the Property-liability Insurance Industry: Empirical Evidence’, *Bell Journal of Economics*, 11, 261–79.

actually reduced insolvencies. This is attributed to the fact that, with the establishment of an IGS, other insurers to which the liability for insolvencies is shifted have greater incentives to monitor potentially weak companies. Contradictory evidence is presented in Lee, Mayers and Smith (1997), who find that IGS introduction in the USA resulted in shifts in the portfolio composition of at least some US property and liability insurers towards more risky assets; the greater risk-taking applies to stock companies but not mutual insurers.⁶³ In the life assurance sector, Brewer, Mondschean and Strahan (1997) test for the impact of IGS on the portfolio risk of US life assurance companies over the period when IGS were introduced in different US states.⁶⁴ They conclude that risk-taking increases, but only if the IGS are underwritten by taxpayers. No such increases apply for IGS that are funded by industry, which is argued to be the result of stronger incentives for self-monitoring by the industry.

Potential concerns about moral hazard and excessive risk-taking on the part of insurers are reduced by the supervisory framework. Fit-and-proper requirements for senior staff and conduct-of-business rules, as well as prudential regulations, limit the ability of insurers to behave in this way. Moreover, the more risk-based supervision going forward (eg, implementation of Solvency II) is likely to provide further disincentives for insurers to engage in excessive risk-taking.

In addition, there may be strong managerial incentives to avoid insolvency, which will remain in place even with the creation of an IGS. Managers will want to avoid bankruptcy because of reputational, legal or economic effects, such as avoiding the risk of unemployment in the future. Shareholders have little to gain because their capital will generally be used up in the event of insolvency.

Where concerns about moral hazard on the part of firms remain, the IGS can be designed to mitigate such problems.

- **Eligibility restrictions.** Directors, managers, or auditors of a failed insurer, and their close relatives, can be excluded from the scope of the scheme, as can other potential claimants who may have been responsible for, or contributed to, the failure. This means they will be unable to receive protection from the scheme for losses arising from that insurer's failure, although they will be protected if an insurer with which they have no connection were to fail (see section 7.2.2).
- **Risk-based levies.** Through the introduction of risk-based levies, insurers are in principle required to bear the cost of their risk-taking if there are no other penalties for taking risk. Risk-based levies can also help prevent an unfair burden being placed on soundly managed insurers, while giving incentives to riskier insurers to improve their financial soundness (see section 7.4.3).

Risk-based levies are not commonly observed among existing EU IGS (the German scheme for life insurers is the exception). Exclusion of claimants who are connected to the failed insurance undertaking (or who may have contributed to, or benefited from, the failure) is observed in some IGS (eg, in France and the UK). Such exclusions are also envisaged, and often implemented at national level, in the Directives on DGS and ICS in Europe.

Supervisory authorities

When there is an IGS in place, the insurance supervisory authorities may feel less pressure for strict supervision to prevent failure, instead being more inclined to allow insolvency, knowing that the cost will be picked up by the IGS.

⁶³ Lee S.-J., Mayers, D. and Smith, C.W. (1997), 'Guaranty Funds and Risk-taking: Evidence from the Insurance Industry', *Journal of Financial Economics*, **44**, 3–24.

⁶⁴ Brewer, E., Mondschean, T. S and Strahan, P.E. (1997), 'The Role of Monitoring in Reducing the Moral Hazard Problem Associated with Government Guarantees: Evidence from the Life Insurance Industry', *The Journal of Risk and Insurance*, **64**, Symposium on Financial Risk Management in Insurance Firms, June, 301–22.

While supervisory approaches to preventing or tolerating insurance failure vary between countries, there is no evidence available to suggest that the existence of an IGS has an impact on the incentives of supervisors to more readily allow insolvency.

5.2.2 Potential adverse effects on competition and market structure

The existence of an IGS in a market may have an impact on the competition in that market. There are two potential adverse impacts, which are described in more detail below:

- the scheme may act as a barrier to entry to the market, thus limiting the number of insurers operating in the market; and
- following the failure of one insurer, the existence of the scheme may cause further defaults, thus destabilising the system and reducing the number of insurers in the market.

There are arguments that an IGS may negatively affect competition because it can act as a barrier to entry. In particular, it is suggested that a scheme may deter entry to the market because of the costs associated with it, which are financed predominantly (or solely) by insurers.

However, the arguments are not fully plausible. First, if schemes are financed on an ex post basis, there are no fixed upfront costs for insurers that are considering entry into the market, and thus a barrier to entry would not exist. Second, even in the case of ex ante funding, the costs associated with a scheme do not have to be significant (see section 5.1.3) and can be small compared with the other costs of operating in the market. Moreover, the levies are proportionate to firm size and the volume of the business, and thus do not necessarily place a greater burden on smaller firms which may be entering the market.

Provided that all firms operating in the market contribute to the funding of the scheme on a proportionate basis (and as a result are able to pass on costs to their customers), distortionary impacts on competition can be mitigated even if guarantee costs are large. Put differently, from a competition point of view, an IGS should be designed such that it does not affect the level playing field between firms, including new entrants (see section 7.4).

A further potential cost of an IGS is the risk of chain reactions, and thus a destabilisation of the system as a whole. The bankruptcy of an insurance firm is more likely to happen when the insurance market as a whole is experiencing a downturn. Under such circumstances, burdening solvent insurers with contributions to the IGS could lead to further failures and, hence to a chain reaction. This would have important consequences both in terms of consumer protection—more policyholders would lose cover—and competition—concentration would increase, thus potentially leading to higher premiums.

These potential negative impacts on competition could have a greater impact in small, more concentrated markets. This is because costs cannot be spread across a large number of firms and, more importantly, across a large number of their policyholders, in the event of one or more failures. Thus, the concerns about the financeability of a failure are greater in small, more concentrated markets. This could lead to a greater probability of a chain reaction occurring as a result of a single failure.

However, there are remedies that could alleviate this problem. For example, introducing caps on firm contributions would lessen the burden imposed by the scheme on remaining solvent insurers, and thus reduce the risk of a chain reaction. As discussed before, most existing IGS have introduced caps on contributions. Similarly, reducing the costs of the scheme, by setting stricter criteria concerning the qualifying criteria and level of protection, would also reduce the burden on insurers. These remedies fall within scheme design, and are further discussed in sections 7.2 and 7.4.

Importantly, IGS are likely to have a positive rather than negative impact on the structure and competitive process in a market. First, the existence of an IGS can increase consumers' confidence in new firms, leading to a greater number of policies purchased from new firms and allowing them to increase their market share more quickly than would otherwise be the case. Thus, an IGS can promote entry rather than act as a barrier to entry. However, this effect is unlikely to be strong in normal circumstances, given that it rests on the assumption that consumers are aware of the existence of an IGS and act accordingly.

Second, IGS can enhance competition in the market because they allow companies to exit the market with limited consequences for consumers. A healthy competitive market is one in which less-efficient firms fail and exit, leaving their market share to more efficient competitors. However, the political process may intervene—particularly when consumers may be seriously affected by a failure—eg, by rescuing the firm because it is too big to fail and preventing competition from working. IGS would limit the interference of the political process, thus potentially enhancing competition. Put differently, when compared with a bail-out guarantee that may be implicit in the market, particularly when it comes to larger failures, explicit guarantee arrangements in the form of IGS are pro-competitive.

Overall, since IGS can be designed to avoid distortions in the competitive process, from a competition point of view, a case can be made *for* rather than *against* introducing an IGS.

5.3 Summary

IGS incur direct costs (ie, payments made to provide the guarantee and administration costs), as well as indirect costs (ie, potential 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, such 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 more frequent or larger failures. Given the low rate of insurance failure, as well as other factors, the expected guarantee costs are also comparatively small.

Clearly, larger failures cannot be ruled out and costs would be correspondingly higher, increasing IGS funding requirements. Several insurance markets in the EU, particularly 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) could, 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 very large relative to the size of the market.

The direct costs associated with an IGS, taken from a societal point of view, are largely distributional. In the event 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 through scheme design, as is further discussed in section 7. Scheme design can also seek to address the potential negative market impacts that may arise as a result of an IGS—namely, moral hazard and adverse effects on competition. There is little evidence available to support

the view that these effects are empirically significant. In principle, if properly designed, introducing an IGS can be pro-competitive and improve the operation of the market.

6 Operation of current IGS in the cross-border context

As discussed in section 2, there are significant differences between EU Member States as regards the existence and operation of IGS. This section examines whether and how these differences and, more generally, the lack of a harmonised framework for IGS in the EU, may lead to:

- ineffective cross-border consumer protection (section 6.1); and
- distortions to competition and cross-border activity (section 6.2).

Consumer protection and competition issues in the cross-border context need to be understood and evaluated in the context of the current structure of the European market for insurance products and, more specifically, in relation to the degree of cross-border activity (section 6.3). Section 6.4 summarises the main findings, which provide the basis for the evaluation of EU-level policy options discussed in section 8.

6.1 Cross-border consumer protection

The lack of harmonisation in the rules governing the participation and operation of IGS established in the EU Member States as well as the scope and level of coverage provided to policyholders and beneficiaries may result in an uneven degree of consumer protection:

- **across Member States**—ie, differences in the protection offered to consumers in country A and country B; and/or
- **within Member States**—ie, differences in the protection received by consumers in country A, depending on whether they purchase insurance policies from insurers authorised in country A.

Consumer protection issues across Member States are discussed in section 6.1.1, while within-country consumer protection issues are examined in section 6.1.2.

6.1.1 Consumer protection issues across Member States

There are two main consumer protection issues across Member States that may arise:

- lack of coverage; and/or
- differences in the level and scope of protection.

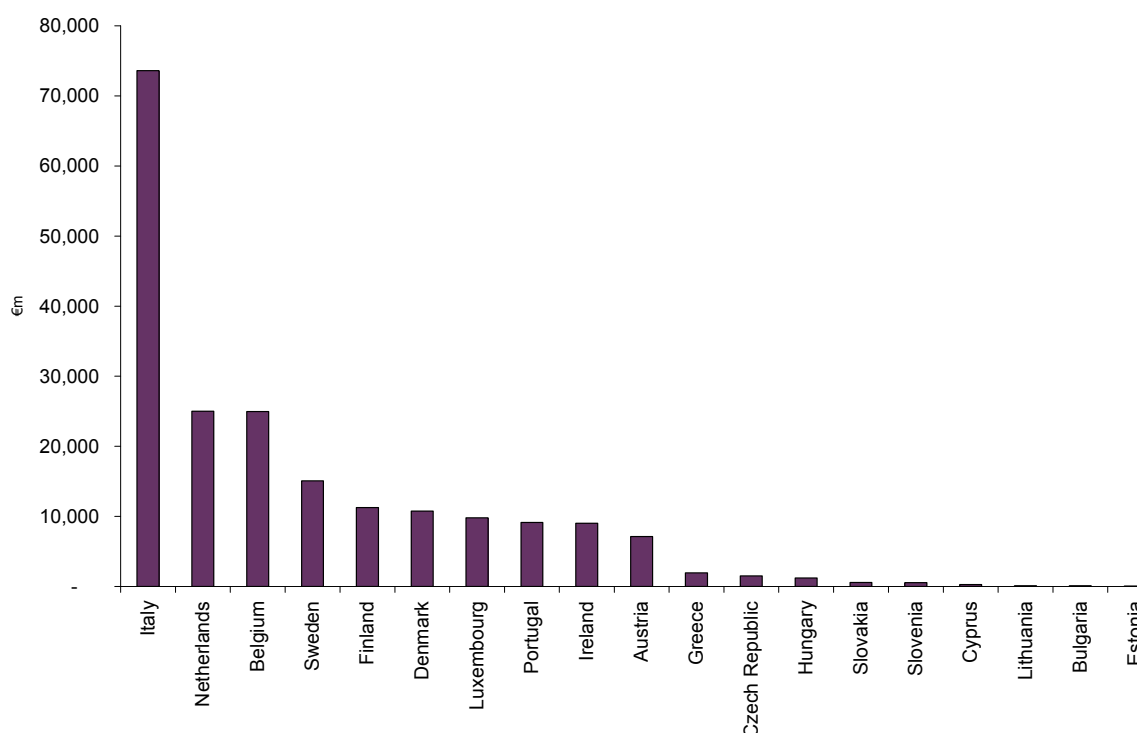
Lack of coverage of consumers in some Member States

Lack of coverage may result from the absence of an IGS, and it is this absence, in many EU Member States, that raises the most basic cross-border consumer protection issues. As summarised in Table 2.1, 14 of the 27 EU Member States have not established any form of IGS for either life assurance or non-life insurance, and among the 13 EU Member States where an IGS exists, the IGS may be established to offer protection for either life or non-life insurance or, within the latter, may cover only very specific types of non-life insurance.

As a result, coverage differs significantly between Member States. A large proportion of policyholders in the EU are not covered by an IGS in the event of failure of an insurance company. Looking at coverage levels in terms of the gross premiums written in the different EU markets, around 35% of the EU life market and more than half of the non-life market are

unlikely to be covered by an IGS.⁶⁵ Figures 6.1 and 6.2 show the size of the life and non-life markets (measured by gross premiums) for countries without a general IGS in the relevant market.⁶⁶

Figure 6.1 Countries with no IGS for life assurance: size of the life market (gross premiums in 2005, €m)

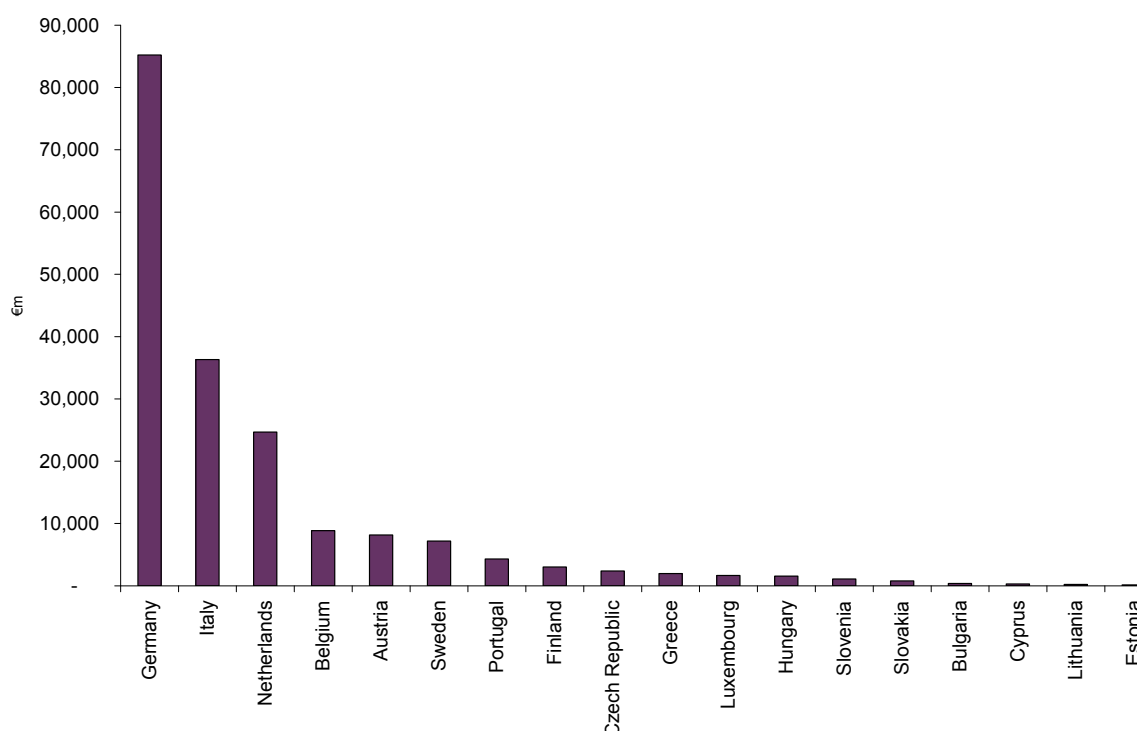


Source: CEA (2006), 'European Insurance in Figures. CEA Statistics, No. 24', June.

⁶⁵ Based on the total market size of countries without an IGS (or, in the case of non-life, without a general rather than a specific IGS for non-life insurance).

⁶⁶ There are three important caveats to these figures. First, in countries where an IGS is in place, not all policies may be covered (eg, commercial policies are typically excluded on the non-life side), but the figures reported include all policies. Second, countries with specific schemes in non-life insurance are reported as not being covered at all by a non-life IGS, thus resulting in an overestimate of the lack of coverage due to the omitted premiums on the specific branches of non-life insurance that are indeed covered. Third, in countries where there is no IGS in place, consumers will be protected if they have acquired policies from an incoming EU insurer whose policies are protected by the home state IGS; the reported gross premiums for any market exclude the business of incoming insurers, and the size of the bias depends on the degree of penetration of incoming EU insurers in each Member State (see section 6.3).

Figure 6.2 Countries without general IGS for non-life insurance: size of the non-life market (gross premiums in 2005, €m)



Note: Figures include motor insurance for all countries.

Source: CEA (2006), 'European Insurance in Figures: CEA Statistics, No. 24', June.

Lack of coverage may also affect consumers in countries with an IGS in place. Take the case of an insurer operating in other EU Member States via freedom of services or branches and headquartered in a Member State where the IGS is structured around the host-state principle—ie, the policies written by the domestic insurer in other Member States are not covered by the IGS of the insurer's home state. If the insurer fails, domestic consumers will be protected, but consumers in other EU countries will not be, unless the host countries have an IGS in place that covers the policies of the incoming insurer. Put differently, in the event of failure of an insurer with cross-border business, consumers in the home state will be protected by the home state scheme, but consumers in other countries will not be protected—ie, the failure of the insurer will have different implications for consumers in different countries.

The overall failure rate of insurance companies is comparatively small (see section 4), and to date the incidence of failures of companies with sizeable cross-border operations has been even smaller. As such, there is limited evidence on the consequences of insurance failure in terms of cross-border consumer protection.

However, one case illustrates the above cross-country consumer protection problem—namely the failure of the non-life insurer, Independent Insurance, in 2001 (see Box 6.1). Independent Insurance had its headquarters in the UK. In the EU, it operated in France through a subsidiary, and in Ireland, Malta and Spain via branches. The UK FSCS is largely structured around the host state principle, meaning that the business sold by branches of UK insurers in another EU Member State do not typically qualify for FSCS protection—the exception being policies sold to UK residents, or policies sold in the other state but issued in the UK. Correspondingly, the FSCS covered (and continues to cover) all eligible claims against Independent Insurance resulting from UK policies. It also extended coverage to policies of Irish policyholders after the decision was reached that these policies could be

considered to be UK policies.⁶⁷ The policies written by the French subsidiary were protected by the relevant compensation scheme in France, the FGAO, at least with respect to compulsory classes of insurance. Claims linked to Independent Insurance's branch in Malta were also covered, through a special arrangement, from the funds the Maltese regulatory authority had asked Independent Insurance to set aside in case it was unable to meet its obligations.

However, the policyholders and beneficiaries of the company's Spanish branches were left unprotected. Since the CCS is structured around the home state principle, it does not cover the policyholders and beneficiaries of incoming EU branches.

In other words, the failure of Independent Insurance affected consumers in different countries differently: UK and Irish policyholders were fully compensated by the FSCS, policyholders of the Maltese branch benefited from the special funds that had been set aside, and policyholders of the French subsidiary were compensated by the FGAO (for compulsory classes of insurance only). However, Spanish policyholders were left unprotected, although no data was available on whether losses were incurred. If Independent Insurance had issued policies through branches elsewhere, consumers resident in most other EU Member States would also not have been covered.

⁶⁷ The failure occurred prior to the establishment of the FSCS, which took over responsibilities from its predecessor scheme, and hence also before the introduction of the new rules on compensation.

Box 6.1 Cross-country consumer protection implications of an insurance failure

Independent Insurance was created in 1986 and was active in the non-life and reinsurance businesses. On June 18th 2001 the company went into liquidation, leaving 500,000 individuals and 40,000 commercial customers without cover.¹ The claims of UK customers were compensated by the FSCS—during 2002/03 and 2006/07, FSCS had paid out almost €500m in compensation, and payments continue to be made (see also section 4.5).

In addition to its UK operations, Independent Insurance had expanded to a number of EU Member States, including France, Spain, Ireland and Malta. In France, the company conducted business through a subsidiary, while in the other three countries it operated via branches.

Independent's failure had cross-border implications. The compulsory non-life insurance claims written in France were covered by the FGAO, which by the end of 2006 had paid €34.5m in compensation for the failure of Independent Insurance's subsidiary.²

Independent Insurance's customers in Ireland were ultimately covered by the FSCS. This is because, according to the FSCS, Irish policies fitted the FSCS description of a UK policy—ie, premiums were collected in the UK and the funds were also held in the country. Maltese customers also received reimbursement, given that the Maltese Financial Services Authority had required Independent Insurance to place certain funds in a trust for the exclusive benefit of Maltese policyholders, should Independent Insurance become unable to pay its debts.³

However, Spanish policyholders were not covered by an IGS. The Spanish scheme, CCS, is structured around the home state principle, which implies that policies written by incoming EU insurers are not covered. In contrast to the Irish policies, according to the FSCS, since premiums were collected in Spain and the branch's funds were held in Spain, Spanish policies were not considered within the scope of the FSCS, so Spanish policyholders did not receive compensation. No data is available on the number of policyholders affected or the losses incurred.

Notes: ¹ Massey, R. (2002), 'Insurance Company Failure', report prepared for The Actuarial Profession, General Insurance Research Organising Committee. ² Information obtained from the FGAO. ³ 'Information concerning the Maltese and the Bahamian Branches of Independent Insurance Company Ltd', '28/3/2006 Frequently Asked Questions', available at <http://www.independent-insurance.co.uk/>.

Another illustration of consumer protection issues comes from the Equitable Life case. Given that Equitable Life has not been declared insolvent and the intervention of an IGS was not triggered, the discussion is hypothetical. Nonetheless, it illustrates the cross-border consumer protection issues that could potentially arise due to a combination of:

- the absence of IGS in some of the countries where the company operated; and
- lack of harmonisation in the cross-border operations of existing IGS.

Equitable Life is headquartered in the UK. It operated through branches, particularly in Ireland and Germany, and had cross-border operations in other EU Member States. If the company had defaulted, the operation of the FSCS would have been triggered. In this scenario, customers outside the UK could have been left unprotected. In Ireland, there is no guarantee scheme for life assurance, and Germany's statutory guarantee scheme for life assurance (Sicherungsfonds für die Lebensversicherer) is based around the home state principle and, given its structure, does not provide for the possibility of branches of incoming EU life insurers participating in the scheme. Therefore, if Equitable Life had been declared insolvent, policyholders in these two countries would generally not be protected. In contrast, losses incurred by UK policyholders would qualify for compensation from the FSCS (or would be otherwise protected—for example, with the FSCS providing the funds to enable portfolio transfer). Box 6.2 summarises the case.

Box 6.2 Potential cross-border consumer protection implications of Equitable Life

The Equitable Life Assurance Society has its headquarters in the UK and operated in Ireland and Germany through branches. The company also had non-UK policyholders in more than ten additional Member States.¹

During the 1950s, Equitable Life began selling 'guaranteed annuity rate' (GAR) with-profit policies to its UK customers, guaranteeing investors a minimum annuity rate when they retired. In the 1990s, as interest rates began to fall, it became increasingly expensive for Equitable Life to honour its policies. In 1994, it decided to cut the size of the final bonuses paid to its 90,000 GAR policyholders. However, in 2000, this approach was ruled inappropriate by the UK House of Lords, which obliged Equitable Life to meet its obligations to its GAR policyholders. The society was forced to sell portions of its business, including its fund management arm, administration systems and sales force. By the end of 2006, however, the with-profits fund had yet to be sold.²

According to the report on the crisis of Equitable Life, published by the European Parliament in 2007, in 2001, 1.5m customers had with-profit policies. Although most of them were UK residents, Equitable Life had around 4,000 with-profit policyholders in Germany and around 8,000 in Ireland.³

Had Equitable Life been declared insolvent, the FSCS would have intervened to protect UK policyholders. Since the company has not been declared insolvent, the FSCS has not been available to policyholders.⁴ Moreover, even if the company had been declared insolvent, FSCS protection would generally not have been available for non-UK policyholders—the common understanding of witnesses heard by the committee is that the FSCS would not cover claims for compensation from the customers of foreign (eg, German or Irish) branches of UK insurance undertakings.⁵ The European Parliament report stated that:

it may therefore be considered that requirements for access to the UK compensation scheme discriminates against non-UK residents and therefore breaches Article 12 of the EC Treaty.⁶

Furthermore, in the event of bankruptcy, Irish and German policyholders would not have access to any alternative guarantee scheme. In Germany, a scheme exists but does not cover customers who have taken out British policies with a British insurer—it is based on the home state principle. In Ireland, there is no formal compensation scheme for life assurance.⁷

Notes: ¹ In the late 1990s, Equitable Life had more than 13,000 non-UK policyholders resident in 13 Member States, including over 1,000 policyholders in France and around 700 in Spain. See European Parliament (2007), 'Report on the Crisis of the Equitable Life Assurance Society', p. 210.

², *The Guardian*, various reports on Equitable Life, available at <http://www.guardian.co.uk/money/equitabliflife>, accessed on November 16th 2007.

³ European Parliament (2007), 'Report on the Crisis of the Equitable Life Assurance Society', p. 210.

⁴ *Ibid.*, p. 251.

⁵ *Ibid.*, p. 281.

⁶ *Ibid.*, p. 282.

⁷ *Ibid.*, p. 274.

Overall, therefore, the fact that IGS do not exist in all EU Member States, and that where they exist, their geographical reach is not harmonised, results in differences in IGS coverage for consumers in different countries. This manifests itself in two main ways:

- at the most basic level, consumers in some countries are protected by an IGS whereas consumers in others are not;
- in specific cases of insurance failure, if the insurance undertaking has cross-border operations, consumers purchasing policies from the same insurer can be covered in some countries but not in others—ie, the level of protection provided to customers of the same insurer can differ depending on where they reside.

Differences in the scope and level of protection

Differences in the extent of consumer protection across EU Member States do not only depend on whether an IGS for life and/or non-life insurance exists. They also depend on the scope, level and form of the guarantee provided. As described in section 2.6, the existing IGS in the EU exhibit significant differences in relation to the rules regarding which classes of insurance policies are protected and the eligibility of claimants. In addition, some schemes intervene by securing the continuation of policies through portfolio transfer, while others pay compensation to claimants (see section 2.5). In the schemes that pay compensation, there are differences in the level of compensation provided, and other conditions affecting the maximum amount claimants can receive (see section 2.7).

Compensation limits for a sample of IGS in the life market can provide an illustration. As set out in section 2.7, these can be broadly classified into three types: absolute payment ceilings, percentage payment ceilings, and combinations (ie, percentage payment up to a ceiling). In the case of a consumer holding a life assurance policy, France has adopted an absolute cap on the level of coverage of up to €90,000 per policyholder in the event of death or invalidity, and €70,000 in other cases. In contrast, in Malta the level of coverage is capped at 75% of the claim. The UK and Poland have adopted a mixed approach: the UK's FSCS compensates 100% of the first £2,000 (ie, around €3,000) and 90% of the remainder of claims against the insurer. In Poland, payment can be 50%, up to a maximum of €50,000. In Latvia, a life assurance policyholder can receive 100% of a claim of up to around €3,000.

Take the case of a customer who acquired a life assurance contract with policy benefits worth €100,000. Table 6.1 shows the different maximum amounts that could be received in compensation in respect of that policy from an IGS in the different countries. As the table shows, the maximum level of compensation varies, from €3,000 in Latvia to €90,300 in the UK. The results indicate that even if there is an IGS in place, in some Member States the level of consumer protection may be relatively limited compared with that offered in other countries.

Table 6.1 Level of compensation for a €100,000 life assurance policy in Member States with an IGS

Country	Maximum level of compensation a beneficiary would receive for €100,000 life assurance policy (€)
Latvia	3,000
Malta	75,000
Poland	50,000
France	90,000 in the case of invalidity or death (€70,00 otherwise)
UK	90,300

Source: Oxera, based on information in section 2.7 and Appendix 1 of this report.

As with the compensation rules, examples of differential protection levels can be provided with respect to virtually all other aspects of the operation of existing IGS. Thus, consumers resident in different Member States can expect different levels of protection.

Where an insurer operates on a cross-border basis (eg, via a network of branches), this also implies that consumers buying policies from the same insurer but residing in different Member States may receive different levels of protection in the event that the insurer fails—unless the insurer is headquartered in a country with an IGS structured around the home state principle.

For example, in the event of failure of a UK life assurer issuing policies in the UK and via branches⁶⁸ in each of the countries listed in Table 6.1:

- UK policyholders could qualify for compensation of up to €90,300 from the UK FSCS;
- French policyholders would receive no compensation—neither from the French scheme which is based around the home state principle nor from the UK FSCS;
- policyholders in Latvia, Malta and Poland would be covered by their national IGS (organised on a host state basis), due to the required participation of the UK branch in those schemes. They could receive up to €3,000, €75,000 and €50,000, respectively, in compensation.

If the failure had involved a French life assurer, the FGAP would have offered compensation up to €90,000 (or €70,000, depending on the policy) to residents in all EU Member States. Interestingly, UK policyholders as well as Polish policyholders would, in principle, also qualify for compensation from their national schemes, given that the branches of the French insurer would be participating in the host state IGS in those countries—ie, there could be duplication of IGS coverage.⁶⁹

6.1.2 Consumer protection issues within Member States

The above has focused on differences in consumer protection across EU Member States, in general as well as in specific cases where the failure of the same insurer can have different consequences for consumers residing in different countries.

Consumer protection issues can also be examined from the perspective of a single country—ie, consumers in any given country may experience different levels of protection depending on which policies they buy. This possibility raises particular concerns from a consumer protection perspective if individual consumers do not have the information or knowledge required to understand the consequences of different protection levels and make their choices accordingly.

Consider a consumer who has the choice of purchasing an identical policy either from a domestic company (authorised by the national supervisory authority—ie, including subsidiaries of EU insurers or non-EU insurance undertakings) or from an incoming EU insurer operating under freedom of services or through an established branch.

If the country of residence does not have an IGS, the consumer would not be worse off were they to buy the policy from the incoming EU insurer rather than the domestic company—in fact, they may be better off (ie, if the incoming insurer is participating in an IGS that offers protection on a home-state basis).

If the country of residence has an IGS and the rules are such that all insurers are required to participate in the scheme, including incoming EU insurers (ie, the host state principle applies), the consumer may be indifferent to the choice of buying the policy from a domestic insurer or non-domestic one, since the IGS established in their country will afford equivalent protection.

The issue is potentially more serious for consumers who reside in a country that operates an IGS that is structured around the home state principle. In this case, purchasing the policy from an incoming insurer may leave the consumer worse off. More specifically, the consumer would be:

⁶⁸ Policies sold cross-border under freedom of services provisions are covered.

⁶⁹ This does not apply to Latvia and Malta, where branches of EU insurers are not required to participate in the local scheme if their home state scheme provides cover for the policies sold in the host state.

- **unprotected** if the policy is acquired from a branch of an EU firm headquartered in a country that either has no IGS or where the scheme is structured around the host state principle;
- **protected** if the policy is acquired from a domestic insurer, or from an incoming EU insurer headquartered in a Member State with an IGS that also operates on a home state basis.

In addition, even if the business of the incoming insurer is in principle protected by the home state IGS, due to differences in the scope and level of coverage between IGS in different countries, the level of protection of the consumer may vary depending on whether they opt for the policy of the domestic insurer or the incoming firm.

Figure 6.3 provides a stylised illustration using as an example a consumer who acquires a life assurance contract from either a German life insurer, or from incoming EU firms with branches in Germany. The figure shows the cases in which the consumer would be covered (or uncovered) by an IGS. Although there are no branches operating in Germany from a large number of the countries included in the example, they have been included for illustrative purposes.

Figure 6.3 Illustration: cases in which a German life assurance policyholder would or would not be protected by an IGS

Protected if consumer buys policy from:	Not protected if consumer buys policy from:
<ul style="list-style-type: none"> - a German life insurer (German scheme steps in and seeks continuation of contracts) - a branch of a UK life insurer provided that contract is considered to be issued in the UK (protected by FSCS) - a branch of a: <ul style="list-style-type: none"> - French firm (FGAP pays compensation up to €90,000) - Latvian firm (Latvian Fund pays up to €3,000) - Spanish firm (CCS provides payment but level varies on a case-by-case basis) 	<ul style="list-style-type: none"> - a branch of an Italian life insurer or of any insurer headquartered in the other 18 Member States where an IGS for life assurance has not been set up - a branch of a UK life insurer unless the policy is considered to be issued in the UK - a branch of a Maltese life insurer (scheme exists, but does not cover risks or commitments situated outside Malta) - a branch of a Polish or Romanian life insurer (schemes exist, but do not protect policies issued by branches in other Member States)

Source: Oxera, based on information in sections 2.7 and 2.8 and Appendix 1 of this report.

Similar examples can be provided for consumers in other Member States. Overall, it is clear that the conditions for effective cross-border consumer protection, in terms of harmonised levels of IGS protection across and within countries, are not met by the current structure of IGS in the EU Member States.

6.2 Cross-border competition

Differences in the IGS treatment between domestic insurers and incoming EU firms (and the business written by them) can result in an uneven playing field between these two groups of firms, and thereby distort within-country competition. They may also negatively impact on the level of cross-border activity (measured in terms of the degree of market penetration of EU branches or companies operating under freedom of services provisions) or on the form of cross-border market entry (subsidiary, branch or freedom of services).

The source of these potential problems may be related to demand- and/or supply-related factors. These are discussed below in turn.

6.2.1 Demand-side factors

As discussed above, due to the lack of harmonisation between IGS in the EU, there can be instances where the policies of different types of firm (ie, domestic versus incoming EU insurers) operating in the same market may or may not be protected by an IGS. Moreover, where protected, the rules of different IGS may apply, resulting in different protection levels.

These differences may affect the demand for policies, and may place firms offering unprotected (or less protected) policies at a competitive disadvantage or, in the extreme, prevent them from operating in the market at all.

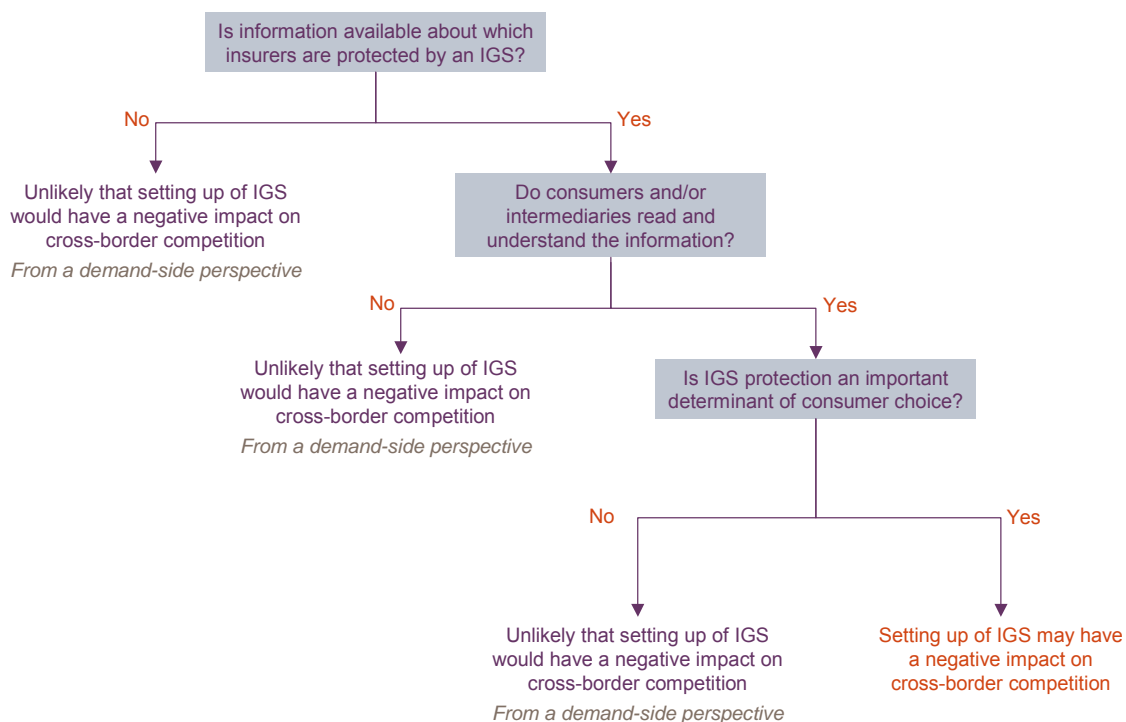
In particular, in countries with an IGS structured around the home state principle, the business of incoming EU insurers is not protected by local IGS. Whether this puts incoming firms at a competitive disadvantage depends in part on whether the policies sold are protected by the IGS in their home state (and to the same degree). Assuming that this is not the case, incoming insurers could be adversely affected from the demand-side if consumers decide not to purchase insurance policies from them due to the fact that the policies are unprotected (or less protected).

The following three conditions would need to hold for this to be the case (see also Figure 6.4):

- there is information available to consumers (and/or intermediaries) on the differences in IGS protection, in particular the fact that policies of incoming insurers are not covered whereas those of domestic firms are;
- consumers (and/or intermediaries) understand the information provided and what it means in terms of protection afforded; and
- IGS protection is an important determinant of consumer choice.

It is of note that the potentially adverse demand effects are not necessarily restricted to incoming EU firms. For example, if the demand effect were strong, in countries without an IGS or only a limited IGS, incoming firms would be at a competitive advantage relative to domestic firms, assuming that the incoming insurers were headquartered in a country with an IGS that covers policies written by branches. This scenario is not further discussed.

Figure 6.4 Conditions required for the lack of harmonised IGS to affect competition through demand-side-related factors



Source: Oxera.

Overall, there is little direct evidence available to support the view that the impact on cross-border competition through demand-side-related factors has been, or is, of general significance—ie, evidence to ascertain each of the conditions set out in Figure 6.4 is missing. In addition, as separately discussed in section 6.3, cross-border operations of the relevant type remain relatively insignificant compared with domestic insurance business.

As regards the first condition, information on IGS participation is in principle available to consumers. For example, in the Member States that have an IGS in place, insurers are generally permitted to disclose information about whether they participate in an IGS. However, it is not clear whether such information is in effect made available to consumers. In some countries, companies are both allowed and required to disclose whether they participate in an IGS to policyholders, but again it is unclear whether and how such information is provided—eg, in some Member States, membership in an IGS cannot be advertised.

More importantly, there is no evidence to support the view that consumers understand, or indeed act upon, the information available to them. Indeed, the very fact that consumers are generally not in the position to process information concerning the characteristics of different insurance products and providers is the reason for regulating insurers and establishing an IGS in the first place. Commercial policyholders would be in a better position to understand and act upon the information, but to the extent that most IGS in the EU offer protection to retail consumers only, the adverse demand-side effect would need to be driven by the knowledge and choices of retail consumers.

What determines consumer choice in the insurance market is not well researched, and it is beyond the scope of this study to conduct primary research in this area. The interviews conducted with market participants supported the view that factors such as 'brand', 'price' and a whole range of other factors are more significant than the protection by an IGS.

Depending on the country and type of policy, intermediaries are the main distribution channel for insurance policies to the retail sector. In these Member States, intermediaries can have

an important role in terms of the dissemination of information related to IGS and ensuring that consumers can process and act on the information relevant to make their choice. This may include providing details on whether a potential insurance provider is covered by an IGS, and the extent of coverage compared with other insurance providers in the market. Again, based on the interviews conducted with insurance providers and intermediaries, there is no evidence available to suggest that IGS coverage has played a significant role in the advice and sales process.

It has been suggested that IGS coverage may play a more significant role going forward, in part as a result of the implementation of the 2002 Insurance Mediation Directive (IMD).⁷⁰ Although the IMD does not specify that intermediaries need to inform consumers about coverage by an IGS, the duty to provide responsible advice may make intermediaries feel increasingly obliged to inform and advise consumers on IGS coverage. Again, there was no direct evidence available to ascertain the strength of the effect going forward.

Thus, while it is clear that the current structure of IGS and lack of harmonisation provides conditions for a distortion of cross-border competition via the demand side, based on the evidence available to date, it is difficult to reach the conclusion that competition is indeed being distorted to a sizeable extent.

One example of problems perceived by incoming EU insurers: an exception or evidence of a wider problem?

During the course of the study, one exception to the general description provided above emerged. It relates to the life assurance market in Germany and the concerns expressed by some incoming EU life insurers about competitive disadvantages relative to domestic firms.

The German scheme for life insurers is structured around the home state principle, consistent with the EU supervisory framework. As a result, it does not cover the business of incoming EU insurers operating via branches or freedom of services in Germany—incoming EU insurers are not required to participate in the scheme, and there is no provision in the German insurance law for them to become members on a voluntary basis. The German scheme secures continuation of contracts, taking over a failed insurer's life portfolio and/or ensuring portfolio transfer to another insurer in the market. Compared with a scheme that pays compensation only, this function would make it more difficult, both from a legal and practical perspective, to extend participation to insurers headquartered in other Member States and not subject to the supervisory powers of the German authority (see section 8.2).

A number of EU life insurers—eg, with headquarters in the UK and Ireland—have entered the German market via branches or freedom of services. The relevant companies that were consulted as part of this study expressed the concern that the current IGS arrangements imply a threat to their ability to conduct business on a cross-border basis. The concern comes from the fact that they are not covered by their home state scheme, nor can they obtain voluntary coverage in Germany.

- For UK companies, the UK FSCS does not extend its protection to policyholders who have purchased a policy issued by a branch in Germany⁷¹—policies sold directly under freedom of services provisions are, however, covered by the FSCS. Thus, policies issued by UK branches in Germany are not covered by the UK scheme; neither can they be covered by the German scheme.

⁷⁰ European Commission (2003), 'Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on Insurance Mediation', OJ L9/3, January 15th.

⁷¹ The UK FSCS covers the business of branches if the risk is located in the UK. In addition, the place of issue matters—the FSCS extends cover if the policies of the branch are issued in the UK.

- For companies headquartered in Ireland, there is no IGS to protect life assurance policies at all, so there is no home state coverage for the policies sold by branches or freedom of services providers in Germany.⁷²

While no evidence is available to show how this has affected, or will affect, life assurance purchase decisions of consumers in Germany, there is evidence to support the view that there could be an effect.

- **Information provided by the supervisory authority.** The website of the German supervisory authority (BaFin) contains information about insurance guarantee arrangements applying in Germany. It explains that incoming EU insurers do not fall within the scope of the German guarantee scheme for life insurers, specifically pointing out the situation for policies issued by branches of UK insurers (highlighting also that those may not be covered by FSCS).⁷³
- **Media coverage.** A number of newspaper articles have examined differences between life policies of UK and German insurers, specifically referring to the fact that UK policies sold in Germany are neither protected by the FSCS nor by the German scheme. For example, the *Trade Journal* states that:

British Life Insurance Companies ... are not part of the British Financial Services Compensation Scheme nor in the German Funds Protection Scheme, Protektor ...

This loophole, about which the public knows little, has affected all German customers who have arranged a British insurance policy with a branch of a British insurer or in the free service market since November 2001. The EU Commission intends to harmonise the insurance systems.⁷⁴

In an article summarising a number of features of UK life assurance policies, the *Frankfurter Allgemeine Zeitung* states that:

The British contracts sold in Germany have another shortcoming. Clients are not protected by the German security fund [*Sicherungsfonds*] or by any equivalent fund in Great Britain or Ireland ... In the unlikely event that a British insurer stumbles into financial difficulty, its German policy holders would be directly affected. Their losses would not be mitigated by a security fund, as was the case for policy holders when Mannheimer Leben collapsed.⁷⁵

An article published by the magazine, *Finanztest*, headlines the following:

Watch carefully: Contracts with a British life insurer are for many German policyholders more risky than many think. If the provider goes bust, your capital is not protected.⁷⁶

- **Guidance provided to intermediaries.** The main distribution channel for life policies in Germany is intermediaries. Following the implementation of the IMD, intermediaries have to document their insurance advice in writing and hand this out to customers after giving them the advice. While the law implementing the IMD does not go into detail about what the documentation needs to contain, various guidances have been issued to intermediaries to help them deal with the new rules; these list 'insolvency protection' as

⁷² Ireland (but not Germany) operates a general scheme for non-life insurance, but not for life assurance.

⁷³ http://www.bafin.de/versicherungsaufsicht/va_sicherungen.htm#p11.

⁷⁴ *Trade Journal* (2005), 'Standard Life Fears Setbacks', June 17th.

⁷⁵ *Frankfurter Allgemeine Zeitung* (2005), 'British Life Insurers Close In', June 18th.

⁷⁶ Translated from 'Britisch kann kritisch werden', *Finanztest*, issue 9/2005.

one of the key criteria to be included in the documentation to customers.⁷⁷ However, the importance of this criterion relative to other criteria is not clear, and it is too early to assess the impact that the guidances have on the advice process and ultimate consumer purchases.⁷⁸

While indicative of the potential distortions to cross-border competition, the above illustration does not allow any strong conclusions to be drawn.

- If the incoming EU firms were from a country that operates an IGS on a home state basis, the same concerns would not apply. Rather, given the home-state structure of the German scheme, the problem arises because the incoming firms are based in a country without IGS or with an IGS that does not follow the home state principle.
- Considering EU insurance markets overall, the cross-border business that may be affected by differential approaches to IGS between home and host states remains small, as discussed in section 6.3. Put differently, the above example indicates an adverse impact for specific insurers and their cross-border business in specific markets only, but it cannot imply wider market impacts in the EU overall.
- Other IGS structured around the home state principle (eg, the FGAP in France) do not require participation of incoming EU insurers, but nonetheless allow for the possibility. Thus, if incoming firms perceived that they were at a competitive disadvantage compared with domestic insurers, they would have the option to become members of the local scheme—the fact that they do not is indicative of IGS membership not being regarded a significant driver of demand.
- Given that there has been a failure in the German life market, there may be particular awareness about the benefits of protection from an IGS on the part of the regulator, the media, intermediaries and also consumers. Moreover, the special concerns raised about incoming UK life insurers may be connected to general concerns about differences in the nature of products offered (as is evident in some of the press articles reviewed above) as well as the direct experience of problems encountered with the UK insurer, Equitable Life.
- Evidence was sought from other markets to understand whether incoming EU insurers in these markets are (actually or perceived to be) at a competitive disadvantage compared with domestic firms (or possibly vice versa). No such evidence could be found. Moreover, for the German market, no direct evidence was available to ascertain or quantify the significance of the problem perceived by some incoming insurers, in terms of the impact on consumer purchase decisions.

Overall, it is clear that the conditions for a level playing field within a country are not met by the coexistence of different national approaches to IGS. However, there is no direct evidence of any significant distortions in within-country competition due to demand-side factors.

6.2.2 Supply-side factors

Instead of, or in addition to, the demand-side effect, cross-border competition may be distorted from the supply side. In particular, due to the lack of harmonisation, firms operating in the same market may be exposed to different costs depending on the contributions they need to make to an IGS, and the level of those contributions.

⁷⁷ See, for example, the website of the 'Arbeitskreis Vermittlerrichtlinie' <http://vermittlerprotokoll.de/ergebnis/auswahl/auswahlkriterien.php> or IVM Institut für Versicherungsmakler (2006), 'Auswahlverfahren für den Rat des Maklers—Vorstellung eines Musterprotokolls', presentation to the Arbeitskreis Vermittlerrichtlinie Dokumentation on May 17th 2006.

⁷⁸ The IMD was implemented in German law in December 2006 through the 'Gesetz zur Neuordnung des Versicherungsvermittlerrechts' of December 19th 2006.

For example, domestic insurers headquartered in a country with an IGS that is structured around the home state principle (eg, France) may be placed at a competitive disadvantage to incoming EU insurers headquartered in a country without IGS (eg, Austria). Similarly, they may find it more difficult to enter another market via branches or freedom of services if other players in that market do not need to contribute to financing an IGS (eg, Sweden). The insurer may also be more reluctant to enter a market which has an IGS that is structured around the host state principle (eg, Poland)—in this case, the insurer could be required to contribute both to the home state and host state IGS.

The asymmetry in the treatment of incoming EU insurers and domestic firms could also distort the way in which foreign insurers penetrate a particular market. For example, an insurer headquartered in a country without IGS (eg, Luxembourg) but planning to enter a market with an IGS (eg, France) may find it advantageous to set up a branch or operate under freedom of services rather than through a subsidiary—the form of entry would be neutral only if the local IGS was organised around the host state principle (eg, UK).

On the other hand, an insurer headquartered in a country with an IGS (eg, Germany for life business) but planning to enter a market without an IGS (eg, Austria) could face lower costs if it structured its entry by setting up a subsidiary rather than through freedom of services or branches.

The lack of harmonisation in IGS participation rules when it comes to cross-border business, combined with differences in the way the existing IGS are funded, provides the conditions for the supply-side effect to be significant.

However, as further discussed in section 5.1, the costs imposed by different IGS in the EU have to date been comparatively small, largely due to the absence of significant failures. Going forward, costs may of course increase if an IGS in a particular country is required to raise funds to cover the cost of larger failures. In this case, the differential treatment of firms operating in that market could increase concerns about lack of a level playing field in the market (unless the IGS is structured around the host state principle); it could also raise costs to a level that makes entry into a particular market less attractive or influence the form of entry (subsidiary, branch or freedom of services). To date, however, there is no evidence of significant distortions through the supply side.

6.3 Cross-border activity in the EU

The significance of concerns about both cross-border consumer protection and competition depends to a large extent on the volume of cross-border provision of insurance in the EU. Cross-border provision can take three main forms:

- establishing a branch in another EU Member State;
- cross-selling through freedom of services provisions; or
- operating through locally established subsidiaries.

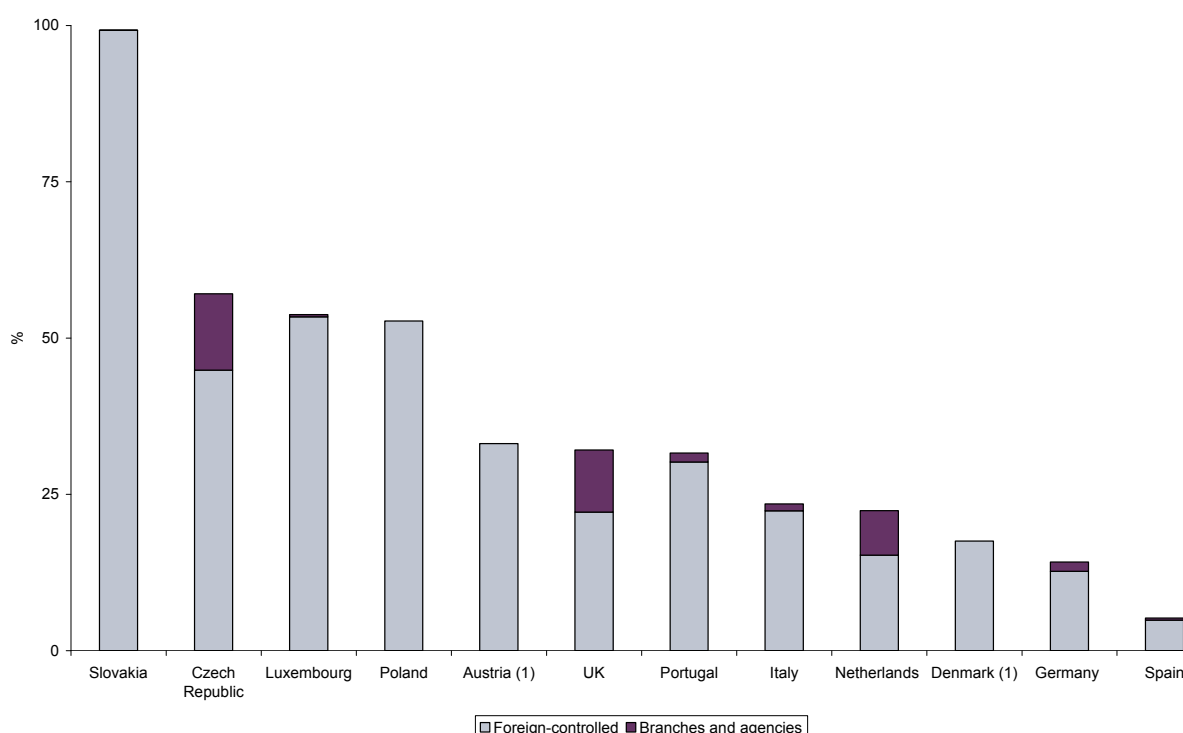
Subsidiaries established by EU insurance groups fall under the same supervisory framework as domestic insurers and, where an IGS is established, the participation requirement applies to subsidiaries as it does for any domestic firm. Concerns about the lack of harmonisation and potential negative consequences for consumer protection and competition therefore largely arise with respect to cross-border insurance provision via branches and freedom of services.

Although cross-border activity has increased over time, it is still relatively limited in the main insurance markets—particularly when it comes to the provision of life assurance and non-life insurance in the retail market. Moreover, cross-border activity mainly takes the form of business through subsidiaries.

Figures 6.5 and 6.6 show the relative shares of foreign providers (distinguishing between branches and subsidiaries, where the latter can include non-EU insurance groups) in the life and non-life markets in a sample of EU Member States. The premiums earned by foreign providers operating under freedom of services are not included. In addition, the data captures the entire market rather than the retail market, which is more relevant in the context of the IGS debate.

With these data limitations in mind, the figures show that foreign providers have a small share of the market or, in those Member States where there is a relatively high degree of penetration by foreign insurers, this mainly comes in the form of subsidiaries—eg, foreign insurers have often entered the market through acquisitions of existing domestic insurers.

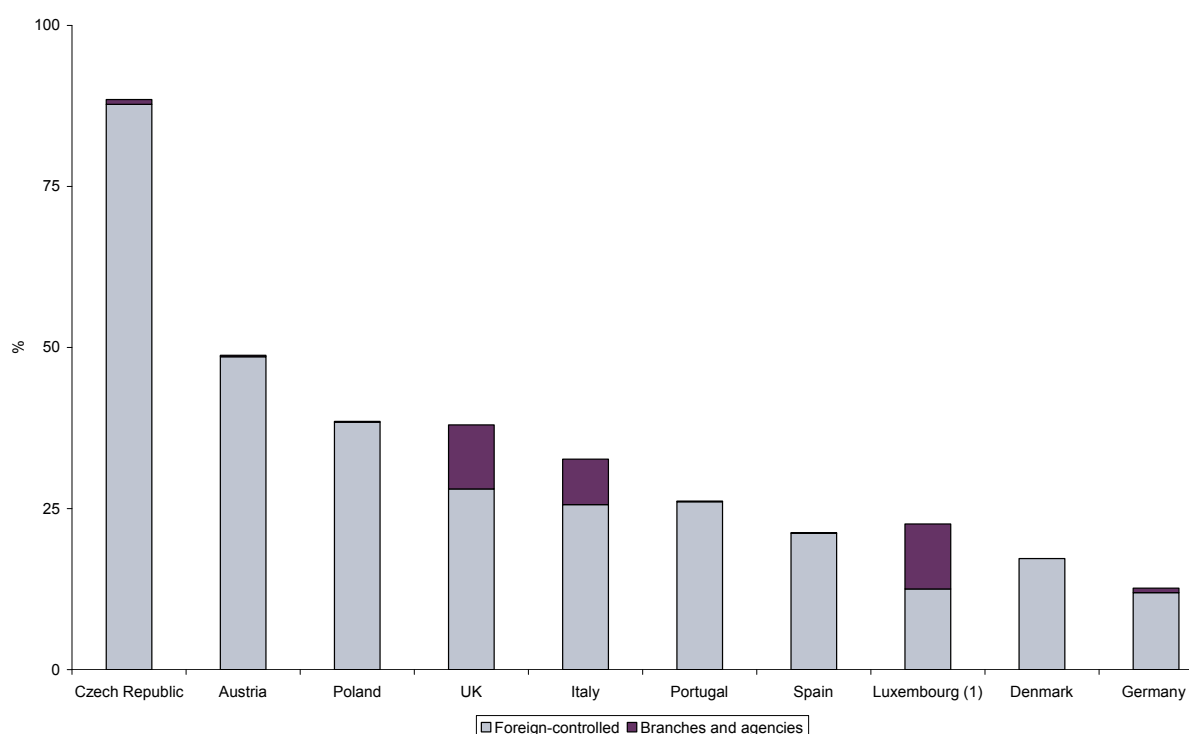
Figure 6.5 Market shares of branches and agencies, and foreign-controlled firms in life assurance business in a sample of Member States, 2003 (% of gross premiums)



Note: ¹ Corresponds to 2001 data.

Source: OECD (2005), 'Insurance Statistics Yearbook'.

Figure 6.6 Market shares of branches and agencies, and foreign-controlled firms in non-life insurance business in a sample of Member States, 2003 (% of gross premiums)

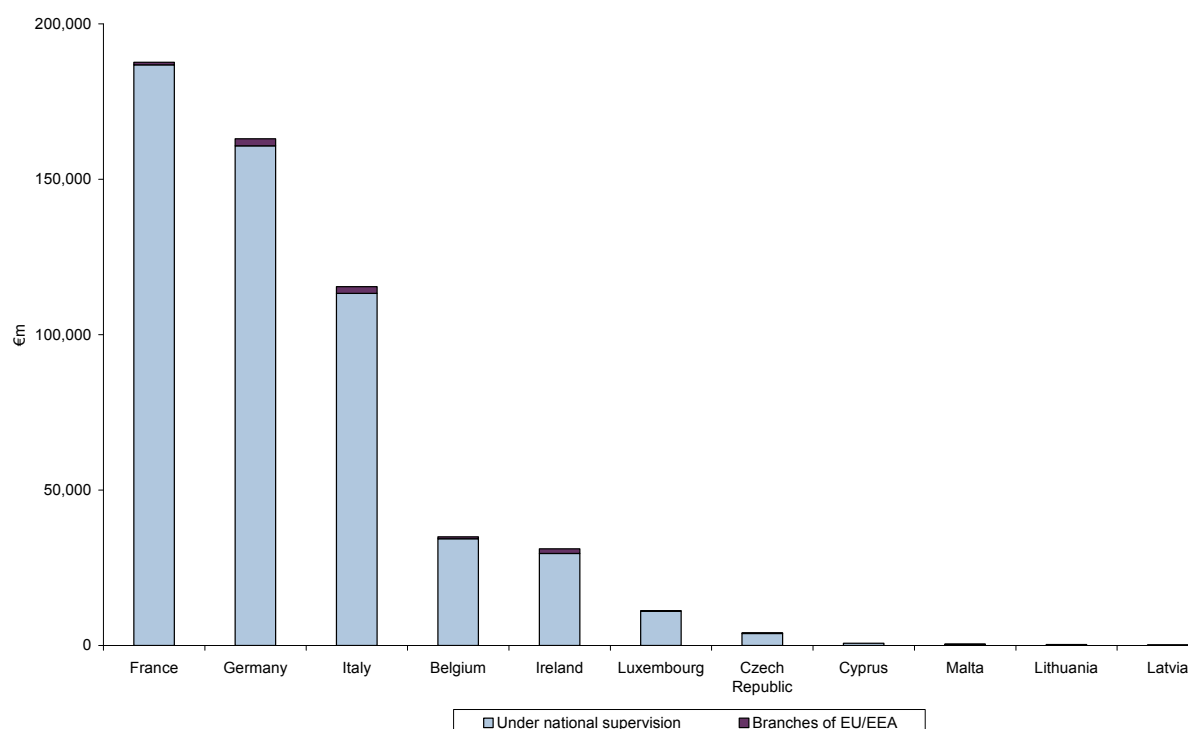


Note: ¹ Corresponds to 2001 data.

Source: OECD (2005), 'Insurance Statistics Yearbook'.

Using data from CEIOPS, further evidence of the relatively limited role of branches in European insurance markets is presented in Figure 6.7, which shows the total premiums for life, non-life and composite insurers for a sample of Member States. The figure disaggregates between the premiums earned by firms under national supervision (including domestic companies and branches of third countries) and incoming EU/EEA branches. Premiums earned in the countries by freedom of services providers are not included, and again the data refers to both retail and commercial policies. In 2005, the premiums of branches for the sample of countries represented on average around 2% of total premiums in the market. The only Member States where branches have a market share above 5% are, in the sample considered, relatively small, including Malta (6.4%) and the Czech Republic (5.3%).

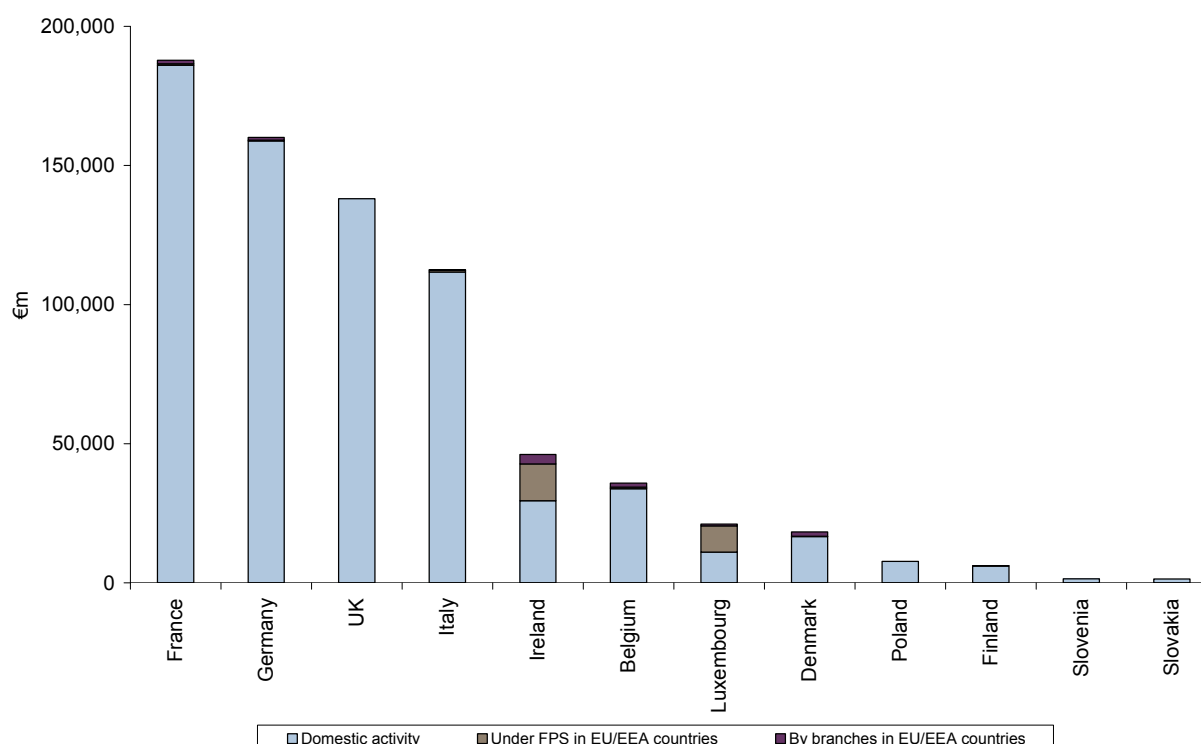
Figure 6.7 Premiums earned by companies under national supervision and branches of EU/EEA insurers in a sample of Member States, 2005 (€m)



Source: CEIOPS (2005), 'Reports on Financial Conditions and Stability: Statistical Annex'.

As for cross-border activity via freedom of services, the only data available is on an outgoing basis—ie, premiums earned by domestic insurers through direct sales in other countries as opposed to premiums earned by incoming firms in the country. Figure 6.8 presents the source of the premiums earned by domestic firms, distinguishing between domestic business, business written through branches and business via freedom of services in other EU Member States. In 2005, averaged over the sample of Member States considered, business via freedom of services generated premiums that represented only around 3.4% of total premiums earned (including commercial policies).

Figure 6.8 Premiums earned domestically, through branches and via freedom of services by domestic insurers in a sample of Member States, 2005 (€m)



Source: CEIOPS (2005), 'Reports on Financial Conditions and Stability, Statistical Annex'.

One potential explanation for the relatively low cross-border activity via branches and freedom of services could be barriers related to the lack of harmonised IGS. However, this is not plausible based on the evidence available. As explained in section 6.2, neither the costs associated with IGS, nor negative demand-side effects, have been significant.

While differences in the legal or regulatory framework can affect cross-border operations,⁷⁹ this does not specifically refer to rules concerning the IGS. Moreover, evidence is available to suggest that, in relative terms, factors relating to laws and regulations do not impose a clear obstacle to entry into different markets. For example, evidence presented as part of the EC sector inquiry into business insurance suggests that of the 13 factors examined as influencing market entry by insurers, 'regulatory costs and barriers' ranked as the fourth least important factor.⁸⁰ Factors such as the potential growth, size and profitability of the market, as well as access to an effective distribution infrastructure, were considered more important. From the perspective of consumers, 'natural' barriers appear to be a key deterrent of cross-border activity. This includes, for example, the 'domestic bias' of consumers in the choice of insurance providers—ie, they prefer to rely on local providers and distribution networks they are familiar with.⁸¹

Overall, the volume of insurance business conducted on a cross-border basis via branches and freedom of services remains small in comparison with the total market. As a consequence, while the lack of harmonised IGS arrangements has the potential to raise

⁷⁹ Beckmann R., Eppendorfer C. and Neimke, M. (2002), 'Financial Integration within the European Union: Towards a Single Market for Insurance', mimeo, p. 20.

⁸⁰ European Commission (2007), 'Report on the Business Insurance Sector Inquiry. Inquiry into the European Business Insurance Sector Pursuant to Article 17 of Regulation 1/2003: Interim report', Figure V.2, January, p. 54.

⁸¹ For a more detailed discussion on barriers to cross-border activity in insurance markets, see Beckmann, Eppendorfer and Neimke (2002), op. cit, pp. 17–22. See also European Commission (2007), 'Report on the Business Insurance Sector Inquiry: Inquiry into the European Business Insurance Sector Pursuant to Article 17 of Regulation 1/2003—Interim Report', and CEA (2004), 'The European Retail Insurance Markets', CEA Policy Report.

significant concerns from a consumer protection point of view, these concerns remain limited in the wider market context. Potential concerns about cross-border competition should also be evaluated in this context.

This is not to say that the concerns are not important. At least from a cross-border protection point of view, the fact that some consumers are exposed to the risk of losses due to the lack of harmonisation may give sufficient cause for concern, also on a forward-looking basis if the level of relevant cross-border business increases.

6.4 Summary

The lack of harmonised IGS arrangements in the EU provides the conditions for ineffective consumer protection when it comes to cross-border insurance operations. The functioning of the EU internal market may also be impeded through the potential distortions of cross-border competition.

Lack of IGS coverage and differences in the level and scope of coverage result in an uneven degree of consumer protection across EU 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. Failures of insurers with significant cross-border operations have, to date, been rare, so the evidence on their impact for consumers is limited.

In addition to the differential level of protection for consumers across countries, the current IGS arrangements imply that (except for countries operating an IGS on a host state basis) consumers in any 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 branches.

Asymmetries in the treatment of domestic and EU incoming insurers when it comes to the operation of the IGS in some markets 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 that places firms required to contribute to an IGS at a competitive disadvantage compared with those that do not. There is no direct evidence available to date to suggest that the impact on cross-border competition is significant, either from the demand or the supply side.

The potential impacts on cross-border consumer protection and competition must be understood in the wider 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 volume of current cross-border operations. This may change in the future as cross-border activity grows. 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.

7 Options: establishment and design of an IGS

As set out in section 3, the evaluation of options is split into two parts: first, options concerning the introduction of an IGS and scheme design at the general level, and second, options that are of specific relevance at the EU level. This section focuses on the first part, with EU policy options being discussed separately in section 8.

The section starts with a summary of the case for and against establishing an IGS (section 7.1), drawing from the analysis presented in sections 4 and 5. In particular, it shows how the decision to establish an IGS involves a trade-off between often conflicting objectives. While the case for establishing an IGS relates to the benefits of enhanced consumer protection and market confidence and stability, the case against relates to concerns about costs.

There are many ways of designing an IGS, and the choice of scheme design has an important impact on the trade-off between the costs and benefits of establishing and operating an IGS. This section therefore discusses the options for scheme design, focusing on design options relating to:

- the scope of IGS protection (section 7.2);
- the nature of intervention and operating arrangements for IGS (section 7.3); and
- IGS funding (section 7.4).

The evaluation is based on the criteria set out in section 3. These include economic or efficiency criteria (incentives, competition and market confidence and stability), distributional criteria (individual consumer protection and wider notions of fairness and proportionality), and the criterion of administrative feasibility and practicality.

7.1 The case for and against establishing an IGS

IGS provide last-resort protection in the event of an insurance failure. As examined in section 4, 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 very low frequency—Solvency II is not a zero-failure regime.

If failure occurs, policyholders can incur losses. 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 policyholders—the insurance business is technical in nature, insurance undertakings are opaque, and many insurance contracts are sold years before claims are settled. Moreover, losses may be incurred by consumers other than policyholders, such as third-party victims who cannot themselves choose the insurance provider. As a consequence, there are good reasons to introduce an IGS in the interest of consumer protection.

A second argument to set up an IGS is that, after a failure, unprotected consumers may lose confidence in insurance companies altogether, which in turn may lead to underinsurance or a reduction in the overall size of the market. In addition to confidence losses, the failure of a larger insurer can disrupt market operations and have wider market impacts, as discussed with examples in section 4.2.2.

Thus, based on the consumer protection and market confidence and stability criteria, a strong case can be made for establishing an IGS. As discussed below, consumer protection and market confidence/stability also provide the main reason why guarantee schemes have been established in the investment and banking sector in all Member States.

The case for establishing an IGS is further strengthened by the fact that there are many examples where Member States implemented an IGS when insurance failures occurred (see section 4.4)—ie, 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.⁸² First, they create uncertainty and may not allow intervention in a timely and cost-effective manner, which may bring unnecessary stress to policyholders. Second, they may raise fairness concerns 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, and the policy decision to introduce an IGS involves a trade-off between benefits and costs.

As discussed in section 5, IGS impose both direct and indirect costs. Among the direct costs, there are first the costs of implementing and administering an IGS (captured by the practicality/feasibility criterion in the evaluation). While the costs are pure additional costs to be borne by the system, the evidence presented in section 5.1.2 suggests that these are small, certainly compared with the other actual or potential 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 in general it is the policyholders of the failed insurance company who benefit at the expense of solvent companies and their policyholders. Given that the impact is largely distributional, the decision to establish an IGS depends to a large extent 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 presented in section 5.1.1 suggests that the level of direct guarantee costs and hence the degree of redistribution has been relatively small, given the absence of large-scale failures in the market. 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.

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 (moral hazard). As discussed in section 5.2.1, 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

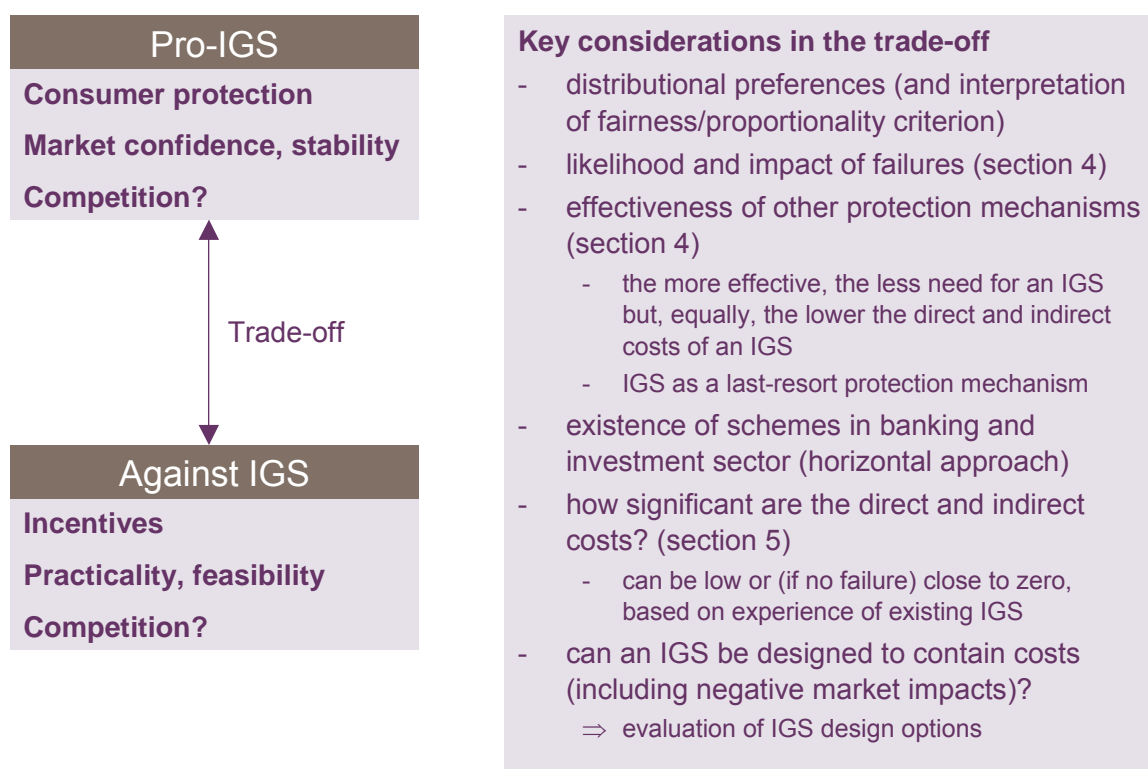
⁸² For a discussion of explicit versus implicit guarantees, see Davis, K. (2004), ‘Study of Financial System Guarantees’, Canberra, Australia.

incentives for moral hazard behaviour on the part of industry because greater risk-taking will be penalised through higher capital requirements. Moreover, moral hazard concerns can be further reduced through scheme design.

Some argue that IGS may reduce competition in the market for insurance—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 have distortionary effects on the market. However, as discussed in section 5.2.2, IGS are in fact 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 may benefit from enhanced consumer confidence.

Figure 7.1 summarises the trade-off involved in the decision to establish an IGS, as well as the key considerations that influence the trade-off.

Figure 7.1 The trade-off in the decision to establish an IGS



Source: Oxera.

The introduction of an IGS depends to a large part 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. In the EU, many countries have already established an IGS or responded by establishing an IGS in the event of failure; moreover, similar schemes are operated in all countries in the banking and investment sector, as briefly discussed below.

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. Sections 7.2 to 7.4 discuss different options for IGS design, including how IGS can be structured to limit costs.

Is the case for establishing an IGS weaker than for guarantee schemes in other financial sectors?

Unlike in the insurance sector, all EU Member States have, in accordance with European Directives, introduced guarantee schemes in other sectors of the financial services industry to provide a safety net if an institution fails and is not able to meet its obligations to its clients.

- **Deposit-taking.** Directive 94/19/EC on DGS obliges Member States to ensure the existence of one or more schemes in their territory, and has been effective in ensuring a minimum level of protection for depositors throughout the EU.
- **Investment services.** Directive 97/9/EC was modelled on the earlier Directive on DGS and requires Member States to implement ICS that guarantee a minimum level of protection in the event of failure of an investment firm being unable to meet its obligations to its investor clients.

The Directives require a minimum protection level for retail consumers of at least 90% of claims, providing compensation for lost deposits or lost investor assets with a limit of no less than €20,000.⁸³

The existence of guarantee schemes in other sectors of the financial services industry does not in itself make the case for introducing guarantee schemes in the insurance sector, and the nature of risks and consequences of failure and consequently the need for, and role of, a guarantee scheme in the insurance sector differ from those in deposit-taking and investment services. Nonetheless, if guarantee schemes are accepted as being important last-resort protection mechanisms in other sectors, it may be more challenging to argue against the introduction of similar arrangements in the insurance sector.

- **Consumer protection.** As in insurance, the risk of failure of a bank is small due to internal risk management practices, a strict prudential supervision framework and other protection mechanisms. Nonetheless, although infrequent, failures have occurred and DGS have intervened to compensate depositors in those cases where the failed bank was not able to return the deposited funds.⁸⁴

Failures among investment firms have been more frequent, but the case experience of existing ICS in the EU suggests that there have been only a few cases where investors needed to be compensated for losses of assets held by the failed investment firm on their behalf; asset segregation requirements for investment firms mean that client assets are generally protected in the event of firm default.

Loss events for consumers are rare due to the existence of alternative protection mechanisms, but cannot be ruled out. While the strength of protection mechanisms (eg, the prudential framework) differs between sectors, this general statement applies to insurance as much as to other sectors. Where an insurance failure occurs, the consequences for individual policyholders can be significant. The value of a life assurance policy can well exceed the deposit balance held with a bank or the monies or securities entrusted with an investment firm. Moreover, while consumers may find it easier to diversify bank accounts and investments, it may be more difficult to efficiently diversify (life and non-life) insurance policies across providers. Although insurers make provisions for their liabilities to policyholders, unlike in the investment sector, there is no

⁸³ For a review of EU ICS, see 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. For recent discussions on EU DGS, see European Commission (2006), 'Communication from the European Commission to the European Parliament and the Council Concerning Directive 94/19/EC on Deposit Guarantee Schemes', November COM/2006/729 final (http://ec.europa.eu/internal_market/bank/docs/guarantee/comm9419_en.pdf).

⁸⁴ The number of bank defaults since implementation of Directive 94/19/EC is summarised in European Commission (2006), 'Scenario Analysis: Estimating the Effect of Changing the Funding Mechanisms of EU Deposit Guarantee Schemes', Joint Research Centre, Unit G09, Ispra (Italy) (http://ec.europa.eu/internal_market/bank/docs/guarantee/final_report_en.pdf).

segregation of client assets. In non-life insurance, losses due to claims outstanding in the event of insurance insolvency may be comparatively small on average, but can be significant for some policyholders at the long-tail end of the claims distribution. In addition, outstanding claims for liability insurance damage third parties rather than the policyholders, raising protection issues that are different from those in other sectors.

- **Market stability and confidence.** In the banking sector, the risk of ‘bank runs’ means that the failure of a firm (or a series of failures) may lead to contagion and affect the stability of the whole market. Such bank runs were one of the reasons for the early introduction of DGS.

Such contagion effects are not, or are less, prevalent in insurance (and in the investment services industry).⁸⁵ Hence, there is less rationale for establishing IGS (and ICS) for reasons relating to systemic risk. However, a major failure of an insurer (and investment firm) may have spillover effects and hence wider market consequences if it results in a reduction of confidence in the market on the part of consumers, although the strength of such impacts is difficult to quantify. There have been select cases of insurance failure that triggered, or would have triggered, significant market disruptions if no intervention had occurred (see section 4.2.2).

- **Competition.** Given the existence of guarantee schemes in deposit-taking and investment, the question arises of whether there is a need to introduce similar arrangements on the insurance side to ensure a level playing field between different financial products. Differential guarantee arrangements may affect competition if insurance products are in the same economic market as, and thus directly compete with, other financial products.

Given the product characteristics, this condition is more likely to be met for life assurance products than non-life products. To the extent that life assurance products are savings and investment vehicles, they have similarities with some banking and investment products, and certain life assurance products (eg, unit-linked insurance) may be seen as direct substitutes for certain investment products (eg, retail investment funds). As regards the latter, retail investment funds and other collective investment schemes are outside the scope of the Investor Compensation Directive, and failures of collective investment scheme operations would generally not be compensated by an ICS.⁸⁶ In this respect, lack of IGS in the life sector cannot be considered problematic, and introducing an IGS may, all other things being equal, create an unlevel playing field between life products and retail investment funds.

Other than retail investment funds, there may be deposit and investment products that are protected by a guarantee scheme and that have similar characteristics to life products, which in many countries are not protected by a guarantee scheme. While this has the potential to distort competition between the products, the distortion may not be particularly strong in practice. On the demand side, consumers are generally not aware of guarantee arrangements, and even if they could assess the implications, other factors are likely to be more important determinants of consumer choice between financial products. On the supply side, the levies paid by firms to fund guarantee schemes in different financial sectors are, or at least have been to date, not significant cost factors. Therefore, arguments in support of introducing IGS for reasons relating to competition between different financial products appear less important than those relating to consumer protection and market confidence.

⁸⁵ While banks rely on potentially volatile, unsecured, short-term deposits for much of their funding, insurers and other financial institutions have a much higher proportion of long-term funding. In addition, insurance companies tend to have the reverse maturity transformation of banks: marketable and, hence, liquid assets and long-term liabilities. The marketability of assets also means that, in contrast to banks, the value of insurers in liquidation may differ less from the value on a going-concern basis.

⁸⁶ For a discussion, see Oxera (2005), op. cit.

Overall, and in particular if consumer protection is a key objective, although the existence of guarantee schemes in these financial sectors is not in itself a reason for requiring the establishment of an IGS, the case for having a guarantee scheme in the other sectors and not in insurance appears to be weak.

7.2 Design options: scope of protection

As discussed above, from a consumer protection and confidence point of view, there are good reasons to establish an IGS, although such schemes incur both direct and indirect costs. Limiting the scope of IGS protection can reduce those costs, and if properly targeted may still deliver the desired benefits. The following discusses how the protection of an IGS can be prioritised in terms of insurance policies, claimants and amounts claimed. Thus, it discusses options in relation to:

- **protected policies**—ie, what classes of insurance are to be covered by the IGS, and which insurance classes can be excluded?
- **eligible claimants**—ie, which claimants are to benefit from the IGS, and which claimants can be excluded?
- **protection amounts and limits**—ie, what level of protection is to be afforded by the IGS, and what is the case for limiting the protection to eligible claimants?

The options are discussed separately, although in practice IGS often combine these options—for example, by setting differential protection limits according to type of policy or claimant.

7.2.1 Protected policies

For consumer protection reasons, a case can in principle be made to cover/protect policyholders in relation to all policies, given that losses may arise to all in the case of failure of the insurance provider. However, there are different classes of insurance, and there are grounds for giving particular attention to the protection of policies for some insurance classes.

Concerning **life assurance**, it is generally argued that policyholders cannot predict failure because these policies involve long-term commitments with insurers. At the time when the choice is made, it is usually difficult, or even impossible, to know whether the company will remain financially sound until the expected maturity of the contract. Policyholders could in principle switch provider when they discover that their insurer faces financial problems, but this may be cumbersome (or costly), and policyholders may delay switching until they obtain further information, which may come too late.

Moreover, as discussed in section 4.2.1, the failure of a life insurer may result in severe financial hardship for some policyholders, especially if the life policy was purchased to provide for retirement. Even if policyholders can recover part of their savings, in the case of protection products, they may be unable to purchase similar coverage, because their personal situation (eg, in terms of age and health) has changed.

Thus, consumer protection reasons and related market confidence objectives make the case for setting up an IGS to cover life assurance, if only to provide last-resort protection in the rare event of a failure in the life market. Such protection is already provided for in many savings and investment products in the EU banking and investment sectors through DGS and ICS.

A number of Member States have therefore already established a scheme dedicated to life assurance. In some cases, these schemes have been set up as a response to the failure of a life insurer in the domestic market (eg, in France and Germany).

Concerning **non-life insurance**, as discussed in section 4.2.1, the consequences of a failure are different because of the short-term nature of the contracts. The majority of policyholders would suffer losses mainly in relation to prepaid premiums; in most cases, they can easily purchase replacement cover from another firm in the market. Only those policyholders with outstanding claims at the time of insolvency are likely to incur more significant losses. Nevertheless, non-life insurers' failures have historically been more frequent, and there can be cases where claims against an insurer are very large even if the average amount claimed on policies is relatively small.

Hence, although the likelihood and consequences of failure may differ, the consumer protection argument applies to non-life policies as much as it does for life policies, and it is for this main reason that a number of Member States have already established a scheme to protect non-life insurance policies, some of which are in response to a failure occurring in the market (eg, Denmark, France and the UK).

The non-life insurance market is more heterogeneous in terms of types of risk covered and classes of insurance available. Three types of policy may deserve some priority in terms of IGS protection.

- **Liability insurance.** Certain classes of insurance, such as motor vehicle and general liability insurance, cover the risk of injury of third parties, and it is these third parties that may incur losses in the event of insurance failure if their claim for compensation is not met. Injured third parties did not choose the insurance company themselves, and hence cannot be held responsible for not having chosen a financially sound insurer (see also claimant eligibility in section 7.2.2).
- **Compulsory insurance.** Some non-life insurance policies are compulsory, and the policymaker may feel obliged to cover those policies that are considered particularly important by law. In addition, compulsory policies are often a pre-condition to undertake an activity (professional or not). As a consequence, any disruption in insurance cover may lead to high social cost, because the activity will need to cease unless alternative cover becomes available. What is compulsory differs significantly across countries. Compulsory policies may include accident and sickness, general liability, hunting liability, employers' liability, and motor vehicle liability, and in some countries, more than 100 different policies are compulsory by law. Some of the EU IGS are set up to exclusively cover compulsory classes of insurance, such as the schemes for workers' accidents in Belgium and Finland, the hunting liability scheme in Italy, or the French FGAO, which covers only compulsory non-life insurance classes (of which there are many in France).
- **Retail policies.** As discussed further in section 7.2.2, there are reasons to target IGS protection to retail consumers only. This is because 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 behaviour. If the decision is to protect natural persons only, a case can be made for excluding certain policies from the scope of IGS protection given that they cover commercial risks only. This applies in the non-life market—for example, to motor, aviation and transit (MAT) or credit and suretyship insurance. For the same reasons, reinsurance policies are typically outside the scope of IGS protection. Thus, a case can be made for focusing the scope of IGS protection on policies commonly sold in the retail market, including accident and sickness, motor vehicle, general TPL, property and travel insurance. While average claims on these policies may be relatively small, some claims can be very high and, if outstanding at the time of insolvency, may result in financial hardship, often combined with difficult personal circumstances (eg, illness).

Thus, while losses can in principle apply with respect to all policies, there are arguments for focusing IGS protection on specific policies only—particularly if there are concerns that an unlimited IGS would impose too high a cost (or trigger too great a redistribution) on the system.

However, for practicability and fairness reasons, it may be problematic to subdivide the IGS coverage rules applying to different types of policy too narrowly, and thereby to create too many regimes for different types of insurance. First, policies do not always belong to a discrete number of categories, and there can be a continuum of policies designed to meet the insurance needs of customers. In addition, it may be difficult to separate policies and underlying risks into groups that are treated differently for IGS protection purposes. Second, it is sometimes the case that a single policy covers different risks—eg, if customers want to cover different risks related to the same object by a single policy. Examples include motor vehicle insurance policies that may cover both liability and damages to the vehicle or property insurance policies that include protection for both the building and content. Customers may not understand, or they may find it unfair, that risks covered by the same contract are not protected in the same way by the IGS. Finally, even if they hold different contracts, many policyholders purchase them from the same insurance provider. Again, in the event of failure, consumers may consider it unfair that only a subset of their policies is covered.

The main impact of an IGS is to redistribute funds from (customers of) solvent companies to (customers of) failed companies. To the extent that the impact is largely distributional, the preferred approach depends on, or should be assessed in light of, society's broad views about equity and fairness. For example, favouring injured third parties, or giving lower priority to large businesses, may be considered preferable. However, distributional preferences and notions of fairness vary. Hence, decisions concerning which policies to prioritise in terms of IGS protection are largely a matter for policy.

7.2.2 Claimant eligibility

An IGS can in principle be designed to cover all policyholders, regardless of their nature (natural person or not, wealthy or not, etc), given that all policyholders may suffer loss in the event of insurance failure. In addition, beyond policyholders, there may be reasons to protect persons who are ultimately harmed in case of insurance failure, including beneficiaries in the case of life policies and injured third parties in the case of liability insurances.

However, protecting all potential claimants is costly, and the cost is ultimately borne by other insurers and their customers. One way to reduce this burden is for the legislator to require policyholders, or other claimants, to satisfy certain criteria in order to qualify for IGS protection.

In particular, among the EU IGS, some exclude larger corporate policyholders in relation to non-life policies. The main rationale for excluding these policyholders is that they are better equipped to assess the financial soundness of insurers. They also benefit from access to a network of insurance brokers with the capacity to scan the market and match buyers with insurers that have the skills, capacity and financial strength to underwrite the risk. Moreover, they can diversify their risks by purchasing policies with various insurance companies or seek other forms of protection. As a consequence, concerns about consumer protection are less obvious for larger corporate policyholders. The exception may be policies where the person ultimately protected is a natural person (eg, employers' liability insurance).

On similar grounds, other classes of policyholder that are considered to be ineligible by some EU IGS are persons connected to the failed insurance company, including managers or auditors, as well as insurance companies or other financial institutions.

Moreover, to the extent that they are better informed about IGS arrangements, large corporate buyers, other insurers and managers of the failed company are likely to be more

susceptible to moral hazard problems. These policyholders may be more prone to opt for a cheaper but more risky insurance solution knowing that they will be protected. Excluding these policyholders therefore has merits on the grounds of concerns about adverse incentives.

From a practicality point of view, imposing eligibility restrictions may raise some issues. First, whenever eligibility criteria are added, the scheme needs to check whether claimants satisfy the criteria when processing a claim. This may increase the administrative burden for the IGS (or other body responsible for establishing claimant eligibility).

Moreover, the eligibility criteria applied would need to be legally certain and transparent. For example, if it is decided that larger corporate buyers are to be excluded from IGS protection, but smaller ones covered (on the grounds that the latter may require protection similar to that of natural persons), the definition of what constitutes a large corporate buyer and what does not becomes an issue. There is a continuum of corporate buyers, and the threshold for defining 'large' is not obvious. Excluding all legal persons may be the more practical solution, but could raise concerns about an inadequate protection of those legal persons that fit the characteristics of other retail customers. There are classifications of what constitute 'non-large' corporate buyers (eg, Recommendation 2003/361/EC defines 'medium', 'small' and 'micro' corporate buyers), which reduces difficulties in this regard.⁸⁷ The application of such classifications to determine claimant eligibility is nonetheless likely to be more burdensome than not having to apply any screening of claimants at all.

Although none of the IGS established in the EU has implemented such a policy, a scheme could be considered that distinguishes between natural persons on the basis of their wealth and likely financial hardship they would incur if their claims were not covered by the IGS. The main rationale behind this policy would rely on distributional preferences and a notion of fairness/proportionality in that the IGS should be dedicated to protect the most vulnerable consumers. However, for practical reasons, such a scheme would be difficult to implement, since decisions would be required on how to define thresholds for wealth and financial hardship and to categorise claimants accordingly.

Overall, one way to limit the scope of IGS protection would be to impose eligibility restrictions. A case can be made for targeting IGS protection at retail claimants (policyholders, beneficiaries and injured third parties).

Eligibility restrictions for financial institutions, larger corporate customers and persons connected with the failed institution are also provided for in the EU Directives on DGS and ICS.⁸⁸ Such restrictions are also observed, to varying degrees, among the IGS established in the EU. While less important in the life market, where the policyholder or beneficiary is a natural person, restrictions on eligibility for non-retail clients in the non-life market are likely to have a more significant cost reduction effect for the IGS.

7.2.3 Protection amounts and limits

IGS can provide protection in different forms—ie, by paying compensation on insolvency of an insurer or by securing continuity of policies via portfolio transfer just prior to formal insolvency. For both types of intervention, it is possible to design the IGS such that the level of protection is reduced, with corresponding cost reduction effects for the IGS and those

⁸⁷ As an alternative classification, the Directives on DGS and ICS allow the exclusion of companies that are of such a size that they are not permitted to draw up abridged balance sheets.

⁸⁸ The Directives allow the following to be excluded from coverage: professional and institutional customers including, among others, investment firms, credit institutions, insurance undertakings, collective investment undertakings and pension and retirement funds; supranational institutions, government and other authorities; directors, managers, persons holding 5% or more of the capital of the failed institution, etc and their close relatives; other firms in the same group; claimants who have any responsibility for or have taken advantage of certain facts which gave rise to the firm's financial difficulties or contributed to the deterioration of its financial situation; and large companies (defined with respect to whether they are permitted to draw up abridged balance sheets).

required to fund it. For IGS that pay compensation, the cost reduction can be achieved by limiting the amount of compensation that is paid. For IGS that secure continuity of contracts, costs can be reduced by allowing a change in the contractual terms when transferring the portfolio.

The option to secure continuity of insurance cover as opposed to paying compensation is analysed in more detail in section 7.3.1. The following discussion focuses on compensation payments and the case for and against limiting such payments, but it can be extended to limiting payments under portfolio transfer or other arrangements to secure continuity of cover.

Other than through restricting certain policies or policyholders from claiming compensation, IGS payments can be limited in different ways:

- restricting coverage to certain types of claim against the insurer or to certain types of loss incurred (eg, cover outstanding claims but not prepaid premiums);
- capping the maximum amount of compensation that can be claimed or paid;
- compensating less than 100% of the claimed amount; or
- imposing a deductible on payments or setting a minimum floor for a claim to be eligible.

While limiting the extent of protection afforded by the IGS, the advantage is cost reduction, which can take two main forms:

- **direct cost reduction**—the IGS pays less compensation than it otherwise would on certain (or all) claims;
- **indirect cost reduction**—the less than full compensation may reduce moral hazard behaviours and other perverse incentives on the part of policyholders, thereby reducing the probability of failure.

The options for limiting the level of protection can differ in the extent of the direct cost reduction effect, depending on the type or size of claims incurred. As regards indirect costs (moral hazard), all options can in principle have a positive effect, provided that policyholders do not expect to be fully compensated.

The different options also have different distributional features (eg, some provide better compensation for small losses and others for large losses) and may differ in the level of administrative burden. These aspects are further discussed below.

Note that the analysis is largely qualitative, even when it comes to measuring the direct cost reduction effect. As with all design options relating to the scope of protection, no data was available to simulate what costs could have been saved (or what reductions in compensation would have been incurred by claimants) had the existing IGS implemented different compensation rules.

Claims or losses covered

IGS can apply different approaches in terms of the types of claim or loss covered and the way they calculate the amount to be compensated.

In non-life insurance, policyholders can incur losses from prepaid premiums and from outstanding claims. While from a consumer protection point of view one would wish to compensate all types of loss, a case can be made for not compensating premiums. Indeed, many of the existing EU IGS do not extend coverage to prepaid premiums. Other than for the general cost reduction reasons described above, the amount of prepaid premiums are typically small and a loss would be unlikely to present financial hardship on individual policyholders. At the same time, compensating these claims could be more onerous for the IGS operator, with corresponding increases in administration costs. In addition, the administration costs for small prepaid premiums are likely to be high compared with the

benefit to the claimant (ie, the compensation received). Thus, for reasons of practicality and proportionality, a case could be made for focusing compensation on the (comparatively few) policyholders that may have outstanding claims at the time of insolvency (or claims that occur for a limited period after insolvency). However, this may not be regarded as fair by all, because different claimants may not consider the same amount as equally 'small'.

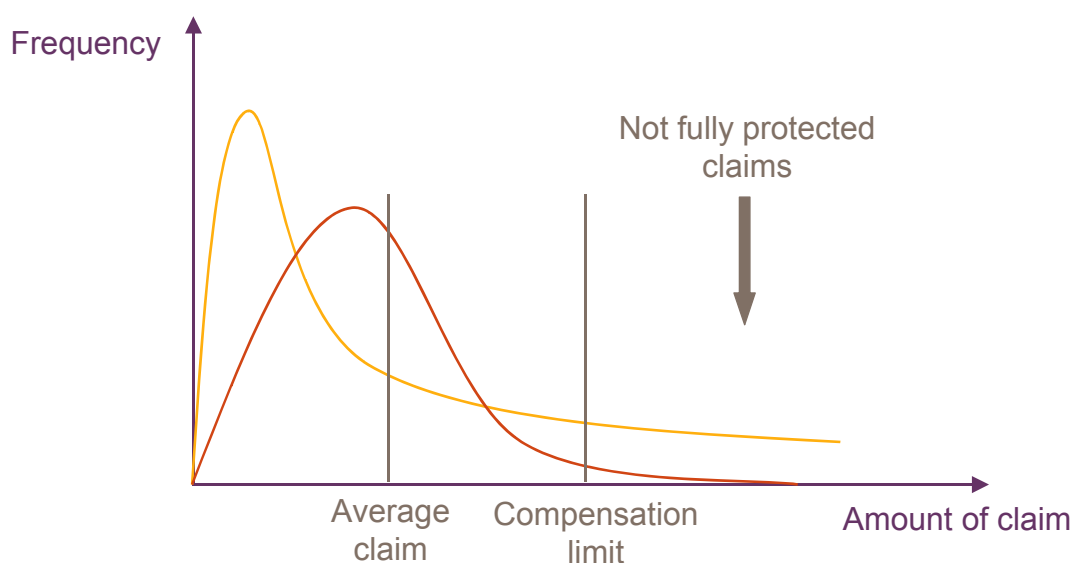
In life assurance, IGS coverage could extend beyond the main contractual commitments (including main guaranteed returns and possibly attributed bonuses) to also include some features of the contract, such as future profit sharing or other benefits, depending on the life assurance policies written. Indeed, compensation could also be provided for any pure investment losses that may be incurred by policyholders. Such extended coverage may again be rejected on the grounds of practicality (eg, difficulties in calculating certain benefits) and proportionality, even if in some cases the relevant benefits may constitute an important part of the value of the contract over and above the contractual commitments. In addition, making the policy purchase decision 'risk-free' for policyholders, or offering overly generous compensation for losses, is likely to exacerbate incentive problems (moral hazard). Although detailed information was not available for all EU IGS, it appears that the majority of life assurance schemes limit the scope of protection to contractual commitments.

Caps or maximum compensation

Introducing a cap on the amount compensated can be appealing from a cost reduction perspective, because some individual claims may be very large. Another argument to opt for a cap on claims is that there are fixed costs in information acquisition such that acquiring information makes more sense when purchasing costly or more valuable policies; hence, one may expect the relevant policies to be held by more informed policyholders. From a consumer protection perspective, it may therefore be considered less important for an IGS to cover the entire loss associated with these policies. The same applies if large claims are most likely to be made by policyholders less susceptible to financial hardship in the event of not receiving full compensation.

The likely impact of a compensation cap on cost reduction (and the level of protection) depends on the distribution of losses or claims against the IGS and the level at which the cap is set. A simple illustration is provided in Figure 7.2.

Figure 7.2 Caps on amounts compensated



Source: Oxera.

In the illustration, while the average claim would be fully compensated, some claims are significantly higher and would therefore be only partially compensated. The more skewed

distribution (the yellow line) reflects an insurance policy that triggers a relatively large number of below-average claims; however, very large claims are also likely to materialise. In this case, a sizeable part of the claims would not be fully protected, potentially for large amounts. While the cost reduction effect would be more significant than in the other, less skewed, claims distribution, the lack of protection may be considered unacceptable, depending on the nature of the losses and their impact on the relevant policyholders.

Given the differences in claims distributions across insurance classes and the impact of uncompensated claims for some policyholders, a one-size-fits-all approach may be considered unfair. A single compensation limit that can be considered appropriate for the majority of claimants in relation to some policies may be considered far from sufficient to protect policyholders (or third parties) seeking compensation on policies that can trigger very high claims and result in significant personal and financial hardship—for example, accident and sickness, motor vehicle, general liability or other classes of insurance that have a markedly skewed claims distribution.

As a consequence, the difficulty lies in deciding where to set the cap, and whether to set the same limit for all classes of insurance. The intention to limit the cost for the scheme may result in limits that are too low to adequately protect those claimants with very high losses. On the other hand, a limit that is set too high has no impact on (direct and indirect) cost reduction. Thus, a balance needs to be struck, which largely depends on distributional preferences.

The compensation limits contained in the EU Directives on DGS and ICS provide for a cover of €20,000 per depositor or investor, respectively. A limit set at this level for IGS may not be considered adequate for consumer protection reasons, at least in relation to some classes of non-life insurance where claims arising out of the insurance contract can be far greater in magnitude. In addition, unlike for bank accounts and investments, consumers are less able to diversify their exposure across providers. Many EU Member States with an IGS have therefore opted to not impose a limit on compensation for insurance claims (even if they adhere to the €20,000 limit for deposit and investment claims).

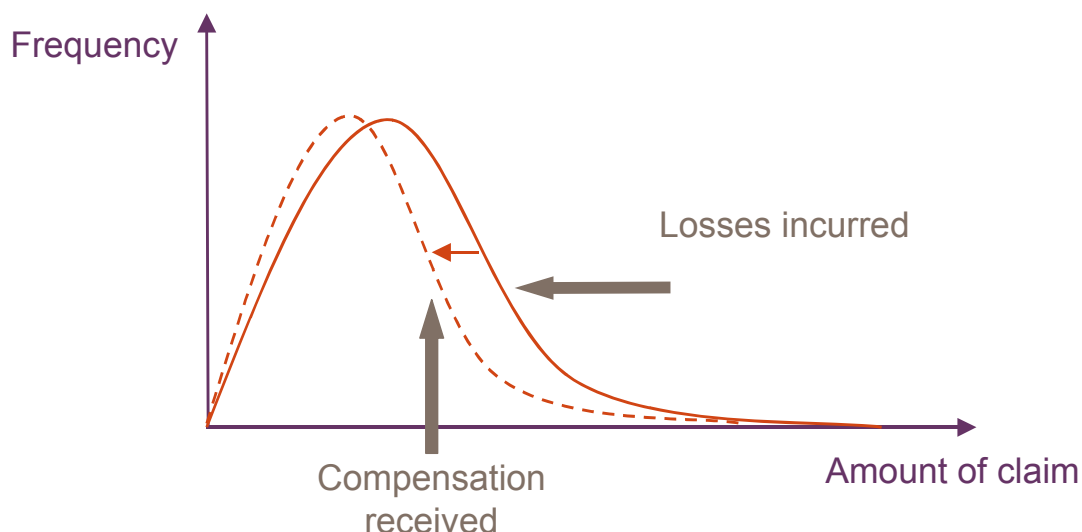
Where limits are imposed, these vary significantly between IGS—ranging from around €3,000 in Latvia to €825,000 in Ireland. In Malta, there is unlimited protection for compulsory classes of insurance, but capped protection (at just over €23,000) for life and non-life insurance that is not compulsory. Similarly, in France, the scheme for compulsory non-life insurance provides unlimited compensation, whereas life assurance claims are capped at €70,000 or €90,000.

Coinsurance via percentage reductions

An alternative way of limiting compensation, and thus reducing costs of the scheme, is to make claimants bear a pre-established proportion of the losses incurred—for example, 10%: if the claim is €1,000, the scheme compensates €900; if the claim is €2,000, compensation is €1,800. Compared with caps on claims, coinsurance has two main advantages.

- Percentage reductions protect policyholders in equal proportion and, compared with capped compensation amounts, do not leave very large losses without protection. This better protection for very large claims may be perceived as fairer. As illustrated in Figure 7.3, depending on the chosen percentage, the bulk of losses are compensated.
- When there is a cap on claims, some policyholders may feel fully protected when they choose an insurer, because there is a low probability that their losses are above the cap. For these consumers, the cap on claims is unlikely to trigger positive incentive effects. Coinsurance via percentage claim reductions is preferable in this respect because all consumers bear part of the costs in the event of failure of their insurer; it therefore has the potential to reduce moral hazard behaviour for all policyholders.

Figure 7.3 A proportion of the costs incurred by the claimant



Source: Oxera.

From a consumer protection perspective, of course, the percentage reduction means that policyholders are not fully covered, which may also adversely affect confidence if consumers fear that their claims will not be fully covered in the event of failure. Even a small percentage reduction may have significant monetary implications (although less so than with an absolute cap) if the claim is large.

In particular, this means that the size of the uncompensated claim, in monetary terms, increases with the size of the claim, which may appear unfair. Nevertheless, this form of coinsurance may be considered fairer than an absolute cap on claims.

The EU Directives on DGS and ICS allow Member States to limit the cover provided. However, the percentage covered must be equal to, or more than, 90 % of the claim as long as the amount to be paid under the scheme is less than €20,000.

While many IGS established in the EU provide 100% compensation, a percentage reduction is observed by some, in conjunction with an absolute cap or in isolation. The largest reduction is 50%, observed in Poland and Latvia, although only for certain classes of (non-life) insurance. The French scheme for non-life insurance applies a reduction to policyholders, but not for injured third parties. In Malta, 100% is protected for compulsory insurance, but 75% for non-compulsory insurance.

Deductibles and minimum floors

Instead of a maximum amount or percentage reduction, the IGS can be designed to pay compensation after a deductible—ie, each claimant receives their claim minus a fixed amount, and thus bears some of the cost.

Such a deductible may have desirable incentive properties and may help prevent moral hazard behaviours, because each claimant receives less than their full claim. In addition, this system excludes policyholders with small claims from seeking IGS compensation if the deductible is higher than the loss incurred. This may be desirable for practical reasons because transaction costs for small claims (ie, costs to the scheme, including handling costs and making payment of the claims) are high compared with the benefit to the claimant (ie, the compensation received). Moreover, the reasons to protect these consumers are less obvious because their losses are relatively small. However, this may not be regarded as fair, because different claimants may not consider the same amount of deductible as equally 'small'.

An alternative way of excluding claimants with small claims is to introduce a floor on claims—ie, not compensating claims below a threshold. This differs from deductibles in that claims below the floor are not compensated at all, while claims above the floor are compensated in full. As a result, floors have similar desirable practical implications as deductibles, through the likely reduction in administration costs because of a lower volume of claims to be processed and paid, but they may not have the same desirable incentive properties because claims above the floor are paid in full. Deductibles or minimum floors for claims are not observed among the EU IGS.

‘Per-policy’ versus ‘per-customer’ compensation

A related issue, when setting limits on claims, is whether these limits apply to customers or policies. While of secondary importance compared with whether caps should be introduced at all, the choice is likely to have interesting side effects. ‘Per-policy’ compensation creates incentives for policyholders to hold multiple policies just below the threshold. However, ‘per-customer’ compensation encourages policyholders to diversify policies across insurance providers. This incentive to diversify across insurers has advantages in terms of risk reduction. However, to the extent that insurers sell packaged solutions that cover slightly different risks, holding policies with various insurers may increase the gaps or create overlaps in terms of risks insured.

The EU Directives on DGS and ICS have selected the compensation per-depositor/investor approach. Compensation per policyholder also tends to be used by the EU IGS.

7.2.4

Summary

Table 7.1 summarises the main points made in the evaluation of options relating to the scope of IGS protection.

Table 7.1 Summary of evaluation of options concerning scope of IGS protection

Protected policies
<p>The case for protecting life assurance relates in particular to the nature of the contracts, the amounts invested, their use for retirement purposes, and the difficulty in obtaining replacement cover in the case of protection products.</p> <p>In non-life insurance, losses are limited to prepaid premiums for the majority of policyholders, but those policyholders with claims outstanding can incur significant losses, particularly for some classes of insurance.</p> <p>Consumer protection reasons therefore make the case for establishing IGS for both life and non-life insurance. In particular for non-life insurance, in order to limit the scope of protection and hence IGS costs, there is a case for targeting certain types of policy: liability insurance classes where the loss may arise to injured third parties, compulsory insurance and insurance relevant in the retail market.</p> <p>Defining different IGS protection rules for too many or overly narrow segments of the market is not desirable for practical purposes. In addition, consumers may find it difficult to understand that different risks are covered differently.</p>
Claimant eligibility
<p>There are reasons for restricting certain policyholders from IGS eligibility (in addition to reasons related to reductions in IGS costs and the degree of redistribution):</p> <ul style="list-style-type: none"> – consumer protection: corporate customers, especially large ones, are better equipped to assess insurers' financial soundness or seek alternative protection; – incentives: better informed (large) corporate customers present greater moral hazard concerns; – natural persons connected to the failed insurer (eg, board members, auditors, etc) may be excluded for the same reason; – eligibility restrictions for large customers and persons connected to the failure also apply in the EU Directives on DGS and ICS. <p>The main disadvantages from excluding certain policyholders is:</p> <ul style="list-style-type: none"> – practicality: where eligibility criteria apply, claimants need to be screened against these criteria, which may increase the administrative burden for IGS; – consumer protection: all types of policyholder can incur losses from insurance failure and may call for protection. Furthermore, there may be reasons for extending eligibility to (large) corporate customers—eg, if the beneficiary is a natural person; – for consumer protection reasons, there is a case for extending protection beyond policyholders—eg, beneficiaries in the case of life assurance and injured third parties for certain types of liability insurance.
Protection amounts and limits
<p>There are reasons for not fully compensating claimants for the losses they have incurred:</p> <ul style="list-style-type: none"> – costs: not fully compensating the claims reduces the cost of the IGS and therefore limits distributional consequences; – incentives: when consumers are not fully compensated, they are less likely to opt for a more risky insurer (ie, fewer moral hazard concerns). <p>In practical terms, there are various ways in which compensation of claims can be reduced:</p> <ul style="list-style-type: none"> – compensation may be restricted to outstanding claims (rather than prepaid premiums) in the case of non-life insurance and to contractual commitments in the case of life assurance; – caps or maximum compensation reduce IGS payment for higher claims, which may not be considered fair if high claims are associated with particular personal circumstances (eg, illness) or financial hardship. Depending on distributional preferences, the caps on claims may need to be significantly higher than those permitted under the EU Directives on DGS and ICS, at least for certain classes of insurance; – applying a percentage reduction to claims protects all claimants in equal proportion. Hence, very high claims tend to be better compensated than when there is an absolute cap on claims. This may also present better incentive properties by implying a degree of coinsurance for all claimants; – deductibles as well as minimum floors on the amount claimed reduce the protection of consumers with small claims. This can be considered practical and proportionate given that the transaction costs of small claims are large for the IGS compared with the compensation benefit received by claimants.

Source: Oxera.

7.3 Design options: operating arrangements

There are different ways of organising an IGS with respect to the nature of intervention, management or wider governance structure, and other procedural aspects. With the exception of the nature of intervention, operating arrangements are likely to be of limited consequence in terms of consumer protection and the guarantee provided. While different operating arrangements may imply different levels of administrative burden and operating costs, they may also be of secondary importance in determining the overall funding requirement of the IGS—the exception again being the nature of intervention of the IGS.

7.3.1 Nature of intervention

As discussed previously, while some IGS established in the EU have as their exclusive function the payment of compensation to eligible claimants after an insurance company is declared insolvent (by the supervisor and/or judicial authority), other IGS intervene to secure the continuity of insurance policies.

From a consumer protection point of view, and to limit wider market impacts, continuity of insurance cover may be advantageous, particularly in those cases where policyholders would otherwise find it difficult to seek equivalent cover (on similar terms) with an alternative insurer. This may apply in particular to life assurance products, where owing to the long-term nature of these products, policyholders are often considered better off if their contracts are continued rather than immediately terminated and receiving compensation in cash. For protection products, this is because policyholders may not find equivalent cover—for example, due to deteriorating health or more advanced age. In addition, for investment products, policyholders may find it difficult to reinvest their funds individually; it would instead be easier to treat all remaining funds together and transfer them to another insurer (or a similar vehicle).

In the case of non-life insurance, the arguments may apply less, since contracts are generally short-term (often one year). In those cases, the continuation of contracts may be considered less important than the efficient handling of insolvency and speedy compensation of claims outstanding (and possibly prepaid premiums—see section 7.2.3). Policyholders can be expected to seek replacement cover with another insurer more easily. However, there may be instances where there could be benefits for an IGS to also secure continuity of cover of non-life policies. For example, the policies may be ‘non-standard’ and hence cannot be purchased easily from another provider. More importantly, where the failed insurer has a significant share of the market, it may be difficult for policyholders to find alternative cover quickly at the same price if supply is restricted. This may raise particular concerns about disruption in economic activities in the case of compulsory insurance (see the cases of larger non-life insurance failure in Australia and Ireland described in section 4.2.2).

However, organising continuity of policies may raise concerns about practicality/feasibility. In order to facilitate the transfer of the portfolio to another insurer in the market, the IGS may need to make substantial payments to match the assets with the liabilities to be transferred. There are ways of limiting the costs to the IGS—eg, by restricting the transfer to certain policies, by reducing the contractual benefits of the policies to be transferred, or by modifying the contractual terms of the policies.

Nonetheless, in some cases it may not be possible to find another insurer in the market willing to take over the entire (or part of the) failed insurer’s portfolio, even if the IGS makes available funds to facilitate the transfer—eg, because the potential liabilities are too high or too uncertain. In those cases, it may be possible to place the insurer into special administration and use the IGS to act as a conduit to fund the administration (the intervention measure chosen in the non-life insurance failures in Ireland is described in section 4.2.2). Alternatively, the IGS operator may itself take over the insurance contract of the failed institution, administer it and pay claims as they arise, as is the approach adopted by the

German scheme for life assurance—the IGS operator (Protektor) has been granted a licence to conduct life assurance business and is in charge of administering claims against the failed insurer as they arise (or until the portfolio can be transferred).

The UK FSCS, which usually pays compensation in the event of failure, is, in the case of life policies, required to make arrangements to secure the continuity of insurance for eligible claimants if ‘it is reasonably practicable to do so’ and if in the opinion of the FSCS ‘it would be beneficial to the generality of eligible claimants covered by the proposed arrangements, and, in situations where the cost of securing continuity of insurance might exceed the cost of paying compensation, any additional cost is likely to be justified by the benefits’.⁸⁹ In addition to facilitating portfolio transfer through payment to the insolvency practitioner or the recipient insurer, the FSCS may also secure continuity of cover by taking measures that would ensure the issuing of policies by another insurer to policyholders in substitution for their existing policies. Due to the lack of relevant cases of failure in the UK life assurance market to date, there is no evidence on how decisions regarding the cost effectiveness of different IGS intervention measures have been, or would be, made.

Overall, IGS intervention to facilitate continuity of cover can deliver greater benefits in terms of consumer protection than the payment of cash compensation. These benefits need to be traded off against any additional costs that such intervention may require in some cases of insurance failure. While there may be instances where facilitating continuity of cover may be the cheaper option, in other cases this option may be less practical or not feasible.

7.3.2 Organisational structure

There are different dimensions of organisational structure, and IGS established in the EU differ along virtually all dimensions (as summarised in sections 2.1 to 2.3, and in more detail in Appendix 1).

Single or multiple IGS

Depending on whether a decision is made to establish guarantee arrangements for both life and non-life business, a relevant question is whether there should be a single IGS (or a single) operator, or one for each of the two classes of insurance business.⁹⁰ Among the EU Member States that have IGS for both classes of insurance, different structures are observed. While many have established a single operating body for both classes, some have separate bodies to administer the guarantee depending on the type of insurer (or class of business of the failed insurer).⁹¹

The joint operation of a single IGS for all classes of insurance protected may generate some efficiencies through economies of scale or scope; this aspect of organisational structure is unlikely to be of relevance for the ability of the IGS to deliver its consumer protection objectives. It is, however, often connected to the structure of IGS funding (ie, single or multiple pools of funding for different classes of insurance covered by IGS), which is discussed separately in section 7.4.2.

Private versus public management

While some countries have opted to operate IGS by way of a public body, others have implemented a model of private ownership and management. Some of the public schemes are operated by, or from within, the financial services supervisory authority, and others are administered by a separate public entity.

⁸⁹ FSA Handbook, Sourcebook on Compensation, Comp 3.3.1.

⁹⁰ A related organisational question relates to motor insurance and the relationship of the IGS with the established motor guarantee funds, which are outside the scope of this study.

⁹¹ There can also be a further division within non-life insurance. In Finland, one IGS operates to cover workers’ accidents insurance claims; one covers statutory employment accident insurance; and the other covers statutory patient health insurance.

Although essentially public, some of the schemes involve participating firms in some way—for example, through the establishment of a committee that includes industry representatives. Among the privately run schemes, some are set up as limited companies, while others are set up as private trusts or foundations.

From a consumer protection perspective, the management or governance structure of an IGS does not matter provided that the structure is effective in delivering the protection that the IGS is designed to provide. However, different structures may have different implications in terms of practicality and feasibility, and the choice will depend in part on the institutional framework within each country.

Cooperation with insolvency practitioner and supervisory authority

The IGS process is triggered by the competent supervisory authority (or a judicial authority), and is linked to the winding-up process. To increase the efficiency of the IGS process, both in terms of delivering consumer protection and in terms of costs, a degree of cooperation is therefore likely to be required between IGS operator and the supervisory authority—for example, in terms of information sharing. Similarly, where the IGS relies on the insolvency practitioner assigned to the estate of the failed insurer to establish claims, such cooperation is also required between IGS operator and insolvency practitioner.

Again, as long as there is cooperation between the various parties involved in the process, there is no reason to expect that any specific allocation of responsibilities or any particular type of arrangement governing the relationships will necessarily be superior in terms of consumer protection provided by the existence of an IGS. Moreover, what constitutes the most practical or least-cost solution is likely to vary according to factors such as the institutional framework and the nature of intervention by the IGS.

Staffing/outsourcing

The number of staff employed to administer the IGS differs markedly between existing IGS. This is largely due to differences in:

- the number and nature of failures dealt with by the scheme;
- the nature of intervention by the scheme and the scope of coverage; and
- the tasks carried out by the scheme as opposed to being outsourced to a third party.

In relation to the last point, for consumer protection reasons, what matters is that sufficient resources are available to effectively deliver the protection if required, irrespective of whether the resources are drawn from the permanent staff of the IGS or made available by third parties through outsourcing arrangements.

Outsourcing tasks may have clear advantages in terms of practicality and feasibility. In particular, in the absence of failures, the IGS can potentially make significant cost savings and operate at no or very low cost by outsourcing (some of) its tasks, since it would not have to employ (as many) staff on a permanent basis. Moreover, the tasks required to establish and administer claims need specific expertise that may be more easily or cost-effectively provided by third parties. Based on the arrangements in place among the existing EU IGS, this may be the insolvency practitioner assigned to the estate of the insurer, other insurance companies in the market, or other parties with the relevant experience.

In addition to claims handling, for IGS that are funded on an ex ante basis, significant funds may accumulate until the point at which failures occur (see section 7.4.1). The accumulated funds will need to be invested in line with given risk–return preferences, which may be more effectively undertaken by professional fund managers with the relevant expertise. Rather than carrying out the fund management internally, such outsourcing is common practice among the ex ante funded IGS in the EU. Again, this decision largely concerns

considerations about practicality and feasibility, and may have an impact on the administrative costs of the IGS.

7.3.3 Summary

Table 7.2 summarises the main points discussed in relation to the nature of intervention and organisational structure.

Table 7.2 Summary of evaluation of options for operating arrangements

Nature of intervention
<p>Some of the EU IGS pay compensation only in the event of insolvency, whereas others can intervene by securing continuity of policy cover. The latter can involve payments to facilitate the transfer of the portfolio to a solvent insurer, or it can take the form of the IGS taking over the policies and administering claims as they arise.</p> <p>The case for extending the IGS function to securing continuity of contract relates to:</p> <ul style="list-style-type: none">– consumer protection: policyholders may not be able to obtain replacement policies on the same terms from another insurer. This is likely to be a particular problem for life (protection) policies, which are long-term and where policyholders may not be able to obtain new cover (at all or on equivalent terms), due to advanced age or poor health;– market confidence/stability: in relation to compulsory insurances in the non-life market, if the failed insurer supplied a significant share of the market, there may be a temporary shortage of supply of substitute cover; as a result, certain economic activities may temporarily cease. <p>The main argument for not securing continuity of contract relates to practicality/feasibility. Depending on the nature of the failed insurer's portfolio, it may not be possible to initiate portfolio transfer to another insurer in the market even if the IGS provides funding. The IGS may act as a conduit to finance a special administration or take over the portfolio itself, but the latter requires an appropriate organisational structure and will increase the administrative burden for the IGS.</p>
Governance, management, staffing
<p>From a consumer protection point of view, the organisational structure is largely irrelevant provided that it ensures that the IGS delivers the promised guarantee effectively.</p> <p>Different arrangements may have different implications in terms of practicality/feasibility, but what constitutes a cost-effective arrangement varies between countries, depending on the institutional framework, the frequency and nature of cases of intervention, etc.</p> <p>In the absence of failures, the IGS can be operated at very low cost if permanent staff is limited and outsourcing arrangements are put in place to take on the tasks were a failure to occur. Even where failures occur more frequently, cost savings can be obtained by outsourcing (some) tasks to external parties with the required expertise and scale to carry out the tasks more efficiently.</p>

Source: Oxera.

7.4 Design options: funding

The design options discussed in sections 7.2 and 7.3 impact on the costs of the IGS and hence the overall funding requirement. The following discusses the options available for an IGS to raise the funds it needs to meet its costs—ie, taking the funding requirement as given.

As is the case for the IGS established in the EU, it is assumed that the IGS costs are largely funded through contributions paid by industry (although the costs may ultimately be borne by consumers). The options considered relate to:

- the timing of funding—ie, ex post or ex ante;
- the pooling (or not) of funding between classes of insurance business;
- the basis of allocating contributions among insurers, including introduction of risk-weighting;
- capping the level of contributions that can be raised in any time period; and
- the availability of alternative sources of funding to complement industry contributions.

7.4.1 Ex ante versus ex post funding

In a pre-funded (or ex ante) scheme, the funds are raised in anticipation of possible future failures, with resources transferred to, and managed by, the IGS via a system of levies on industry. In a post-funded (ex post) scheme, the same resources remain with the contributing institutions until a failure occurs, and levies are due to be paid to the IGS only once costs to the IGS arise. There are arguments for and against the two types of funding, and both types are observed among the established IGS in the EU (see section 2.9).

Ex ante funding has a number of advantages. Provisions are made for future loss events, and firms that become insolvent in the future have at least made some contribution to the guarantee costs they generate, which may be considered fairer. This advantage can be enhanced by introducing ex ante levies that are weighted by the risk of failure of the contributing institution. In contrast, post-funding may be seen as a levy required to make up for the failures of others, and thus the rationale for linkage to the (current or past) riskiness of survivors may be less apparent. Risk-weighting is further discussed below (section 7.4.3).

Under ex ante funding, there is a higher degree of certainty about the value of funds that are available for distribution in the event of a failure, and payments can potentially be made more quickly and efficiently. This may increase the credibility of the scheme in terms of delivering adequate consumer protection.

A further argument commonly advanced in favour of pre-funding is that it avoids the pro-cyclicality associated with post-funded schemes. Since failures of insurers are more likely to occur in times of general weakness in economic conditions, the suggestion is that post-funding arrangements will impose costs on insurers at a time when they are least affordable, thus potentially having a negative impact on market stability. However, the difference between the two funding approaches in terms of their timing impact on insurers may not be as pronounced: Any pre-funded scheme would have to be recapitalised after it is utilised, potentially creating a similar profile of contributions to a post-funded scheme. In addition, in a post-funded scheme, there may be ways to smooth levies and collect them over time rather than as a lump sum (eg, through the imposition of limits on the amount that can be levied in any year, through temporary borrowing, or through spreading IGS payout over an extended timeframe), thus reducing the pro-cyclical impact on insurers.

However, ex ante funding also has a number of drawbacks. While there is a degree of science that can be applied to estimating the probability and impact of insurance failures, in practice, the timing and costs of failures are difficult to predict with any certainty. There is therefore a risk that any pre-funding arrangements will levy higher contributions from participating insurers than are actually warranted. While there are ways of mitigating this problem, such as by targeting a maximum level of accumulated funds, the risk would remain that such funds are never needed. Conversely, the scheme may prove to be under-funded and require increased contributions after failures occur. Under a post-funded arrangement, the size and timing of levies on insurers would be targeted to a known level.

In particular, it may not be a proportionate response to introduce an ex ante system and build up a large standing fund if failures are unlikely to occur, and are small when they do occur. In many EU Member States, the frequency of failures to date has been low, with some countries having experienced no failures at all in recent years. An ex post system may be more fair and proportionate in such circumstances, since no levies would be due from industry except for the rare event that a failure occurs. As shown in section 5.1.3, a number of IGS run ex post systems at virtually zero cost to the industry given the absence of failures in the market.

However, even if failures occur, ex ante funding may not be required if the financial capacity of the industry is sufficient to bear the cost on an ex post basis. For example, the UK has the most comprehensive IGS in the EU. The UK FSCS has experienced a comparatively high number of failures at comparatively high cost. Yet, it is ex post-funded, with levies raised to cover the projected costs of the scheme in a financial year based on known cases of default.

Further levies can be raised over the year if payments exceed those anticipated, or if there is a major new default in that financial year.

Moreover, systemic consequences of insurance failures are less likely than in deposit-taking, and although wider impacts can occur, there is no risk comparable to a bank run. The arguments in favour of pre-funding that are commonly adopted in the context of DGS therefore apply less in the IGS context.

Importantly, the costs imposed on firms (and ultimately consumers) by an ex ante-funded scheme amount not only to the actual levies paid, but include the returns that firms could have earned on the funds had these funds been retained within the firm. This raises the general issue of how a surplus fund should be invested by the IGS operator. If the fund is invested in safe assets, this is likely to increase the opportunity costs to firms relative to their cost of capital. However, if the fund is invested in risky assets, it would be exposed to market risk, and, depending on which assets were purchased by the fund, possibly also credit and liquidity risk. Guarantee costs may also be correlated with market movements, exposing a fund that was invested in marketable securities to the risk that an increase in its liabilities could coincide with a reduction in the value of its assets. These issues generally require the IGS to employ investment professionals to manage the fund, and define and design an investment strategy that strikes an appropriate balance between risk and return.

As a result, ex post funding has lower associated administration costs than ex ante funding, since no fund management is required and funds are kept within insurance companies, provided that no failures occur. This may be considered more desirable under the feasibility/practicality criterion.

A pre-funded system and the potentially larger administration around it may also present some risk of 'regulatory creep'—ie, the expansion of another arm of bureaucracy beyond what is actually required.

Given that the ex ante and ex post forms of funding have advantages and disadvantages, one option is to implement a funding structure that combines the two approaches. For example, this could involve allowing firms to keep contributions in their books that they would otherwise make to the fund, but make provisions for them. As funds would be kept aside by firms, this would deliver many of the advantages of ex ante funding, but since insurers would keep the funds on their balance sheets, reduce the opportunity costs for firms and avoid fund management costs on the part of the IGS. This approach is implemented in part by the French scheme for life assurers, the FGAP, where the participating insurers pay half of their ex ante contributions to the scheme, while the other half of contributions are kept as pledges on the insurers' balance sheets.

Overall, no form of funding strictly dominates the other. The choice depends to a large extent on the level and pattern of expected guarantee costs and on the financial capacity of the industry to meet IGS costs as they arise. It also depends on the availability of other funding sources, which may be considered particularly important when dealing with larger failures.

The choice between the two types of funding is likely to vary from country to country, given the differences in failure rate and market structure. In particular, the case for ex ante funding is likely to be stronger in countries where failures are expected to be more frequent and significant and/or where there are concerns about the ability of industry to meet the IGS funding requirement on an ex post basis. The benefits of ex post funding, on the other hand, are likely to dominate in those countries where failures are infrequent (or likely to be small) and where industry has the financial capacity to absorb IGS costs.

7.4.2 Pooling of funding between classes of insurance business

Irrespective of whether funding occurs on an ex ante or ex post basis, a separate funding issue is the extent to which funds are pooled between different classes of insurance

business. For example, if the IGS covers both life and non-life business, should there be a single pool of funds to cover the costs incurred—ie, if a life insurer fails, would non-life insurers be expected to contribute to the costs and vice versa? Or should there instead be separate pools of funds for the two classes of insurance business, with possible further divisions into smaller insurance-specific pools?

There are general advantages related to the pooling of funds. First, pooling improves the liquidity and overall financial capacity of an IGS. Second, a single large fund to pay for IGS costs irrespective of the source of failure would benefit from diversification and hence improved solvency, as it would cover a more varied set of insurers and insurance business. The more funds that are pooled together, the more likely it is that the IGS can withstand more significant failures, so the consumer protection and market confidence/stability objectives would be more likely to be met.⁹² Third, a pooling of funds may be considered more practical from an administrative point of view—the larger the number of separate funds to be operated, the larger the total administrative costs are likely to be.

However, pooling all classes of insurance business covered by IGS also has significant disadvantages compared with separation by type of business or type of insurer. In particular, cross-subsidies between different types of business and insurer may not meet notions of fairness. Insurers may be even less willing to finance the mistakes of another insurer if they occurred in segments of the market in which they do not operate. By contrast, insurers operating in the same segment as the failed company may be seen as deriving at least some benefit, given that they may have the opportunity to take over part of the business of the failed insurer and generate revenues going forward; they may also be perceived to benefit more directly if the IGS protection afforded to policyholders maintains confidence in this particular segment of the market.

Maintaining separate funding pools can also have advantages if the risk of failure differs by type of business or insurer. If the separate pools were defined to reflect these risk differences, the benefits could be similar to those described below for risk-weighted contributions to the IGS (section 7.4.3)—ie, potentially improved incentives and cost-reflective pricing. However, the challenge is to define the pools such that the market is not artificially segmented and distorted as a result.

Given these trade-offs, a balance needs to be struck to define funding pools of a size that deliver sufficient financial capacity and are practical to operate but at the same time are perceived as fair and not distorting market operations. In practice, this has resulted in separating life and non-life business for funding purposes, in most cases without further separation within those classes.

More specifically, among the EU IGS that cover both life and non-life insurance, there is no pooling between the two types of business—life insurance failures are financed by contributions raised among life insurers, and failures related to non-life insurance are also funded from contributions among non-life businesses only. For example, the UK FSCS operates different contribution groups for life and non-life insurance. Similarly, Malta, Latvia and Romania have separate sub-funds for life and non-life insurance.⁹³ Some of the schemes do, however, allow borrowing between the separate life and non-life funding pools—this provides certain advantages associated with pooling (ie, temporary increase in the financial capacity of the relevant fund) while also maintaining overall separation of

⁹² However, pooling may also be detrimental for some consumers, depending on how the pooled funding is structured. Suppose a life insurer fails and all available funds are used up to protect claimants (eg, all funds that can be raised given existing contribution limits or all funds accumulated in the ex ante reserve fund). If a non-life insurer failed shortly thereafter, there would be no funds to cover that failure. Thus, in this case, the non-life policyholders could incur losses, but to the benefit of the life policyholders.

⁹³ The general winding-up scheme in Spain is different in many respects, including funding, in that contributions are raised with respect to non-life insurance business only, which may also be used to cover the cost of life assurance winding-up. Spain does, however, separate the funding of the general winding-up scheme from the special schemes for hunting liability and travellers' insurance.

funding. In France, where there are two separate IGS for life assurance (FGAP) and non-life insurance (FGAO), the IGS are organised separately in all respects, including funding.

However, a sub-division of funding that goes further than life and non-life is not the norm among existing IGS. Life assurance business is never further divided, and for non-life insurance, a further division is also rare and generally only applies when the country has set up separate schemes for specific classes of (compulsory) non-life insurance.

7.4.3 Basis for allocating contributions

A mechanism is required to allocate the total amount of funds to be raised among the individual contributors to the IGS—ie, the participating insurers, unless the funds are raised directly from policyholders via explicit surcharges on the policies sold.

For the existing IGS in the EU, levies are allocated among participating insurers in proportion to the size of the insurance business. Compared with a fixed-amount contribution that is equal for all insurers, such a size-reflective allocation alleviates concerns that an IGS may distort competition between small and large firms or impose barriers to market entry for new firms.

Although other metrics are conceivable, three broad types of size metric are observed (see section 2.9): amount of premiums (gross or net), amount of technical provisions or reserves, and number of policies.

The choice between these metrics can have significant distributional consequences since it determines the overall allocation of guarantee costs among contributors and the amount of levy to be paid by an individual firm.

For example, the premium-based allocation method, which is most commonly used among the EU IGS, captures both new business and existing regular-premium business. By contrast, the allocation of levies according to reserves or provisions focuses more on existing business. Thus, there may be some distributional impact in that the former places a greater burden on firms with new and regular premium business, thus benefiting insurers that have a large existing insurance book but little or no new business.

Similarly, an allocation based on the number of policies may be considered practical, but it places a disproportionate burden on smaller policies compared with an allocation based on the value of the business written, be it in terms of measuring a flow (premiums) or a stock (technical provisions).

Premium-based allocation methods take account of the size of the insurance business rather than the risk of failure. Technical provisions may be considered closer to a risk-based allocation since they capture the possible size of losses resulting from failures. This will be enhanced with Solvency II, given that the calculations will become more risk-based. However, to the extent that it does not take account of the actual capital and other features of individual insurers, using technical provisions as the allocation metric does not capture the probability of failure. The advantages and disadvantages of risk-weighted levies are discussed separately below.

Where the scope of protection of the IGS is limited to specific claimants (eg, natural persons) or policies (eg, excluding specific classes of non-life insurance), a relevant question is whether the levy base should measure only the part of an insurer's business that can give rise to claims on the IGS, or whether the levy base should also count non-eligible business.

Among the existing EU IGS, the levy applies in most cases to the eligible business only, thus excluding business that is not eligible for IGS purposes. Such an approach can be considered fairer, given that the burden is imposed only on the business that also benefits from the protection afforded by the IGS. However, it may be considered less practical, as the

relevant data needs to be provided and verified. This practicality argument may influence the choice of metric—eg, while insurers may find it easier to identify relevant business in terms of number of policies or premiums earned, they may find it more difficult to allocate technical provisions to different customers according to their eligibility for IGS protection. In addition, to enhance the financial capacity of the IGS (and thereby promote consumer protection and market confidence/stability), there may be arguments for extending the levy base beyond eligible business and also requesting IGS contributions from non-eligible business.

Thus, the choice of levy is more than a technical matter. It significantly affects how much individual insurers are required to contribute to the scheme. It can also affect the efficiency with which funds are raised, and change perceptions of the fairness and proportionality of the IGS in place. It is in this context that calls have been made for introducing a funding mechanism that takes account of the risk of participating institutions.

Risk-weighting of contributions

Each insurer can be considered as creating an expected cost to the scheme at some point in the future, based on the probability of the firm becoming insolvent, and the exposure or level of costs arising if a default were to occur. This expected scheme cost may change over time as the firm's activities and risks evolve. One approach to funding an IGS would be to risk-weight levies such that each insurer's contributions were proportionate or equal to the expected cost to the scheme. Firms assessed as posing greater risks of triggering scheme costs would be charged a higher levy.

Although in principle possible with ex post-funded schemes, the economic advantages of risk-based levies are more likely to be realised if operated under a scheme that is funded on an ex ante basis. This is because under ex ante funding, the failed insurer would have contributed to the scheme before its failure, in proportion to the cost it was expected to impose on the scheme.

Risk-weighted levies can be seen as having desirable incentive properties, since they may encourage firms to control their own risks. Risk-weighting may also facilitate more precise risk measurement of firms, which can help to control risk. In particular, if the establishment of an IGS is associated with concerns about moral hazard behaviour on the part of industry, these concerns can be addressed through risk-weighting.

Risk-weighted levies have further desirable economic properties in terms of competition. They ensure that insurers pay in line with the (expected) cost that they impose on the system, thus reducing concerns that some insurers may gain a competitive advantage by selling policies at prices that do not reflect the risk to policyholders and that may be lower than that of their less risky competitors. Thus, risk-weighted levies can improve level playing field conditions in the market.

Moving towards a more risk-based approach to setting scheme levies must be evaluated in the context of the wider regulatory framework. For example, if the funding structure were designed to produce strong incentives, this could duplicate other rules that may be designed with the same effect (eg, the risk-based prudential framework to be introduced with Solvency II). Put differently, if scheme funding is not seen as an additional regulatory tool, or if the prudential framework is risk-based, setting risk-weighted levies to improve incentives or competitive conditions may be less important than in a world where prudential regulation does not take account of risk differences between insurers.

Not risk-weighting IGS levies implies that there will always be a strong element of cross-subsidy between insurers, with low-risk firms paying for the costs of high-risk firms. This subsidisation would be limited if levies were raised according to the risks, or expected costs to the scheme, of firms and their activities. Thus, risk-weighting can be considered to have desirable distributional properties and to be in line with notions of fairness/proportionality.

However, the introduction of risk-based levies may raise concerns about funding sustainability. Firms may not be able to afford the full economic cost they impose on the IGS. Collecting levies from the weakest firms could further weaken their financial position, possibly triggering more failures, which may have a negative effect on consumer protection and market confidence/stability. Since the resulting costs would then have to be collected from the stronger firms in one way or another, cross-subsidies may ultimately not be avoided.

Feasibility or practicality issues are arguably the most important obstacles to moving towards a risk-based levy structure. As discussed above, risk-weighting levies require, under expected-loss pricing, an assessment of the probability of failure, and of exposure to or severity of scheme costs in the event of failure. This necessitates detailed firm-specific information, which the scheme (and/or regulator) may not have, and which may be difficult and costly to collect.

While full expected-loss pricing may be difficult to implement for an IGS, it may nevertheless be possible to move towards a more risk-based differentiation between firms using simple proxy metrics. One such approach is the risk-weighting adopted by the German scheme for life assurers (see Box 7.1), which is the only IGS in the EU to have implemented an explicit risk-weighting approach when imposing levies on participating insurers.

Box 7.1 Risk-weighting in the German scheme for life assurers

The statutory scheme for life assurance established in Germany is funded on an ex ante basis. The scheme builds up capital through contributions from participating life assurers, up to the target level of 0.01% of total life assurance net reserves. Firms have a share in the accumulated capital of the scheme, which is determined by the firm's reserves relative to the reserves of all participating insurers, with a further adjustment for risk. The annual contribution of each firm is increased (or decreased) if the firm's actual share in the capital is lower (or greater) than the share it should have, based on its relative net reserves and risk. The risk adjustment is twofold:

- first, the amount of net reserves for unit-linked or other insurance contracts for which the risk is borne by the policyholder rather than the insurer are not counted in full but only by one-quarter;
- second, there is an individual firm risk adjustment that depends on the firm's equity capital relative to its solvency margin. Using this metric, firms are ranked from lowest risk to highest risk and classified into three risk categories. For firms in category 1 (low risk), a risk factor of 0.75 is applied to the net reserves; for firms in category 3 (high risk), the risk factor is 1.25; and for firms in category 2 (medium), the risk factor is adjusted from firm to firm on a linear basis to range between 0.75 and 1.25.

7.4.4 Contribution limits

In both ex post and ex ante schemes, IGS have the ability to impose contributions and raise funds in line with the overall funding requirement. Where this ability is unlimited, there may be concerns about the potential size of the contributions and the impact that this may have on the industry. One option to address those concerns is to impose a cap or overriding limit on the IGS contributions that can be raised in any year or over any given period of time.

There are good reasons for introducing such caps. First, participating insurers would otherwise effectively have a potentially open-ended liability to fund the IGS through annual and additional contributions. In particular, in the event of a substantial failure, contributions could be so large that the resulting costs to firms would have a significant impact on firms' ability to continue to operate in the industry which, in turn, could have adverse effects on market stability, competition and choice in the market. Second, even if costs can in principle be passed through to consumers, such a pass-through may not be immediately possible. Moreover, in the event of larger failures and significant IGS costs, the impact on premiums could be significant. Consumers may buy less insurance as a result, which in turn may lead to under-insurance in the market.

Given these concerns, among the Member States with an IGS in place, the majority have adopted an overriding limit on the amount that can be levied in a given year (see section 2.9). The limit is typically expressed as a percentage of premiums or reserves of a participating insurer. For example, in Latvia the limit is 1% of relevant gross insurance premiums (life and non-life); in the UK it is 0.8% of relevant net premium income (life and non-life); in France it is 0.05% of mathematical provisions⁹⁴ (life); and in Ireland it is 2% of premiums (non-life).

However, contribution limits also have clear drawbacks. In the event of a larger failure, funds that can be raised from insurers, up to the contribution limit, may not be sufficient to cover the full guarantee costs arising from a failure. Thus, there may be a problem in raising the funds available to meet the promised guarantee payments, with consequences for consumer protection and related market confidence objectives.

Allowing flexibility in funding, through the introduction of alternative sources of funding, may be one option to address this concern. However, even if other funding is available, some failures may be too large for any IGS to handle. As noted in section 5.1.1, these failures may need to be dealt in other ways.

7.4.4 Other sources of funding

A range of alternative funding sources can be introduced to complement the funds raised from industry contributions. Alternative funding can provide the IGS with some flexibility in dealing with temporary funding shortfalls, which would enhance consumer protection and confidence. Availability of alternative funding sources could also be used to achieve some smoothing of industry levies over time, thus avoiding the potentially adverse pro-cyclical effects of industry levies and aiding market stability.

Access to alternative funding sources may be particularly important when it comes to unexpected larger failures that could impose more costs than had been anticipated and that participating firms would be able to cover. Where caps on industry contributions have been introduced, alternative funding sources may bridge the gap between the funds the IGS needs and the funds that can be raised from industry in a particular period of time.

One such funding source is borrowing from an external credit provider. Among the established IGS in the EU, a few IGS have borrowing powers, but only one IGS (the UK FSCS) has an external credit facility in place. There may of course be limits to which a commercial credit provider may be willing to provide or extend a credit facility at acceptable borrowing costs (or at all).

Borrowing costs could be reduced if commercial loans were backed by the government. Indeed, rather than borrowing with state guarantee, there may be direct state funding. State involvement in IGS funding is limited among existing EU IGS; the exceptions are the IGS in Denmark and Ireland. Government involvement in scheme funding could enhance the financial viability of the scheme and, in particular, its ability to deal with large failures. This would have positive impacts on consumer protection and market confidence/stability, but at the cost of taxpayers. General reliance on state intervention could have negative incentive effects, distort competition, and not be politically acceptable.

As a more market-based solution, the scheme could instead seek private reinsurance for future guarantee costs. Reinsurance has a number of attractive properties in theory, including alternative funding and explicit pricing of risks. However, there may be problems in the supply of such insurance. The IGS could also issue 'catastrophe bonds' or other instruments that have been used by insurers and reinsurers themselves to transfer catastrophic risks. As with direct reinsurance, the major benefits would be access to

⁹⁴ Although the scheme can also borrow up to the same amount from participating firms.

additional funds and the potential improvement in the pricing of risks obtained via the market. Again, however, a number of market imperfections may present significant obstacles to this solution in practice. None of the existing IGS in the EU has implemented such alternative sources for funding purposes.

7.4.5 Summary

Table 7.3 summarises the main points discussed above in relation to the various options for structuring IGS funding.

Table 7.3 Summary of evaluation of options for IGS funding

Ex ante versus ex post funding
<p>The main arguments for ex ante funding include:</p> <ul style="list-style-type: none"> – fairness/proportionality: future insolvent firms will have made at least some contribution to the guarantee costs they generate (applies in particular where ex ante funding is combined with risk-based contributions); – consumer protection: funds are more readily available to provide the guarantee, and there is less uncertainty about the funds available; – market confidence/stability: regular contributions and the availability of a buffer fund avoid the potentially destabilising effect of pro-cyclical IGS contributions under ex post funding. <p>The main arguments for ex post funding include:</p> <ul style="list-style-type: none"> – feasibility/practicality: the administrative costs of an ex post system tend to be lower because no fund management costs arise. In addition, industry may put to better use the funds that would otherwise accumulate in the IGS fund, thereby lowering opportunity costs compared with the industry's cost of capital; – fairness/proportionality: it may not be proportionate to build up a large standing fund if failures are infrequent and/or expected to be small. If no failures occur, an ex post system can be run at virtually zero direct cost. In addition, even where failures occur, it may not be necessary to have ex ante funding if the financial capacity of the industry is sufficiently large to absorb IGS costs as they arise. <p>No form of funding strictly dominates the other, and options are available that combine features of the two types of funding (eg, pledges or guarantees by industry to make payment should a failure arise).</p> <p>The relative strength of arguments is likely to vary between countries, due to differences in expected guarantee costs and in the structure and financial capacity of industry to absorb IGS costs.</p>
Pooling of funding between different types of insurance business
<p>Creating a single large pool of funds to cover IGS costs across all types of business has advantages:</p> <ul style="list-style-type: none"> – consumer protection and market confidence: pooling improves the overall financial capacity, making it more likely that the IGS withstands larger failures; – feasibility/practicality: the lower the number of separate funds that are maintained, the lower the administrative burden is likely to be. <p>However, pooling has disadvantages:</p> <ul style="list-style-type: none"> – fairness/proportionality: pooling implies cross-subsidies between different parts of the market; – incentives (and competition): separate funding pools would be beneficial if they could be designed to reflect different risks of failure among participating insurers. <p>Existing EU IGS that cover different classes of insurance operate separate funding for life and non-life insurance, but a further separation is not the norm.</p>

Basis for allocating contributions

Existing EU IGS use three main bases for allocating levies among insurers: premiums, technical provisions, and number of policies.

Using technical provisions is closer to a risk-based allocation since it captures the possible size of losses resulting from failure of the insurer (and will be more risk-based with Solvency II), but it still does not capture the probability of failure.

Using technical provisions could also be considered fairer compared with premiums since it would capture all existing business rather than new business or regular premium business only; charging a fixed amount per policy may be practical but is likely to be least fair since this does not capture the value of policies.

Using premiums is most commonly observed among existing IGS, and is likely to be more practical than technical provisions, particularly if only the policies eligible for IGS protection are to be included in the levy basis.

Restricting the levy base to eligible business only may be preferable in terms of fairness/proportionality. However, it is potentially less practical (more costly) to collect the relevant data. In addition, by reducing the overall funding basis, the IGS may be less able to meet its consumer protection and market confidence/stability objectives.

Risk-weighted contributions

The main arguments for risk-weighting include:

- incentives: risk-weighting may encourage insurers to control their own risks and alleviate concerns about IGS-induced moral hazard behaviours on the part of industry;
- competition: risk-weighting can avoid the possibility of higher-risk insurers being able to sell policies at prices that do not reflect the (expected) cost they impose on the IGS (and other insurers) and that are potentially lower than that of their low-risk competitors;
- fairness/proportionality: insurers would pay according to the cost they impose on the system, thereby limiting cross-subsidisation between low-risk and high-risk firms.

The main arguments against risk-weighting include:

- feasibility/practicality: risk-weighting can be difficult to implement and imposes additional administration costs;
- market confidence/stability: collecting larger levies from the weakest firms could further weaken their financial position, possibly triggering further failures.

Solvency II will introduce a risk-based approach to prudential regulation, which may reduce the need for risk-weighted levies compared with a prudential framework that is not risk-based.

Contribution limits

The main argument for introducing caps on contributions is to explicitly limit the impact on the remaining insurers in the industry (and their consumers), and avoid what could otherwise be an open-ended liability to fund the IGS.

Most IGS established in the EU have implemented such a limit—eg, set at 1% or 2% of relevant premium income.

If the IGS funding requirement exceeds the limit, it may be possible to spread IGS payment over time, or use alternative funding sources to meet the temporary funding shortfall. Some failures may be too large for an industry-financed IGS to handle.

Other sources of funding

Providing for alternative funding sources enhances the financial viability of the scheme, and therefore delivers greater consumer protection and market confidence/stability. The three main sources are:

- borrowing: funds made available by a commercial credit provider can be used to meet temporary funding shortfalls and achieve some smoothing of industry levies over time. External borrowing is costly, and there are limits to the amount of credit that a commercial provider can make available. Some EU IGS do not have any borrowing powers, and only one IGS has a credit facility in place;
- state funding: government guarantees could reduce borrowing costs, and direct state funding would further improve funding viability, especially for large failures. However, the costs would be borne by taxpayers. Furthermore, explicit state involvement could raise concerns about moral hazard and competition and may not be politically acceptable. Only two of the existing IGS have an element of explicit state involvement;
- reinsurance or other market-based solutions: while conceptually attractive, reinsuring the IGS or implementing similar risk-transfer mechanisms may not be practical or feasible to implement (lack of supply, costs). None of the existing IGS has implemented such solutions.

Source: Oxera.

7.5 Summary

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. The comparison of benefits and costs is problematic 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. Hence, the question of whether to introduce an IGS is closely related to the choice of scheme design.
- The operation of an IGS always triggers a redistribution of funds from one part of the market to another. Hence, decisions concerning the establishment of IGS and scheme design 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 so 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 EU Member States have responded to insurance failure 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, if guarantee schemes are accepted as important last-resort protection mechanisms in the deposit-taking and investment sectors, it becomes more 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 only—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 only—particularly retail consumers for which protection measures are generally more justified.

Limiting the scope of protection does not only reduce 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 policyholders that are more likely to engage in such behaviours (eg, the usually better 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 for the period up to the point when an insurance failure occurs. 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 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 be delivering the desired protection or distributional objectives. This section has examined the main options for IGS design and highlighted the most relevant trade-offs using a set of evaluation criteria. The decision concerning IGS establishment and scheme design depends on the weight attached to the different criteria, and hence is a matter for policy.

This section examines the main options available at the EU level, which are as follows.

- **Preserving the status quo** (section 8.1)—no EU policy action is taken. Member States can decide whether they establish an IGS and the design of any scheme implemented. Existing IGS arrangements may continue in the current form or may be modified, and new IGS may or may not be established in those Member States that at present do not have one.
- **Implementing an EU-wide approach to IGS** (section 8.2)—EU policy action is taken to implement IGS in all Member States. This may take different forms, regarding in particular:
 - the geographic scope of the national IGS implemented (eg, home state or host state);
 - the degree of harmonisation adopted and the dimensions of IGS design harmonised.

The option of introducing a single EU-wide IGS that covers all relevant policies written and purchased within the EU is not discussed, as it is unlikely to present a feasible and politically acceptable option. Furthermore, the evaluation does not consider the different modes of implementing EU policy action (eg, non-binding action versus Directive).

There are a number of intermediate EU policy actions that may address any concerns about the status quo but that do not go as far as introducing IGS on an EU-wide basis, such as taking measures to enhance policyholder information on the existence (and main features) of an IGS, or case-by-case intervention measures such as launching infringement proceedings in the event of discriminatory treatment of non-domestic policyholders or policies. These options are also considered (section 8.3).

The policy decision to implement an EU-wide approach to IGS is fundamentally linked to the question of whether an IGS should be introduced in the first place. As such, the analysis contained in section 7 is directly relevant for the evaluation of EU policy options. However, the arguments for and against an IGS will not be repeated in this section. Instead, the evaluation focuses on the specific issues that arise from the coexistence of different national approaches to IGS, drawing from the analysis presented in section 6, and the corresponding arguments for and against taking policy action at the EU level.

8.1 Preserving the status quo

Preserving the status quo would imply a continuation of the coexistence of different national approaches to IGS. Further convergence may result—for example, if more EU Member States introduce an IGS. However, the current differences in IGS approach and structure can be expected to continue.

As examined in more detail in section 6, the differences may hinder the development of a single EU insurance market by imposing conditions that could result in:

- unequal and ineffective levels of consumer protection within and across Member States;
- the absence of a level playing field between insurers within EU Member States and distortions in competition across Member States.

In relation to cross-border consumer protection, if an insurer conducting business via branches and freedom of services in several EU Member States fails, the status quo implies that policyholders could get no or differential protection, depending on their country of residence. This would be the result of a combination of factors, including the complete absence of IGS in some countries, and the differences in the scope of protection offered by IGS that are currently in place. Such differences in IGS scope can also lead to within-country consumer protection issues. In particular, the status quo in some countries implies that policyholders could receive no or different levels of protection in the event of failure, depending on whether they acquire policies from a domestic or incoming EU insurer.

The lack, or differential level, of protection across or within borders—be it actual or perceived—may also impact negatively on market confidence in the effective operation of the EU insurance market. Although there is no direct evidence that consumers know (or care) about the existence and protection levels of different IGS and the complications that arise in the cross-border context, it is plausible to assume that the failure of a large insurer with significant cross-border business could trigger a confidence crisis that goes beyond national borders and affects wider EU market confidence.

The level of relevant cross-border business remains relatively low, and failures of insurance undertakings with significant cross-border operations have been rare. This limits concerns about cross-border consumer protection and market confidence. However, these issues are likely to become more prominent as the level of cross-border activity increases. Put differently, for consumer protection and confidence reasons, preserving the status quo and not adopting an EU-wide approach to IGS is likely to become a less attractive option.

With respect to cross-border competition, the current arrangements can result in domestic and incoming EU insurers not being covered by the same IGS arrangements, which may fail to provide a level playing field between insurers in a given Member State (ie, distorting within-country competition). The effect may work through the demand side (if firms in the same market do not face the same demand because consumers take account of differential IGS protection) and/or through the supply side (if firms in same country do not face the same costs because they contribute to different or no IGS). Potential demand- and supply-side distortions could also affect an insurer's decision about which Member State to enter and the form of entry (eg, via a subsidiary, branch or freedom of services), thereby distorting competition across Member States. The conditions for effective cross-border competition are clearly not met under the status quo of non-harmonised IGS, but there is no direct evidence to suggest that this has led to significant distortions to date, either through demand- or supply-side effects.

While the above considerations present the case for taking policy action at the EU level, there are arguments in favour of preserving the status quo. In particular, this is likely to be the most practical option. It avoids the difficulties associated with adopting an EU-wide approach to IGS and reaching a consensus on what such an approach should look like in practice. In addition, under the current system, Member States have adopted, or at least have the opportunity to adopt, the approach to IGS that suits national market characteristics and the institutional framework in a particular country. Put differently, there is flexibility for countries to implement (or not) an IGS, depending on their distributional preferences and taking into account the country-specific trade-offs when considering the costs and benefits of introducing and designing an IGS.

Moreover, a case can be made for adopting a 'wait-and-see' approach, given the limited scale of relevant cross-border insurance business to date and the lack of evidence of significant distortions in cross-border market operations under the status quo. Such an approach is also consistent with the view that insurance failures may be less likely going forward as insurance supervision at the EU level improves with the implementation of Solvency II—ie, the view that policy decisions concerning EU-wide implementation of an IGS should wait until these changes are implemented and their impacts evaluated.

Table 8.1 summarises the main advantages and disadvantages of preserving the status quo, categorised according to the criteria used for the evaluation.

Table 8.1 Summary of evaluation of the status quo

Criterion	Issues
Consumer protection within Member State	Conditions for equal (and effective) protection within Member States are not met. Lack of coverage in many Member States. Where a national IGS exists, policyholders may get no or differential protection depending on whether they buy the policy from a domestic or incoming EU insurer
Consumer protection across the EU	Conditions for equal (and effective) protection across Member States are not met due to gaps and differences in the scope of protection. If an insurer active in several Member States fails, policyholders may get no or differential protection depending on their country of residence
Confidence/stability	Gaps and differences in scope of protection may undermine confidence in the operation of the EU single market for insurance. The impact could be observed in the event of a failure of a larger insurer with significant cross-border operations
Competition (level playing field within Member States)	Conditions for a level playing field within Member States not met. Firms operating in the same market may not be subject to the same IGS arrangements. May distort competition through demand side (if consumers make their choice on the basis of IGS protection) and supply side (if firms in the same market incur different costs due to different IGS contributions). No evidence of significant distortions to date
Competition (barriers to entry across EU)	Conditions for a level playing field across the EU are not met due to differential IGS arrangements that may affect demand and supply conditions in different Member States. This may affect the decision of which Member States to enter and the form of entry (eg, subsidiary, branch or freedom of services). No evidence of significant distortions to date
Incentives	Less relevant in the cross-border context. Relates to general moral hazard concerns associated with IGS and depends on specific scheme design (see section 7.2)
Practicality/feasibility	Preserving the status quo may be considered the most practical and lowest-cost option, allowing Member States to adopt an approach to IGS that best suits national preferences and avoiding difficulties associated with implementing EU policy action. 'Wait-and-see' approach given limited cross-border business to date and lack of evidence of significant distortions in market operations
Fairness/proportionality	Current system allows countries to implement IGS (or not), depending on their distributional preferences and the country-specific trade-off of costs and benefits of IGS

Source: Oxera.

The case for changing the status quo and implementing an EU-wide approach to IGS depends to a large extent on the weight attached to the objective of protecting individual consumers (and, depending on the size of future failures, the related objective of preserving consumer confidence).

Furthermore, it depends on the weight attached to the fact that the conditions for a level playing field are not met under the status quo (as opposed to actual evidence of significant distortions in cross-border competition and the operation of the EU internal market). This in turn is likely to depend on the future growth of relevant cross-border insurance business—ie, distortions in the conditions for effective cross-border competition may have a more significant impact on actual market operations as the relevant business gains importance. However, even if cross-border business were to grow, as is expected to be the case, this would not necessarily result in sizeable distortions in the competitive process within or across Member States. As discussed in section 6.2.1, there is little evidence to suggest that the existence (or scope) of IGS protection is a critical factor in influencing consumer demand. In addition, IGS costs imposed on industry may not be sufficiently large to significantly distort competition via the supply side (see section 6.2.2). This could change going forward; however, if failures of insurers with cross-border business were to occur (particularly in the event of larger failures) consumer awareness of IGS protection may increase, and so may the cost for insurers required to fund the failures.

Assuming that failures of cross-border insurers cannot be ruled out going forward, the relevant question to ask is: what if it comes to a failure with cross-border implications? For example, what if a failure occurs that leaves consumers in a country with a home state IGS unprotected because the failure involves an incoming EU insurer from a country that does not have an IGS? Or what if some consumers are protected by an IGS and others not (or to a different degree), depending on their country of residency.

A 'do-nothing' response in those circumstances would be difficult to pursue, as confirmed by previous case experience. For example, the failure of Independent Insurance in the UK triggered the renewed debate to implement an EU-wide approach to IGS in 2001, and even the near failure of Equitable Life raised questions about the lack of harmonised IGS in the EU, despite the fact that no IGS protection was ultimately required (see section 6.1.1). The experience within individual Member States further supports the theory that not taking any policy action may not be a feasible response (see section 4.5 for examples of countries that have implemented an IGS in response to failure of a domestic insurer).

Arguably, the relevant question may therefore be not so much 'are there good reasons for changing the status quo?', but 'can EU policy action wait until a failure with significant cross-border implications occurs?'.

If such a failure occurs, it may be possible to respond with ad hoc policy measures to protect individual consumers affected (or, depending on the scale of failure, to prevent any wider adverse effects on consumer confidence or other market impacts). However, ad hoc measures may take time to implement and create uncertainty. There may be conflicts in reaching agreement about the appropriate measure to be taken and how to finance it. These frictions are likely to be exacerbated in the cross-border scenario where several countries are involved. Moreover, ad hoc measures risk being perceived as non-transparent and unfair, especially if they vary on a case-by-case basis (eg, depending on the countries involved or the nature of the failure). Thus, as in the single-country context, there are advantages of putting in place explicit arrangements to deal with insurance failures that have cross-border implications.

More generally, the case for and against an EU-wide approach to IGS is fundamentally linked to the question of the need for an IGS in the first place, and the costs of implementing and operating an IGS. The arguments for and against IGS (summarised in section 7.1) are not repeated here.

In the EU context, however, the balance of arguments will significantly vary across individual Member States. It will also depend on what an EU-wide approach to IGS would involve in terms of scheme design and degree of harmonisation.

- Countries that currently have an IGS may prefer an EU-wide approach to establish similar IGS elsewhere in the EU (at least as long as no significant changes to their own IGS are required). For example, assuming that the domestic IGS is based around the home state principle, the introduction of IGS in other Member States would ensure that domestic consumers are protected even if they purchase policies from incoming EU insurers; it would also ensure that incoming firms are required to participate and contribute to an IGS, thereby reducing any competition concerns among domestic firms.
- Countries that currently do not have an IGS, or that have a more limited IGS than may ultimately be required at EU level, would as a result of any EU requirements have to implement a scheme, or to extend their existing scheme. This could be considered detrimental from these countries' point of view if failures of domestic insurers were rare, but the required changes imposed significant costs to domestic insurers (and consumers). However, depending on the design of the IGS to be implemented, the costs could actually be very low: For example, if the IGS were organised around the home state principle, countries could implement an ex post-funded scheme (assuming that funding decisions were left to each Member State). If no failures of domestic insurers

occurred, no direct IGS costs would arise. At the same time, domestic consumers purchasing policies from incoming EU insurers would benefit from the protection afforded by the IGS established in other Member States. In this scenario, countries that currently do not have an IGS may therefore also gain from a change in the status quo that implements an EU-wide approach to IGS.

The following discusses different options for implementing an EU-wide approach to IGS. The advantages and disadvantages of different options are discussed at the general level, without considering the implications for individual Member States and their respective starting positions (ie, whether they currently have an IGS, or what changes to any existing national IGS may be required).

8.2 Implementing an EU-wide approach to IGS

The coexistence of different national approaches to IGS raises concerns about consumer protection within and across EU Member States. It also results in conditions that may distort the level playing field and the development of a single market in insurance. If the policy aim is to resolve these issues, an EU-wide approach to IGS will be required.

One such approach would involve the creation of a single EU-wide IGS that covers all relevant policies written and purchased within the EU. While a single EU IGS could address many of the problems associated with the status quo, this approach is not discussed further as it is unlikely to present a feasible and politically acceptable option, not least given the insurance supervisory framework in the EU and the differences in national market conditions and institutional structures. For example, although Solvency II will further harmonise regulatory approaches in the EU, perceived lack of uniformity in regulatory practices may leave insurance providers (and customers) in a country that has not experienced any recent failure with the impression that they are subsidising failing insurers (and their customers) in other countries.

A more limited EU-wide approach would be to create a pan-European IGS that covers only those policies that are written and sold across borders or, alternatively, that covers only those insurers that engage in cross-border business. Given that the relevant cross-border business is still limited, this could address the special (and in the broader scale still limited) problems that arise in the cross-border context, while leaving national autonomy when it comes to purely domestic business. However, a specific cross-border scheme is likely to create a number of important complications. For example, the participants in a specific scheme for cross-border insurers may change between years as insurers expand into, or withdraw from, cross-border business. Moreover, such a scheme would mean that some insurers in a country would belong to the cross-border scheme, while others in the same country would belong to the national scheme, which in turn could create problems relating to the lack of a level playing field. Furthermore, consumers may find it difficult to understand the system. Similarly, if the scheme were designed to cover cross-border policies only, insurers with cross-border business would need to participate in both the cross-border scheme and the national scheme, adding to complexity and potentially segmenting the market between domestic and cross-border provision.

For these reasons, the options of introducing a single EU-wide IGS, be it for all insurance business or only for relevant cross-border business, are not further discussed. Instead, ‘implementing an EU-wide approach to IGS’ is defined as ‘introducing an IGS in all EU Member States’.

If an IGS is to be implemented in all Member States to address cross-border problems, two main questions arise, which are further discussed below.

- What should be the geographic scope of the IGS—ie, should the national IGS be based on the home or host state principle?

- What degree of harmonisation is required between national IGS, and which dimensions of IGS design should be harmonised?

8.2.1 Geographic scope of IGS: host state versus home state

Among the existing IGS, some are structured largely around the home state principle, whereas others largely take a host state approach. In order to improve on the status quo, a consistent application of either the host or the home state principle (or possibly some combination) would be required. Any inconsistencies are unlikely to overcome the current problems associated with a lack of IGS coverage of some insurance policies (eg, if there is a failure of an insurer headquartered in a country with a host state IGS but operating through a branch in a country with a home state IGS), or indeed duplication of coverage (eg, if there is a failure of an insurer headquartered in a country with a home state IGS but operating through a branch in a country with a host state IGS).

Put differently, the minimum requirement for an effective EU-wide approach to IGS is a clear definition of the geographic scope of national IGS. As long as the scope is consistently defined across Member States, both the home and the host state structure can in principle deliver improvements in market outcomes compared with the status quo. However, there are differences in outcomes.

Adopting a host state structure for IGS has two main advantages.

- A host state structure would ensure that consumers resident in a Member State are protected to the same degree, irrespective of whether they acquire insurance policies from a domestic firm or an incoming EU insurer, as long as the host state IGS provides equivalent coverage for policies issued by branches or sold locally under freedom of services provisions. This would allow Member States to implement an IGS and offer protection to a level considered adequate for domestic consumers, which, for example, may depend on country characteristics such as national preferences and history of disruptive insurance failures. In contrast, equivalent within-country **consumer protection** would not be achieved by IGS structured around the home state principle unless the rules regarding the scope of IGS protection were fully harmonised across the EU. In other words, for a home state scheme to deliver the equivalent outcome, it would be necessary to fully harmonise the rules relating to policies covered, claimant eligibility, and protection limits, etc.⁹⁵
- Structuring IGS around the host state principle would also resolve any potential concerns about distortions in the level playing field between domestic and incoming EU insurers—ie, the host state principle would deliver a system that is neutral, all else being equal, with respect to **competition** within a Member State. Such conditions cannot be achieved by IGS structured around the home state principle, unless the IGS are fully harmonised with respect to the scope of protection *and* funding. Harmonisation in the scope of protection would be required to ensure that the demand-side conditions are equivalent for domestic and incoming EU insurers. Moreover, harmonised funding would be required to allow a level playing field from the supply side—however, even if the funding approach were fully harmonised across home state IGS, differences in costs would remain due to differences in the incidence of insurance failures, and hence the overall funding requirement for the IGS in different countries.

Thus, a host state structure has significant advantages over a home state structure when it comes to achieving effective consumer protection and competition *within* Member States—ie, there is no need for harmonisation across national IGS.

⁹⁵ Other problems may also need to be addressed to ensure equivalent protection under a home state scheme, such as concerns about language barriers to ensure that non-resident claimants have the same access to protection as resident claimants.

However, in relation to consumer protection and competition *across* Member States, neither the host nor the home state structure would, by itself, deliver the objectives desired—ie, some harmonisation of IGS design is required under both the host and home state structure in order to achieve more equal protection of consumers across Member States, or to create conditions that are more neutral for decisions concerning market entry into different Member States, including form of entry (ie, via subsidiary, branch or freedom of services).

Despite the advantages that host state IGS offer in terms of consumer protection and competition within Member States, adopting a host state structure can be considered less desirable from a **practicality/feasibility** point of view than a home state structure.

- **Duplication of administrative costs.** Insurers with cross-border business would be required to participate in more than one IGS, with corresponding increases in the number of information flows, data requests, contribution payments, etc. In addition, the failure of an insurer active in a number of Member States via branches and freedom of services would trigger the operation of more than one (and potentially up to 27) IGS.
- **Efficiency of IGS intervention.** Structuring IGS around the host state principle would not fit well with the supervisory framework for insurance in the EU, which is structured around the home-state principle. The home state supervisor is responsible for the prudential regulation of insurers and, under existing frameworks, for invoking the winding-up process. If the IGS were designed under the host state principle, the local supervisor may remain responsible for triggering and operating the IGS to protect the business of incoming EU insurers. This separation of responsibilities between jurisdictions may result in difficulties in the IGS process. For example, if the IGS intervenes by way of portfolio transfer prior to formal insolvency, it may not be possible for the host state supervisory authority to mandate the transfer of the portfolio of a branch or to activate the local IGS to facilitate such a transfer. Difficulties could also arise if the IGS makes compensation payments—eg, due to frictions in the information flow between the home state supervisor on the one hand, and the supervisor and IGS in the host state on the other hand. More generally, the process of establishing claims and handling IGS intervention is in many cases closely linked with the winding-up proceedings, requiring coordination between the supervisory authority, IGS operator, and the insolvency practitioner or administrator assigned to the estate of the failed insurer. Thus, a separation between the relevant jurisdictions for operating the IGS on the one hand, and for conducting and supervising the winding-up on the other, is likely to cause difficulties given existing legal frameworks, and to create inefficiencies in the IGS intervention process. However, such concerns may be reduced by an exchange of information and close cooperation between the relevant bodies in the home and host state before, during and after failure occurs and the IGS is triggered.
- **Political acceptance.** Industry may be more reluctant to contribute to an IGS if it perceives that its contributions flow to the financing of failures of incoming EU firms that may be subject to what may be perceived as a less stringent supervisory regime. Similarly, local supervisors may have reservations about the quality of home state supervision, and may therefore be more reluctant if they are required to trigger the local IGS in the event of failure of an incoming EU insurer. Such reluctance may be reduced, however, given the cooperation and mutual recognition of EU supervisors, and given the further harmonisation of supervisory practices as a result of Solvency II.

This final disadvantage of a host state IGS structure depends on notions of **fairness** and **proportionality**. Paying for the failures of incoming EU insurers operating via branches and freedom of services may be considered ‘unfair’ if those insurers are seen as otherwise exploiting a competitive advantage—for example, due to less stringent supervision. However, under the notion that ‘all firms operating in the same market should be subject to the same cost burden’, a host state structure would be more likely to meet the ‘fairness’ criterion. Put differently, the decision to adopt a host or home state approach to IGS implies different

allocations of costs and benefits across countries, and the advantage of one relative to the other is likely to depend on distributional preferences and the willingness to share IGS protection costs and benefits across borders.

One argument that has been put forward against the home state approach is that if an insurer with headquarters in a small country and with substantial cross-border business fails, the home-state IGS may face significant problems in terms of raising the funding necessary to make the promised payments. However, this argument is currently unlikely to apply to the majority of Member States (except, for example, in the case of Luxembourg). Moreover, if organised around the home state principle, the business earned via branches or freedom of services abroad can be included in the funding basis.

The choice between the home and host state structure may be less relevant when it comes to the other two main evaluation criteria applied, which are as follows.

- **Market confidence and stability.** From the perspective of consumers and their confidence in the system, it may not matter whether schemes are structured on a home or host state basis, as long as there is an IGS that intervenes and provides adequate protection in the event of a failure.
- **Incentives.** The incentive criterion is largely used in the context of discussions of moral hazard and, as such, is relevant to addressing the question of whether to introduce an IGS and how to design it with respect to the scope of protection and funding (sections 7.2 and 7.4). The criterion is considered to be less relevant when defining the geographic scope of an IGS, although it is conceivable that the choice between host or home state could affect incentives. For example, it may change the incentives of the supervisory authorities to declare a firm insolvent and trigger the IGS. Furthermore, it may affect incentives of insurers—for example, with respect to where to locate their business or how to enter different markets. This is captured in the discussion about the competition criterion above.

Table 8.2 summarises how structuring an IGS around the host or the home state principles would score against the different evaluation criteria.

Table 8.2 Summary evaluation of host versus home state approach to IGS

	Home state	Host State
Consumer protection within Member States	Ensured if scope of protection is harmonised ¹	Ensured
Consumer protection across the EU	Ensured if scope of protection is harmonised ¹	Ensured if scope of protection is harmonised ¹
Confidence, stability	Home versus host may not matter as long as there is an IGS that intervenes	Home versus host may not matter as long as there is an IGS that intervenes
Competition (level playing field within Member States)	Ensured if scope of protection and funding arrangements are harmonised ²	Ensured
Competition (barriers to entry across EU)	Ensured if scope of protection and funding arrangements are harmonised ²	Ensured if scope of protection and funding arrangements are harmonised ²
Incentives	Not considered relevant in this context	Not considered relevant in this context
Practicality, feasibility	Fits EU supervisory framework. Case handling easier if IGS is in a country where insurer is wound up. Potentially more politically acceptable	Potential problems with information-sharing and case handling if IGS, competent supervisory authority and winding-up are not in same jurisdiction. Single failure could trigger operation of several IGS.
Fairness, proportionality	Fairer than host state if incoming EU insurers are perceived to be subject to less stringent home supervision	Fairer than home state under the view that 'all firms in the market should pay the same'

Notes: A home state IGS is defined as one that covers all domestically authorised insurers, including their relevant business conducted via branches and freedom of services in other Member States. A host state IGS is defined as one that covers all relevant policies sold to domestic policyholders, including policies of incoming EU insurers (branches and freedom of services). It is assumed that either the home state or the host state approach is consistently adopted in all Member States. ¹ Equal consumer protection (within or across countries) is achieved only through full harmonisation, and varying degrees of harmonisation will deliver different degrees of consumer protection. ² Even if funding is harmonised, there may not be a level playing field within or across countries if there are differences in the level of (expected) IGS costs to be funded.

Source: Oxera.

Overall, while the host state principle has significant attractions in terms of equal protection for consumers and a level playing field for insurers within countries, the more practical and feasible approach is likely to be IGS structured around the home state principle. This approach would be consistent with the single authorisation and the home supervision principle applicable in the insurance sector.

It would also mirror the approach taken by the DGS and ICS established in Member States in accordance with the relevant Directives.⁹⁶ The Directives provide for a minimum harmonised level of protection for consumers in the event of failure of a deposit-taker or investment firm. Incoming EU firms are given the option to join the scheme in the host state on a voluntary basis and seek supplementary cover ('topping up') if the level of cover exceeds that of the insurer's home state. In practice, the number of firms making use of the topping-up

⁹⁶ It would, however, not be consistent with the geographical scope of existing motor guarantee funds in the EU, which, although related, are outside the scope of this study. Victims of road accidents can claim against the local guarantee fund and there is an agreement between national guarantee funds in cross-border cases. Another example of a scheme structure based around what is essentially a host state principle comes from the IGS in the USA. Each state has two IGS (one covering life and health insurance, and the other covering property and casualty insurance). Insurance providers are required to become members of the relevant scheme in each state in which they operate. In the event of the insolvency of an insurer operating in multiple states, the state schemes are supported by two separate supra-state organisations (NOLHGA and NCIGF). However, incoming insurers also need a licence from the relevant state supervisor, so the situation is not directly comparable with cross-border business in the EU carried out under the single passport.

provisions has been limited, also due in part to the fact that protection levels in many countries do not exceed the minimum protection requirements set out in the Directives.⁹⁷

Adopting a home state approach for IGS could in principle also be complemented by ‘topping-up’ arrangements for branches of incoming EU insurers, and potentially also for freedom of services providers. However, such arrangements will raise practical difficulties in line with those discussed above in the context of host state IGS. In particular, and unlike in the banking or securities sector, providing top-up protection for incoming EU insurers leads to difficulties if the local IGS aims to facilitate the continuation of policies via portfolio transfer to another insurer, or indeed if the IGS operator assumes the portfolio itself.

Geographic scope in the context of lead supervision

As part of Solvency II, the European Commission is introducing the concept of a lead (or group) supervisor for the supervision of insurance groups. The lead supervisor is the supervisory authority in the home country of the parent company, and is responsible for the supervision of the entire group, working in cooperation with the local supervisors of Member States in which the subsidiary companies of the group are located.

The detailed proposals concerning the change in the allocation of supervisory responsibilities are yet to be finalised and implemented. The following sets out some considerations that are relevant to assessing the implications of the adoption of the lead supervisor concept in the context of defining the geographic scope of IGS.

Under the status quo, in those Member States where IGS have been established, subsidiaries participate in, and are covered by, the local IGS like other domestically authorised firms (and incoming non-EU insurers). The question is therefore whether a case could be made for changing the IGS structure such that subsidiaries, irrespective of where they are located, participate in the IGS of the Member State where the parent company is located and lead supervision is undertaken. In other words, can the arguments that have been presented above in favour of a home state IGS be extended to apply not only to branches (and freedom of services providers) but also to subsidiaries?

There would be three main advantages to designing the geographical scope of an IGS in line with lead supervisor responsibilities, and hence including subsidiaries in the home state IGS of the parent company.

- The level of consumer protection in the event of failure of an insurance group would be equivalent *across* EU Member States, irrespective of the place of residency of policyholders and of whether the policyholders in different countries had purchased the policies from subsidiaries, branches, or freedom of services providers. The level of consumer protection *within* Member States would not be equivalent, however, unless national IGS were harmonised.
- Decisions of insurance groups to enter different EU markets would not be affected by cross-country differences in local IGS, since all business conducted within the group, be it domestically or in other Member States via subsidiaries, branches or freedom of services, would be covered by the same home state IGS. While this solution may improve some competition conditions *across* Member States, a level playing field *within* Member States would not be ensured unless national IGS were harmonised.
- There would be coherence between the Member State in which lead supervision is carried out and the Member State in which the IGS is located. To the extent that the lead supervisor is responsible for the ongoing supervision of the entire group, including

⁹⁷ For information on the lack of cross-border participation in investor compensation schemes, see, for example, Oxera (2005), ‘Description and Assessment of National Investor Compensation Schemes Established in Accordance with Directive 97/9/EC’, a report prepared for the European Commission, January.

subsidiaries, it may be considered 'fairer' if the lead supervisor is also responsible for delivering the IGS protection to policyholders. There could be concerns, or indeed reluctance, at the local level to pay for any mistakes that have been made, or are perceived to have been made, by the lead supervisor (or by internal risk management at the group level), especially if there have not been any failures at the local level in the recent past. However, harmonisation of supervisory approaches and coordination between lead and local supervisor may alleviate these concerns.

Despite these advantages, there are important arguments for not changing the IGS participation requirements for subsidiaries and retaining the current practice of their participation in the local IGS, irrespective of whether there is a move to lead supervision.

- From the perspective of the local insurance market, equivalent treatment of subsidiaries and domestic insurers ensures equal protection for domestic consumers and a level playing field between the two types of provider in the market.⁹⁸ If the IGS of the lead supervisor country were in charge of subsidiaries, these conditions could be achieved only if the scope of protection and IGS funding were fully harmonised across countries.
- In contrast with branches, subsidiaries can in principle default while the parent remains solvent. Moreover, under the lead supervision proposals, it is the local supervisor that takes back the control of the subsidiary solvency on a local basis in the event of a breach of the subsidiary's MCR and the request for capital transfer to refill the MCR has not been fulfilled. Administrative feasibility and other practicality reasons therefore favour an approach where the local supervisor is responsible for taking the winding-up decision and triggering the IGS, and where the local IGS provides the protection. This approach would ensure consistency (in terms of jurisdiction) between supervision around the MCR, winding-up of the subsidiary and operation of IGS.
- Local participation of subsidiaries of a group means that, in the event of failure, the guarantee costs and resulting funding requirement are spread across local IGS rather than concentrated in the single IGS of the parent's home state. If losses across the entire group had to be covered by a single IGS, this could in some cases present significant financing problems. It may be possible to reduce these problems by requiring the group to make ex ante contributions to the IGS in proportion to the scale of both their domestic and foreign business, but the impact on remaining insurers in the market (and their policyholders) may be significant nonetheless. Moreover, there could be greater reluctance from those required to fund the IGS, particularly in those Member States that host a significant number of groups.
- Assigning responsibilities for subsidiaries to the IGS in the jurisdiction of the lead supervisor could also present problems and give rise to particular opposition in those Member States that are host to a significant number of subsidiaries of EU insurance groups. Since foreign subsidiaries would no longer participate in the local IGS and take a share of the costs in the event of domestic failures, this could lead to concerns about the ability and usefulness of running a reduced-size domestic IGS. Moreover, it would shift last-resort protection for a significant part of the local insurance market abroad. Retaining the current participation of foreign subsidiaries in the local IGS may therefore be more acceptable.

8.2.2 Degree of harmonisation of IGS across countries

The decision concerning the geographic scope of the IGS has implications for the need for, and degree of, harmonisation of the national IGS. In particular, as summarised in Table 8.2:

⁹⁸ While an unequal treatment may also apply to branches and freedom of services, the impact could be potentially more significant given the importance of foreign subsidiaries in many markets.

- if the IGS is structured around the **host state** principle, equivalent consumer protection *within* EU Member States is achieved without any harmonisation of IGS arrangements. In addition, no harmonisation is required to ensure level playing field conditions between domestic and incoming EU insurers operating in the same jurisdiction. Harmonisation is required only if the objective is to achieve more equal consumer protection and competition conditions *across* countries;
- if the **home state** principle is adopted, a minimum level of harmonisation between the IGS of different Member States is required to deliver the desired market outcomes in terms of cross-border consumer protection and competition, both *within* and *across* countries.⁹⁹

Assuming that the home state principle were to be adopted, the question is what dimensions of IGS design should be harmonised and to what degree. This depends in part on the policy objectives.

- If the objective is to improve **consumer protection** in cross-border business, some harmonisation is required with respect to the scope of protection afforded by IGS in different countries. There is no need to harmonise funding requirements or organisational structures across IGS, as long as national IGS arrangements are such that the promised protection can actually be delivered.
- If the objective is to improve the **competitive conditions** for cross-border business, harmonisation of the scope of protection is required so as to ensure level playing field conditions on the demand side. In addition, IGS funding would need to be harmonised to deliver level playing field conditions on the supply side.

However, the decision to harmonise funding arrangements should take into account the following considerations that weaken the case for harmonising this dimension of IGS design.

- Cost differences across IGS do not only depend on the way the relevant IGS are funded but, more importantly, on the amount of IGS funding required. As long as the frequency and impact of insurance failures differs across EU Member States, there are limits on the extent to which a level playing field in terms of IGS costs can be achieved. Even if all dimensions of IGS funding were fully harmonised between countries, insurers required to contribute to an IGS that makes (or is expected to make) more frequent or larger payments would be at a competitive disadvantage compared with those insurers participating in an IGS that is infrequently triggered and has an overall low (expected or actual) funding requirement.
- There is little evidence of significant competitive distortions in cross-border business under the status quo. Hence, the case for harmonising funding is limited, or at least smaller, than if distortions had been found to be significant.
- As discussed in section 7.4.1, building up a large ex ante fund is likely to impose disproportionate costs on industry (and customers) in countries where IGS costs are expected to be low and industry structure is such that funds can easily be made available even if a larger-than-expected failure occurred. In those countries, the arguments for establishing an ex post-funded IGS are likely to dominate. In other countries, however, the arguments for ex ante funding may dominate. A one-size-fits-all approach to funding is unlikely to be optimal given differences across the EU in industry structure and the financial capacity of industry to bear the cost of failures, even if the implementation of Solvency II is expected to further harmonise regulation (and with it the incidence of insurance failures) across countries.

⁹⁹ Harmonisation would also be required under a home state principle defined around the geographic reach of a future lead supervisor (perhaps even more so given the significance of business conducted via foreign subsidiaries in many countries).

- There may be concerns among Member States that currently do not have an IGS that the mandated IGS could impose significant costs on industry (and consumers) because the chosen harmonised funding structure could imply that large ex ante contributions to be paid to the IGS would be required. Section 5.1.3 showed that an IGS could be operated without any direct cost on industry if it is ex post-funded and no failures occur in the country. In this case, the country can only gain from the introduction of IGS in other countries. This is because there will be no direct cost for the domestic IGS, but at the same time there will be the benefit that domestic policyholders who purchase policies from incoming EU insurers would be protected by the IGS established in the relevant home states—ie, protection for domestic consumers can in principle be achieved without imposing direct costs on the domestic industry. More generally, allowing flexibility on the funding side may increase the acceptance for implementing an EU-wide approach to IGS.
- The relevant EU Directives on DGS and ICS leave it to Member States to decide on scheme funding. The need for harmonisation of the funding of EU DGS was recently reviewed by the European Commission, although it was concluded that no policy action would be taken in this regard, at least for the time being.¹⁰⁰

As discussed in section 7.3, the way existing IGS are organised differs significantly across countries (eg, with respect to management and staffing), and there is no reason to believe that one form of organisation is in all circumstances preferable over another. If the focus is on improving market outcomes—eg, in terms of improved consumer protection—there would appear to be no need to harmonise the process or methods through which these outcomes are being delivered. Put differently, as long as the organisational structure of national IGS are such that the outcomes are being delivered, the case for harmonising these arrangements across countries is limited, especially given that the optimal choice of organisational structure is likely to depend on the legal or wider institutional framework in a country. The EU Directives on DGS and ICS also leave decisions concerning operating arrangements to each Member State. Nonetheless, what is likely to be important in the cross-country context is that structures are implemented that allow effective coordination and/or communication between national supervisory authorities, IGS operators and other stakeholders when it comes to failures with cross-border implications.¹⁰¹

For these reasons, and the fact that the case for EU policy action largely rests on concerns about ineffective consumer protection (and related market confidence reasons), harmonisation can be considered most appropriate or necessary in relation to the scope of protection afforded by national IGS. The relevant dimensions to be considered include those set out in section 7.2—ie, type of policies covered, claimant eligibility and protection amounts and limits. Depending on the degree and consistency of protection desired, they may also include the nature of IGS intervention (section 7.3.1).

The question is how far these dimensions should be harmonised, and what harmonised requirements should be imposed.

Section 7.2 sets out how scheme design can be adjusted to deliver different levels of protection, and presented the arguments for and against specific design options. These arguments are not repeated here. What is clear is that there is no single option that is optimal in all circumstances, and the chosen scope of IGS protection ultimately depends on distributional preferences and the weight attached to consumer protection objectives.

¹⁰⁰ Commission of the European Communities (2006), 'Communication from the Commission to the European Parliament and the Council concerning the review of Directive 94/19/EC on Deposit Guarantee Schemes'.

¹⁰¹ If the IGS operate on a home state basis, this also includes structures to ensure that non-resident policyholders are not disadvantaged when they have to access the home state IGS responsible for providing the guarantee. In terms of IGS operation, this may require special measures to ensure that non-resident policyholders are notified about the guarantee and can claim and receive compensation despite any language barriers or other difficulties that may arise in the cross-border context.

In the cross-border context, the choice concerning the scope of protection is further complicated by the fact that what is considered adequate in some countries may not be considered adequate in others—eg, given the cross-country differences in household income and insurance cover.

Thus, while full harmonisation may be required for consumer protection purposes, and to resolve the concerns associated with the status quo, this approach may not be practical or feasible. It is also likely to be counter to the subsidiarity principle and not politically acceptable.

Given that a balance needs to be struck between conflicting objectives, the compromise that may need to emerge is one of minimum harmonisation. How to set the minimum standards, or where to set the minimum level of IGS protection, depends on policy preferences at the EU level overall and the weight of relative preferences between individual countries. Relevant considerations in relation to each of the main IGS design dimensions include the following.

- **Policies covered.** Section 7.2.1 presented the arguments for prioritising specific classes of insurance for the purpose of IGS protection, and (all or some of) the prioritised classes could define the minimum harmonised scope in terms of policies to be covered on an EU-wide basis. The prioritised classes included life assurance, liability insurance where third parties are at risk, and other non-life insurance that covers (significant) risks in the retail market. In the EU context, a definition of scope on the basis of what constitutes compulsory insurance does not appear feasible given the differences in the number and type of compulsory insurances across Member States.
- **Claimant eligibility.** Similarly, the minimum harmonised requirements in relation to eligible claimants could be defined such that all EU IGS cover at least (some of) those claimants that, as discussed in section 7.2.2, could be argued to merit priority in terms of eligibility because of greater protection needs and/or because they are less likely to engage in moral hazard behaviours—ie, retail policyholders, beneficiaries and injured third parties. Consistent with the EU Directives on DGS and ICS, Member States could therefore be allowed to exclude from IGS protection (large) corporate policyholders, other insurers or financial institutions, and persons connected to the failed insurer.
- **Protection amounts and limits.** In line with the discussion in section 7.2.3, the minimum requirements could define the protected amounts with respect to contractual commitments (rather than wider policy benefits) and outstanding claims (rather than pre-paid premiums). As regards compensation limits, a percentage reduction applied to claims could be considered more appropriate than the imposition of a maximum amount because of the highly skewed distribution of claims for some classes of insurance, and because of the difficulty of specifying a single absolute amount that is appropriate for all EU Member States given differences in income and insurance cover. (Small) deductibles or minimum floors on claims could also be allowed at the level of national IGS; they may reduce the administrative burden for IGS without unduly jeopardising any wider cross-border consumer protection objective.
- **Nature of intervention.** As discussed in section 7.3.1, the consumer protection objective is in many cases more effectively met if the IGS intervenes to facilitate the continuity of insurance cover rather than to pay cash compensation for losses incurred. However, continuity of cover may not always be feasible and may require the IGS to assume responsibilities and adopt an organisational structure that goes beyond that required for an IGS that only has a ‘pay-box’ function (ie, collects levies and pays compensation for claims established as eligible). This applies in particular where the IGS operator may itself take over the portfolio of the failed insurer because portfolio transfer to another insurer is not possible or is too costly. As with IGS operating arrangements more generally, it could therefore be argued that a ‘minimum harmonisation’ approach to IGS in the EU should not specify the nature of IGS

intervention, or set minimum compensation standards only, but allow Member States to implement IGS that could deliver potentially superior forms of consumer protection.

The minimum harmonised protection standards would still imply differences between national IGS—ie, unless all EU Member States adopted only the required minimum, the level of IGS protection available would still vary across Member States and, unless the host state principle were adopted, within a Member State, depending on whether the policy is bought from a domestic insurer or incoming EU firm. As such, cross-border consumer protection would improve compared with the status quo, but would not necessarily deliver equal protection within and across countries. The higher the minimum standards, the more likely it is that IGS protection levels will be equal—but at the costs and with the problems set out before.

8.3 Other options at EU level

The above evaluation has focused on two main policy options at EU level: preserving the status quo and implementing an EU-wide approach to IGS. There is a range of further EU policy measures that could be implemented to change the status quo, but without going as far as mandating the establishment of IGS in all EU Member States. The following considers two such measures and discusses their likely effectiveness in addressing the concerns associated with the current situation of different national approaches to IGS.

- Enhancing the information available to policyholders about the existence of IGS and the level of IGS protection afforded.
- Launching infringement proceedings against Member States if aspects of national IGS operation are found to be discriminatory, or taking other actions that may provide ad hoc solutions for specific cases of cross-border insurance failure.

8.3.1 Enhanced policyholder information

Information is generally considered an essential element of consumer protection—consumers must be able to receive clear and accurate information about the essential characteristics of the products offered to them and any other information that is necessary to enable them to choose the contract best suited to their needs. This general point applies to policyholders in the IGS context as much as it applies to consumer purchase decisions in other areas.

Enhancing policyholder information about the existence and level of protection of IGS (be it directly from providers, via intermediaries or through other means) may indeed alleviate some of the consumer protection concerns that arise specifically in the cross-border context. In particular, assuming that it is properly understood and incorporated in the decision-making process, such information may enable consumers to choose between the policies of domestic insurers and incoming EU insurers, taking into account differences in IGS protection and other relevant factors. Put differently, in countries where the policies of domestic and incoming insurers are subject to different levels of IGS protection, enhanced information can reduce concerns about consumer protection within Member States.

However, it does not address all cross-border consumer protection concerns, such as the following.

- There are limits to information as a tool for improving consumer protection. Given the diversity of national approaches to IGS and the additional complexities that arise in the cross-border context, it is unlikely that the majority of consumers would be able to understand and process the information they would need to fully assess which policies are covered by an IGS and which are not, and how IGS protection levels vary between the policies on offer. Furthermore, more or better information does not improve the

position of third-party claimants who may suffer losses in the event of cross-border insurance failure.

- While better information may reduce some concerns about consumer protection *within* Member States, it does not address the problem of differential consumer protection *across* Member States. The failure of the same insurer could still imply that policyholders receive very different levels of IGS protection (or indeed no protection), depending on their country of residency. Furthermore, the main consumer protection concern—ie, the lack of IGS in many Member States—would not be addressed.

Enhanced information does not address other problems associated with the status quo, and indeed may exacerbate some problems. For example, if the provision of information about IGS existence and coverage were effective, this could affect the demand for policies of incoming EU insurers relative to domestic insurers, which in turn may aggravate concerns about the lack of a level playing field between different insurers. Information may also be misunderstood, or indeed used for misleading advertising purposes, which may further distort the competitive conditions between domestic and cross-border insurers operating *within* the same country (see section 6.2.1). The greater weight attached to IGS (and IGS differences) could also exacerbate concerns about competition *across* countries.

8.3.2 Infringement proceedings and other case-by-case solutions

Some cross-border concerns associated with the status quo stem from a differential IGS treatment of policyholders or policies, depending on the place of residency of the policyholder (or the location of the risk) in the EU or the country of incorporation of the insurance provider (or type of cross-border provision). Such concerns could be addressed through selective policy intervention without overhauling the system and implementing a consistent IGS approach across all EU Member States. This intervention could take the form of formal infringement proceedings against Member States (eg, if evidence of discriminatory treatment can be provided), or less formal measures to invoke changes in the relevant national IGS. It could take place once a failure has occurred, or before so as to prevent frictions and delays in the event that a failure with cross-border implications occurs.

For example, such intervention could be applied in the following cases.

- National IGS that currently operate on a host state basis and do not typically cover the policies issued by branches of domestic insurers in other EU Member States could be required to extend the protection to non-domestic policyholders on the same terms as domestic policyholders. This would ensure that policyholders of the same insurance undertaking receive equivalent protection in the event of failure, irrespective of their country of residency. A similar requirement could be imposed on those IGS that currently do not cover risks located outside their jurisdiction.
- National IGS that currently operate on a home state basis and do not allow the participation of incoming EU insurers could be asked to open the national scheme to branches, which could then decide to participate on a voluntary basis. Such voluntary participation would be similar to the ‘topping-up’ possibility envisaged under the Directives for DGS and ICS in the EU. It would enable incoming EU insurers that are not covered by a home-state IGS (or that are covered to a more limited degree) to seek additional protection for their policies in the local market, putting them on a level playing field with domestic insurers.

However, the feasibility and political acceptance of these intervention measures is not clear. For example, in the first case, suppose that the non-domestic policyholders were residing in a Member State that currently does not operate any IGS at all. Given that the policyholders would not have received any protection had they purchased the policies from a domestic insurer, it is less clear why they should benefit from protection if they purchased the policies from a branch of an incoming insurer; since the protection would be largely financed by other

insurers (and their policyholders) in the home state of the incoming insurer, there may be further reluctance to provide this protection.

Similarly, in the second case, as discussed above, extending IGS participation to branches of incoming EU insurers can create administrative problems for the local IGS operator, particularly for those IGS that facilitate portfolio transfer or themselves take over the portfolio to ensure continuation of policies. Also, as discussed in section 8.2.1, the separation of the relevant jurisdiction for operating the IGS on the one hand and conducting and supervising the winding-up on the other hand may cause difficulties, given the home state structure of the existing EU supervisory framework. Furthermore, the solution may not be considered acceptable from the perspective of the relevant host state if the problem results from the fact that the home state has not established any IGS (as is the case in 14 EU Member States), or if the problem could be more easily addressed by introducing or extending IGS coverage in the home state.

Select intervention measures may close some gaps in consumer protection that currently arise in the cross-border context. They may also improve conditions for a level playing field between domestic and incoming EU insurers in some Member States. However, such measures fall short of addressing cross-border consumer protection and competition problems on a comprehensive and consistent basis across the EU.

8.4 Summary

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 by two facts. First, the relevant cross-border business (ie, retail business carried out via branches and freedom of services) remains low. Second, there has been a lack of insurance failure with cross-border implications.

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 EU Member States.

Select 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 (for all insurance business or only for the relevant cross-border business) is unlikely to be feasible or politically acceptable, this could instead involve setting up national IGS in all EU Member States, similar to 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 (or possibly some combination). 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 could raise a number of related problems in terms of both practicality 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 other) mistakes in the home state. For these reasons, the home state principle may be preferred.

A move to lead supervision under Solvency II may give rise to new issues about the geographic scope of IGS. While there are advantages to 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 also are 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 in different 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 policies that should be covered; claimant eligibility; protection amounts and limits; and, depending on the degree and consistency consumer protection desired, the nature of IGS intervention. As discussed in section 7.2, 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.

Appendix 1 IGS in the EU

This appendix provides the background for the inventory and cross-country comparison of IGS in the EU Member States. IGS have been established in 13 Member States, and a summary description is provided for each country.¹⁰²

Table A1.1 Types of IGS in 13 EU Member States

	General schemes for life and non-life insurance	General schemes for life assurance	General schemes for non-life insurance	Special schemes for non-life insurance
Belgium				✓ ¹
Denmark			✓	
Finland				✓ ²
France		✓	✓ ³	
Germany		✓		✓ ⁴
Ireland			✓	
Italy				✓ ⁵
Latvia	✓ ⁶			
Malta	✓			
Poland		✓ ⁷		✓ ⁷
Romania	✓			
Spain	✓ ⁸			✓ ⁸
UK	✓			

Notes: ¹ Covers compulsory workers' accidents insurance only. ² Scheme for statutory employment accident insurance, and scheme for statutory patient insurance. ³ Scheme covers only compulsory non-life insurance, but classified as a general scheme because of the number of compulsory insurances in France and to distinguish it from the special schemes that only cover one insurance branch. ⁴ Covers substitutive private health insurance only. ⁵ Covers hunting liability insurance only. ⁶ Several classes of non-life insurance excluded, but classified as a general scheme to distinguish it from the special schemes that cover only one insurance branch. ⁷ One scheme that covers life and non-life insurance but not classified as a general scheme because only specific branches of non-life insurance are covered (farmers, farm buildings, professional and motor TPL). ⁸ General winding-up scheme for life and non-life insurers as well as special schemes for travellers' accident and hunting liability insurance.

Source: Oxera.

In addition to the 13 countries, a description is provided of the Early Intervention Arrangements for Life Insurers (EIALI) in the Netherlands, which cannot be classified as constituting an IGS, but which nonetheless offer an outcome, in terms of consumer protection, that is similar to the protection provided by some of the schemes established for life insurers in other countries. The description for the Netherlands also includes the protection scheme established within the new insurance system for curative healthcare.

The country descriptions are ordered alphabetically, rather than by type of scheme. The descriptions cover:

¹⁰² Conversion rates: most schemes have provided figures in euros, which are directly comparable. However, where the schemes did not provide conversions from their domestic currency, into euros, Oxera has used exchange rates from www.oanda.com dated April 3rd 2007.

- background information on the schemes, including legal and regulatory frameworks and date of establishment;
- governance arrangements in terms of ownership and scheme management;
- scheme participation requirements and information about the type and number of insurers participating in the schemes;
- scheme coverage, which relates to criteria for eligibility (protected policies and eligible clients, including cross-border arrangements) as well as to any protection limits applying;
- operating arrangements relating to the nature of intervention and claims processing by the schemes;
- funding arrangements, including industry contributions as well as other sources of funding;
- experience with past or ongoing cases of intervention by the schemes.

The information contained in the country descriptions is based on the questionnaire circulated among scheme operators (see Appendix 2), in-depth interviews, annual reports, laws and other published documents, as well as information already available to the European Commission. Unless otherwise stated, the quantitative information provided in the tables comes from the data provided by the scheme operators in their questionnaire responses and/or interviews.¹⁰³

¹⁰³ For countries outside the Eurozone, the reported amounts were in some cases converted into euros directly by the scheme operators providing the relevant information. In other cases, the national currencies were converted using the exchange rate as of April 3rd 2007 from www.oanda.com.

A1.1 Belgium

Background information

There is no general IGS to cover life assurance and non-life insurance in Belgium. However, a special scheme covering workers' (compulsory) accidents insurance policies has been set up. Workers' accidents insurance is privately provided for in Belgium rather than being part of social security. The scheme is operated by the Fonds voor Arbeidsongevallen/Fonds des Accidents du Travail (FAO/FAT), which are part of the Belgian Federal Public Service Social Security.

The FAO/FAT assumed responsibility for handling insurance failures on January 1st 1972 following the approval of the Law of April 10th 1971. Article 58 of this Law specifies that one of the FAO/FAT's functions is to compensate employees or beneficiaries (eg, relatives) when winding-up proceedings are initiated.

Scope of coverage

Scheme participation

Companies authorised to provide workers' accidents insurance in Belgium are required to participate in the scheme. Insurers have to make a fixed contribution of €1.4m to the FAO/FAT when they enter the workers' accidents market. This money is put aside by the FAO/FAT for policyholders or other beneficiaries in the event of insolvency.

There are currently 17 domestic firms participating in the scheme. EU and non-EU insurance undertakings, including branches of EU insurers, would, in theory, be required to participate in the scheme. However, none are currently offering workers' insurance, and thus there are no non-domestic undertakings participating in the fund.

Protected policies and eligible claimants

The fund protects only workers' accidents insurance policies, which are compulsory for all employees in Belgium.

Protected claimants are natural persons—ie, either the employee or beneficiaries (eg, the employee's family).

Operating arrangements

Following a declaration of insolvency of the sector regulator (Commission Bancaire, Financière et des Assurances, CBFA), the FAO/FAT steps in and administers the insurance policies of the insolvent insurer and pays any claims arising. Since no insurance undertaking has initiated winding-up proceedings since 1975, the FAO/FAT has not performed the tasks relating to an IGS.

In addition to protecting claimants in the case of winding up, the FAO/FAT performs a number of activities, including compensating employees for work-related accidents in the event of the employer not insuring them.

Funding

The scheme is funded through a combination of ex ante and ex post funding. Where the former is concerned, all insurers offering workers' accidents insurance have to make a €1.4m

contribution to the FAO/FAT. This deposit is used only in the event of the insurance company in question going bankrupt.

As for ex post funding, if the above funds plus those arising from selling off the assets of the insurance undertaking in difficulties are not sufficient to compensate policyholders and beneficiaries,¹⁰⁴ the FAO/FAT imposes a levy on other insurers offering workers' accidents insurance. However, legislation does not specify the structure of such levies.

Finally, management and administration expenses of the FAO/FAT are funded by general budget—ie, public servants.

Past cases of intervention

While the FAO/FAT has covered claims relating to instances of non-insurance, since its establishment, there have been no claims arising from cases of insolvencies of insurance undertakings.

¹⁰⁴ According to Article 101 of the Law of April 10th 1971, the FAT has priority over the assets of the insurer in liquidation.

A1.2 Denmark

Background information

Denmark has an IGS for non-life insurance, the Garantifonden for Skadesforsikringsselskaber. The scheme was introduced by the Guarantee Fund for Non-life Insurance Companies Act 2003 (Consolidated Act no. 457 of June 10th 2003).

The scheme was established following the bankruptcy of a small non-life insurance company on October 18th 2002 (Plus Forsikring A/S). The question of whether the portfolio of the failed insurer should be transferred to another company was debated, but since no other insurer was prepared to take over the policies, it was decided that claimants should be compensated instead, and a scheme was established for that purpose.

A corresponding scheme for life assurance companies does not exist in Denmark, although there is a special arrangement for handling the bankruptcy of life assurance companies.

Structure and governance

The Guarantee Fund is under private ownership and private management, with the daily management of the scheme undertaken by the Danish Insurance Association.

There is a board of directors consisting of five members who are appointed by the Minister for Economic and Business Affairs. The members and their proxies are appointed for three years. Decisions are based on a simple majority of votes.

The scheme is directly accountable to, and regulated by, the Danish Financial Supervisory Authority. The Authority and the scheme have the power to demand from the insurance companies covered by the scheme all the information deemed necessary to ensure compliance with regulations.

Two staff from the Danish Insurance Association carry out the operational functions of the scheme, each spending half of each working day on scheme-related activities. Thus, in total, the scheme has the equivalent of one full-time staff member.

The costs of administration of the scheme are shown in Table A1.2 for the period 2004–06.

Table A1.2 Administration costs of the Danish IGS, 2004–06

	2004	2005	2006
Administration costs (€)	197,520	183,913	115,733

The administrative costs cover all running costs, including remuneration of the board and accountants, information resources and office supplies. The administrative costs for 2004 and 2005 also include costs for setting up the scheme as well as the administration of the claims following the bankruptcy of Plus Forsikring A/S. Therefore, the administrative costs from 2006 would be expected to be significantly lower.

Scope of coverage

Scheme participation

The scheme provides coverage when a non-life insurance company, which has permission from the Danish Financial Supervisory Authority to carry out insurance business, is declared bankrupt. The scheme covers the business of these insurance companies conducted in

Denmark or via branches or cross-border services within the EU, or in countries with which the European Community has entered into agreements.

The scheme does not require participation of EU branches operating in Denmark, so there are currently no EU branches participating in the Danish scheme. However, the scheme does require non-EU undertakings to participate since these need authorisation from the Danish Financial Supervisory Authority in order to conduct business in Denmark. There are currently no non-EU undertakings participating in the scheme.

Table A1.3 shows the number of insurance companies participating in the Danish guarantee scheme. In total, there were 51 companies participating in 2006.

Table A1.3 Number of participating non-life insurers

	2006
Domestic insurance undertakings	51
EU branches	0
Non-EU insurance undertakings	0
All participants	51

Protected insurance policies

The Danish IGS protects non-life insurance policies, for both compulsory and non-compulsory classes of insurance. In particular, the following qualify for compensation by the scheme:

- policyholders with private consumer insurances (consumer policies);
- third parties insured against personal injury and damage to property under third-party motor liability insurances;
- third parties insured against personal injury under other TPL insurances;
- collective insurances, to the extent that an insurance policy corresponds to the individual insurances covered;
- damage to property as a result of fire;
- premiums earned after the date of bankruptcy for the above-mentioned insurances.

Protected claimants

The Danish IGS provides protection to natural persons, as well as some small and medium-sized companies, which are covered largely for TPL.

Residents of other EU Member States, as well as those of other countries are eligible to receive protection from the scheme on the same terms as domestic claimants.

The scheme does not cover claims from members of the board of management or the board of directors of the failed insurance company.

Cross-border arrangements

As mentioned above, the scheme does not allow participation of EU branches operating in Denmark. This is because EU branches do not need to be authorised by the Danish Financial Supervisory Authority to operate in Denmark. However, the scheme does allow and require non-EU undertakings to participate.

The scheme covers policies issued by domestic companies that participate in the scheme, including policies issued by the companies' branches established in other Member States (home state principle).

There are no restrictions in scope of coverage in terms of geographic location of claimants or risks.

Compensation limit

The Danish IGS does not have a compensation limit, and it pays 100% of the claim.

However, the reimbursement of premiums paid for the period after the date of bankruptcy is subject to a deduction of DKK1,000 (around €134¹⁰⁵) per policy.

Operational arrangements

Nature of intervention

The operation of the Guarantee Fund is triggered by declaration of bankruptcy by a court. The scheme operates by paying compensation to policyholders in the event of insolvency of an insurer. It does not take over and administer the insurance policies of an insolvent insurer to ensure the continuation of policies, nor does it facilitate portfolio transfer to another insurer.

The scheme covers claims that have arisen prior to the bankruptcy order being issued, and up to four weeks after the liquidator has notified the creditors of the bankruptcy of the insurance company.

Claimant notification and claims processing

Immediately following the issue of the bankruptcy order, the Danish Financial Supervisory Authority publishes a notification in the daily press including the following:

- the bankruptcy of the insurance company;
- cancellation of insurance cover;
- new compulsory insurances and similar insurances; and
- notification of claims under the guarantee scheme.

The scheme needs to be notified of claims to be compensated as soon as possible, and no later than six months after the bankruptcy order being issued. Payments from the scheme are made as soon as possible, with no maximum period for processing payment.

The scheme itself does not process claims. Instead (for the only case dealt with by the scheme to date—Plus Forsikring A/S), the scheme makes an agreement with an established insurer to handle the claims. The costs incurred by the scheme for services undertaken by the insurer are shown in Table A1.4.

Table A1.4 Payments to insurer handling claims, 2004–06

	2004	2005	2006
Handling claims (€)	571,745	13,391	7,333

Note: The year 2004 covers the period from the bankruptcy of one non-life insurer on October 18th 2002 to December 31st 2004.

The scheme has prepared and approved measures to deal with future bankruptcies. The measures include ways of informing the public of an eventual bankruptcy and procedures for obtaining offers from some of the major insurance companies to take over the administration of the policies and settlement of any insurance claims against the bankrupted company. The

¹⁰⁵ DKK1 = €0.13422. Exchange rate as of April 3rd 2007 from www.oanda.com.

aim is to ensure that, in the event of a bankruptcy, the policyholders are able, in accordance with the applicable rules, to have their insurance premiums refunded and claims settled without further delay, instead of having to wait for winding-up proceedings. These measures should also ensure that policyholders are not left without any insurance cover in the period after the bankruptcy of the insurance company and before they have obtained a new policy from another company.

Funding

Contributions from insurance undertakings

The scheme is pre-funded up to the fixed amount of DKK300m, which is around €40.3m. The insurance companies are obliged to be members of the scheme and to pay contributions. As such, the guarantee scheme is 100%-funded by contributions from the insurance companies that are covered. Contributions are calculated on the basis of the number of insurance policies, using an amount per policy that is fixed annually by the Danish Financial Supervisory Authority.

Under the present rules, which came into force in 2005, the insurance companies may charge the amount to be paid in contributions directly to the consumer. Insurance companies are charged a fixed amount per policy (only for specific policies, including motor insurance, health insurance and property insurance) in contributions to the scheme, and the Danish Financial Supervisory Authority notifies the scheme each year before July 1st of the amount of contributions due for the following year. The amount for 2006 was fixed at DKK10 (around €1.3) per consumer policy; this figure was retained for 2007.

The total contributions raised from participating insurers during 2004–06 is shown in Table A1.5.

Table A1.5 Contributions from participating insurers, 2004–06

	2004	2005	2006
Amount of levies raised from participating insurers (€)	8,016,000	7,994,533	7,818,800

The contributions to the fund cease when it reaches DKK300m (€40.3m).

There is no upper limit that the scheme may impose on an individual firm in any one year. Similarly, there is no upper limit that the scheme may impose on the industry as a whole.

Levies on policyholders

The Danish IGS does not levy policyholders directly, but, as explained above, the rules specify that insurance companies can charge the levy (DKK10, €1.3, per policy) directly to policyholders.

Size of standing fund

Table A1.6 shows the extent of the funds available to the scheme in the period 2004–06, accumulated from ex ante industry contributions net of any costs incurred by the scheme. Starting with a deficit in 2004, the fund size was €11.6m in 2006. The target size for the fund is DKK300m (around €40.3 million).

Table A1.6 Standing fund, 2004–06

	2004	2005	2006
Size of standing fund (€)	–6,002,000	3,946,267	11,643,733

State funding

The scheme does not receive direct contributions from the state. However, Article 3 (5) of the Guarantee Fund for Non-life Insurance Companies Act 2003 provides that the scheme can take out loans guaranteed by the state.

Other sources of funding

There are no other funding sources available for the scheme.

Past cases of intervention

There have been no bankruptcies among non-life insurance companies since the scheme was set up in 2003.

As stated above, the Fund was initially set up as a consequence of the bankruptcy of Plus Forsikring A/S in 2002. As a result of the bankruptcy, both policyholders and claimants were left without insurance coverage. Following negotiations between the association representing the Danish insurance and pension industry, Forsikring & Pension, the Danish Ministry of Finance, and the Financial Supervisory Authority, the association agreed to cover the costs arising from certain insurance claims which had occurred before December 1st 2002. The insurance claims covered concerned the following:

- policyholders with private consumer insurances;
- third parties insured against personal injury and damage to property under third-party motor liability insurances;
- third parties insured against personal injury under other TPL insurances;
- collective insurances, to the extent that an insurance policy corresponds to the individual insurances covered;
- damage to property as a result of fire.

Insurance premiums paid before the bankruptcy order was issued were also refunded, although with a deduction of DKK1,000 (€134).

As part of the agreement, the association's expenses were refunded by the scheme after the Guarantee Fund for Non-life Insurance Companies Act was passed by Parliament and came into force.

The cost incurred as a result of the bankruptcy of Plus Forsikring A/S is estimated at DKK91m (around €12.2m), and the scheme has made reserves of approximately DKK6.5m (around €0.87m) for the last few remaining claims relating to the bankruptcy of the insurer. In total, the bankruptcy is expected to have cost approximately DKK97.5m (around €13.1m).

The majority of claims were processed and settled within two years of the bankruptcy. However, the winding-up proceedings are ongoing and not expected to be finalised for at least another few years. If the industry association had not agreed to take over the administration and coverage of the claims (to be reimbursed by the newly established guarantee scheme), the claimants would in principle have had to have waited for the winding-up proceedings to be finalised.

A1.3 Finland

Background information

Finland does not have a general IGS that covers life and/or non-life insurance, but it has established two special schemes (other than motor insurance) that cover specific non-life insurances that are considered compulsory and part of social security.

- Joint guarantee for statutory employment accident insurance (Lakisääteisen tapaturmavakuutuksen yhteistakuu).
- Scheme for statutory patient insurance (Potilasvakuutuksen yhteistakuu).

The principal legislation that established the scheme for employment accident insurance was the Employment Accident Insurance Act. The principal legislation establishing the scheme for patient insurance was the Act on Patient Injuries Insurance. Both schemes were launched on January 1st 1997.

The schemes rest on provisions in the relevant Acts and will come into effect only in the event of a liquidation, or bankruptcy, of an insurance company where the estate is not able to pay the compensation, either in full or in part, relating to a claim. The schemes have not been activated to date.

Structure and governance

The schemes are under the supervision of, and are accountable to, the Ministry of Social Affairs and Health, which is responsible for statutory employment accident and patient insurances. The schemes have no staff, and there are no operating costs—they constitute provisions only. The insurance companies that provide either type of insurance contribute to the IGS that would compensate claims if an undertaking in the market were to be wound up. As such, the schemes become active only in the event of insolvency.

In the event of a failure of an insurer providing employment accident insurance (statutory patient insurance), the Federation of Accident Insurance Institutions (FAII) (Finnish Patient Insurance Centre) would manage the scheme.

Scope of coverage

Scheme participation

All insurance companies providing employment accident insurance in Finland are required to participate in the relevant scheme. This includes non-EU insurance undertakings, as well as any incoming EU insurers. However, only domestic and non-EU undertakings need to contribute to the scheme on an ex ante basis by setting aside provisions in their balance sheets. Funding is explained in more detail below.

Table A1.7 shows the number of insurance companies participating in the scheme for employment accident insurance, broken down by domestic undertakings, EU branches and non-EU undertakings. There were 13 companies participating in the scheme in 2006.

Table A1.7 Number of participating insurers in the Finnish scheme for employment accident insurance

	2006
Domestic insurance undertakings	12
EU branches	1
Non-EU insurance undertakings	0
All participants	13

All insurance companies providing statutory patient insurance in Finland are required to participate in the scheme for patient insurance. Currently, there are no non-domestic undertakings participating in the scheme, as is shown in Table A1.8. In total, there were ten companies participating in the scheme in 2006.

Table A1.8 Number of participating insurers in the Finnish scheme for patient insurance

	2006
Domestic insurance undertakings	10
EU branches	0
Non-EU insurance undertakings	0
All participants	10

Protected insurance policies

The scheme for employment accident insurance covers only the statutory employment accident insurance policies, while the scheme for patient insurance covers only the statutory patient insurance policies. Both schemes cover policies issued in Finland, by domestic companies as well as branches of non-domestic companies (host state principle).

Protected policyholders

The scheme for employment accident insurance covers natural persons only. Residents of other EU Member States, as well as other countries, are eligible to receive protection from the scheme on equal terms as domestic employees.

The scheme for patient insurance also covers natural persons only. Residents of other EU Member States, as well as other countries, are eligible to receive protection from the scheme on equal terms with domestic policyholders.

Cross-border arrangements

All insurance companies providing statutory employment accident insurance or patient insurance in Finland are required to participate in the schemes, and all policies are covered irrespective of whether they are issued by a domestic insurer, an EU branch or a non-EU insurance undertaking. As such, the schemes operate strictly on the basis of the host state principle.

While there are no differences in the level of protection, the scheme for employment accident insurance distinguishes between domestic and foreign undertakings providing the insurance when it comes to scheme funding. As part of the Finnish supervisory framework, only domestic and non-EU undertakings are required to set aside provisions for the guarantee scheme in their balance sheet. These provisions do not apply to incoming EU firms, which would participate in the scheme only on an ex post basis. No such distinction is in place for

the patient insurance scheme, which is ex post-financed for all participating insurers, irrespective of whether they have headquarters within or outside Finland.

Compensation limit

Neither the scheme for employment accident insurance nor that for patient insurance has an absolute compensation limit. Rather, they compensate 100% of a claim without any limit.

Operational arrangements

The operation of schemes is triggered by the liquidation, or bankruptcy, of a participating insurance company where the compensation to be paid remains unsecured, either in part or in full. The amount of compensation to be paid is to a large extent decided by the liquidator of the failed insurance company and the Insurance Supervisory Authority.

The function of both schemes is to pay compensation to policyholders in the event of an insolvency of an insurer, as well as to facilitate portfolio transfer to another insurer. If portfolio transfer is not possible, the schemes can take over and administer the insurance policies of the insolvent insurer. These functions would be carried out by the FAI in the case of employment accident insurance, and by the Finnish Patient Insurance centre in the case of patient insurance.

Policyholders and third-party claimants are notified of the existence of the schemes following the failure of a participating insurer. Claims can be made to the scheme itself, or to the failed insurer, where they will be dealt with by the liquidator.

Funding

The operation of the schemes for employment accident insurance and patient insurance is funded through levies on participating insurance companies. In exceptional circumstances, the schemes could also raise levies directly from policyholders.

Contributions from insurance undertakings

The levies imposed on participating insurance companies to fund the scheme for employment accident insurance are a combination of ex ante and ex post funding.

Where the former type of funding is concerned, Finnish and non-EU insurance undertakings form a provision for the IGS as a part of the balance sheet's technical provisions. This provision should be accumulated at 4% (of gross premium) per year, with a maximum of 3% of the gross technical provisions relating to the statutory employment accident insurance in the undertaking. Pre-funding is not required for incoming insurers from EU countries—contributions would only be collected in the event of an insurance company failure.

The ex post levy is allocated among insurers on the basis of gross premium income relating to employment accident insurance. The scheme can charge participating insurers a maximum of 2% of premiums per year.

The scheme for patient insurance is funded solely through ex post levies on participating insurance companies. The maximum levy on an insurance company is 2% of its relevant gross premium in any given year.

Levies on policyholders

Neither scheme levies policyholders directly; however, the insurance companies may pass on their costs to policyholders. In addition, the legal provisions allow for schemes to levy policyholders directly in exceptional circumstances. For example, if policyholders were to

benefit from low premiums, which then resulted in the failure of the insurer, the policyholders of that insurer could be levied directly by the scheme.

Size of standing fund

The scheme for employment accident insurance does not hold a standing fund as such. Rather, Finnish and non-EU insurance undertakings form a provision for the IGS as part of the balance sheet's technical provisions. Thus, although the scheme does not hold the funds itself, it would have access to the money in the event of a failure of a participating company.

Table A1.9 presents the balance sheet provisions of Finnish insurance undertakings for the scheme for statutory employment insurance. At the end of 2006, there was in total around €61m in the balance sheet provisions of Finnish undertakings.

Table A1.9 Balance sheet provisions of Finnish insurers for the scheme for employment accident insurance, 2003–05

	2003	2004	2005	2006
Balance sheet provisions (€m)	55	57	59	61

The scheme for patient insurance does not accumulate any reserves since it is funded purely on an ex post basis.

State funding

Neither scheme benefits from any guarantees or other provisions (eg, last-resort lending) by the government to meet obligations in the event of funding shortfalls. Furthermore, the schemes do not receive direct contributions from the state.

Other sources of funding

Neither scheme has the ability to borrow funds, and there are no other sources of funding.

Past cases of intervention

There have been no cases concerning defaults of insurers providing employment accident insurance or patient insurance. Therefore, neither scheme has been activated to date.

A1.4 France

Background information

France has established two main IGS—one for life assurance and the other for compulsory non-life insurance. The Fonds de garantie des assurances de personnes (Fonds de garantie des assurés contre la défaillance des sociétés d'assurances de personnes, FGAP) was established by the law of June 25th 1999.¹⁰⁶ It protects policyholders against the risk of failure of a life assurance undertaking licensed in France.

The FGAP was established following the insolvency of a life assurer, Europavie, whose licence to operate was withdrawn in December 1997. The policies issued by the company to around 5,000 policyholders were terminated in July 1999, and the French insurance industry provided full compensation through a specially created body, the Association pour l'indemnisation des assurés d'Europavie. Policyholders were given the choice of receiving either a one-off compensation payment or a substitute policy issued by a member of the French insurance association (FFSA).

In the non-life insurance sector, the Fonds de garantie automobile had been in place since 1951. In addition to protecting victims of motor accidents in the event of non-insurance, it also covered motor liability insurance and hunting insurance in the event of insolvency of the insurance undertaking. The legislation of August 1st 2003¹⁰⁷ extended the competencies of the fund to provide insurance guarantees for compulsory classes of non-life insurance, which, in France, includes a large number of insurance classes. As a result, the fund was renamed the Fonds de garantie des assurances obligatoires de dommages (FGAO). From 1999 to 2003, there were five failures of insurance undertakings providing compulsory non-life insurance (excluding motor). The liquidation of the companies was ongoing, so the intervention of the FGAO was initiated retrospectively to these cases.

In addition to the FGAP and the FGAO, there are separate funds for the mutuals (Fonds de garantie des mutuelles du code de la mutualité) and for institutions of social protection (Fonds de garantie des institutions de prévoyance du code de la Sécurité Sociale). These funds are new, and cover a specific segment of the market (mainly health insurance). The following description therefore focuses on the two main IGS in France.

Governance

The FGAP is a legal entity established under private law. It is managed by a board under the control of a 'Conseil de surveillance', comprising of 12 industry representatives who are nominated by participating life assurance companies.

The FGAP's staff is limited to a director, who works around 20% on an FTE basis for the fund, and a support person, who spends around half of their time on issues related to the FGAP. Should a life assurer fail, the FGAP would use external service providers to handle the case. Management and administration expenses have therefore been limited in the past—ie, around €144,000 in 2006.

Like the FGAP, the FGAO is a separate legal entity established under private law. After assuming its new function with respect to compulsory insurances in 2003, the administrative council of the fund was enlarged, and its statutes and internal regulations amended. The total

¹⁰⁶ Loi no. 99-532 due 25 juin 1999 relative à l'épargne et à la sécurité financière. An additional decree applies (Décret no. 99-688 due 3 août 1999).

¹⁰⁷ Loi no. 203-706 due 1er août 2003.

number of staff from which the FGAO can draw is 227, although most staff members carry out functions that are unrelated to insurance guarantee (excluding motor).

In particular, in addition to insurance guarantee cases, the 227 staff members deal with the compensation of victims of motor accidents in the event of non-insurance and work for three further funds that are integrated in the operation—namely a fund for terrorism acts and other offences (created in 1986); a fund to compensate victims of HIV-contaminated blood transfusions (created 1991); and a compensation fund for victims of asbestos poisoning (created in 2000).

Around half of staff time is devoted to FGAO functions, primarily in relation to compensating victims of motor accidents rather than providing insurance guarantee triggered by insolvencies. However, the estimated staff time devoted to dealing with non-motor-related insolvencies is much lower, and operating costs can be estimated at around €250,000 per year.

The operations of the FGAP and the FGAO are initiated by the Autorité de contrôle des assurances et des mutuelles (ACAM), the authority responsible for supervising insurance undertakings in France, under the overall control of the French economics and finance ministry.

Scheme participation

All life assurance undertakings established in France that adhere to the French insurance law (code des assurances), and that are under the control and supervision of the ACAM, are required to participate in the FGAP. This includes subsidiaries of EU insurance groups as well as non-EU insurers. However, branches of EU insurers or firms selling under the freedom of services provisions are not required to participate in the fund.

The participation requirements of the FGAO extend to all insurers that are subject to French insurance law and that cover risks which, by law or regulation, are compulsorily insured. As with the FGAP, only insurance undertakings authorised in France and supervised by ACAM are required to participate. Branches of EU insurers are therefore excluded from the participation requirement, except with regard to their provision of motor liability and hunting insurance—in 2006, seven EU branches participated in the FGAO.

The number of insurers participating in the FGAP and the FGAO is reported in Table A1.10

Table A1.10 Number of participating insurers

	Total number of participants	Comment
FGAP	128	Refers to December 2005 and includes one non-EU life insurer.
FGAO	127	Refers to December 2006 and includes seven EU branches

Source: FGAP and FGAO.

Scheme coverage

Nature of intervention

Intervention by the FGAP and the FGAO follows a declaration by the ACAM that an insurance undertaking is no longer able to meet its obligations. Prior to triggering the operation of the schemes, ACAM must consult and inform the schemes of its intentions in writing, giving them 15 days in which to raise concerns or object to the decision. Should they

object, the case is referred to the minister of economics and finance, who, within a further 15 days, will request a new determination by the ACAM.

Once the decision to trigger the FGAP or the FGAO is taken and the relevant insurer notified, the ACAM will launch an initiative to transfer all or part of the insurer's portfolio. If a transfer is effected, the scheme will use its funds to facilitate the transfer and protect the rights of the insured that are not fully covered by the transfer. If no transfer can be arranged, the scheme will provide compensation payments up to the limits and subject to the conditions described below. The liquidation process of the insurer is automatically initiated following the transfer of the portfolio and triggering of the scheme.

Protected insurance policies

The FGAP covers all classes of life assurance, including traditional life contracts, unit-linked insurance, permanent health insurance, tontine operations, marriage and birth, and group and collective insurances (branches 1, 2 and 20–26 listed in article R.321-1 in the code des assurances).

The scope of coverage of the FGAO is defined by reference to whether the non-life insurance is compulsory. With more than 100 compulsory insurances in France, many of which cover only professional risks, the list of protected contracts includes various insurances, including construction liability, professional liability, workplace accidents, etc. Certain insurances are specifically excluded, such as maritime, fluvial, air transport, financial guarantees, nuclear, etc.

Eligible claimants

The FGAP offers protection to all natural and legal persons, but with some specific exclusions.

- Natural persons are not eligible if, for example, they had management responsibilities in the insolvent insurer or in a company of the same group with a 5% ownership stake in the insurer. Accountants or auditors of the insurer, or of a company in the same group, are also excluded.
- Excluded from coverage are other insurance undertakings, credit institutions, collective investment schemes, and pension schemes. However, the exclusion does not apply to staff or customers on whose behalf the contract was concluded.

Eligibility requirements for the FGAO differentiate between policyholders and third parties (victims). Where policyholders are concerned, natural and legal persons are covered as long as the policies were not purchased in a policyholder's professional capacity. Also excluded from coverage are the natural and legal persons listed above in the case of the FGAP.

With regard to victims, personal and legal persons are covered as long as they are resident or established within the EU. Furthermore, the individual should not be in a contractual relationship with the insolvent insurer. If a contractual relationship exists, eligibility depends on whether the relationship is of a professional nature. Only if the relationship is non-professional in nature does the FGAO provide protection. Consequently, for both policyholders and third parties, a distinction is drawn between professional and non-professional risks, with only the latter being eligible for protection.

Cross-border arrangements

In terms of participation and geographic scope, both FGAO and FGAP follow the home state principle—all insurers authorised in France are required to participate in the schemes, and protection is also accorded to the operations of those insurers in other EU Member States via branches or provision under freedom of services. However, firms which are incoming under

the EU passport do not participate in the schemes, the exception being insurers providing motor and hunting insurance which are required to participate in the FGAO.

Policyholders and beneficiaries are eligible for compensation irrespective of both their place of residence within the EU and the location of risk.

The FGAO does not protect risks located outside the EU and victims resident outside the EU are not eligible for protection.

Calculation of claim and compensation limits

The FGAP provides a guarantee for all contractual benefits due or expired at the date on which the fund is triggered, including death benefits, capital guarantees, etc. Where compensation is paid, the amount compensated includes the totality of the mathematical provisions covering the contracts of insurance. In general, therefore, any bonuses or unexpired premiums would not be compensated. The amount of compensation is limited to:

- €90,000 for contractual benefits arising from life policies in the event of death or invalidity;
- €70,000 for all other contractual benefits.

The FGAO compensates outstanding claims equal to the amount to which the policyholder or victim would have been entitled from the insolvent insurer. There is no cap on the compensation that can be paid, but policyholders are entitled to receive 90% of the amount. Victims receive 100%. In addition, there is an overall compensation limit that caps the intervention of the FGAO to €700m (cumulative).

Operational arrangements

Claims processing and payment

As described above, intervention by the FGAP is triggered by a determination of the ACAM. Where a portfolio is not transferred, or transferred only in part, the scheme has the obligation to compensate policyholders and beneficiaries up to the specified limits. The amount of compensation payable is established by the liquidator assigned to the process rather than by the scheme itself. In addition to a judicial liquidator who is nominated by the courts, the ACAM nominates an independent liquidator in charge of establishing claims and compensation entitlements.

The amounts established by the liquidator are then covered in a one-off payment by the FGAP within a period of two months (although an extension for the payment period can be granted by the ACAM under exceptional circumstances). Prior to payment, the scheme verifies that the claims are indeed eligible for protection. It can also request further information or clarification from the liquidator during the process.

A determination by ACAM also triggers intervention of the FGAO. The FGAO can draw from a large number of staff and thus deals with the claims-handling process internally.

For both schemes, the payment of claims is followed by a subrogation of rights (up to the amount paid). Both schemes are also entitled to take legal action against those responsible for the failure.

Policyholder notification and application

The start of the operation of the schemes, as determined by the ACAM, is made known to the insolvent insurance undertaking, which in turn is required to inform each policyholder or beneficiary. Policyholders do not need to apply for compensation via the schemes. Rather,

the liquidator takes the initiative in establishing the claim and requesting compensation payments from the schemes.

Funding

Contributions to the Fonds de garantie d'assurances des personnes (FGAP)

The FGAP is financed by participating insurance undertakings, as established in the French code des assurances. The fund is financed on an ex ante basis, and it can draw from resources that amount to 0.05% of mathematical provisions of all participating life insurers, calculated as of year-end in the preceding year. Half of this sum has been paid to the FGAP, while the other half takes the form of a guarantee in the books of participating insurers.

Each company's share is established annually, in proportion to its mathematical provisions. For unit-linked contracts, only one-quarter of the provisions is counted in the calculations. A minimum annual contribution of €15,000 is required per firm (except for new firms that have been in the market for less than three months).

In 2006, 0.05% of mathematical provisions amounted to €480m. Firms are required to pay half the amount as contributions to the FGAP, with the other half remaining in the insurers' books as a guarantee.

A mechanism is in place to adjust a company's share in the fund through increases or reimbursements of the annual contributions.

Contributions to the Fonds de garantie d'assurances obligatoires

The operations of the FGAO as a whole (including functions other than insurance guarantee in the event of insolvencies) are funded from different sources:

- a charge on policyholders amounting to 0.1% of motor liability insurance policies;
- a contribution of insurance undertakings amounting to 1% of the costs of the FGAO;
- a contribution from those responsible for uninsured accidents;
- fines and penalties.

The FGAO maintains a separate section in the accounts for its operation of insurance guarantee in the event of insolvencies (including motor liability insurance). This section, titled 'opérations du fonds de garantie résultant de la défaillances d'entreprises d'assurances de dommages', shows the reserves available for cases of insolvencies and the corresponding assets. These are increased through contributions from participating insurers up to a limit of 12% of the FGAO's costs relating to insolvency cases, with the current contribution rate being set by ministerial order at 1% of costs.

In addition to this ordinary contribution, participating insurers need to make extraordinary contributions should the reserves fall below €250m for a period of six months. Contributions are allocated to individual firms in proportion to premium income on compulsory insurances that are covered by the scheme.

The scheme received an initial endowment of €304m in 1994, and insurance firms contributed €1.1m in 2003. This includes amounts raised for insolvencies relating to motor liability insurance. No further contributions were required in 2004 and 2005, and the extraordinary contribution has never been raised.

Size of standing fund

The FGAP'S directly available funds amount to 0.05% of mathematical provisions (€480m in 2006). Half of this sum has been paid to the FGAP, while the other half takes the form of a guarantee in the books of participating insurers.

The reserves of the FGAO for cases of insolvencies cannot fall below €250m. Below this level, extraordinary contributions from participating insurers would be raised.

State funding

Neither the FGAP nor FGAO benefit from any contributions or guarantee from the state.

Other sources of funding

The FGAP has borrowing powers, and is entitled to borrow from participating insurers an amount equal to the normal funding resources of the scheme (ie, 0.05% of mathematical provisions). Thus the FGAP could obtain a total of 0.1% from participating insurers, which, based on 2006 data, would give a maximum financial capacity of €960m. The amounts borrowed are to be repaid over a period of three years.

As indicated above, the FGAO has several sources of funding in addition to contributions from participating insurers. Like other IGS, it also receives funds from recoveries in the liquidation process.

Past cases of intervention

The FGAP was established following the failure of a life assurer (Europavie), but the scheme was not required to intervene in this failure. Since its establishment it has only dealt with one life assurance failure—ICD Vie in 2000. However, intervention was limited to assisting the liquidator in checking the assets available to meet the contractual rights of policyholders. Sufficient assets were found to be available, so no compensation costs arose. In addition, 99% of the portfolio of the insurer was ultimately transferred. The costs incurred by the scheme amounted to €423,000, and took the form of a payment to service providers engaged to assist in the checking of assets.

When the FGAO was established in 2003, it took over responsibilities regarding five insurers providing compulsory insurance (other than motor) that were already in the liquidation process.¹⁰⁸ The insurance policies covered mainly guarantees, work accidents, construction and general civil liabilities. Data on claims handled and compensation costs of failures up to December 2006 is provided below. The claims and costs exclude those relating to motor insurance policies written by the insurers.

¹⁰⁸ A further 15 cases of failure relating to motor liability insurance have been dealt with by the scheme (since 1951).

Table A1.11 Cases of insurance failures dealt with by FGAO (excluding motor)

Name of insurer	Year of insolvency	Total cost up to December 2006 (€000)	Total claims up to December 2006
International Claims Services SA	1999	10,238	260
Groupment d'Assurances Européennes	2000	1,466	27
Independent Insurance	2000	209	3
Compagnie Internationale De Caution Pulr le Developpement	2001	5,770	187
Caisse Générale d'Assurances	2003	2,638	407

Source: FGAO.

Background information

Germany has two statutory IGS—one for life assurers (Sicherungsfonds für die Lebensversicherer) and one for private health insurers (Sicherungsfonds für die privaten Krankenversicherer). The legal basis for the two schemes was implemented through amendments to the Insurance Supervision Law (Versicherungsaufsichtsgesetz, VAG) in December 2004,¹⁰⁹ and the two schemes were established in 2006. No insurance guarantee arrangements exist for other classes of insurance.

The two statutory schemes were preceded by private initiatives to provide insurance guarantee in the event of failure of a German life insurer or private health insurer.

In 2002, German life assurance companies founded the Protektor Lebensversicherungs-AG on a private initiative, with the assistance of the supervisory authority (Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)). In the event of a failure of a German life insurer, Protektor Lebensversicherungs-AG had to take over the company's contracts as an asset deal to fulfil life contracts going forward.

In 2003, Protektor took over the business of Mannheimer Lebensversicherung AG. Protektor will continue to handle the run-off business until the last contract is terminated or another company acquires the business. As such, the private initiative remains operational in relation to the Mannheimer case, but future failures of life insurers in Germany would be guaranteed by the statutory scheme that was implemented in 2004. In May 2006, the operation of the new statutory scheme was delegated by law to Protektor. As such, although legally separate, there is some integration between the new and existing voluntary schemes with respect to operation and funding, as described below. Although focused on the statutory scheme, the following description is therefore also relevant in some respects to the private initiative.

Private health insurers founded Medicator AG in July to provide insurance guarantee for a special type of insurance that can be a substitute for statutory health insurance in Germany. In May 2006, Medicator was made responsible for the operation of the new statutory scheme for private health insurance. To date, neither the private initiative nor the statutory scheme has been operational, since there has been no failure of a participating private health insurer.

Governance

Founded on a private and voluntary initiative, the Protektor Lebensversicherungs-AG is a privately managed and owned company. Its purpose is to take over the business of insolvent life insurers and ensure continuation of contracts by managing those contracts and/or by transferring parts or all of the portfolio to another insurer. It was granted a licence by BaFin in 2002 to undertake life assurance activities in order to fulfil this function. Shareholders of Protektor are the German life insurers that are organised within the industry association, the Gesamtverband der Deutschen Versicherungswirtschaft (GDV). The participating life insurers put up the initial share capital and, by bilateral agreement with Protektor, provide guarantees for further capital contributions.

Following the implementation of the statutory guarantee scheme in 2004, Protektor was given the responsibility to operate the statutory scheme by the Ministry of Finance in 2006. The statutes of Protektor were amended accordingly.

¹⁰⁹ Gesetz zur Änderung des Versicherungsaufsichtsgesetzes und anderer Gesetze vom 15. Dezember 2004 (BGBl. 69/2004 of 20 December 2004, S.3416ff.). Paragraphs 124ff of the Versicherungsaufsichtsgesetz (VAG) contain the legal provisions for the guarantee schemes.

In the event of an insolvency of a life insurer, BaFin would transfer the policies to the statutory scheme, administered by Protektor. Assets of the statutory scheme are strictly separated from the other assets of Protektor.

Since establishment of the statutory scheme, there have been no failures of life insurers. The main operations of Protektor therefore relate to the handling of the Mannheimer case under the private initiative. Protektor has a total staff of 107, the majority of whom have been taken on from Mannheimer, with some additional staff to fulfil management and board functions. These employees handle a life portfolio that amounted to €174m of premiums in 2006.

The statutory scheme has no separate employees, and since there has been no case of failure, the staff time attributed to operating the statutory scheme is minimal. It is expected that fewer than two people would be required to operate the statutory scheme. Operations relate only to the collection of contributions from insurers once per year as well as the controlling of fund management. In the event of future insolvencies, staff would either be acquired (eg, from the insolvent insurer) or administration would be delegated to a third party.

Like Protektor, Medicator AG was founded by a private initiative by German health insurance companies with a view to ensuring continuation of policies. The insurance companies provided the initial capital required to establish Medicator, which is now owned by the German association of private health insurers (Verband der privaten Krankenversicherung e.V., PKV) as the single shareholder. The operation of the new statutory scheme was delegated to Medicator in May 2006.

Since there have been no failures to date, Medicator does not actively operate. The office is situated within the office of the PKV. Three board members share any management tasks that may arise, but do this alongside their main functions, so no separate administration costs arise. In the event of a failure requiring takeover of the portfolio, Medicator has reached agreements with three private health insurers to outsource the functions required to ensure continuation of contracts.

Scheme participation

The Insurance Supervision Law (Para. 124, VAG) specifies the participation requirements in the two statutory IGS. All insurers licensed under the VAG to carry out life assurance or substitutive private health insurance activities are required to participate in a statutory scheme.

For the statutory scheme for life insurers, this implies that all German life assurance companies as well as establishments of life insurers located outside the EU (but requiring a licence to carry out business in Germany) are required to participate in the scheme for life insurers. Branches of EU companies, on the other hand, are not permitted to participate in the scheme.

The Law also allows the Pensionskassen (a type of funding vehicle for occupational pension provision that is similar to direct insurance contracts) with a similar financial situation to life assurance companies to seek participation in the statutory scheme for life insurers on a voluntary basis. As at end 2006, 23 Pensionskassen participated in the scheme.

The numbers of participants in the life assurance scheme and the separate scheme for substitutive private health insurers are set out in Table A1.12.

Table A1.12 Number of participating insurers

	Total number of participants	Comment
Statutory scheme for life assurers	128	Includes 23 Pensionskassen and 3 establishments of non-EU insurers. Branches of EU insurers are not permitted to participate
Statutory scheme for private health insurers	48	Only domestic insurance undertakings

Scheme coverage

Nature of intervention of scheme

As determined in the VAG (Para. 125), the objective of both the statutory scheme for life assurance and the separate scheme for health insurance (as well as the private initiatives that preceded the statutory schemes) is the continuation of insurance contracts. Paying compensation is not considered to be a function of the schemes.

The continuation of contracts is ensured through a transfer of the entire portfolio (and the corresponding assets) to the relevant scheme—ie, the scheme takes over the business and will operate the business until the last contract is terminated or the business is sold to another company.

The transfer is initiated by BaFin, after the supervisory authority has established that a participating insurer is not capable of meeting its obligations and other measures are not adequate to protect policyholders.

Protected insurance policies

The statutory scheme for life assurers covers all classes of life assurance, without exclusions. The coverage provided by the other statutory scheme applies only to private health insurance policies.

Eligible claimants

The schemes take over all contracts of the insurer in default and ensure continuation of all contracts, irrespective of the type of policyholder. There are no exclusions and no differentiated treatment between policyholders.

Cross-border arrangements

In terms of scheme participation, all German insurers, as well as non-EU insurers operating in Germany, are required to participate in the scheme for life assurers. Branches of insurance undertakings with their head office in another Member State, however, do not participate in the scheme, and their contracts are therefore not covered. The scheme for private health insurers follows the same participation principles.

There are no differences in eligibility criteria depending on the place of residency of the policyholder or the location of the risk, so all contracts of participating insurers are protected. For the life assurance scheme, this applies both within and outside the EU. For the private health insurance scheme, contracts apply across the EU; if the place of residency is moved to a third (non-EU) country, the contract would usually cease, making location irrelevant.

Broadly speaking, arrangements with respect to cross-border business within the EU follow the home state principle, protecting all contracts issued by insurers licensed and regulated in Germany, irrespective of where they operate.

Calculation of claim and compensation limits

The statutory guarantee schemes do not pay compensation. Instead, the life assurance scheme takes over all obligations of the insolvent insurer, and meets the contractual benefits in full without limits or reductions in contractual benefits. However, BaFin is allowed to reduce benefits by up to 5%, provided that it has been established that the funds accumulated in the life scheme, plus any additional contributions that can be raised by insurers (see below), are insufficient to ensure continuation of contracts.

Under the insurance guarantee provided by Protektor as part of the private initiative, contracts of Mannheimer Lebensversicherung AG are also continued in full without reduction of contractual benefits.

The scheme for private health insurers will, in the event of failure, secure portfolio transfer to another insurer active in the market. To facilitate the transfer, the contractual terms of existing policies may be modified if this is more practical for the new insurer and acceptable to the insured. Any modifications to the contract terms need to be checked and accepted by an independent adjudicator.

Operational arrangements

Claims processing and payment

The statutory scheme for life assurers takes over the business of the insolvent life insurer and will run off the business until the last contract is terminated or the business is sold to another insurer. Thus, the scheme takes over the contracts, which are then handled and administered by Protektor in the usual way. Any deficits established or funds required for recapitalisation are provided by the scheme and raised from the life assurance industry. The handling and administration of contracts could, in principle, be delegated to an insurer other than Protektor.

Similarly, once decided by BaFin, the scheme for private health insurance would take over the policies, and Medicator would take charge of their continuation. Unlike Protektor, Medicator would not aim to operate as the insurer itself, but would try to effect rapid portfolio transfer to another insurer in the market. Any payment required to facilitate this transfer would be covered by participants of the scheme.

Policyholder notification and application

In the case of life assurance, policyholders are informed as soon as contracts have been transferred to the scheme. However, no action is required on the part of policyholders since all contracts are automatically transferred and administered accordingly by Protektor.

Similar arrangements may apply for Medicator and the statutory scheme for private health insurance. However, no details are specified in law and no specific arrangements have yet been put in place due to the lack of cases.

Operating costs

The management and administration expenses of the statutory scheme for life assurers have been estimated at €153,000 for the first half-year since establishment. As the scheme has not dealt with any failures, these costs relate mainly to the implementation of the new arrangements. To the extent that the statutory scheme was integrated into the existing private scheme and operated by Protektor, the costs may be lower than those of setting up and running a scheme on a stand-alone basis.

Protektor itself incurs operating costs like any other life insurer—particularly those arising from administering the insurance contracts of Mannheimer. Full details of Protektor's cost levels are provided in its annual reports.

The management and administration functions for the statutory scheme and Medicator are minimal, given that the scheme has not been activated to date, and are carried out by the PKV. The small expenses that arise are covered by the interest earned on the operating capital of Medicator.

Funding

Insurers participating in the statutory schemes are required to make contributions. These are used to cover any deficits and to recapitalise the insurance business that has been transferred to the scheme, as well as to meet any operating expenses incurred.

Funding arrangements differ between the scheme for life insurers and that for health insurers, particularly with respect to the timing of contributions. The life scheme is financed ex ante with a fund accumulating up to a target level, whereas the scheme for private health insurers is financed on an ex post basis, with contributions due only as failures arise and costs are incurred.

Contributions for life insurers

The statutory scheme for life insurers builds up capital through yearly contributions from its members. The total contributions amount to 0.02% of life insurance net reserves of all members, until the capital has reached the target of 0.1% of life insurance net reserves. Based on net reserves in 2006, the yearly contribution amounted to around €123m, and the target capital to around €615m.

If required in the event of a failure, the scheme can raise additional special contributions of up to 0.1% of net reserves.

Table A1.13 Contributions and target capital of scheme for life insurers

	Description	€m based on 2006 data
Annual contribution	Up to 0.02% of net reserves until target capital is reached	123
Target capital	0.1% of net reserves	615
Additional special contribution	Up to 0.1% of net reserves if required in the event of failure	615

Life insurers have a share in the accumulated capital of the scheme. This share is determined by a firm's net reserves relative to the net reserves of all participating insurers, with a further adjustment for risk. The annual contribution of each firm is increased (or decreased) if the firm's actual share in the capital is lower (or greater) than the share it should have based on its relative net reserves and risk.

The risk adjustment is twofold. First, only 25% of the net reserves are counted for unit-linked or other insurance contracts for which the risk is borne by the policyholder rather than the insurer.

Second, there is an individual firm risk adjustment that depends on the firm's equity capital relative to its solvency margin. Using this metric, firms are ranked from lowest risk to higher risk and classified into three risk categories: For firms in category 1 (low risk), a risk factor of 0.75 is applied to the net reserves; for firms in category 3 (high risk), the risk factor is 1.25; and for firms in category 2 (medium), the risk factor is adjusted from firm to firm on a linear basis to range between 0.75 and 1.25.

Contributions to the scheme are to be paid before October 31st of each year and are calculated on the basis of net reserves as reported in the annual accounts of the previous

financial year. To calculate the amount of contributions due, insurers must submit the required data (approved by the auditor) to the scheme by August 31st.

In the event of an insurance failure triggering the operation of the scheme, financing would proceed in a number of steps, depending on the scale of the failure:

- step 1: utilising the regular yearly contributions and the accumulated capital;
- step 2: raising the additional special contributions;
- step 3: potential reduction of benefits (up to 5%) by BaFin if funds raised by steps 1 and 2 are insufficient to ensure continuation of contracts;
- step 4: drawing from additional funding guaranteed by a private initiative of insurance companies.

As a result of step 4, the potential contributions of insurance companies may exceed those set out above. Step 4 originates from the financing arrangements introduced as part of the private initiative, when, in addition to an initial capital contribution, insurance companies (as the shareholders of Protektor) guaranteed to finance Protektor via capital contributions of up to €5 billion.¹¹⁰ The guarantee available to Protektor was changed in 2006 to apply also to the statutory fund, so that by taking steps 1 to 4, life insurers now guarantee to finance Protektor or the statutory fund for around €6 billion. The change also included the implementation of a restricted right of Protektor for information and auditing in relation to companies with a low solvency margin.

Levies for private health insurers

The scheme for private health insurers is funded on an ex post basis. Only in the event of failure would there be a levy on the participating insurance companies. The total levy would be allocated pro rata on the basis of net reserves. Financial capacity and risk of participants would also be taken into account.

The statutory limit for industry levies is 0.2% of net reserves of participating private health insurers.

As part of the private initiative, however, the insurers further commit to pay up to €1 billion in the event of failure. This guarantee was initiated in 2003 with the establishment of Medicator AG, but continues to apply following the introduction of the statutory scheme.

Size of standing fund

The target capital of the statutory scheme for life insurers is 0.1% of life insurance net reserves. As discussed above, based on 2006 reserves, this amounted to €615m. By end 2006, the actual size of the fund amounted to €246m.¹¹¹ Each insurer has a share in the fund, with the share being rebalanced every year depending on the relative net reserves and risk of the firm. Fund management has been outsourced to external fund managers; assets are generally invested in liquid assets or in low-risk fixed income securities.

The scheme for private health insurers is funded on an ex post basis, so no capital accumulates.

State funding

The statutory schemes do not receive any contributions from the state, and do not benefit from any guarantees or explicit provisions by the state to meet their obligations in the case of funding shortfalls.

¹¹⁰ Life insurers agreed to guarantee funding of up to 1% of capital based on their 2001 accounts, with a single company's contribution capped at 10% of the total.

¹¹¹ The actual amount corresponds to two yearly contributions.

Other sources of funding

The statutory schemes are allowed by law to borrow, but no credit facility has been established.¹¹²

Past cases of intervention

There have not been any cases of insurance failure since the implementation of the statutory schemes for life insurers and private health insurers in 2004. Thus, the operation of the schemes has not yet been triggered.

Protektor continues its operation under the private initiative with respect to the failure of Mannheimer Lebensversicherung AG. There have been no other cases of failure—either for Protektor or for the voluntary scheme established by private health insurers.

The portfolio of Mannheimer (344,000 life contracts) was transferred to Protektor in 2003. The 104 life insurers participating in Protektor at the time made a one-off contribution of €240m in 2003 to cover the shortfall and meet solvency margin requirements. The actual cost turned out to be lower than expected, resulting in a loss to Protektor and its shareholders of about €100m with a refund of the excess contributions made by the industry.

Medicator has not yet dealt with a case since there has been no failure of a private health insurer.

¹¹² For the purpose of the private initiative rather than the statutory scheme, Protektor has taken out a credit facility of €60m. As an additional funding source, Protektor is reinsured with respect to part of the portfolio it is administering.

A1.6 Ireland

Background information

Irish insurance law includes provisions for a support or guarantee fund which may be used:

- to meet minimum payments to consumers in the case of a liquidation of a non-life insurance company, or
- to support the administration of the company on a going-concern basis.

The scheme—the Insurance Compensation Fund—was introduced in 1964 (by The Insurance Act of July 7th 1964) to assist with the liquidation of an insolvent insurer. It was amended in 1983 to provide for the administration of a major motor insurer, and again in 1985 to facilitate the administration and acquisition of a general insurer.

There is no mechanism at present to support an insolvent life assurance company.

Governance

The Insurance Compensation Fund is maintained and administered under the control of the President of the High Court, acting through the Accountant of the High Court. As such, it is under public ownership, with public management.

The Fund has no staff since it becomes operational only in the event of liquidation or administration, at which point it meets the costs of supporting those proceedings.

Set-up and administration costs for the Fund are minimal since they cover only the legislation procedure to establish the Fund as well as some ongoing management and audit costs for the court's services.

Nature of intervention

The Fund is set up to pay compensation to finance the payment of compensation in relation to claims established by the liquidator. It can also intervene to finance the administration of a failed company on a going-concern basis.

Scope of coverage

Scheme participation

There is no participation model as such—rather, provisions are in place for a levy to be raised from insurers to finance the Fund's operation in order to support liquidation or administration proceedings. In the event of a failure of a non-life insurance company, all insurance undertakings providing non-life insurance in Ireland, including EU branches, would be required to contribute to the Fund.

Protected insurance policies and eligible claimants

The Insurance Compensation Fund covers all classes of non-life insurance.

The scheme compensates only natural persons in the case of a liquidation of an insurer, while all claimants are protected when the Fund facilitates administration on a going-concern basis.

Residents of other Member States, as well as other non-EU countries, are eligible to receive protection from the Fund on equal terms with domestic claimants.

Cross-border arrangements

EU branches and non-EU undertakings providing non-life insurance in Ireland would be required to contribute to the Fund in the event of a failure of a non-life insurance company.

The scheme applies only to companies being wound up or in administration under Irish Law. For those companies, all policies are protected, including policies issued by the companies' branches established in other Member States (home state principle).

Claimants are protected irrespective of their country of residence, and there are no restrictions on the location of the risk covered in the policies.

Compensation limit

With the approval of the High Court, money may be paid out of the Fund to the liquidator of an insolvent insurer to meet claims (other than the refund of a premium) due to a natural person under a policy issued by the insurer, up to a limit of 65% of such claims and a ceiling of €825,000 per claimant.

However, in the case of administration, continuity of insurance cover is ensured—ie, claims are paid in full to all claimants, and not just to natural persons.

Operating arrangements

The operation of the Fund is triggered by the formal start of proceedings for winding-up or administration. The Fund is available to support liquidations or administrations, and as such does not process claims itself. Rather, it pays any claims established by the liquidator, or the costs incurred in facilitating the administration process.

There is no direct contact between a claimant and the Fund. Policyholders and claimants continue to deal with the firm in liquidation or administration. Both processes are widely publicised due to the court application and statutory notices of appointments of liquidators or administrators. There is no time limit within which claimants need to make a claim, and there are no specific provisions concerning the processing time of a claim or payment by the Fund.

Funding

Contributions from insurance undertakings

The operations of the Insurance Compensation Fund are funded by an ex post levy on insurance companies participating in the scheme. The levy can be up to 2% of the aggregate premium income of non-life insurers. The contributions are collected by the Central Bank and the Irish Financial Services Regulatory Authority, which have powers to set the rate.

Levies were collected in the 1980s to meet the Fund's costs in supporting administrations of two non-life insurers, but no levy has been collected since.

Size of standing fund

The Fund is financed on an ex post basis and therefore does not accumulate a standing fund.

State funding

The Minister for Finance may, on the recommendation of the Bank, make repayable advances to the Fund to enable payments to be made expeditiously. However, the Fund does not receive any direct contributions from the state.

Other sources of funding

The Accountant of the High Court may borrow for the Fund (up to a limit) and provide security for any borrowings.

Any investment income, borrowings and repayments or dividends on the winding up of an insurer are paid into the Fund.

The Fund has not taken out reinsurance cover to meet funding needs.

Past cases of intervention

The Fund has been accessed on three occasions. In the 1960s it supported payments to consumers in the liquidation of Equitable, a non-life insurer. In two other cases in the 1980s, it was used to support the administration of insolvent insurers PMPA/Primor and ICI/ICAROM. The Fund enabled insurance cover to be continued in key sectors of the market (40% of motor in the case of PMPA/Primor, while ICI/ICAROM was the principal insurer for employers' and public liability insurance). Following disposal of the viable ongoing parts of the businesses, the Fund financially supported the run-off of historical liabilities of these insurers. In total, it paid €190m for the administration of PMPA/Primor, which was financed by the statutory levy. It also acted as a conduit for private sector financing of €315m (mainly from the former parent company) for the administration of ICI/ICAROM.

Background information

In Italy, there is no general IGS for life or non-life insurance. However, in addition to the special scheme for motor insurance (Fondo di Garanzia per le Vittime della Strada), there is a special scheme for hunters' liability insurance—Fondo di Garanzia per le Vittime della Caccia.

Both special schemes were established by the Codice delle Assicurazioni Private (Decreto Legislativo No.209 del 05-09-2005), which came into effect on January 1st 2006, and which merges several pieces of insurance legislation. However, the schemes existed prior to this legislation.

The Fondo di Garanzia per le Vittime della Caccia has two functions:

- to compensate third parties damaged by a hunter insured with a company in winding-up procedures; and
- to provide compensation for damages caused by an unidentified or uninsured hunter.

This Fund was constituted following the introduction of the Legge No.157 del 1992 (Art 12), which made it compulsory for all hunters to hold TPL insurance. However, following a ruling of the Constitutional Court, only after 2000 did the scheme start paying compensation for accidents caused by hunters who were insured with failed insurance companies.

Governance

The hunters' liability scheme, as well as the motor guarantee fund, are managed by Concessionaria Servizi Assicurativi Pubblici S.p.A (Consap). Consap's only shareholder is the Ministry of the Economy (Ministero dell'Economia), and it is accountable to the Ministry of Economic Development (Ministero dello Sviluppo Economico). The latter supervises Consap by means of a committee, which for the hunters' liability insurance fund comprises seven members representing the Ministry, the users (hunters), consumer associations, and insurance companies.

Consap employs two individuals to undertake the activities related to the hunters' liability insurance fund. Table A1.14 presents the management and administration expenses of Consap over the 2002–06 period.

Table A1.14 Management/administration expenses of the fund, 2002–06 (€000s)

	2002	2003	2004	2005	2006
Management/administration expenses	61.7	74.1	79.4	77.0	80.0

Note: These expenses exclude the fixed fee paid to insurance companies designated to handle claims in the event of the liquidation of another insurer. This fee was €34,000 in 2006.

Scheme participation

In compliance with Article 303 of the Insurance Code, all domestically licensed and regulated insurance companies, as well as branches of EU companies operating in Italy that sell hunters' liability insurance, must contribute to the fund. Any insurance company that sells hunters' liability insurance in Italy must therefore contribute to the fund.

Insurance undertakings are permitted to inform their customers that they participate in the fund, but are not required to do so.

Table A1.15 Number of insurers contributing to the general winding-up scheme, 2006

	Number of participants
Domestic insurance undertakings	52
EU branches	1
All participants	53

Scheme coverage

Nature of intervention

The fund starts operating once Consap receives a claim related to a damage caused by a hunter insured with a company that has gone into winding-up procedures (or from an uninsured/unknown hunter).

Consap does not acquire the portfolio of the failed company, but pays compensation to claimants when they lodge a claim with Consap. However, it may acquire assets and liabilities of an insurance company in liquidation if there are few claims and employees have left the failed insurer. However, it has not yet done this.

Protected insurance policies

The fund protects compulsory hunters' liability insurance.

Protected claimants

According to Article 302 of the Insurance Code, only natural persons that have incurred damages by a hunter can claim compensation, including both residents and non-residents of Italy if the accident has taken place in Italy.

Cross-border arrangements

The fund covers insurance policies issued in Italy by any insurance undertaking providing hunters' liability insurance in Italy, including EU branches. As such, it operates on the basis of the host state principle.

There are no differences in the eligibility criteria depending on the place of residency of the claimant. However, the scheme covers only risks located in Italy.

Compensation limit

Legge No. 157 del 1992 (Art 12) established absolute compensation limits of:

- €387,342.67 for personal damages;
- €129,114.22 for material damages.

The above limits apply to anyone who has been injured as a result of a hunting accident; 100% of any claim within those limits is compensated.

Operational arrangements

Claims processing and payment

Claims are verified, quantified, and initially paid by private insurance companies. The insurance supervisory authority (Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo (ISVAP)) designates a number of firms (between six and ten) for this purpose, which handle the claims, make payments accordingly, and are reimbursed by Consap. Consap sets out the principles to which the designated insurance companies have to adhere, and ensures homogeneity of practices.

Claimant notification and application

The injured party submits a claim to Consap within five years in the event of personal damage, and within ten years in case of death. Claims normally start to be paid six months after the insurer has been wound up. The fund is not required to inform customers of companies undergoing winding-up proceedings that they can claim compensation.

The fund also pays compensation for accidents that occur after the winding up of the company, until the expiry of the policy for which the premium was paid.

Funding

Contributions from insurance undertakings and size of standing fund

The scheme for hunters' liability insurance is funded through ex ante levies on insurers. According to Article 303 of the Insurance Code, a levy of up to 5% can be applied to the value of net premiums. This percentage is determined on a yearly basis by the Ministry of Economic Development (currently, the full 5% is charged).

Table A1.16 summarises the levies that the scheme has raised for the period 2002–06, as well as the reserves that have accumulated to cover the costs of providing the guarantee. The reserves have been falling in recent years (despite the growth in contributions) because of retrospective compensation payments following the failure of the insurance company, Firs (but also due to accidents caused by unidentified hunters).

Table A1.16 Funding of hunters' liability scheme, 2002–06 (€000s)

	2002	2003	2004	2005	2006
Amount of levies raised from participating insurers	223.4	291.7	367.8	408.7	416.5
Fund reserve	1,375.7	951.3	703.6	215.7	60.0

Note: Figures correspond to funding raised to compensate third parties in the event of the winding-up of the insurer, and also to provide compensation in the event of damage/injury caused by an unidentified or uninsured hunter.

The hunters' liability scheme has separate rules to recover management and administration expenses. The funding for the compulsory motor insurance fund is raised separately from the companies providing motor insurance.

State funding

The state is not involved in the funding of the scheme.

Other sources of funding

There are no provisions relating to borrowing by the scheme. Like other IGS, the scheme benefits from additional funding in the form of recovering assets from the winding-up of failed insurance companies, as well as recoveries of funds from uninsured hunters after the damage has occurred.

Past cases of intervention

The fund has dealt with one case of liquidation, namely that of Firs, an insurer providing hunters' liability insurance, which went into liquidation in 1998. The fund intervened in 2000 and assumed seven damages claims at a total cost of €1m. It eventually recovered €120,000 as a result of a claim that was challenged because the accident had taken place in another country.

There has been a compensation request relating to the failure of another insurance company, Tirrena; however, at the time of writing, this request was under dispute, and compensation has not yet been paid by Consap.

Table A1.17 provides details about the total amount of compensation paid by the scheme to claimants; the amount of compensation for the single largest claim; and the size of the average claim. This information refers to the total amount of compensation paid, including damages incurred by an unidentified or uninsured hunter. The costs of the only liquidation case handled to date amounted to a total of €1m.

Table A1.17 Past cases of intervention (€000s)

Company	2002	2003	2004	2005	2006
Total amount of compensation paid	282.9	598.8	512.0	780.0	567.5
Amount of single largest claim	172.0	420.1	405.6	403.0	316.0
Amount of average (median) claim	94.3	120.0	170.7	125.0	189.2

Notes: Amounts include claims relating to insolvencies as well as claims when the damaging party was unidentified or uninsured.

Background information

Latvia has an IGS covering specific classes of non-life insurance as well as all classes of life assurance. The scheme—the Fund for the Protection of the Insured (Apdrošināto aizsardzības fonds)—was introduced in 1998 by the Law on Insurance Companies and Supervision Thereof (Apdrošināšanas sabiedrību un to uzraudzības likums) of June 30th 1998. The scheme became effective on September 1st 1998. It was established on the basis of the legislation and practical experience of the UK and Canada, which had been analysed while preparing the draft Law.

Structure and governance

The Latvian scheme is under public ownership, with public management. It is operated by the national supervisory authority: Financial and Capital Market Commission (FCMC).

The Financial Division of the FCMC is responsible for the management of the IGS. Two officials of the above division carry out the operational functions of the scheme. They devote approximately 10% of each working day to the IGS.

The costs of administration of the scheme (calculated as a percentage of the remuneration paid to the officials of the Financial Division of the FCMC) are met by the FCMC (see Table A1.18).

Table A1.18 Administration costs of the Latvian IGS, 2002–06

	2002	2002	2004	2005	2006
Total (LAT)	2,000	2,000	2,000	2,000	3,000
Total (€)	2,833	2,833	2,833	2,833	4,250

Note: LAT1 = €1.41660. Exchange rate as of April 3rd 2007 from www.oanda.com.

Scope of coverage

Scheme participation

All insurance undertakings registered in Latvia, EU and non-EU branches of insurance companies, as well as EU insurance undertakings operating in Latvia on the basis of the freedom to provide services, are required to participate in the Latvian scheme.

The provisions of the scheme are not binding on incoming EU insurers if the regulatory enactments of those Member States provide for the protection of the insured in their branches in Latvia and cover all the cases provided for in the Law on Insurance Companies and Supervision Thereof. In addition, the guaranteed insurance indemnity should not be less than the one prescribed by Latvian law.

Table A1.19 shows the number of insurance companies participating in the Latvian guarantee scheme, broken down by domestic undertakings, EU branches and non-EU undertakings, as well as by life and non-life insurers. There were 20 companies participating in the scheme in 2006, four of which were EU branches. No non-EU insurance undertakings were participating in the scheme.

Table A1.19 Number of participating insurers in the Latvian scheme, 2006

	Life assurers	Non-life insurers	Total
Domestic insurance undertakings	5	11	16
EU branches	2	2	4
Non-EU insurance undertakings	0	0	0
All participants	7	13	20

Protected insurance policies

The scheme covers all classes of life assurance. The following specific classes of non-life insurance are covered by the scheme:

- accident insurance;
- health (sickness) insurance;
- land vehicle (except railway rolling-stock) insurance;
- insurance of property against fire and natural elements;
- insurance of property against other damage;
- motor vehicle liability insurance;
- general liability insurance;
- assistance insurance.

Protected claimants

The scheme covers only natural persons. Residents of other Member States, as well as of non-EU countries, are eligible to receive protection from the scheme on equal terms as domestic claimants.

Cross-border arrangements

EU branches of insurance companies, as well as EU insurance undertakings operating in Latvia on the basis of the freedom to provide services, are required to participate in the Latvian scheme. However, the provisions of the scheme are not binding if the regulatory enactments of those states provide for the protection of the insured in their branches in Latvia and cover all the cases provided for in the 1998 Law. In addition, the guaranteed insurance indemnity should not be less than the one prescribed by the Latvian law.

The scheme covers policies issued by domestic participating companies, including policies issued by the companies' branches established in other EU Member States (home state principle), and policies issued in Latvia, by domestic companies as well as incoming EU insurance business via branches or freedom of to provide services (host state principle), provided that the incoming business is not covered by a home state scheme.

Residents of EU Member States, as well as other countries, are eligible to receive protection from the scheme on equal terms as domestic policyholders.

Compensation limit

The Latvian IGS has a compensation limit of LAT2,000 (around €2,833) for both life and non-life insurance.

However, the proportion of the claim that is compensated differs for life and non-life policies. For life assurance, 100% of the claim is compensated up to the amount of LAT2,000 per policyholder, while for non-life insurance, 50% of the claim is compensated up to the amount of LAT2,000 per policyholder.

Operational arrangements

Intervention of scheme

The scheme becomes operational following a decision taken by the meeting of creditors to initiate bankruptcy proceedings, which has been confirmed by a court.

The function of the scheme is to pay compensation to policyholders in the event of the insolvency of an insurer. It does not take over and administer the insurance policies of an insolvent insurer, nor facilitate portfolio transfer to another insurer.

An insurance indemnity from the Fund for the Protection of the Insured may be paid only where a claimant has submitted an application for the receipt of insurance indemnity to the insolvency administrator within three months of the insurer being declared insolvent. The insurance indemnity from the Fund is paid on the basis of a list prepared by the insolvency administrator.

The insolvency administrator receives remuneration on the basis of the general rules stipulating the insolvency process without any payments made by the Financial and Capital Market Commission. Therefore, there are no costs of services provided by the insolvency administrator.

Claimant notification and claims processing

After the decision has been taken (and confirmed by the court) to initiate bankruptcy proceedings, the insolvency administrator informs all known creditors of the liquidation—individually and in writing—irrespective of their location. The insolvency administrator would include in the notification the time limits binding on the creditors; the consequences of failure to meet the deadline; the competent authority entitled to accept submitted claims or other communications relating to claims; and information creating, changing or terminating creditor liabilities, including the information about the existence of the scheme and ability to submit an application for the receipt of insurance indemnity from the Fund for the Protection of the Insured.

The deadline for making claims is three months from the insurer being declared insolvent. There is no maximum period specified in the law for processing a claim; however, it typically takes between one and three months to process claims.

Funding

The operations of the Latvian IGS are funded from levies on insurance companies participating in the scheme. The scheme maintains two separate funding pools: one for non-life insurance and one for life assurance.

Contributions from insurance undertakings

Contributions from participating insurance companies are made on an ex ante basis. The companies are levied 1% of the total gross insurance premiums received from natural persons for the classes of non-life insurance covered by the scheme, as well as all classes of life assurance. The contribution amount is defined by the Law, and thus cannot vary by company. The risk of a participant insurer failing is not taken into account when determining the amount to be levied.

The amount raised from participating insurers in the period 2002–06 is shown in Table A1.20.

Table A1.20 Levies raised from participating insurers in Latvia, 2002–06

	2002	2003	2004	2005	2006
Life assurance (LAT)	25,000	35,000	39,000	78,000	144,000
Non-life insurance (LAT)	149,000	181,000	231,000	298,000	434,000
Total (LAT)	174,000	216,000	270,000	376,000	578,000
Life assurance (€)	35,415	49,581	55,247	110,495	203,990
Non-life insurance (€)	211,073	256,405	327,235	422,147	614,804
Total (€)	246,488	305,986	382,482	532,642	818,795

Size of standing fund

Table A1.21 shows the standing fund for the period 2002–06, accumulated from the ex ante contributions made by participating insurers. There is no target size for the standing fund.

Table A1.21 Size of the standing fund in Latvia, 2002–06

	2002	2003	2004	2005	2006
Life assurance (LAT)	188,000	232,000	281,000	370,000	531,000
Non-life insurance (LAT)	669,000	874,000	1,141,000	1,485,000	1,981,000
Total (LAT)	857,000	1,106,000	1,422,000	1,855,000	2,512,000
Life assurance (€)	266,321	328,651	398,065	524,142	752,215
Non-life insurance (€)	947,705	1,238,108	1,616,341	2,103,651	2,806,285
Total (€)	1,214,026	1,566,760	2,014,405	2,627,793	3,558,499

State funding

The Latvian scheme does not benefit from any government guarantees or other provisions (eg, last-resort lending) to meet its obligations in the case of funding shortfalls. Furthermore, the scheme cannot and does not receive direct contributions from the state.

Other sources of funding

The scheme does not have the ability to borrow funds, and it is not possible to pool the funds of the life assurance and non-life insurance funds.

The IGS has not taken out reinsurance cover to meet funding needs.

Past cases of intervention

There has been only one insurance company failure since the establishment of the Fund for the Protection of the Insured in 1998.

In 2002 the insurance company, Alianse, went into liquidation. It failed to fulfil its obligations according to the requirements of the insurance contracts largely in the field of TPL insurance for inland motor vehicle owners. The Motor Guarantee Fund covered the relevant claims in relation to motor insurance, which amounted to LAT300,000 (around €425,000). Regarding the Fund for the Protection of the Insured, in most cases the insurance indemnity was paid for sickness insurance. To date, the total cost of the failure to the Fund for the Protection of the Insured is LAT8,000 (around €11,333), with 40 claims. Table A1.22 summarises the details of the Alianse failure.

Table A1.22 Summary of previous insurer failures in Latvia

Name of insurer	Year of winding up	Year of intervention	Class of insurance	Nature of intervention	Total cost to date	Number of claims to date	Single largest claim	Average claim
Alianse	2002	2003–04	Accident, health (sickness), land vehicle	Payment of compensation	LAT8,000 (€11,333)	40	LAT2,000 (€2,833)	LAT243 (€344)

Background information

The IGS in Malta is the Protection and Compensation Fund, and covers both long-term business and general business of insurance. The Insurance Business Act of 1998 is the legal basis for the Fund, which was established on January 1st 2004, and which replaced the Insurance Security Fund of 1986. The Protection and Compensation Fund Regulations ensure that the provisions of the Act are fulfilled; such provisions relate to the appointment, tenure, removal and administration of the Fund.

The Fund provides for the payment of any outstanding claims against an insolvent insurer. All claims must be in respect of protected risks (general business) situated in Malta and protected commitments (long-term business) where Malta is the country of commitment.

The Fund was established for the future protection of policyholders, rather than as a response to a failure of an insurer.

Structure and governance

The Fund is administered by, and under the general control of, the Protection and Compensation Fund Management Committee, which consists of seven members, one of whom is the Chairman. The remaining members are nominated as follows:

- one member is nominated by the regulator;
- three members are nominated by the insurance industry in Malta;
- one member is an independent individual;
- one member represents the interest of consumers.

The Fund is accountable to the national supervisory authority, the Malta Financial Services Authority (MFSA). The Fund does not employ any staff on a daily basis.

No data is available on the initial set-up costs of the Fund. The running and administrative costs for the period 2002–06 are set out in Table A1.23.

Table A1.23 Administration costs of the Maltese IGS, 2002–06 (€)

	2002	2003	2004	2005	2006
Total	14,000	12,136	18,020	17,901	18,111

Scope of coverage

Scheme participation

All insurers requiring formal authorisation to conduct insurance business in Malta are required to participate in the scheme. This includes domestic and non-EU insurance undertakings, as well as EU branches from Member States that do not have a scheme, or whose scheme offers less protection than that offered in Malta.

The obligation to pay contributions under regulation 7 of the Protection and Compensation Fund Regulations 2003 also applies to an insurer which ceases, or which may cease, to conduct long-term business of insurance and is entrusted with carrying out servicing of that business. The obligation to pay contributions remains until the insurer proves to the satisfaction of the MFSA that it has no further liability arising from such business.

Table A1.24 shows the number of insurance companies participating in the Maltese guarantee scheme, broken down by life and non-life insurers. In total, there were 20 companies participating in the scheme in 2006, seven of which are life assurers, and 13 non-life insurers. Of the 20 companies, eight were domestic undertakings, while nine (including an EU branch, which ceased to conduct business in Malta prior to May 1st 2004, and which is currently servicing that business) and three were EU branches/agencies and non-EU undertakings respectively.

Table A1.24 Number of participating insurers in the Maltese scheme, 2006

	Life assurers	Non-life insurers	Total
Domestic insurance undertakings	4	4	8
EU branches/agencies	1	8	9
Non-EU insurance undertakings	2	1	3
All participants	7	13	20

Protected insurance policies

The Fund covers specific classes of both non-life insurance and life assurance.

General insurance

The following classes of non-life insurance are covered by the Fund:

- accident (where the insured is an individual);
- sickness;
- land vehicles;
- fire and natural forces;
- other damage to property;
- motor vehicle liability;
- general liability;
- miscellaneous financial loss;
- legal expenses;
- assistance.

Specifically excluded from coverage are the following classes of non-life insurance:

- accident (where the insured is not an individual);
- railway rolling-stock;
- aircraft;
- ships;
- goods in transit;
- aircraft liability;
- liability for ships;
- credit;
- suretyship.

Long-term insurance

The following classes of life assurance are covered by the Fund:

- life and annuity;
- marriage and birth;
- permanent health;
- pension fund management;
- social insurance.

The following classes of life assurance are not covered by the Fund:

- linked long-term;
- tontines;
- capital redemption;
- collective insurance.

Further geographic restrictions on coverage also apply, as described below.

Protected claimants

The Management Committee pays compensation to a 'qualifying person'. According to the Regulations, this can be:

- the insured;
- a person to whom payment, in respect of any sums falling due under the policy, could have been made in accordance with the policy;
- a person to whom the insolvent insurer is liable to pay any sum, or other consideration, in respect of the insured's legal liability to that person under the policy of insurance.

In the case of life assurance, payment is made to every qualifying person. However, in the case of non-life insurance, payment is made only in instances where the qualifying person is an individual, and to every non-corporate body or association of persons if all persons are individuals.

Moreover, the Regulations specify that no payment is made where the claim is in respect of unearned premiums and where the claim is by, or in respect of, a person who is a shareholder of the insolvent insurer and holds 20% or more of the issued shares of the insolvent insurer.

Cross-border arrangements

Insurance undertakings with their head office in Malta, non-EU undertakings and EU branches from Member States which either do not have a scheme, or whose scheme offers protection that is less comprehensive than that offered in Malta, are required to participate in the Compensation and Protection Fund.

As a general rule, the Fund covers policies issued by companies authorised under the Insurance Business Act to conduct general and long-term business (which includes non-EU insurers) in respect of risks situated in Malta or commitments where Malta is the country of commitment.

Compensation limit

The claim is compensated in full in the case of compulsory insurance. In the case of non-compulsory long-term business, protected commitments are limited to 75% of the actuarial valuation of the contract of insurance remaining unpaid at the time the company ceased operating, or MTL10,000 (around €23,294¹¹³), whichever is less.

In the case of non-compulsory general business, protected risks are limited to 75% of the liabilities incurred remaining unpaid in any one case, or MTL10,000, whichever is less.

However, the total amount of payments to be made by the Fund with respect to any one insolvent insurer cannot exceed MTL1,000,000 (around €2,329,373).

¹¹³ Converted at the central parity rate of MTL1 = €2.3294.

Operational arrangements

Intervention of scheme

The Fund becomes active when an insurer fails. Compensation is also paid from the Fund if the insolvent insurer was servicing or running off the business of insurance it was licensed to conduct under the Act at the time when it became insolvent. In addition, for a claim for compensation to be made under the Fund, the name of the insolvent insurer must be struck off the register, or the insolvent insurer must be wound up.

The Maltese IGS operates by paying compensation to policyholders in the event of insolvency of an insurer. There are no provisions for the taking over and administration of the insurance policies of the insurer to ensure continuation of policies, nor does the IGS facilitate portfolio transfer to another insurer.

Claims processing

Under the current legislation, the processing of a claim by the Fund will not occur more quickly than that of a claim under traditional winding-up proceedings since no payment is made out of the Fund unless the Management Committee is satisfied that the insolvent insurer is struck off the register or wound up.

A claim against the Fund has to be made within two years of the insurer being wound up or struck off the register.

Funding

The operations of the Maltese IGS are funded from levies on insurance companies participating in the scheme. The scheme maintains two separate funding pools, one for non-life and one for life assurance.

Contributions from insurance undertakings

The Protection and Compensation Fund is a pre-funded scheme for both general and long-term business, as the contributions are raised annually to accumulate funds for future insolvency cases. Prior to the establishment of the Fund in 2004, the previous scheme was financed on an ex post basis.

Compensation in Malta is funded through contributions collected from the insurance industry on the basis of an insurer's profile. The contribution is calculated as a fixed percentage (0.125%) of the gross premium income of an insurer for the previous year for general business or long-term business.

Table A1.25 shows the levies raised from insurers since the Fund began operating on a pre-funded basis. The contributions from life assurers and non-life insurers are shown separately.

Table A1.25 Levies raised from participating insurers in Malta, 2004–06

	2004	2005	2006
Life assurance (€)	110,177	118,008	141,253
Non-life insurance (€)	110,485	138,076	142,325
Total (€)	220,662	256,084	283,578

A sum not exceeding 5% of the total contributions in any given year is at the disposal of the Management Committee to meet expenses incurred by the administration of the Fund.

The Fund can request additional contributions to make up funding shortfalls.

Size of standing fund

The target size for the standing fund is MTL1,000,000 (around €2,329,373) for both life assurance and non-life insurance. Table A1.26 shows the size of the fund in the period 2004–06, broken down by life and non-life insurance.

Table A1.26 Size of standing fund in Malta, 2004–06

	2004	2005	2006
Life assurance (MTL)	47,299	96,911	156,945
Non-life insurance (MTL)	47,431	105,521	166,010
Total (MTL)	94,730	202,432	322,955
Life assurance (€)	110,178	225,744	365,588
Non-life insurance (€)	110,486	245,801	386,704
Total (€)	220,664	471,545	752,291

Source: Protection and Compensation Fund Annual Report and Financial Statements, December 31st 2005 and 2006.

If the target of MTL1,000,000 is reached in either of the life or non-life sub-funds (or both), the MFSA can direct the Management Committee to suspend the collection of contributions from participating insurers. However, the Fund would still have to collect an annual payment of MTL300 (around €700) from participating insurers (other than an insolvent insurer), to cover expenses incurred by the administration of the Fund.

The Fund relies on external parties for management of the funds held by the scheme. The money is invested in treasury bills and treasury stocks by the Maltese government, prior to the adoption of the euro in Malta. The Fund has appointed an Investment Committee, comprising three members of the Management Committee, which approves the investment strategy.

State funding

The Fund cannot receive direct contributions from the state.

Other sources of funding

The scheme can borrow funds in the event of funding shortfalls. However, the amount borrowed should not exceed 30% of the total amount of payments to be made by the Fund to all qualifying persons of any one insolvent insurer.

It is not possible to pool the funds of the life assurance and non-life insurance sub-funds.

The Fund has not taken out reinsurance cover to meet funding needs.

Past cases of intervention

To date, the Protection and Compensation Fund has not dealt with any cases of insolvency in view of the fact that, before 2004 (prior to Malta acceding to the EU), foreign companies were required to maintain deposits in relation to the Malta business and therefore recourse is to be made to such deposits first. If the deposits are not sufficient to meet these liabilities, redress can be made to the Fund for any amount remaining unpaid. Furthermore, the predecessor to this scheme, which was established in 1986, did not deal with any cases.

A1.10 The Netherlands

In the Netherlands, there is no general IGS covering life or non-life insurance. With regard to life assurance, the Early Intervention Arrangement for Life Assurers (Opvangregeling Leven; EIALA) has been in place since 2001. As explained below, the EIALA is not an IGS.

Special arrangements are in the process of being implemented for health insurance. These are briefly described below.

Early Intervention Arrangement for Life Assurers

The EIALA was created following the implementation of the 'Wet tot wijziging van de Wet toezicht verzekeringsbedrijf 1993 teneinde daarin een opvanginstrument voor levensverzekeraars op te nemen (Stb. 2001, 73)' (Act to amend the Insurance Business Supervision Act in order to incorporate the Early Intervention Arrangement for Life Assurers), which came into force on December 22nd 2001. This law was replaced in 2006 by the 'Wet op het Financieel Toezicht' (Act of 28th September 2006, on rules relating to the financial markets and their supervision (Financial Supervision Act)).

The EIALA was established to protect consumers in the life assurance industry. Before a life assurer becomes insolvent, the EIALA obliges the insurer to sign a reinsurance agreement with a special Early Intervention Arrangement entity. This entity is formed by the Dutch Association of Insurers (Verbond van Verzekeraars). Obligatory reinsurance is, in principle, intended to be in place for a relatively short period of time, after which the life assurer is expected to continue its business independently.

Alternatively, the insurer is obliged to transfer its portfolio to a special entity. This entity then seeks to transfer the portfolio of the undertaking in difficulties to another life assurer through a public auction.

Whether the reinsurance agreement or portfolio transfer is used by the EIALA depends on the nature of the insurance undertaking's difficulties. Specifically, obligatory reinsurance is considered if there is sufficient confidence in the company's management and the evolution of its business. Where there is not sufficient confidence, obligatory portfolio transfer takes place.

Life assurers that have headquarters in the Netherlands and are authorised by the Pensioen- & Verzekeringskamer have to pay an ex post contribution to meet the costs incurred under the EIALA. Hence, branches of life assurers with head offices in another EU Member State do not have to contribute to the EIALA. If the EIALA has to intervene, the contributions are allocated as a percentage of the gross premium income of life assurers. Such contributions are limited by law—eg, in 2006, the total contributions were limited to €107m in an individual case of firm failure, and under specific circumstances to €213m in total for all cases during a year. In return for their contributions, life assurers receive shares in the special entity and become creditors of a subordinated loan (granted to the special entity). The aim of the special entity is to pay back the contribution to insurers, including a reasonable return.

The EIALA is not an IGS according to the usual definition due to the following reasons.

- It starts operating when companies' solvency margins fall below a certain legal threshold but *before* they go into liquidation. In effect, a precondition for intervention is that the portfolio of the life assurer should be viable—ie, technical provisions should be fully covered. If this is not the case, the company is put into liquidation.
- The arrangement does not guarantee a given level of protection. It would not operate if there were a shortfall of assets to meet claims.

As such, the EIALA is not considered in the cross-country comparison of IGS.

Special scheme in the health sector

A new insurance system for curative healthcare came into force in 2006. All Dutch residents are obliged to take out health insurance, and insurance companies are not permitted to exclude anyone or charge different premiums for different risks. A risk equalisation system is in place to protect health insurers from suffering financial losses due to an unequal distribution of risks. Compensation arrangements are part of the system. In the event of the failure of an insurer, policyholders are compensated by the Health Care Insurance Board (CVZ) for unsettled claims. The costs are first recovered on the estate of the bankrupt insurer by the CVZ, with any deficits borne by the state.

Given the special nature of the system and the fact that the design of the system was being finalised at the time of writing, the compensation arrangements are not considered in the cross-country comparison.

Background information

The Insurance Guarantee Fund (IGF) in Poland (Ubezpieczeniowy Fundusz Gwarancyjny) protects:

- life insurance;
- four types of compulsory non-life insurance: insurance for motorcar TPL, farmers' TPL, professional TPL and farm buildings.

Insurance guarantee arrangements in Poland were introduced by the Act on Insurance Activity of July 28th 1990 (which entered into force in January 1st 1991). Originally, car owners were automatically covered by motor TPL insurance on acquiring the vehicle, irrespective of whether they had purchased an insurance policy. As a result, there were no uninsured drivers. The 1990 Act on Insurance Activity made it compulsory for car owners to purchase an insurance policy—therefore, claims involving uninsured/unidentified drivers became an issue. As a result, the Act also established the IGF to protect third parties for damages caused by uninsured or unidentified drivers. The Act also appointed the Insured Protection Fund, a separate institution from the IGF, to settle the claims of insured natural persons in the case of insolvency of both life assurers and certain types of non-life insurers (ie, those offering motorcar and farmers' TPL insurance, and insurance of farm buildings). In June 1995, the Act was amended, and the IGF took over the rights and duties of the Insured Protection Fund.

Some of the IGF's tasks were extended by the Act of May 22nd 2003 on Compulsory Insurance, Insurance Guarantee Fund and Polish Motor Insurers' Bureau,¹¹⁴ which entered into force on January 1st 2004, and was amended on May 1st 2004.¹¹⁵ In addition, the Articles of the Association of the Insurance Guarantee Fund,¹¹⁶ approved in 2004, set out the specific rules for the IGF concerning governance, scheme coverage and funding, among other issues.

The IGF's functions currently include the following.

- Payment of compensation to policyholders, claimants and beneficiaries of an insurer following bankruptcy declaration (ordered by the court) or in compulsory winding-up (ordered by Financial Supervisory Commission). Since 1991, this applies to life assurance, compulsory motorcar and farmers' TPL insurance, and compulsory insurance of farm buildings. Professional TPL insurance has also been covered by the Fund since 2004.
- Securing continuation of certain policies by facilitating portfolio transfer. This preventative function consists of granting a repayable loan to third-party insurers taking over the portfolio of the undertaking in question. This function was introduced in 2004, and applies only to motor and farmers' TPL insurance, not life assurance or the other branches of compulsory non-life insurance.

In addition to these two activities, the IGF continues to pay compensation for claims involving unidentified or uninsured drivers, which constitute the largest part of IGF activities.

¹¹⁴ Official Journal No. 124 of July 16th 2003, Item 1152.

¹¹⁵ When Poland became a Member State on May 1st 2004, it was obliged to make some modifications in order to transpose EU legislation—eg, Polish insurers selling motor TPL insurance were obliged to establish claim representatives in other Member States.

¹¹⁶ Official Journal of the Ministry of Finance No. 15 of October 30th 2004, Item 144.

Governance

The IGF is a private body represented by, and under the management of, an Executive Board. The Executive Board is appointed by the Fund's Council, which is composed of nine members. One is designated by the Ministry of Finance, one by the Financial Supervisory Commission, and a further seven by insurers. These seven insurers are appointed by the IGF's General Assembly, which comprises insurers offering motorcar and farmers' TPL insurance. Insurers with more than 20% market share have two votes, and those with a market share below this threshold have one vote.

The IGF is accountable to the Ministry of Finance and the Financial Supervisory Commission. The Ministry is ultimately in charge of supervising the IGF and deciding the levels of membership contributions. The IGF needs to submit regular financial reports to the Financial Supervisory Commission.

The IGF employs around 155 people, five of whom deal with issues related to insurers' insolvency. Of these five people, two are case handlers, two provide administrative support, and one performs various activities. The number of staff handling and settling claims related to insolvencies varies according to the IGF's caseload. For example, in 1996 there were 13 full-time employees performing these tasks; in 1997 the number increased to 14; and from 1998 to 2001 there were around nine. Since the IGF fulfils other functions, it is difficult to estimate the operating expenses that arise specifically from activities related to cases of winding up.

Scheme participation

Participation requirements vary according to the type of insurance.

- **Motor and farmers' TPL.** All insurers offering motor and farmers' TPL insurance are required to become permanent members of the IGF once they start selling policies covering these types of insurance in Poland. In practice, the requirement is that domestic insurance companies as well as undertakings with headquarters in other EU Member States and non-EU countries conducting their business in Poland are required to participate and pay contributions to the IGF.
- **Life, professional TPL and farm buildings.** Domestic insurers, EU branches and non-EU undertakings offering life assurance, professional TPL insurance, or insurance of farm buildings become temporary members of the IGF in the event of a bankruptcy declaration or compulsory liquidation.¹¹⁷ In the event of liquidation, the IGF will intervene and compensate policyholders, claimants and beneficiaries. The costs incurred by the IGF will be shared between all insurers offering the relevant type of insurance in Poland, whether domestic firms or incoming EU or non-EU insurers.

Table A1.27 presents the number of permanent members of the IGF. In total, 30 companies are currently offering motor and/or farmers' TPL insurance and contribute to the IGF, including two EU branches and three firms providing insurance under freedom of services.

¹¹⁷ See Articles 97 and 98 of the 2003 Act on Compulsory Insurance, Insurance Guarantee Fund and Polish Motor Insurance Bureau.

Table A1.27 Number of insurers participating in the IGF, 2006

	Total
Domestic insurance undertakings	25
EU branches	2
Direct sales of EU-based insurers	3
Non-EU insurance undertakings	–
All participants	30

As for its temporary members, since there have been no bankruptcies of insurance companies offering professional third-party liability insurance, farmers' buildings insurance or life assurance since the IGF assumed the responsibilities of the Insurance Protection Fund in 1995, the IGF has not yet intervened. There are currently around 35 firms offering life assurance, and there are some companies offering other non-life insurance. These companies would become members of the IGF should a life assurer go into liquidation.

Insurance undertakings operating in Poland are permitted to disclose to policyholders that they participate in the IGF, but they are not required to do so.

Scheme coverage

Protected insurance policies

According to the provisions of the Act of May 22nd 2003, the IGF operates a general scheme for life assurance that protects all policies without exclusion of particular classes of life assurance.

The special schemes protect policies covering motor, farmers' and professional TPL insurance, and insurance for farm buildings, which are all compulsory classes of insurance in Poland.

Eligible claimants

According to Chapters 2–4 and 7 of the Act of May 22nd 2003, for both life assurance and the compulsory types of non-life insurance mentioned previously, the IGF covers only natural persons.

Cross-border arrangements

All Polish insurers as well as incoming firms from within and outside the EU operating in Poland are required to contribute to the IGF. The IGF operates on a strict host state basis. Policies written by branches of Polish insurers in other EU countries would therefore not be covered.

There are no eligibility criteria depending on the place of residency of the claimant. However, only risks located in the territory of Poland are guaranteed in relation to compulsory insurance.

Compensation limit

Table A1.28 presents the limits to the amount of compensation that can be paid by the IGF, as set out by the Act of May 22nd.

Table A1.28 Compensation limits

Type of insurance policy	Compensation limit
Motorcar insurance, and farmers' TPL insurance	100% of contractual benefits and up to €1.5m for personal injuries and €300,000 for material damages
Life assurance and professional TPL insurance	50% of contractual benefits and up to €30,000
Insurance of farm buildings	100% of contractual benefits (up to the amount insured)

Compensation relates to the amount insured and contractual benefits. Premiums paid are not compensated, and any bonuses or similar are not taken into account in establishing the compensation amount.

Operational arrangements

Nature of intervention and claims processing

The IGF has two functions: a compensation function and a preventative function.

For the latter, since 2004 the IGF has been obliged to seek continuation of motor and farmers' TPL insurance policies of the insurer in financial difficulties. The preventative function consists of the IGF facilitating portfolio transfer and granting a repayable loan (on soft terms) to the insurer taking over the portfolio of the firm in difficulties. The IGF would only offer such a loan in the event of the portfolio transfer threatening the financial soundness of the insurer taking over the portfolio. Thus far, this preventative function has not been activated—ie, IGF intervention has been limited to paying compensation.

Following the Act of May 22nd 2003, the IGF has to compensate policyholders, claimants and beneficiaries when:

- an insurer files for bankruptcy;
- the application to be declared bankrupt is dismissed or the bankruptcy proceedings have been stopped, if the assets are evidently not sufficient to cover the costs of the bankruptcy proceedings; or
- the entitled claims of an undertaking in compulsory liquidation are not covered by assets backing up the technical and insurance reserves.

Claims processing and payment can be summarised as follows.

- **Motor and farmers' TPL insurance.** The IGF takes over from the receiver assigned to the bankruptcy proceedings, receives the damages documentation, fixes the level of compensation according to the rules and limits, and pays it to the claimants. Similarly, in cases where damages were not lodged to the insurance undertaking before bankruptcy, the IGF accepts the damages notification and makes a compensatory payment to the damaged parties. Policyholders and third-party claimants that are entitled to claim compensation can lodge their claims with the IGF directly or through any insurer offering motor or farmers' TPL insurance.
- **Life assurance.** The IGF settles the claims on the basis of the debt and claimants listed, as established during the bankruptcy proceedings.
- **Professional TPL insurance and compulsory insurance of farm buildings.** The IGF settles the claims on behalf of the insurance undertaking in liquidation (including those received before and after the insurer has gone into liquidation).

Policyholder notification and application

The time limit within which policyholders/third-party claimants must make a claim against the IGF varies depending on the type of insurance, and the type and extent of damage. According to Polish regulations, the overall maximum is ten years.

Claimants typically receive payment within three months of lodging their claim, but in some cases the Law specifies a minimum time period for making payments. For example, the Fund is obliged to cover claims resulting from motor TPL insurance within 30 days of receiving the damage documentation from the insurance undertaking or from the receiver. If it is necessary to clarify certain issues concerning the determination of the amount of the claim, the benefits should be paid within 14 days after such issues have been clarified.

Funding

The operating costs of the IGF are currently met through regular levies on insurers offering motor and farmers' TPL insurance (around 60% of IGF revenues), revenues resulting from penalties paid by uninsured drivers or farmers, and proceedings against uninsured drivers or farmers found guilty of causing damage. In the event of failures involving insurers providing other protected classes of insurance, the funding would be raised from ex post industry levies.

Contributions from insurers

As the permanent members of the IGF, insurers offering motor and farmers' TPL are required to pay regular contributions that are levied on the basis of gross premiums written. The percentage of gross premiums due can vary, and the rules do not specify explicit limits.

In 2006, insurers paid 1% of their gross written premiums to the IGF. Of the total paid, a proportion (0.8% in 2006) is used to pay for the regular compensation activities of the Fund, and the remainder (0.2% in 2006) is paid into an aid fund. Funds accumulated in the aid fund are set aside solely for the purpose of undertaking preventative action, and facilitate the transfer of the motor and farmers' TPL portfolio in the event that an insurer runs into financial difficulties.

Hence, to provide the guarantee function in relation to motor and farmers' TPL insurance, the IGF is funded on the basis of both ex ante (for the aid fund) and ex post contributions (for the current compensation and operating costs). The contributions to fund current costs include the costs of motor claims where the damage has been caused by unidentified or uninsured drivers—ie, not just for cases of insolvency.

Table A1.29 shows the development of levy rates as a percentage of gross premiums on motor and farmers' TPL insurance since 2002. The levies raised for the aid fund start in 2004, when the IGF assumed the preventative function.

Table A1.29 Levies imposed on motor and farmers' TPL insurers, 2002–06
(% of relevant gross premiums written)

	2002	2003	2004	2005	2006
Levies for IGF expenses	Jan–March: 1.6 April–Dec: 1.0	1.0	1.0	Jan–March: 1 April–Dec: 0.8	0.8
Levies for the aid fund			0.2	0.2	0.2

On the other hand, the funds required to pay compensation in the event of bankruptcy of a life assurer or non-life insurers providing professional TPL or farm buildings insurance are raised ex post. Insurers would be obliged to start paying a percentage of their gross

premiums to the IGF when it is announced that a company has gone bankrupt and compensation payments are due. After consulting the Financial Supervisory Commission and the Polish Chamber of Insurance, the Ministry of Finance would determine the level of the contribution.

Size of standing fund

The IGF largely ex post-financed. Funds accumulate only with respect to the preventative function in the case of failure of an insurer providing motor and farmers' TPL insurance. Since 2004, 0.2% of gross premiums written in relation to these two classes of insurance have been accumulating in the aid fund, with the fund amounting to €8.8m at the end of 2006.

The accumulated funds relate mainly to motor TPL insurance and are therefore not comparable with the standing funds accumulated by other EU IGS, which exclude motor or at least include other significant classes of insurance.

Table A1.30 Aid fund for motor and farmers' TPL insurance, 2004–06 (€m)

	2004	2005	2006
Aid fund	2.4	5.5	8.8

State funding

There is no state involvement in the financing of the IGF.

Other funding sources

The rules governing the IGF do not envisage borrowing, and there are no other sources of financing scheme activities (other than those listed above and recoveries from winding-up proceedings).

Past cases of intervention

Since 1993, seven bankruptcies have triggered intervention of the scheme and payment of compensation, with the last failure occurring in 2000. Six out of these seven failures involved non-life insurers (see Table A1.31). The most important case related to the insolvency of TUR Polisa SA, which offered both motor and farmers' TPL insurance. This insurer initiated winding-up proceedings in 2000, with a cost of €20m arising from compensation of nearly 12,800 claimants. Note that the majority of claims in this case (as well as in the other non-life cases) related to Motor TPL insurance.

The last failure of a life assurer occurred in 1993, and there are no details about compensation payments made (the case was dealt with by the Insured Protection Fund, the predecessor of the IGF). Between 1993 and 2006, the total cost to the IGF exceeded €55m (excluding those costs generated by the liquidation of Westa SA and Westa Life SA), and around 40,000 single compensations.¹¹⁸ Furthermore, between 2000 and 2006, the IGF paid around 3,700 long-term annuities.¹¹⁹ Since all these cases took place before 2004, the IGF's intervention took the form of payment of compensation.

¹¹⁸ 'Single compensation' refers to direct payments by the IGF in the event of the winding-up of an insurer.

¹¹⁹ Long-term annuities relate to compensation for permanent or temporary disability and medical care.

Table A1.31 Details of liquidations, 1993–2006

Company	Year of winding-up	Year of intervention	Class of insurance	Total cost to date (€m)	Number of claims to date ('000s)
TUR Polisa	2000	2000	Motor and farmers' TPL insurance	20	12.8
Westa SA	1993	1993	Motor and farmers' TPL insurance	18.7	n/a
Westa Life SA	1993	1993	Life assurance	NA	n/a
PTU Gryf SA	1996	1996	Motor and farmers' TPL	9.3	10.2
Hestja SA	1996	1996	Motor and farmers' TPL insurance	4.4	4.3
Fenix SA	1997	1997	Motor and farmers' TPL insurance	1.3	2.9
Gwarant SA	2000	2000	Motor and farmers' TPL insurance	1.1	0.6

Notes: The information on total costs and number of claims includes single compensations only. Long-term annuities were not included because of a lack of reliable data.

Table A1.32 provides information on the compensation paid by the scheme, number of claims accepted, and the average size of claim for the period 2002–06. In 2006, the average size of single compensations was €9,600, while that of long-term annuities was €124. The table also includes information on the amount recovered by the IGF from the winding-up proceedings (expressed as a percentage of costs in the year). As the table shows, there is an important variation in the percentage recovered, which ranges from 0% in 2005–06 to more than 20% in 2003. Most of this data relates to liquidations of insurers offering motorcar insurance.

Table A1.32 Past cases of intervention

	2002	2003	2004	2005	2006
Total payments (€000s)	3,600	2,390	1,510	1,520	1,270
Single compensations	2,800	1,700	690	690	420
Long-term annuities	800	690	820	830	850
Total number of claims (number)	1,366	719	669	612	577
Single compensations	841	159	96	47	36
Long-term annuities	525	560	573	565	541
Amount of average (median) claim (€)					
Single compensations				13,200	9,600
Long-term annuities				119	124
Percentage recovered by the IGF	1.7	22.2	7.4	0	0

A1.12 Romania

Background information

In addition to the special fund for protecting motor accident victims, Romania has introduced a general IGS, covering all classes of life and non-life insurance policy. The Guarantee Fund (Fondul de Garantare) pays compensation to policyholders in the event of insolvency of an insurer. It was introduced through a number of laws between 1995 and 2005 (Legea nr. 136/1995 privind asigurarile si reasigurarile in Romania, Legea nr. 32/2000 privind activitatea de asigurare si supravegherea asiguratorilor, Legea nr. 503/2004 privind redresarea financiara si falimentul societatilor de asigurare). The Guarantee Fund has collected contributions from participating insurers since 2001, but started payments in 2005, when the legislation was fully implemented. In 2005, the Guarantee Fund was divided into two separate sub-funds, one for life and the other for non-life insurance, each collecting contributions from the respective parts of the insurance market.

Structure and governance

The Romanian scheme is under public management, being operated by the Insurance Supervisory Commission (Comisia de Supraveghere a Asiguratorilor, CSA), which protects policyholders' interests and promotes the stability of the insurance sector in Romania. Within the Insurance Supervisory Commission, a specialised department, the Guarantee Fund Directorate, is responsible for the management of the IGS. The operational functions of the Fund and certain related functions are undertaken by 28 members of staff. The administration costs amounted to RON2,472,061 (€ 647,560) in 2006.

Scope of coverage

Scheme participation

All insurance undertakings authorised to operate in Romania are required to participate in the Guarantee Fund, making contributions to the relevant sub-fund depending on their life assurance and non-life insurance business. The scheme neither requires nor allows the participation of incoming EU insurers operating under freedom of services or via branches.

40 domestic insurance undertakings participate in the Guarantee Fund—eight life insurers, 21 non-life insurers, and 11 composite insurers with both life and non-life business.

Protected insurance policies

The scheme covers both life assurance and non-life insurance contracts, without exclusions for specific classes of insurance.

Protected claimants

Law no. 503/2004, regarding financial recovery and the winding up of insurance undertakings, sets out which claimants are eligible for the purpose of insurance guarantee. Protection is not restricted to natural persons. All claimants classified as insurance creditors are eligible, which includes insured persons, insurance policyholders, beneficiaries of insurance contracts and any other persons whose claims have not been honoured by the insurance undertaking.

Cross-border arrangements

The Guarantee Fund operates on the basis of the home state principle—participation is intended for insurance undertakings authorised in Romania, and the protection applies to the insurance contracts written by those insurers. Incoming EU insurers operating in Romania on the basis of freedom of services or freedom of establishment are therefore not required (nor permitted) to participate in the Guarantee Fund.

Compensation limit

The Guarantee Fund pays compensation in the event of failure of an insurance undertaking. Compensation is in general unlimited, and claimants can receive 100% of their claims up to the full amount.

The exceptions are claims relating to motor vehicle insurance, where maximum limits of compensation for damage to property or personal injury are fixed on an annual basis through Orders.

Operational arrangements

The operation of the Guarantee Fund is triggered at the beginning of the winding-up proceedings, on declaration of insolvency and withdrawal of authorisation of an insurance undertaking by the Insurance Supervisory Commission.

Within ten days of the publishing date of the supervisor's decision, the insolvent insurer is obliged to hand in to the Guarantee Fund administrator (ie, the Guarantee Fund Directorate within the Insurance Supervisory Commission) a complete list of the claims files as well as the technical/operational evidence and bookkeeping related to these files.

Within this period, the Fund administrator appoints a special commission of internal experts, charged with evaluating and publishing the list of claims and claimants and deciding on payment.

Any person not present on the list of certain claimants may apply for compensation to the Fund administrator within 60 days of publication of the list, in writing and on submission of supporting documents. The special commission will evaluate the compensation claims and, on approval, add the claim to the list. The average time between making a claim and receiving compensation from the Fund is estimated to be around 30 days.

The payments from the Guarantee Fund are made in full, in succession of the registered claims. In the event of funds being insufficient for the settlement of any obligations, such obligations will be paid within a period of three years from the date on which the decision on the insolvency was approved, while the Fund will receive new resources. After the payments, the Guarantee Fund is registered on the creditor lists of the bankrupted undertaking as a privileged creditor and entitled to recover the amounts paid.

Funding

The operations of the Guarantee Fund are financed by contributions of participating insurance companies. Contributions have been collected since 2001, and the first payment was made in 2005. As such, funding is received on an ex ante basis—ie, in expectation of future failures occurring; however, contributions are adjusted on an annual basis in light of funding requirements. Since 2005, the scheme has maintained two separate funding pools, one for non-life insurance and one for life assurance.

Contributions from insurance undertakings

The Insurance Supervisory Commission establishes on an annual basis the contribution rate, which is based on the gross earned premiums from the relevant direct insurance business. In 2006, the rate was 0.3% for life assurance and 0.8% for general insurance. This has fallen from the contributions levied in 2005, which were at a rate of 0.5% for life assurance and 1% for non-life insurance.

Following a proposal of the Guarantee Fund, the Insurance Supervisory Commission has the power to modify the level of contributions in the event of a shortfall. Law n. 136/1995 establishes a cap on the contribution quota, which is set at 10% of gross earned premiums on the relevant direct insurance business. This is the target size of the standing fund.

The amount raised from participating insurers from 2002 to 2006 is shown in Table A1.33.

Table A1.33 Levies raised from participating insurers in Romania, 2005–06

	2002	2003	3304	2005	2006
Total (RON)	23,869,203	35,587,840	33,081,744	36,459,780	45,946,663
Total (€)	7,636,923	9,476,192	8,161,883	10,062,312	13,036,363

Size of standing fund

The Guarantee Fund does not have an explicit standing fund (eg, with a minimum or maximum target fund size) to finance the cost of future failure. However, reserves accumulate each year due to a surplus of contributions over payments. The reserves amounted to:

- €54.4m in total (€43.2m for life assurance and €11.2m for non-life insurance) in 2005;
- €73.3m in total (€58.9m for life assurance and €14.3m for non-life insurance) in 2006.

State funding

The Guarantee Fund does not benefit from any state guarantees or other funding to meet obligations in the case of funding shortfalls.

Other sources of funding

The Guarantee Fund does not have a borrowing facility with an external credit provider, and there are no provisions that anticipate such borrowing. In addition, there is no borrowing between the two sub-funds established for life assurance and non-life insurance.

Past cases of intervention

Since its establishment, the Guarantee Fund has dealt with three cases of insurance failure, all involving composite insurers with both life and non-life business. As summarised in Table A1.34, the largest case to date involved Grup AS, which was declared insolvent in 2003; to date the Guarantee Fund has paid out more than €1.7m in compensation to 1,250 claimants; more claims remain to be paid.

Table A1.34 Summary of cases of intervention of the Romanian Guarantee Fund

Name of insurer	Start of winding-up proceedings	Total cost to date	Number of claims paid to date	Number of claims remain to be paid
Metropol SA	2003	RON5,556,410 €1,554,677	1,114	2,000 non-life 9,313 life
Grup AS	2003	RON5,999,580 €1,678,674	1,250	10,000 non-life
Croma	2005	RON858,836 €240,301	144	660 non-life

The first payments were made by the Guarantee Fund in 2005, amounting to RON5.1m (€1.4m). Compensation payments in 2006 totalled RON4m (€1.2m).

The single largest claim made in 2005 was RON522,922 (€144,450), while the average claim was RON7,848 (€2,353). The single largest claim in 2006 was RON151,664 (€44,234), while the average claim was RON2,830 (€825).

Background information

The Consorcio de Compensación de Seguros (CCS) was established by the Royal Decree-Law of 1940, and regulated by law for the first time by the Act of December 16th 1954. The rules governing the CCS are laid down in its Legal Statute (text revised by the Royal Legislative Decree 7/2004 of October 29th). The rules regarding activities related to the winding-up of insurers are laid down in the Royal Legislative Decree 6/2004.

Although, strictly speaking, the CCS does not operate an IGS since it does not guarantee a level of protection, it does operate a general winding-up scheme that protects policyholders and beneficiaries of life and non-life insurers against the financial losses they might face should an insurer go into liquidation. In practice, once winding up has been formally declared, the CCS attempts to transfer the portfolio of the firm in difficulties. If this is not possible, it acquires all the contractual obligations at a price that is higher than the one policyholders and beneficiaries would receive if they were compensated once the liquidation process were finalised. Thus, in addition to providing policyholders and beneficiaries with upfront liquidity, the CCS can improve the payments they receive.

The tasks related to the general winding-up scheme have been performed since 1984, first by the Comisión Liquidadora de Entidades Aseguradoras (CLEA) and, as a result of Law 44/2002, by the CCS since 2002.

In addition to the general scheme, the CCS is in charge of three special guarantee schemes:

- travellers' insurance—approved by the Royal Decree 1575/1989 December 22nd;
- hunters' liability insurance—Ministerial Order of July 20th 1971;
- motorcar insurance—Act 122/1962, December 24th (first regulation of the compulsory motor vehicles' liability insurance).¹²⁰

These schemes were created when the relevant types of insurance became compulsory. They provide compensation not only for uninsured risks (in the case of travel insurance) or damages (hunters' liability insurance), but also if the insurer goes into liquidation. The schemes guarantee 100% of the compulsorily insured amounts.

In the remainder of this section, unless otherwise specified the discussion refers both to the general winding-up scheme and to the travellers' insurance and hunters' liability insurance sub-schemes. However, focus is on the general winding-up scheme because, to date, there has not been a case of failure requiring operation of the two special schemes.

In addition to providing protection to policyholders and beneficiaries in the event of winding up, and compensating for uninsured risks or damages, the CCS performs the following activities:

- offering certain types of insurance policy when the policyholders cannot find a private insurer—eg, motorcar insurance;
- directly insuring catastrophic risks that affect goods insurance by any policy in Spain, and reinsuring against natural perils affecting agriculture;
- treasury functions relating to public export credit insurance;
- proposing the levels of charges imposed on policyholders to fund the IGS.

¹²⁰ The CCS is currently in the process of approving a Draft Act for the formation of a specific fund for (compulsory) environmental liability.

Governance

The CCS is a publicly owned and managed legal entity. However, it has its own capital, independent from that of the state, and is governed by the rules applying to private companies (código de derecho privado). Its main sources of income are:

- premiums it charges for the coinsurance and reinsurance services it provides;
- ex ante contributions based on premiums paid by policyholders to fund the protection it provides for uninsured risks and damages, and in the event of the winding-up of the insurer; and
- real estate investments.

The supervisory authority, the Insurance and Pensions Unit (Dirección General de Seguros y Pensiones) of the Ministry of Economy and Finance, plays an important role in the CCS. In particular, the head of the supervisory authority is the president (chairman of the board) of the CCS. In addition, the CCS is accountable to the supervisor.

Scheme participation

There are differences in the extent to which insurance undertakings participate in both the general winding-up scheme and the special sub-schemes in relation to the insurers that are protected by the schemes and that have to contribute to them.

In relation to the scope of protection of the general winding-up scheme, in compliance with Section 3, Article 31 of the adapted text of the Private Insurance Regulation and Supervision Act, the only insurance undertakings that can be wound up by the CCS are those which have headquarters in Spain, are subject to the control and supervision of the Directorate-General of Insurance and Pension Funds, and which possess assets that the CCS can control in the event of winding up. It is of note that all policyholders/claimants of these companies are protected, including those resident in other Member States or in non-EU countries. In summary, the home state principle applies in relation to the protection offered by the system.

According to Article 23.4 of the CCS's Legal Statute, all contracts covering risks located in Spain (except life assurance and export credit insurance) are subject to a surcharge intended to finance the CCS' winding-up activity, irrespective of whether the company that issues the policy is a domestic firm or a non-EU insurer, or whether the policy has been sold by a branch of an EU insurer or under free provision of services. In other words, the host state principle applies for financing.

Table A1.35 presents the total number of companies currently protected by the general winding-up scheme and, separately, those contributing to the general scheme. Data is not currently available for the special schemes.

Table A1.35 Number of insurers protected by, and contributing to, the general winding-up scheme, 2006

	Domestic insurance firms	EU branches	Non-EU insurers	Total
Number of firms protected by the general scheme	364		2	366
Life	27			
Non-life	337			
Number of firms contributing to the scheme (non-life only)	364	51	2	417

Life assurance policies benefit from protection by the general winding-up scheme, but contributions are made with respect to non-life policies only. According to the CCS, this asymmetry is explained by the fact that only a minority of the insurers that have gone into liquidation were life assurers—ten out of the approximately 200 companies that have been wound up since 1984.

Insurance undertakings operating in Spain are permitted to disclose to policyholders that they participate in the general winding-up scheme, but it appears that, in practice, they do not divulge such information.

Nature of intervention

Once the Insurance and Pensions Unit at the Ministry of Economy and Finance orders the liquidation of the insurer, the CCS analyses the portfolio of the firm in question and attempts to facilitate portfolio transfer. In this case, the CCS offers the portfolio to other insurance companies active in the same business line. After approximately one month, the Ministry must take a decision based on the suggested propositions .

When it is not possible to transfer the portfolio—for example, because it includes policies that have very high risks, or because the interested insurers would pay a very low price, or possibly because they are not interested in retaining the undertaking's staff—the CCS assumes all of the insurer's contractual obligations. The CCS pays policyholders and beneficiaries a percentage of the value of their policies and claims, and provides them with upfront liquidity.

According to Article 33 of the adapted text of the Private Insurance Regulation and Supervision Act, the price paid by the CCS is calculated by applying a number of accounting benefits to the insurer's assets and liabilities that raise the value above that which would be realised in liquidation. In particular, the CCS:

- excludes some provisions from the liabilities; and
- chooses the higher value of the market price and the original premium paid by the policyholders.

As a result, in many instances, payments are considerably higher than those policyholders and beneficiaries would obtain if they were compensated on the basis of the liquidation value of the undertakings' assets and liabilities. The difference between the amount paid and the amount recovered by the CCS from the liquidation of the company in question is the extra coverage provided by the CCS, and the loss it assumes.

Scheme coverage

Protected policies

The general scheme protects both life and non-life insurance policies without exclusion of particular classes of insurance.

The two special schemes protect policies covering hunting liability and travellers' insurance, which are compulsory classes of insurance in Spain.

Eligible claimants

According to Section 3, Articles 31 to 37 of the adapted text of the Private Insurance Regulation and Supervision Act, all policyholders and beneficiaries are protected by the general winding-up scheme, irrespective of whether they are natural or legal persons—except when the policyholder is another insurance undertaking.

For the special schemes covering hunting liability and travellers' insurance, only natural persons are protected in relation to personal or property damages.

Cross-border arrangements

All Spanish insurers, as well as EU-branches and non-EU insurers operating in Spain, are required to contribute to both the general and the special schemes. The policies issued by branches of insurance undertakings with their head office in another EU Member State and non-EU insurers, however, are not covered by the schemes.

In terms of protection, there are no eligibility criteria concerning the place of residence and the location of the risk. Furthermore, the risk is covered independently of where the policy has been purchased, provided that it has been sold by a company with headquarters in Spain.

Compensation limit

A percentage (which can be up to 100%) is established by the CCS for each company to determine the payment to policyholders and beneficiaries under the general winding-up scheme. This percentage is calculated by applying a number of accounting benefits (allowed by Article 33 of the adapted text of the Private Insurance Regulation and Supervision Act) to the undertaking's assets and liabilities (see 'Nature of intervention' above).

For the two special schemes, as in the case of compulsory motor insurance, the CCS has to cover 100% of any claims according to the limits specified by Law, which vary according to the type of insurance and damage. For example, in the case of travellers' insurance the law specifies limits for 14 different types of damage, including death (covers up to €56,000) and serious disability (around €60,000). In relation to hunters' insurance, the limits are around €36,000.

The maximum payment in the case of the special schemes can be improved using the same accounting benefits to the insurers' balance that are applied in the case of the general scheme. For example, if the CCS receives a claim for serious disability of €100,000, it will pay the claimant €56,000 plus the additional funds resulting from the CCS' uplift procedures—which could be in a range of €0–€44,000.

Operational arrangements

Claims processing and payment

If the CCS assumes responsibility for the portfolio of an insolvent insurer, the CCS makes payments to all claimants for claims received before the creditors' meeting. Claimants can still receive payments after the meeting has taken place, but only if there is a court sentence ordering the CCS to do so. The CCS must begin to make payments no later than nine months after the formal declaration of liquidation, and if all the required information is provided by the claimant, payments can be completed in a month's time.

Policyholder notification and application

Once the Insurance and Pensions Unit initiates formal winding-up proceedings, the CCS sends a letter to all policyholders informing them about the situation. If the undertaking's portfolio is to be transferred to another insurer, policyholders are kept informed while the selection of the new insurance company is taking place. If the CCS buys the undertaking's contractual obligations, policyholders are given guidance about the procedure they would need to follow to receive payment.

Operating costs

The CCS currently employs 366 people, of which 40 are fully dedicated to the general winding-up scheme. Table A1.36 shows the management and administration expenses of the general winding-up scheme. As the table shows, the expenses have decreased during the 2002–06 period from €5.3m to €2.9m, which is largely explained by the reduction in the number of insurance undertakings being wound up and, hence, the decrease in the number of claims that the CCS has to process.

Table A1.36 Operating expenses of general winding-up scheme, 2002–06 (€m)

	2002	2003	2004	2005	2006
Operating expenses	5.3	6.5	3.1	3.1	2.9

The special schemes have not yet been activated since there has been no insolvency of an insurer with policies covering hunting liability and travellers' insurance. The resource requirements and operating costs of the schemes are therefore small.

Funding

Contributions and size of fund reserve

The general winding-up scheme is funded on an ex ante basis. As stated in Article 23.4 of the CCS' Legal Statute, passed by Royal Legislative Decree 7/2004 of October 29th, the consumer protection functions of the CCS in the context of the liquidation of an insurer are funded through a 0.3% surcharge on the premiums of the insurance policy—except for life assurance and export credit insurance. The surcharge is collected by the insurance companies, which then transfer the money to the CCS. This money is exclusively used for funding the uplift in the level of payments made to policyholders and beneficiaries, and the winding-up expenses.

Table A1.37 summarises the amount of money raised for the general winding-up scheme, as well as the accumulated fund reserves. The CCS does not have a target fund size; however, given the current level of reserves, the CCS is considering reducing the level of the levies imposed on policyholders. The CCS adopted this measure in 2002 when the surcharge fell from 0.5% to 0.3% of the value of premiums—this explains the reduction in the level of contributions between 2002–03 from €109.9m to €85.7m.

Table A1.37 Contributions and fund reserve for general winding-up scheme, 2002–06 (€m)

	2002	2003	2004	2005	2006
Amount of contributions	109.9	85.7	82.0	89.0	94.1
Fund reserve	620.6	723.1	838.0	970.7	1,099.3

There are separate funding pools for providing protection in the event of liquidation of hunters' liability and travellers' insurance providers, as opposed to the general scheme. In these cases, a 3% surcharge is levied on the value of premiums of compulsory coverage. No data is available on the funds collected for the special schemes.

State funding

Neither the general winding-up scheme nor the special schemes benefit from any state involvement in the financing.

Other funding sources

Neither the general winding-up scheme nor the special schemes have access to other sources of funding.

Past cases of intervention

Since the general winding-up scheme was established in 1984, 259 insurance companies have been wound up. Of these 259 companies, 181 were involved in non-life insurance (mainly automobile and civil liability); ten in life assurance; and 77 were mutuals. Most of these liquidations took place during the 1980s and related to relatively small companies. None of the 259 insurers sold travellers' or hunters' liability insurance, so the special schemes have not yet been activated.

Table A1.38 provides information about the payments made by the general winding-up scheme to policyholders and beneficiaries, the number of claims accepted, and the average size of the claim for the period 2002–06. In the five years up to 2005/06, the CCS paid out nearly €69.2m. On average, the CCS recovered around 38% of compensation payments, and the average period until recovery is three years.

Table A1.38 Payments and claims accepted by general winding-up scheme

Company	2002	2003	2004	2005	2006
Total amount of payments (€m)	14.7	16.4	21.3	2.5	14.3
Total number of claims	17,638	11,306	11,638	3,451	1,747
Amount of average claim (€)	835	1,450	1,831	726	8,178

Table A1.39 provides details of the four most important cases in terms of the total cost to the CCS. Reunión, an insurance company selling non-life policies, was the most important case, with formal winding-up proceedings beginning in 1992, and total costs to the CCS totalling €35.4m by 2006.

Table A1.39 Largest liquidations

Company	Year of liquidation	Class of insurance	Nature of intervention	Total cost to date (€m)
Reunión	1992	Non-life	CCS assumed all contractual obligations	35.4
Apolo	1993	Non-life	CCS assumed all contractual obligations	30.6
Nórdica	2000	Life	Portfolio transfer	26.3
Monteco	2004	Life	CCS assumed all contractual obligations	19.4

Background information

The Financial Services Compensation Scheme (FSCS) is the UK's statutory fund of last resort for customers of financial services firms, including life assurance and non-life insurance undertakings. Created under the Financial Services and Markets Act 2000 (FSMA), the FSCS became the single guarantee scheme on December 1st 2001 when FSMA came into force.

Divided into five sub-schemes, the FSCS protects:

- insurance policies—this includes both life and non-life policies, the latter including motor insurance and other compulsory insurances, and, since January 1st 2004, policies written by members of Lloyd's;
- deposits;
- investment business;
- insurance intermediation (for business on or after January 14th 2005);
- mortgage advice and arranging (for business on or after October 31st 2004).

The summary below focuses on the insurance sub-scheme, which, for funding purposes, is divided into two further contribution groups: one for life assurance (contribution group A4) and one for non-life insurance (contribution group A3).

The FSMA, which since 2001 has constituted the primary legislation governing the UK financial services industry, also established the Financial Services Authority (FSA) as the new single regulator for the UK financial services industry. The FSMA gave the FSA the power to establish the FSCS, and to make rules on the powers and obligations of the FSCS. These rules are set out in the *FSA Handbook of Rules and Guidance*, which contains a specific section on redress and compensation.

Insurance guarantee arrangements existed prior to 2001 when the FSCS assumed the functions of its predecessor schemes, in particular the Policyholders Protection Board (PPB) which was established under the Policyholders Protection Act 1975, in light of a series of insurance failures to guarantee both life and non-life insurance policies.¹²¹ The assets and liabilities of the PPB and other pre-existing schemes were transferred to the FSCS, and the FSCS also assumed responsibility for outstanding claims.

Governance

The FSCS is operated by a scheme management company, which is a company limited by guarantee (FSCS Limited). Companies limited by guarantee under UK law are private limited companies, often set up for non-profit organisations that require corporate status and a clear legal identity. Instead of shareholders, a guarantee company has members who are the guarantors of the company—the members guarantee to pay a nominal sum (£1, or approximately €1.48, in the case of the FSCS) in the event of the company being wound up.

The FSCS board of directors comprises ten members, including the chief executive of the FSCS. All directors are appointed by the FSA, with the chairman's appointment also being

¹²¹ The other schemes replaced were the Building Societies Investor Protection Scheme, the Deposit Protection Scheme, the Friendly Societies Protection scheme, the Investors Compensation Scheme, the Personal Investment Authority Indemnity scheme, the Section 43 scheme (which covered business with transacted money-market institutions), and the arrangements between the Association of British Insurers and the Investors Compensation Scheme for paying compensation in relation to the Pensions Review (ie, instances of pension mis-selling).

subject to the approval of HM Treasury. The FSCS is operationally independent of the FSA, but is accountable to it. The FSA was granted the power to establish the scheme under the FSMA, and to set the details of its structure and operation through rules. The relationship between the FSCS and the FSA is governed by a Memorandum of Understanding, which sets out the respective responsibilities and provides rules of cooperation and information sharing.

The FSCS has a staff of 211 (as of early 2007), which covers all five sub-schemes. Around 16 full-time employees are devoted to the insurance sub-scheme.

Most FSCS resources are allocated to the investment sub-scheme, which deals with the majority of cases. In addition, in the insurance sub-scheme, in contrast to other sub-schemes, the claims processing depends largely on the insolvency practitioner assigned to the insurance estate, who will manage the run-off of claims against the insurer, rather than on FSCS staff alone (see below).

Scheme participation

All FSA-authorised and -regulated life assurance and non-life insurance undertakings must participate and contribute to the insurance sub-scheme of the FSCS if they conduct regulated activities relating to the insurance business for retail clients.

The insurance sub-scheme is divided into two contribution groups—life insurance (A4) and general insurance (A3)—and firms participate in the groups according to the business they conduct.

The participation requirement applies to subsidiaries of non-UK firms. In addition, incoming EEA firms that conduct insurance business via branches in the UK are typically required to participate in the FSCS.

The number of FSCS participants in the insurance sub-scheme for the financial years 2005/06 and 2006/07 are reported in Table A1.40. The participants include EEA passporting insurers required to participate in the FSCS.

The number of FSCS participants that pay the levy is lower than the total number of insurance undertakings authorised to undertake insurance business in the UK. Undertakings without FSCS-protected business (eg, firms that have no eligible clients) are exempt from contributing to the levy.

Table A1.40 Number of participating insurers

	2005/06	2006/07
Life assurance (A4)	302	288
General insurance (A3)	265	258

Scheme coverage

Nature of intervention of scheme

The FSCS awards compensation in the event of a firm being unable, or likely to be unable, to pay claims against it. If a firm is still trading and has sufficient financial resources to satisfy a claim, the firm will be expected to meet the claim itself.

Instead of paying compensation, in the case of protected contracts of long-term insurance, the FSCS must make arrangements to secure continuity of insurance for an eligible claimant

if it is reasonably practicable to do so, and if in the opinion of the FSCS this would be beneficial for the generality of eligible claimants. There has been no case of failure where this decision needed to be made.

To secure continuity of insurance, the FSCS may:

- secure or facilitate the transfer of business of the insurer in default;
- secure the issue of policies by another firm to eligible clients in substitution for their existing policies.

The FSCS's duty is to ensure that the claimant will receive at least 90% of any benefit compared with the original contract of insurance. If less than 100% of the benefit is secured, the FSCS must ensure that any future premiums to which the claimant is committed will be reduced by an equivalent amount.

In practice, given that there have not been any failures of life assurance companies since the establishment of the FSCS, its main function has been the payment of compensation of eligible claimants.

Protected insurance policies

The FSCS protects both life and non-life policies. A protected insurance contract is defined as a contract that:

- relates to a protected risk;
- is issued through an establishment in the UK, another EEA Member State, the Channel Islands or the Isle of Man; and
- is not a reinsurance contract, or a contract concerning certain excluded classes of general insurance (eg, aviation, marine, credit).

Whether a risk is protected depends on the location of the risk. If situated in the UK, the risk is protected. If situated in another EEA country, the risk is only protected if the policy is issued through an establishment in the UK (see also below).¹²²

In general, for personal insurance, the situation of the risk is determined by the habitual residence of the individual (or if not an individual, the location of the establishment to which the risk relates at the time the contract commenced).

Since 2004, the FSCS also protects certain claims in relation to insurance policies written by members of the Society of Lloyd's in those cases where the Lloyd's Central Fund is unlikely to be able to meet the liabilities.

Eligible claimants

To qualify for protection from the FSCS, claimants need to be eligible under the FSCS rules on compensation, as set out in the FSA Handbook. Broadly speaking, the scheme protects retail customers of insurance undertakings only (ie, private individuals and small businesses).

The following categories are typically excluded from protection under the rules.

- Firms (other than a sole trader firm, a credit union or a small business with a claim that arises out of a regulated activity for which they do not have authorisation).
- Overseas financial services institutions.

¹²² If situated in the Channel Islands or Isle of Man, the risk is protected only if issued through an establishment in the UK or in the Channel Islands or Isle of Man.

- Collective investment schemes, and operators or trustees of such a scheme.
- Pension and retirement funds, and trustees of such a fund (except a trustee of a small self-administered scheme or an occupational pension scheme of an employer which is not a large company, large partnership, or large mutual association).
- Supranational institutions, governments, and central administrative authorities, in addition to provincial, regional, local and municipal authorities.
- Directors and managers of the relevant firm in default and their close relatives.
- Corporate bodies in the same group as the relevant firm in default, and persons holding 5% or more of the capital of the relevant firm in default, or of any corporate body in the same group.
- The auditors of the relevant firm in default, or of any corporate body in the same group as the relevant firm in default, or the appointed actuary of a friendly society or insurance undertaking in default.
- Persons who, in the opinion of the FSCS, are responsible for, or have contributed to, the relevant firm's default.
- Large companies, large mutual associations and large partnerships.
- Persons whose claim arises from transactions in connection with which they have been convicted of an offence of money laundering.

However, there are exceptions, particularly with respect to liability subject to certain compulsory insurance (ie, employers' liability and road traffic accidents), in which case otherwise excluded claimants are eligible. For example, although large companies are typically excluded as eligible claimants, they are eligible to receive compensation in the case of employers' liability insurance if the insurer underwriting the policies defaults.

Cross-border arrangements

The FSCS participation requirement applies to subsidiaries of non-UK firms and, in general, incoming EEA firms that conduct insurance business via branches in the UK. Thus all contracts of insurance issued by incoming firms in the UK are covered by the FSCS if the risk is located in the UK or in another EEA Member State. Risks located outside the EEA are typically not covered.

Whether the FSCS covers contracts of insurance issued by UK firms through their establishment in other EEA countries (or outside the EEA) depends on the location of risk: If issued by an establishment in another EEA country, the FSCS covers only the contract for risks located in the UK; risks located outside the UK are not covered. For example, if the contract is issued by a branch of a UK firm established in Germany, policyholders resident in the UK would be eligible for FSCS protection, but the protection would not apply to German policyholders.

As such, whether cross-border business is eligible for FSCS protection depends on: a) the place of issue; and b) the location of risk (which for personal insurance usually means the place of residence).

Calculation of claim and compensation limits

If the FSCS determines that compensation is payable, it must pay it to the claimant, or as directed by the claimant, unless arrangements have been, or are being, made to secure continuity of insurance.

In cases where compensation is paid, there are no upper limits to the amount payable, although the FSCS pays only 90% for claims above £2,000 (approximately €3,000), except for compulsory insurance, where the level of cover is 100%. This is summarised in Table A1.41.

Table A1.41 Level of cover and limits

	Level of cover	Maximum payment
General insurance (compulsory)	100% of claim	Unlimited
General insurance (non-compulsory)	100% of first £2,000 (around €3,000) and 90% of remainder of the claim	Unlimited
Long-term insurance	100% of first £2,000 (around €3,000) and 90% of remainder of the value of the policy	Unlimited

The amount of compensation payable is the amount of the overall claim against the insurance undertaking in default (net of any liability). This includes premiums paid to the insurance undertaking, proceeds of a long-term insurance contract that has matured or been surrendered which have not yet been passed on, and the unexpired portion of any premium in relation to general insurance contracts.

For life contracts, the FSCS does not need to treat any bonus as part of the claim, except when a value has been attributed to the bonus by a court in accordance with winding-up rules or equivalent provisions, or if the FSCS considers that a court would be likely to attribute a value to the bonus. If the FSCS considers any benefits to be excessive, it must refer the contract to an independent actuary and may then reduce or disregard those benefits.

Operational arrangements

Claims processing and payment

The operation of the scheme is triggered when the FSCS determines that a firm is in default because it is unable, or likely to be unable, to pay claims against it and/or is subject to one or more of the following proceedings:

- the passing of a resolution for a creditors' voluntary winding up;
- a determination by the firm's home state regulator that the firm appears to be unable to meet claims against it and has no early prospect of being able to do so;
- the appointment of a liquidator or administrator, or provisional liquidator;
- a court order;
- the approval of a company voluntary arrangement.

As noted above, in the case of long-term insurance, the FSCS would first seek to secure continuity of cover rather than pay compensation. In doing so, it expects to work with the insolvency practitioner and the FSA.

In cases where compensation is paid, the FSCS needs to determine the overall net claim on the protected contract. In doing so, it relies on the insolvency practitioner assigned to the estate. In a life company, the claims will be valued according to the insolvency rules; for a general insurer, the starting point will be the run-off of the insurer, so that claims are still handled (and admitted) by the insurer even after insolvency. The FSCS is responsible for determining whether any claim is eligible for protection.

According to FSA rules, the FSCS must pay a claim 'as soon as reasonably possible' after the claim has been established, and in any case within three months of that date, unless the

FSA has granted the FSCS an extension, in which case payment must be made no later than six months from that date.

Policyholder notification

Under the rules, the FSCS must take appropriate steps to ensure that potential claimants are informed of how they can make a claim for compensation as soon as possible after the determination that the firm is in default. In practice, the FSCS works with the insolvency practitioner to receive claims that are protected.

To receive compensation, claimants need to give an 'assignment of rights'. This gives the FSCS the right to recover from the defaulting firm any funds the firm has remaining, including third-party claims. The amounts that the FSCS is able to recover present an important source of additional funding.

Unsuccessful claimants will receive a written explanation of why their claim has been rejected. If they are not satisfied with the explanation, they can ask for the claim to be reviewed by senior management and ultimately by the chief executive. The FSCS also has in place a formal complaints procedure.

The FSCS is able to withdraw any offer of compensation made to a claimant if that offer is not accepted or if it is disputed after 90 days of the date on which it was made.

Other operational issues

The FSCS is required to publish information for claimants and potential claimants on the operation of the scheme. It must also submit an annual report of its operation to the FSA. The annual report is publicly available.

Operating costs

As explained below, the operating costs of the FSCS are split into two categories: base costs (basic costs of running the scheme) and specific costs (costs specific to assessing claims and making payments).

Table A1.42 reports the costs for the three financial years 2003/04–2005/06. The higher specific costs for general insurers reflect the fact that most failures dealt with by the FSCS have been general insurance failures.

Table A1.42 Management expenses

	2003/04		2004/05		2005/06	
	Base	Specific	Base	Specific	Base	Specific
Life assurance (A4) (£'000s)	342	40	390	17	359	9
General insurance (A3) (£'000s)	143	1,515	146	1,060	129	1,436
Life assurance (A4) (€'000s)	505	59	576	25	530	13
General insurance (A3) (€'000s)	211	2,237	216	1,565	191	2,121

Note: £1 = €1.4768. Exchange rate as of April 3rd 2007 from www.oanda.com.

Source: FSCS annual reports.

Additional management expenses were incurred in the process of setting up the FSCS. The funding of these establishment costs was deferred until after December 2001, when firms were asked to recover the costs through contributions, to be levied over the first three years. For life assurance and general insurance combined, the establishment costs disclosed in the FSCS annual reports amounted to £39,000 (around €57,600) in 2001/02, £118,000 (around

€174,300) in 2002/03, £125,000 (around €184,600) in 2003/04, £89,000 (around €131,400) in 2004/05 and nil thereafter.

Funding

Contributions from insurance undertakings

The FSCS is funded by levies on the financial services industry and operates on a pay-as-you-go basis: Levies are raised to cover the projected costs of the scheme in a financial year (ie, administration expenses and foreseeable claims based on known cases of default). The levies are announced one year before they are collected, a process that is normally undertaken once every financial year. Further levies can be raised if FSCS payments exceed those anticipated, or if there is a major new default in that financial year. The levy rules are contained in the FSA Handbook, and the levies are collected by the FSA on behalf of the FSCS.

Each FSCS sub-scheme is further split into contribution groups—for the insurance sub-scheme, the split is between life and general insurance. Firms are allocated to the groups according to their FSA permissions to carry out regulated activities. A firm could be allocated to one or more contribution group (and sub-scheme) by virtue of its permitted activities.¹²³ Payments arising from claims against a specific contribution group can be levied from firms only within that specific group. The aim is to avoid cross-subsidy between firms engaged in dissimilar business activities. For example, an insurance undertaking that has only life business is not required to contribute to the costs of paying claims arising from the failure of a general insurer. Similarly, it does not need to contribute to the costs of failures in the other sub-schemes. However, all firms contribute to the scheme's management expenses.

The way in which the scheme's costs are categorised and allocated to firms is outlined below.

- **Management expenses.** These are split into two categories.
 - **Base costs.** These are the core costs of operating the scheme that are independent of the level of activity of the scheme. All firms contribute to the base costs in proportion to the periodic fees they pay to the FSA.
 - **Specific costs.** These are the costs of assessing claims and making compensation payments. They depend on the number of claims and are allocated to the relevant contribution groups in which the defaulting firms are members. The tariff base for calculating specific costs corresponds to that for compensation payments, and is detailed below.
- **Compensation costs.** These are the costs incurred in making payments to claimants.¹²⁴ They are allocated to the relevant contribution group, in line with the tariff base for that group. Table A1.43 shows the contribution groups of the insurance sub-scheme, and the tariff base according to which costs are allocated to individual firms in the two contribution groups in the sub-scheme.

¹²³ Participant firms must submit statements by the end of February each year showing the contribution groups to which they belong and the total amount of business conducted in relation to each group, as at December 31st of the previous year.

¹²⁴ All participant firms are required to contribute to the FSCS's operating (base) costs; however, those that do not conduct any business that could give rise to a claim for compensation can exempt themselves from compensation-related levies. For example, this could apply to firms with wholesale business only.

Table A1.43 Tariff base for calculating contributions and contribution limits

	Tariff base	Annual contribution limit
Life assurance (A4)	Net premium income earned on relevant life business	0.8% of relevant net premium income
General insurance (A3)	Net premium income earned on relevant general insurance business	0.8% of relevant net premium income

Although compensation costs (and specific management expenses) can be levied only from the contribution groups in which the costs are incurred, the FSCS may use any excess funds of one contribution group (or sub-scheme) to cover the costs of another. However, this is provided that the creditor contribution group (or sub-scheme) is not disadvantaged; for example, interest must be credited to the group (or sub-scheme).

There are no aggregate limits on the amount that the scheme can pay out, but there are limits on the amount that the scheme can levy in a financial year. For the insurance sub-scheme, the levy limit is fixed at 0.8% of relevant net premium income—ie, in any year, the levy paid by an insurance undertaking cannot exceed 0.8% of the tariff base. This limit is laid down in the FSA Handbook and can be amended only by the FSA. The management expenses levy is also subject to an annual limit, following annual consultation with the industry by the regulator.

Based on tariff data for the period 2006/07, the 0.8% limit implies a maximum capacity to raise contributions of around £544m (around €803m) from life assurers in contribution group in A4 and £267m (around €394m) from general insurers in A3.¹²⁵

The FSCS has appointed the FSA to act as its agent and collect the relevant data, raise and issue the levy invoices, and collect all payments due on behalf of the FSCS. The aim is to avoid duplication and reduce costs to firms.

Firms must pay the levy within 30 days of the date on which the contribution invoice is issued. If a firm does not pay within this time limit, it must pay an additional administrative fee based on the amount outstanding at a rate of 5% over the Bank of England's repurchase rate. The FSCS may take further steps to recover the money owed and/or refer the matter to the FSA for disciplinary action.

The levies raised from participating insurers in the full financial years since the establishment of the FSCS are reported in Table A1.44.

Table A1.44 Amount of levy received from participating insurers

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Life assurance (A4) (£m)	0	0	0	0	0	0
General insurance (A3) (£m)	145.7	0	0	140.1	10.3 ¹	0
Life assurance (A4) (€m)	0	0	0	0	0	0
General insurance (A3) (€m)	215.2	0	0	206.9	15.2 ¹	0

Notes: ¹ Net of a £42m (around €62m) refund paid in March 2006 as a result of recoveries.
Source: FSCS annual reports and issues of 'FSCS Outlook'.

¹²⁵ Oxera (2007), 'Funding the Financial Services Compensation Scheme: Analysis of Policy Options'.

Size of standing fund

The FSCS is primarily funded on a pay-as-you-go basis. This means that the scheme raises money as required to meet the costs of paying compensation for the next 12 months. Thus, although there may be excess funds if more money was raised than ultimately required, there is no explicit standing fund.

In addition, the FSCS may refund any fund surplus to members of a contribution group, if it believes that there are more funds available than required for the next year. For example, in March 2006, the FSCS refunded £42m (around €62m) to general insurers following substantial recoveries achieved from insolvent insurance estates and a temporary slow-down in the claims against general insurers.

State funding

The FSCS does not receive any contributions from the state, and does not benefit from any guarantees or explicit provisions by the state to meet obligations in the case of funding shortfalls.

Other sources of funding

The FSCS has borrowing powers under the rules of the FSA Handbook. It has in place a credit facility of £50m (around €74m) for the funding of the scheme. This borrowing facility applies to the FSCS as a whole and not specifically to the insurance sub-scheme.

Instead of using the credit facility, the insurance sub-scheme can borrow any excess funds available in the other sub-schemes (ie, deposit, investment, insurance intermediation and mortgage advice). The borrowed funds must be repaid as soon as possible.

In general, if new cases of failure need to be funded, the insurance sub-scheme would first use any excess funds it has available, raise levies from insurers, and then borrow from the other sub-schemes before making use of the external credit facility.

FSCS Funding Review

In March 2007, the FSA published a consultation paper containing proposals to reform the funding arrangements of the FSCS.¹²⁶ The proposals envisage a number of changes to the existing funding structure. For insurance undertakings, the proposed changes could imply, for example:

- a requirement for life assurers (general insurers) to contribute to meeting the compensation costs arising from the failure of life and pensions intermediaries (general insurance intermediaries), if these costs exceed a certain threshold level;
- a requirement for insurers to contribute to meeting the compensation costs in the event of very large failures arising in other parts of the industry (eg, deposit-taking or investment);
- adjustments in the tariff base to a metric that includes not only relevant net premium income but also eligible mathematical reserves (for life assurers) or technical liabilities (for general insurers).

In a policy statement issued in November 2007, the FSA outlined its final policy decision to make changes to the funding structure effective as of April 2008.¹²⁷

¹²⁶ FSA (2007), 'Financial Services Compensation Scheme—Funding Review', Consultation Paper 07/5, March.

¹²⁷ FSA (2007), 'FSCS Funding Review: Feedback on CP07/5 and Made Text', Policy Statement 07/19, November.

Past cases of intervention

There has been one small default of an insurer since the establishment of the FSCS in December 2001, although the FSCS remains involved in the insolvency of 25 general insurers and two life assurers that occurred prior to the establishment date.

Table A1.45 summarises the number of claims accepted by FSCS in relation to those cases and the amounts of compensation paid to meet the claims.

Table A1.45 Compensation costs

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Life assurance (A4) (£m)	0	0.3	0.2	0	0.3	0.2
General insurance (A3) (£m)	26.4	131.0	131.2	112.9	92.8	65.9
Life assurance (A4) (€m)	0	0.4	0.3	0	0.4	0.3
General insurance (A3) (€m)	39.0	193.5	193.8	166.7	137.0	97.3

Source: FSCS annual reports.

The single biggest case of insurance failure concerns the insolvency of Independent Insurance in 2001. At the date of appointment of the provisional liquidators, there were around 190,000 policyholders and in excess of 50,000 outstanding insurance claims. A further 41,000 insurance claims were received during provisional liquidation. By May 2005, 60,000 insurance claims had been agreed, and the FSCS had paid out £220m (€325m) towards protected claims.¹²⁸ By early 2007, the FSCS had paid out a total of £330m (€487m), but the case is ongoing and total costs are expected to be as much as £500m (€738m).

¹²⁸ See letter, dated May 2005, to creditors of Independent Insurance by joint provisional liquidator. Available at <http://www.independent-insurance.co.uk/Articles.asp?id=1>.

Appendix 2 Questionnaire

Study into Insurance Guarantee Schemes in the EU Member States

Questionnaire

March 6th 2007

Oxera has been commissioned by the European Commission (DG Internal Market and Services) to conduct a study on Insurance Guarantee Schemes (IGS) in the EU. The aim of the study is to provide:

- an inventory and comparative analysis of existing insurance guarantee arrangements that cover life and/or non-life business in the Member States (motor guarantee funds are beyond the scope of the study);
- an independent economic assessment of the current situation, focusing on consumer protection and competition issues that arise from the coexistence of different national arrangements;
- an evaluation of the policy options available to address any problems identified.

In carrying out this research, we would like to work closely with the different operators of IGS and to seek your input on the issues that need to be addressed. As such, at this early stage of the research, we would like to ask you for your participation in a survey. The attached questionnaire has been sent to all IGS in the 27 Member States, and aims to collect information from the schemes on a consistent basis.

Your participation in this questionnaire would be extremely helpful since it would enable us to gain an understanding of the most important features of the different schemes across the EU. We hope that you will also benefit from this exercise. In particular, the research report will be made available to your scheme; it will contain a useful pool of information on your own scheme and the ways in which it compares with the schemes of other Member States.

As part of the research, we would also like to speak to you and your colleagues in person in order to discuss the research issues in more detail. We will contact you shortly to arrange a meeting on a convenient date between March and June 2007.

The questionnaire is organised into the following six parts.

- **Part 1: Background information**—basic facts about your scheme and the legislative framework governing it;
- **Part 2: Ownership, management and administration**—including questions about the structure of your scheme as well as the size and costs of scheme operations;
- **Part 3: Scheme participation**—this section seeks information about the firms participating in your scheme;
- **Part 4: Scheme coverage**—aims to establish the scope of your guarantee scheme in terms of the policyholders and claims covered;

- **Part 5: Operation of scheme**—focuses on your scheme’s operational arrangements that provide insurance guarantee, including past cases of the winding-up of insurers that have triggered the operation of your scheme;
- **Part 6: Funding arrangements**—covering the arrangements in place for funding your scheme.

The European Commission conducted previous surveys of insurance guarantee arrangements in the EU. This new questionnaire seeks to address some issues in more detail, and also examines new issues. Although the questionnaire is long, we have sought to focus only on the questions that are essential for the initial research analysis. You may make your answers as detailed as you wish or address additional issues—please use as much space as required under each question, or attach additional sheets if preferred.

Some countries operate general schemes that cover both life and non-life insurance. Other schemes provide cover for life assurance only, while some cover non-life insurance claims only, either on a general basis or for special types of (compulsory) insurance. The questionnaire has been designed to apply to all types of IGS, asking you to provide details where required.

Your responses should refer to your IGS only. If more than one scheme operates in a particular Member State, all schemes in that country will be requested to participate separately in the survey.

If you are unable to answer a question, please indicate why this is the case or, where possible, provide at least a partial answer. We would be willing to sign a confidentiality agreement should you consider this necessary.

If you wish to obtain more information about the research analysis, please contact [name]. The questionnaire is in English; however, if it is not possible for you to answer the questions in English, please respond in your preferred language. In addition, we would be happy to help you with completing the questionnaire, and could offer assistance if you require the questions to be translated from English into your national language.

We are working towards a deadline, and would be grateful if you could return the completed questionnaire by **March 26th 2007** to [name], either:

- by email: [name]@oxera.com;
- or fax: +44 (0) 1865 251 172.

Thank you very much for your cooperation.

Background information

1. Please provide the full name of your IGS (also in your national language).

.....

.....

2. Please indicate what description best fits the type of IGS you operate.

General scheme covering both life and non-life insurance	
General scheme covering life assurance	
General scheme covering non-life insurance	
Special scheme covering only specific (compulsory) non-life insurance <i>Please specify in box below</i>	
Other <i>Please specify in box below</i>	

Please use this space if you wish to provide further details.

.....

.....

3. Does your scheme operate different sub-schemes or funds for different types of insurance business?

YES/NO

If YES, please provide a short description.

.....

.....

4. What is the full name (and date) of the principal legislation that establishes your IGS (also in your national language)?

.....

5. Please provide the date on which the legislation was implemented and scheme established.

.....

6. Please list any other national laws, regulations or provisions that are relevant to your guarantee scheme and should be consulted by Oxera as part of the research.

.....

.....

7. Please provide a short description of why the scheme was established. For example, the scheme may have been established following an insurer's winding-up or other event in your country.

.....

.....

8. Please tick the box next to the description that best fits the type of protection your IGS offers to policyholders.

Paying compensation to policyholders in the event of insolvency of an insurer	<input type="checkbox"/>
Taking over and administering the insurance policies of an insolvent insurer to ensure continuation of policies	<input type="checkbox"/>
Facilitating portfolio transfer to another insurer	<input type="checkbox"/>
A combination of the above functions <i>Please specify in box below</i>	<input type="checkbox"/>
Other <i>Please specify in box below</i>	<input type="checkbox"/>

Please use this space if you wish to provide further details, or if the type of protection differs by insurance class.

.....

.....

9. Does your scheme, or entity operating the scheme, have functions that go beyond those of an IGS—ie, beyond awarding compensation to eligible claimants of an insurer in winding up, facilitating portfolio transfer, etc? For example, does your scheme or entity have functions prior to the winding-up of insurance companies (eg, providing funding to firms in financial difficulties)?

YES/NO

If YES, please list the other functions.

.....

.....

10. Motor insurance guarantee funds are beyond the scope of this study, but does your scheme also provide motor insurance guarantee?

YES/NO

Please provide a short description of the relationship, if any, with the motor guarantee fund.

.....

.....

11. Are there other IGS(s) operating in your country?

YES/NO

If YES, please provide the name of the other scheme(s) and a short description of the relationship, if any, with the other scheme(s)

.....

.....

Ownership, management and administration

1. Please indicate which characteristics best describe the ownership and management structure of your IGS by ticking *all* relevant boxes.

Private ownership	
Public ownership	
Private management	
Public management	
Operated by national supervisory authority	
Regulated by national supervisory authority	
Accountable to national supervisory authority	
No formal links with national supervisory authority	

Please use this space if you would like to elaborate—for example, by describing in more detail the body that owns and manages the scheme, and the links with the national supervisory authority (or authorities).

.....

.....

2. Please indicate the number of staff employed to manage and operate your IGS. If possible, the number of staff should refer to the most recent financial year (please specify the date of measurement).

	Number of staff (full-time equivalent)
Managers/case handlers	
Administrative/support staff	
Other <i>please specify</i>	
Total staff	

Some of the above staff may undertake functions that are unrelated to the operation of the IGS. For example, if a scheme is operated by the national supervisory authority, some staff may also be involved in regulatory functions. In this case, please provide your best estimate of the proportion of time devoted to insurance guarantee issues.

.....

.....

3. Please report your scheme's total management/administration expenses for the past five financial years—ie, all operating costs such as staff or IT costs, but excluding the cost of paying compensation or transferring a portfolio. In addition, please specify the currency in which your costs are reported (eg, € '000s).

	2002	2003	2004	2005	2006
Management/administration expenses					

If you operate different sub-schemes or funds for different insurance classes and have separate information on the management/administration expenses, please provide the details for each sub-scheme/fund.

Please explain if any of the expenses include costs incurred in relation to functions unrelated to the operation of the IGS.

.....

.....

4. Does your scheme rely on external parties (eg, insolvency practitioners or other professional services firms) in the process of handling claims, paying compensation, or transferring portfolios? **YES/NO**

If YES, please explain any outsourcing or other arrangements that exist.

.....

.....

Please also provide information about the level of payments made to cover the costs of services provided by external parties. If included in the management/administration expenses reported above, what percentage is paid to external parties? If not included in the above expenses, what additional costs are incurred?

.....

.....

5. Many EU Member States do not currently have an IGS, so the question of initial set-up costs is particularly relevant. Do you have any information or data available that indicates the total initial costs (direct and/or indirect) incurred when setting up your scheme?

.....

.....

Scheme participation

1. Please specify which insurance undertakings (or other bodies if relevant) are required to participate in your scheme. Include details of the relevant section in the law or regulation.

.....

.....

2. Does your scheme *allow* participation of EU branches operating in your country (ie, branches of insurance companies with a head office in other EU countries)? YES/NO
3. Does your scheme *require* participation of EU branches? YES/NO
4. Are EU branches currently participating? YES/NO

If YES, briefly explain if your scheme's provisions for branches differ from those for domestic insurance undertakings.

.....

.....

5. Does your scheme *allow* participation from non-EU insurance undertakings operating in your country? YES/NO
6. Does your scheme *require* participation from non-EU insurance undertakings? YES/NO
7. Are non-EU insurance undertakings currently participating? YES/NO

If YES, briefly explain how your scheme's provisions for non-EU insurance undertakings differ from those for EU branches or domestic insurance undertakings.

.....

.....

8. Please specify the total number of scheme participants, distinguishing between domestic insurance undertakings, EU branches and non-EU insurers. (If data for December 2006 is not available, please use the most recent data and indicate the date of measurement.)

	Number of participants
Domestic insurance undertakings	
EU branches	
Non-EU insurance undertakings	
All participants	

If your scheme is divided into sub-schemes or funds for different types of insurance business, please provide the numbers for each sub-scheme or fund.

9. Are insurance undertakings operating in your country *permitted* to disclose to policyholders whether they participate in your/any scheme? YES/NO
10. Are insurance undertakings operating in your country *required* to disclose to policyholders whether they participate in your/any scheme? YES/NO
11. Please briefly explain the rules in place that establish whether and how firms can or must disclose or advertise their participation in an IGS.

.....

.....

Scheme coverage

This section seeks to obtain information about the scope of coverage of your IGS. If the scope differs according to the type of insurance business (or between different sub-schemes or funds you may operate), please highlight the differences in your answers.

Protected insurance policies

1. Please indicate which type of insurance policy is protected by your IGS by ticking *all* relevant boxes.

Life assurance policies	
Non-life insurance policies, but only for specific compulsory insurance	
Non-life insurance policies, for both compulsory and non-compulsory insurance	

Please list which classes of insurance business are specifically *excluded* from scheme coverage. (Or if easier, specify which classes of business are included.)

.....

.....

2. Please indicate which statement best describes the geographic scope of your scheme, by ticking the relevant box.

Scheme covers policies issued by domestic companies that participate in the scheme, including policies issued by the companies' branches established in other EU Member States (<i>home state principle</i>)	
Scheme covers policies issued in your country, by domestic companies as well as branches of non-domestic EU companies (<i>host state principle</i>)	

If neither of the above statements applies, please describe the geographic scope of your scheme in terms of coverage of policies depending on location of issuer and place of issue as well as the location of risk.

.....

.....

Does the geographic scope described above differ if the location of issuer, issue or risk is outside the EU? Please explain if yes.

.....

.....

3. Please explain if your scheme imposes any other restrictions on what constitutes a protected policy. For example, insurance contracts concluded before a specific date may be excluded from coverage.

.....

.....

Eligible claimants

1. Please list all the types of claimant that are eligible to receive protection from your scheme.

Natural persons (private individuals)	
Small (or medium-sized) enterprises <i>Please define in box below</i>	
Other entities <i>Please define in box below</i>	

Please describe any explicit additional restrictions on claimant eligibility (eg, some private individuals may not qualify as eligible).

.....

.....

Also explain if eligibility differs depending on the type of insurance (eg, whether compulsory or not).

.....

.....

2. Are residents of other EU Member States considered eligible to receive protection from your scheme (assuming the issuer of the policy is participating in your scheme)?

YES/NO

Please explain if there are any differences in the eligibility criteria between domestic policyholders and residents of other EU Member States.

.....

.....

What about policyholders from non-EU countries?

.....

.....

3. Which relevant section in the law or regulation sets out which policyholders are eligible for the purpose of insurance guarantee?

.....

Compensation limit

1. If your scheme pays compensation, is there a limit to the amount of compensation that is paid per claim or policyholder?

YES/NO

If YES, please describe the compensation limit that applies.

.....

.....

Does the compensation limit differ by type of insurance policy?

YES/NO

If YES, please specify.

.....

.....

Does the compensation limit differ by policyholder?

YES/NO

If YES, please specify.

.....

.....

2. Does your scheme pay out 100% of a claim, or is there an element of co-insurance whereby the policyholder bears part of the loss (eg, only 90% of a claim is compensated)? Please specify.

.....

.....

3. What is the section in the relevant law or regulation that specifies the above rules on limits?

.....

Comments

Please use this space if you wish to comment on the scope of existing guarantee arrangements in terms of achieving adequate policyholder protection. You may also wish to indicate areas that you would like to see analysed in detail as part of the cross-country comparison to be undertaken during this study.

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Scheme operation

Past or ongoing cases of operation

1. Please provide details of cases, dealt with by your scheme, of insurance undertakings in winding up by listing (for the five largest cases):
 - the name of the insurer;
 - the year in which the winding-up proceedings started;
 - the year in which the operation of your scheme was triggered (if different);

- the main class of insurance policies protected by your scheme (eg, life/non-life or a more detailed description if possible);
- the nature of intervention by your scheme (eg, compensation payment, portfolio transfer);
- the total cost incurred by your scheme to date due to compensation payments or portfolio transfer (specify currency, eg, €'000s);
- the total number of claims accepted to date.

Name of insurer	Year of winding-up	Year of intervention	Class of insurance	Nature of intervention	Total cost to date	Number of claims to date

2. What is the total number of cases of insurance company winding-up dealt with by your scheme?

Cases dealt with in 2006:

Cases dealt with since establishment of scheme:.....

3. Please provide information about the nature of the insurance failures and resulting claims against your scheme. In particular, what was the source of failure and the main type of insurance underwritten by the insurance undertakings concerned?

.....

.....

4. If your scheme pays compensation, please report the amount of compensation paid in the past five financial years. Please also state the currency (eg, €'000s).

	2002	2003	2004	2005	2006
Amount of compensation paid					

If your scheme is divided into sub-schemes or funds for different types of insurance business, please provide the amounts for each sub-scheme or fund.

In relation to past cases of compensation payment, what did your scheme recover from the winding-up proceedings? Please provide an estimate or range of typical amounts recovered (in absolute terms or as a percentage of compensation payments). Please also provide an estimate of the time period until recovery.

.....

.....

5. If your scheme provides protection by securing the continuation of policies (including portfolio transfer to another insurer), please state the cost incurred in the past five financial years. Please also state the currency (eg, €'000s).

	2002	2003	2004	2005	2006
Total cost of securing continuation of policies					

If your scheme is divided into sub-schemes or funds for different types of insurance business, please provide the amounts for each sub-scheme or fund.

6. Please report the number of claims by policyholders accepted by your scheme in the past five financial years.

	2002	2003	2004	2005	2006
Total number of claims					

If your scheme is divided into sub-schemes or funds for different types of insurance business, please provide the numbers for each sub-scheme or fund.

7. Please provide actual amounts or estimates of the size of the claims accepted by your scheme in the past five financial years. If this not possible, please provide an estimate for at least one of the years (stating the currency).

	2002	2003	2004	2005	2006
Amount of single largest claim					
Amount of average (median) claim					

Please use this space if you can provide further information about the nature of these claims (eg, type of insurance business).

.....

.....

Operating arrangements

1. What triggers the operation of your scheme (eg, formal start of winding-up proceedings, declaration of insolvency by supervisory authority, other)?

.....

.....

2. Please explain briefly when and how policyholders are notified about the existence and operation of your scheme, and set out what they must do to apply for compensation.

.....

.....

3. Is there a time limit within which policyholders must make a claim against your scheme? (For example, claims may have to be posted with your scheme within X months following the start of the proceedings in order to be considered.)

If YES, what is the time limit?

.....

4. If the function of your scheme is to pay compensation to policyholders:

- a) Who provides the information that your scheme needs to decide whether and how much compensation is payable? Or, if not decided by your scheme, who establishes whether and how much is compensated (eg, external insolvency practitioner or actuary)?

.....
.....

- b) Approximately how long is the time period between policyholders making a claim and receiving payment? Please provide an estimate of the average processing time for a typical claim, as well as the range between the minimum and maximum.

.....
.....

Does the law or regulation specify a maximum period for processing/payment?

.....

- c) Does the calculated amount of compensation include:

Premiums paid to the insurance undertaking in winding-up	YES/NO
Unexpired premiums on long-term insurance policies	YES/NO
Bonuses or similar on long-term insurance policies	YES/NO

- d) Please provide further details on the calculation methodology, highlighting in particular any deductibles or reductions in the compensation amount.

.....
.....

- e) Have there been instances where it was difficult to establish claims or the amount of compensation?

YES/NO

If YES, please explain.

.....
.....

- f) If your scheme has rejected claims for compensation, please list the main reasons for doing so.

.....
.....

5. If the function of your scheme is to secure continuation of insurance policies:

- a) Please provide a short description of how the continuation of policies is secured. What measures are taken, and which other parties are involved?

.....
.....

- b) What are the implications from the perspective of policyholders? Please list any reductions in the benefit (eg, limitations on claims, disregarded bonuses) compared with the situation where the policy continued with the original insurer.

.....

.....

- c) Please provide an estimate (average and/or range) of the time it takes before claims can again be paid out to policyholders—ie, the time required to transfer the portfolio or the duration of disruption of business.

.....

.....

- d) Have there been instances where it has been difficult to secure the continuation of policies?

YES/NO

If YES, please provide details.

.....

.....

6. Has your scheme experienced any difficulties in its operations because of delays or other problems before, during or after the winding-up proceedings?

YES/NO

If YES, please describe these difficulties.

.....

.....

7. If possible, please provide general comment or evidence comparing the claims processing time of your scheme with the length of time for payment of claims within a normal winding-up procedure. You may also want to use this space to provide further comment or evidence on the advantages of having an IGS.

.....

.....

Funding arrangements

This part of the questionnaire seeks to obtain information about your scheme's funding arrangements, distinguishing between potential sources of funding.

1. How are the operations of your scheme funded (please tick all boxes that apply)?

Levies on insurance companies participating in the scheme	
Direct levies on insurance policyholders	
Government funding (direct contributions, borrowing)	
Borrowing (from commercial lender)	
Other <i>Please specify in the box below</i>	

2. Does your scheme maintain separate funding pools for different classes of insurance business covered by your scheme?

YES/NO

If YES, please give details. (In the subsequent questions, where required, please provide separate answers for the different funding pools.)

.....

.....

3. If your scheme covers motor insurance in addition to other types of insurance, do you raise separate funds, or have separate funding rules, for motor and other types of insurance business?

YES/NO

If relevant to your scheme, please give details.

.....

.....

4. Does your scheme raise separate funds, or have separate funding rules, to cover i) management/administration expenses, and ii) the costs to pay compensation or ensure continuation of policies?

YES/NO

If YES, please give details. (In the subsequent questions, please state if your answer differs between these costs.)

.....

.....

Levies on insurance companies

If your scheme does not raise any part of its funding through levies on insurance companies, please go directly to section 6.2.

1. How does your scheme levy contributions from participating firms?

Contributions are levied on a regular basis in anticipation of future liabilities (ie, ex ante).	
Contributions are levied on a backward-looking basis (ie, ex post once the costs are known).	
There is a combination of ex ante and ex post funding.	

Please use this space if you wish to elaborate.

2. What is the measurement basis that determines the level of an insurer's contribution (eg, gross or net premium income), and how is the level set? Please give details.

3. Do contributions have a fixed element (ie, equal amount for all insurers) or are they purely variable (eg, depending on firm size)? Please give details.

4. Does your scheme take into account the risk of a participant insurer when determining the level of the firm's contribution—ie, are levies risk-weighted? Please give details.

5. Does your scheme have powers to request additional contributions in light of funding shortfalls?

YES/NO

Please use this space if you wish to expand on your answer. Also, refer to the section in the relevant law or regulation that specifies the way in which your scheme can levy contributions.

6. Are there any upper limits on the annual level of contribution that your scheme may impose on an individual firm?

YES/NO

Are there any upper limits on the level of contribution that your scheme may impose on the industry as a whole per year?

YES/NO

If YES, please specify any individual or aggregate limits on contributions.

7. Please report the total amount of levies raised from participating insurers for the past five financial years. Please specify the currency in which you report the data (eg, €'000s).

	2002	2003	2004	2005	2006
Amount of levies raised from policyholders					

If you raise separate levies from insurers for different classes of insurance business (or different types of insurer), please provide the amount of levies raised separately for each insurance class (or insurer type).

Direct levies on policyholders

If your scheme does not raise any part of its funding through direct levies on policyholders or policies, please go to section 6.3.

1. Please explain how the levy on individual policyholders or policies is determined.

.....
.....

2. Are there any regulations or upper limits on the amount that can be directly levied from policyholders?

YES/NO

If YES, please specify.

.....
.....

3. Are there any specific provisions concerning the information policyholders receive about the levy?

YES/NO

If YES, please specify.

.....
.....

4. Please refer to the section in the relevant law or regulation that sets out the provisions concerning the levy on policyholders or policies.

.....
.....

5. Please report the total amount of levies raised directly from policyholders or policies for the past five financial years. Please specify the currency in which you report the data (eg, €'000s).

	2002	2003	2004	2005	2006
Amount of levies raised from participating insurers					

If you raise separate levies for different classes of insurance business, please provide the amount of levies raised separately for each insurance class.

Government funding

1. Does your scheme benefit from any guarantees or other provisions (eg, last-resort lending) by the government to meet obligations in the case of funding shortfalls?

YES/NO

If YES, please describe the nature and (potential) size of the guarantees or other provisions.

.....
.....

2. Does (or can) your scheme receive direct contributions from the state—either to cover management/administration expenses or to meet compensation payments or ensure portfolio transfer?

YES/NO

If YES, please describe the nature and (potential) size of the state contributions.

.....

.....

3. If YES to either of the above two questions, please refer to the section in the relevant law or regulation that sets out the provisions concerning government funding.

.....

.....

Other information on funding

1. Does your scheme accumulate a standing fund or fund reserve (eg, through regular contributions from industry or policyholders) that can be used to cover the costs of providing insurance guarantee?

YES/NO

If YES, please state the size of the standing fund or fund reserve for each of the past five financial years (or at least for the most recent year). Please specify the currency in which you report the data (eg, €m).

	2002	2003	2004	2005	2006
Fund reserve					

If you maintain different funds for different classes of insurance business, please provide the amount for each insurance class.

Does your scheme have a *target* size for the standing fund or fund reserve?

YES/NO

If YES, please specify the target amount.

.....

.....

Is your scheme *required* to maintain a minimum level of capital?

YES/NO

If YES, please specify the amount of capital required.

.....

.....

2. Does your scheme have the ability to borrow funds?

YES/NO

If YES, does your scheme currently have in place any borrowing facilities (eg, loans, overdrafts) or similar arrangements to secure funding?

YES/NO

If YES, please describe the nature and size of these facilities.

.....

.....

3. If your scheme maintains sub-schemes or funds for different insurance classes, is there a possible pooling of funds (or borrowing) between sub-schemes or funds?

YES/NO

If YES, please explain.

4. If there are other IGS in your country, is there any relationship (in terms of funding or otherwise) between the schemes?

YES/NO

If YES, please explain.

5. Does your scheme have any relationship (in terms of funding or otherwise) with the deposit guarantee or investor compensation schemes in your country?

YES/NO

If YES, please explain.

6. Has your scheme taken out reinsurance cover to meet any funding needs?

YES/NO

If YES, please describe the nature and size of this cover.

7. In addition to the above funding sources, does your scheme have additional special provisions (eg, contingency plans, ability to cut payments or smooth compensation over time) in order to deal with very large failures?

YES/NO

If YES, please explain these provisions.

8. Has your scheme experienced a shortage of funds or funding difficulties?

YES/NO

If YES, please explain.

9. If there are any other important aspects that would help us to assess the nature of funding arrangements of your scheme, please expand.

Appendix 3 Abbreviations and acronyms

Abbreviation	Description
ACAM	Autorité de contrôle des assurances et des mutuelles—insurance supervisory authority in France
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht—financial supervisory authority in Germany
CBFA	Commission Bancaire, Financière et des Assurances—financial supervisory authority in Belgium
CCS	Consortio de Compensación de Seguros—general winding-up scheme in Spain
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CLEA	Comisión Liquidadora de Entidades Aseguradoras—predecessor of Spanish CCS
Consap	Concessionaria Servizi Assicurativi Pubblici—manages the hunters' liability scheme and the motor guarantee fund in Italy
CSA	Comisia de Supraveghere a Asiguratorilor—insurance supervisory commission in Romania
CVZ	Healthcare insurance board in the Netherlands
DGS	Deposit guarantee scheme
EEA	European Economic Area
EIALA	Early Intervention Arrangement for Life Insurers in the Netherlands
FAII	Federation of Accident Insurance Institutions in Finland
FAO/FAT	Fonds voor Arbeidsongevallen/Fonds des Accidents du Travail—guarantee scheme for workers' accidents insurance in Belgium
FAT	Fundo de Acidentes de Trabalho—workers' accidents compensation fund in Portugal
FCMC	Financial and Capital Market Commission in Latvia
FFSA	Fédération Française des sociétés d'assurances—insurance association in France
FGAO	Fonds de garantie des assurances obligatoires de dommages—IGS for non-life insurance in France
FGAP	Fonds de garantie des assurances de personnes—IGS for life assurance in France
FPIC	Finnish Patient Insurance Centre
FSA	Financial Services Authority in the UK
FSCS	Financial Services Compensation Scheme in the UK
FSMA	Financial Services and Markets Act 2000 in the UK
FTE	Full-time equivalent
GAR	Guaranteed Annuity Rate
GDV	Gesamtverband der Deutschen Versicherungswirtschaft—industry association in Germany
ICS	Investor compensation scheme
IGF	Ubezpieczeniowy Fundusz Gwarancyjny—Insurance Guarantee Fund in Poland
IGS	Insurance guarantee scheme
IMD	Insurance Mediation Directive
ISVAP	Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo—insurance supervisory authority in Italy

Abbreviation	Description
MAT	Motor, aviation and transit
MCR	Minimal capital requirement
MFSA	Malta Financial Services Authority
NCIGF	National Conference of Insurance Guarantee Funds in the USA
NOLHGA	National Organization of Life and Health Insurance Guaranty Association in the USA
PKV	Verband der privaten Krankenversicherung e.V.—association of private health insurers in Germany
PPB	Policyholders Protection Board in the UK (predecessor scheme of FSCS)
SCR	Solvency capital requirement
SM	Solvency margin
TPL	Third-party liability
VAG	Versicherungsaufsichtsgesetz—insurance supervision law in Germany

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