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Agenda

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Insurance guarantee schemes: challenges for cross-border insurance

In 2011, the European Commission is likely to introduce a Directive requiring all Member States to have a national insurance guarantee scheme that covers life and non-life insurance and that is structured around the home-state principle. Arno Wicki and Brian Hunt of Zurich Financial Services examine the Commission's proposals from the perspective of a pan-European insurance group

The European Commission's 2010 White Paper proposes a compulsory insurance guarantee scheme (IGS) that follows a set of design requirements, structured around the home-state principle.[1] In response to this proposal, Zurich, as a cross-border insurer, consistently argues that:

- a compelling case has yet to be made for an EU Directive on IGS. On the one hand, IGS set adverse incentives and may foster irresponsible behaviour (known as 'moral hazard'). On the other hand, Solvency II, the new prudential framework for insurers, introduces additional levels of protection. This is a good reason for suggesting that measures on IGS should be adopted only once the experiences derived from a fully implemented Solvency II framework can be assessed;
- a host-state approach to national IGS would be superior on the grounds that a home-state approach is less capable of delivering the consumer protection and Single Market objectives of the Commission's White Paper;
- if the Commission were to decide to propose a Directive requiring Member States to adopt a home-state regime, we believe that special design features would have to be incorporated so as to limit the distorting impact caused by a home-state regime.

This article explains our points in more detail.

Is there a case for introducing IGS?

Before entering the debate on whether there should be a legislative initiative on IGS, it should be remembered that there is already a series of preventive measures in place that will assist in preventing an insurance company from reaching the point of insolvency. Only when those lines of defence have fallen does the need for IGS come into play. The first line of defence in protecting policyholders against the collapse of an insurer is a credible, well-embedded risk policy, followed by the supervisory and enforcement powers of the regulators.

The second line of defence is the imminence of Solvency II. It is expected that Solvency II will significantly improve insurers' risk management and supervision. Capital requirements are likely to increase, and the supervisory community will have additional tools to intervene and discipline market participants. There are therefore strong reasons to suggest that any initiative on IGS should be postponed and its necessity reconsidered some time after the full implementation of Solvency II. It should also be remembered that IGS tend to cause an unfair redistribution effect among prudent and less prudent insurers, and can set the wrong incentives.

There is also a danger that IGS might foster irresponsible behaviour (moral hazard) and could impose additional compliance costs that are hard to justify, especially in Member States that currently do not have IGS. Additional costs will ultimately be passed on to the consumers, which will result in insurance becoming more expensive and will affect the ability of some consumer segments to afford insurance in the first place.

Finally, policy-makers should abstain from copying policies developed for the banking sector. The ways in which banks and insurers become insolvent are very different. At the point of insolvency, banks are faced

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with large-scale, incessant withdrawals of deposits over a very short period of time. In contrast, insurers are funded in advance by payments of premiums, and can run off their policies over a long period of time. This significantly reduces the need for a large fund to be instantaneously made available.

If there is a convincing argument in favour of IGS, it is the enhancement of the European Single Market—and we are of the view that a host-state approach would serve as the best means of achieving this.

Geographic scope: delivering Single Market objectives

Zurich favours a host-state regime, and we have advanced the view that a home-state approach to the EU-wide harmonisation of IGS does not deliver the objectives set down in the Commission's White Paper.

Under the host-state approach, national IGS cover insurance policies issued in the host state by domestic insurers as well as by branches of incoming EU insurers. This has two significant advantages:

- **consumer protection**: a host-state structure would ensure that consumers resident in a Member State would have equivalent consumer protection irrespective of whether they buy insurance from a domestic insurer or an incoming EU insurer;

- **competition**: a host-state structure would ensure a level playing field for domestic and incoming EU insurers. It would make the system of national IGS neutral in terms of competition in any given Member State, from both the supply and the demand side. On the supply side, all insurers would be participating in the same IGS and bear the same cost burden from making contributions to the scheme. On the demand side, all policies available to consumers in the Member State would come with the same level of protection and access to the same scheme (in the local language), such that there would be no distortions in demand due to any perceived or actual differences in IGS protection levels.

In our view, these *economic* advantages are not sufficiently acknowledged in the White Paper, although they are key to delivering the Commission's two main policy objectives of equivalent consumer protection and a level playing field for insurers within a Single Market for insurance. Instead, the White Paper highlights shortcomings of the host-state approach that are largely bureaucratic and political in nature. For example, the Paper refers to the duplication in administrative costs if insurers with cross-border business are required to participate in two or more IGS. It also refers to the potentially difficult operation of national IGS if the authorities that operate the schemes are not the same as those that conduct and supervise the winding-up proceedings. Compared with the fundamental policy objectives of consumer protection and competition, these issues appear secondary and in principle could be addressed, for example, through effective coordination and information exchange between host- and home-state authorities.

Problems inherent in a home-state approach

In addition to not fulfilling the objectives set out in the Commission's White Paper, there are some other problems inherent in a home-state approach to IGS.

Destabilising effect

The home-state approach implies a more concentrated exposure of national IGS, especially in countries with small or more concentrated domestic markets, and which are home to insurers with significant cross-border business. Ireland is an example of such a country; it has a comparatively small domestic market, but is a hub location for pan-European insurance carriers. Under the home-state approach, the Irish IGS would have to not only fund domestic liabilities, but also insure policies written and sold by Irish-based insurers across the EU.

The failure of a large cross-border insurer could be more difficult to finance through a single home-state scheme than through a collection of host-state schemes where the costs are spread more widely. This spreading of costs enhances the financial capacity of schemes. To the extent that shocks that trigger the failure of larger insurers are idiosyncratic and can affect different countries, a sharing of costs between those countries corresponds to a diversification of risks, making each country's scheme less vulnerable to shocks than if a single failure resulted in a more concentrated exposure in one country.

Likely impact on demand for insurance

The decision about home- versus host-state regimes might have implications not only for the cost of insurance provision but also for insurance demand. There is evidence that IGS can affect customers' purchasing decisions (see Oxera's report on IGS).[2]

Under a home-state regime, the branches of incoming EU insurers would not be covered by the same IGS as domestic insurers. There could be some variation in the cover provided by the different schemes (eg, the local IGS that protects policies written by domestic insurers might offer higher protection levels than those offered by the home-state IGS of the incoming insurer). Even where there are no such differences in cover, consumers are likely to incur greater transaction costs in making a claim under a foreign-based IGS. These costs relate particularly to any language barriers, but also arise from administrative difficulties due to the geographic distance between the location of the consumer and the IGS. It is also possible that some consumers might have more trust in a guarantee scheme based in their own country.

It is possible that consumers take these factors into account when purchasing insurance. Under a home-state regime, this could therefore potentially impair the ability of cross-border insurers to compete in local markets, and could result in additional costs to insurers.

Calibrating a home-state approach to limit the negative effects

If the European Commission were ultimately to decide to propose a Directive requiring Member States to adopt a home-state regime, there would be a need to design national schemes such that the distorting impact caused by a home-state regime (as described above) were limited. We now address the necessary design features under a number of headings.

Approach to funding

With respect to how IGS funding is allocated between firms under a home-state regime, a number of options are available for reducing any potential unfairness and the scope for market distortion, and for enhancing the ability of incoming insurers to compete with domestic insurers in host-state markets. We have suggested that at least two options are worth exploring further, at least in the context of insurance export countries (such as Ireland).

- **Separate domestic and export pools**: funding for the IGS covering domestic insurance could be separated from that for exported insurance. A domestic failure would then be covered by levies imposed on providers of domestic insurance. If an insurance exporter failed, its domestic liabilities would be covered by levies from providers of domestic insurance, while its export business would be covered by levies from other exporters. This would remove the need for foreign branches to pay for the failure of a domestic insurer, or vice versa. It also mitigates the problem of businesses paying for failures caused by losses in countries in which they do not operate. This is because domestic-only insurers would not pay for liabilities abroad, and firms that only export would not pay for domestic liabilities.

- **Lower rate for cross-border business**: levies on cross-border business could be charged at a lower rate. This would reflect the fact that exporters are more geographically diversified than domestic-only insurers, and therefore pose a reduced risk in the context of IGS. It would also reflect the lower value to consumers of being protected by an IGS based in a different country (since, as explained above, the transaction costs of using a foreign scheme are likely to be higher than the costs of using a domestic scheme).

Risk-based contributions

In its White Paper, the Commission notes that it favours funding through levies which 'should be calculated according to the individual risk profiles of the contributors'.[3] It does not specify how these risk profiles should be assessed, but indicators are suggested, such as 'portfolio of risks, solvency, and asset quality'. Moreover, the White Paper notes that these indicators are already available under existing reporting obligations.

We have expressed our support for the Commission's proposal on risk-based levies. It would be desirable to require higher contributions from insurers judged to be riskier than average. The experience with risk-weighted levies is still limited, but models such as that adopted by the German IGS for life insurance are worth exploring. This uses a risk weighting based on the solvency ratio of participating insurers, and has a cap on how much the largest insurer(s) in the market pay to the IGS (in addition to a general cap for all insurers).

Avoidance of excessive costs

A home-state regime for IGS could impose a disproportionate burden on pan-EU insurers located in countries that are significant exporters of insurance, which could affect their ability to compete in the host markets in terms of both the costs resulting from the levies to be paid to the IGS and the distortion of demand from consumers.

One key approach to limiting the costs is ensuring that IGS are post-funded (with contributions to be paid by the industry after a failure has occurred). This approach is favoured because ex ante contributions paid into newly created public funds bear the risk of politicisation and mismanagement. In addition, the level of contributions from industry in a particular time period should be capped.

Finally, compensation limits and other reductions in benefits available to consumers from the IGS should be introduced in order to reduce moral hazard at the policyholder level. Policyholders also bear their share of responsibility when purchasing insurance. An IGS should therefore not give policyholders the incentive to buy protection from the cheapest (and most aggressive) companies in the market.

Closing remarks

We are still not convinced of the necessity of an EU Directive on IGS. However, in contributing to the debate on the Commission's White Paper, we argue that the home-state approach, which the Commission advocates, would not deliver the objectives of enhancing consumer protection and improving the Single Market. For the reasons set out above, we are of the view that the host-state, rather than the home-state, principle represents the best way forward.

In our view, any harmonisation measure needs to ensure that all consumers are protected, wherever they live and in whichever country their insurer is based. This is necessary in order to ensure consumer protection as well as fair competition.

Arno Wicki and Brian Hunt

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[1] European Commission (2010), 'On Insurance Guarantee Schemes', White Paper, Com 370. IGS organised on the basis of the home-state principle cover not only policies issued by domestic insurers, but also those sold by branches of domestic insurers established in other EU Member States. By contrast, IGS based on the host-state principle cover policies issued by domestic insurers in the country (but not their branch business in other EU Member States), as well as policies issued in that country by branches of incoming insurers.
[2] Oxera (2007), 'Insurance Guarantee Schemes in the EU', section 6.
[3] European Commission (2010), p. 12.