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WORKING PAPER ON INSURANCE GUARANTEE SCHEMES

1. BACKGROUND

- 1.1. At its meeting on 9 April 2003 the Insurance Committee had an orientation debate on the provisional results of the work carried out by the ad-hoc group on insurance guarantee schemes. The members of the IC were asked to discuss whether the working group should start to draft a legislative text on this matter. The Committee agreed that further preparatory work was still required before starting to prepare a draft legislative text. It was agreed that the working group should examine in depth some technical issues such as moral hazard and costs and financing before preparing a legislative text.
- 1.2. Following the IC decision, the working group met on 9 July 2003. The discussion focused on document [MARKT/2525/03](#) which presented the main arguments in favour and against the setting-up of insurance guarantee schemes in particular "moral hazard" and costs. The document also considered the tasks and scope of the system.
- 1.3. As a result of the working group's discussion it appears that "moral hazard" does not seem to be, for the very large majority of delegations, a major difficulty for the establishment of guarantee schemes. Any possible risk of moral hazard would be minimised or excluded if the guarantee scheme involves a partial payment of claims. However, the main concern for a number of delegations was the problem of the cost of the system, even if it was clear that the financing of the scheme would be a matter left to national legislation in the event of future EU harmonisation.
- 1.4. Furthermore, the group felt the need to examine the situation of motor guarantee funds (as provided for in the motor insurance directives) and other, similar bodies which may exist in the Member States in the field of compulsory insurance, with regard to the cover of the risk of insolvency of the insurance undertaking. The problem is the extent to which these special guarantee funds, when they cover insolvency risk, should co-exist with general insurance guarantee schemes. The EU motor directives provide that each Member State shall set up or authorize a body with the task of providing compensation, at least up to the limits set out in the directives for

damage to property or personal injuries 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 provide that these special guarantee funds should cover the insolvency risk

- 1.5. A questionnaire covering the two afore-mentioned issues – cost of the system and compulsory insurance – was sent by the Commission to the Member States ([MARKT/2528/03](#)) on 17 September 2003. The Commission Services received answers from all Member States and all 10 Accession Countries as well from 2 EEA countries and 2 organisations (GDV, CTIP).¹ A summary of the replies is attached as Annex 1 to this paper.
- 1.6. At the request of the Spanish delegation a new issue was submitted to the consideration of the working group. The question was whether the group, in examining the future harmonisation of insurance guarantee schemes in the European Union, should include pension funds within its scope of reflections. This question was put forward to the IC on 26 November 2003. The IC was not in favour of the inclusion as it thought that the problem of insolvency of pension funds constitutes a specific and complex matter which should be treated independently from the insurance undertakings.
- 1.7. In order to examine the issue in more detail the Commission Services conducted some research in this area. The Commission Services contacted Dr. Horsch, who is currently qualifying as a university lecturer and working as a research associate at the chair for banking and finance at the Ruhr-Universität Bochum, Germany. He wrote his thesis about Insurance Guaranty Funds for the German Insurance Industry. He focused in his research on the options and limits of those schemes for life insurance and motor vehicle liability insurance. Before developing an own fund design, he analysed arguments which were raised against guarantee schemes. Further details can be found in Annex 2 to this paper. Furthermore, the Commission Services contacted NOLHGA (National Organisation of Life and Health Insurance Guarantee Associations in America). A report is annexed as Annex 3 to this paper.

¹ Country codes:
Member States: BE = Belgium, DK = Denmark, DE = Germany, EL = Greece, ES = Spain, FR = France, IE = Ireland, IT = Italy, LU = Luxembourg, NL = Netherlands, AT = Austria, PT = Portugal, FI = Finland, SE = Sweden, UK = United Kingdom
Accession Countries: CZ = Czech Republic, EE = Estonia, CY = Cyprus, LV = Latvia, LT = Lithuania, HU = Hungary, MT = Malta, PL = Poland, SI = Slovenia, SK = Slovakia
EEA countries: IS = Iceland, LI = Liechtenstein, NO = Norway

2. FINDINGS

In this section the main findings of the Annexes are summarised:

2.1. Questionnaire on Motor Insurance and other compulsory insurance (Annex 1)

- 2.1.1. Most Member States and EEA States are in favour of the exclusion of the existing motor guarantee funds from the scope of the general guarantee schemes in a future directive. This is due to the fact that the risk of insolvency of insurance undertakings conducting compulsory motor insurance is already covered by their motor guarantee funds in their domestic legislation. Some of these States have proposed an amendment to the existing directives on motor insurance in order to add the insolvency of the insurance undertaking as a further case for intervention of the motor guarantee funds.
- 2.1.2. On the contrary most Member States, EEA countries and some accession countries favour the inclusion of compulsory non motor insurance within the scope of the general insurance guarantee schemes.
- 2.1.3. A home Member State approach is favoured for both, general guarantee schemes and compulsory insurance, including motor insurance. With regard to motor guarantee funds such an approach would imply a main change of the regime currently in force in the Member States, which, according to the motor directives, is based on a host country principle.

2.2. Questionnaire on the costs/financing of guarantee schemes (Annex 1)

In 6 countries there is a system in place for protecting policyholders regarding life insurance. The systems vary quite a lot. There are traditional guarantee schemes as well as systems which attempt to provide protection at an earlier stage by means of portfolio transfer (DE and NL). In 8 countries there is a system regarding non-life. In 3 countries (out of the 6 covering life and the 8 covering non-life) the system covers life and non-life (ES, UK and MT). However, the replies do not indicate specific reasons why schemes for life instead of non-life or vice versa have been set up.

As a general note, the small insurance markets are more concentrated than the bigger ones. The market share of the first 5 companies is above the average in IE, PT, FI and SE (regarding life and non-life), in BE and EL (regarding life) and in DK and LU (regarding non-life). The markets of the ACs are in general much more concentrated than in the smaller current Member States (the first 5 companies represent 100% of the market in life in EE and MT and in motor in SI).

Most countries have their first 5 companies doing under 5% of their business abroad. The countries with significant business abroad in life are IE, LU, and to a lesser extent NL and UK. IE has one of its main five companies doing 100% of its activity abroad. LU stated that 93% of the main companies do business abroad. The countries with significant business abroad in non-life are BE, IE, LU, SE and to a lesser extent IT and PT. No ACs seem to have their first 5 companies doing a significant part of their business abroad except MT.

Normally the guarantee schemes are financed by contributions which are related to the premium income of the insurance companies. In no State the contributions are related to the risk-profile of the insurance companies. Roughly half of the States have mechanisms in place to permit the guarantee scheme to borrow or receive income from other sources. Generally the State does not finance the guarantee schemes.

Even States with a guarantee scheme in place were not able to provide any national impact analysis (some pointed out that the given time-frame was too tight). No cost-benefit-studies regarding the implementation and the operation of such a scheme have been provided. One can suggest that the schemes were a rapid reaction to emergency situations without a thorough impact assessment. However, it is interesting to note that not all countries which have a guarantee scheme in place have experienced a winding-up of an insurance company before. The reason for setting up guarantee schemes might be in some countries that there were one or maybe even several “near-misses”² or that these markets were affected by the winding-up of a foreign insurance company.

Regarding the impact of the different ceilings or exclusions on the cost of the scheme no concrete estimations or simulations were provided. With respect to life insurance all Member States where there is a conventional guarantee scheme in place have a limitation on the compensation. In non-life there are 4 States which have a limitation and 3 without such a limitation.

Regarding the advantages and disadvantages of the introduction of a guarantee scheme no new arguments have been brought forward. Reference was made to the OECD Paper on Policyholder Protection Funds, DAF/AS/WD(2001)16/REV1, and previous Commission working-papers (MARKT/2504/03, MARKT/2525/03).

2.3. Dr. Andreas Horsch (Annex 2)

The main conclusion of Dr. Horsch's thesis may be summarized as follows:

Traditional objections cannot disqualify guarantee schemes, but they only show which details of fund design should be avoided (e.g. post-financing) or included (e.g. deductibles). Consequently, efficient fund design and activity is possible even from a theoretical point of view. Furthermore, empirical evidence of insurance systems in other countries (e.g. UK, USA) and of other businesses in Germany (e.g. deposit guarantee systems, guarantee scheme for travellers) proves the good functioning of existing guarantee schemes in other areas.

² See: *Prudential Supervision of Insurance Undertakings, December 2002, "Sharma-report"*

2.4. NOLHGA (Annex 3)

With regard to the American system, the findings can be summarized as follows:

The introduction of NOLHGA (National Organisation of Life and Health Insurance Guaranty Associations) reduced costs and simplified the American system (1 instead of 52 guaranty association).

The guaranty association assure the continuing coverage for policyholders. In more than 40 multi-state insolvencies that NOLHGA has been involved with over 2 million policies have been assumed by new carriers.

By statute, all covered policyholders are covered for values and claims within limits set by the States in which they reside. In recent insolvencies, more than 90 percent of policyholder obligations have been covered in full.

Guarantee associations have provided nearly USD 20 billion in benefits. After recovering assets from the estates of insolvent companies, guaranty associations contributed over USD 5,5 billion to ensure that obligations were met.

The guaranty association system has improved the speed in the resolution of insolvencies. In most insolvencies now handled by the guaranty association system, the time required to move policyholders to a sound company has been reduced from years to months. This quick resolving of insolvencies contributes very much to reinforce the public confidence in the insurance industry.

3. COMMISSION SERVICES' CONCLUSIONS

3.1. Motor Insurance and other compulsory insurance

After examining the findings of the Questionnaire on Motor Insurance and other compulsory insurance, the following issues should be solved:

3.1.1. There are three main options for covering claims arising from compulsory motor insurance in case of winding-up of the insurance undertaking.

- (a) The first option would be that a future Directive on Insurance Guarantee schemes would also cover claims arising from compulsory motor insurance in case of winding-up of the insurance undertaking. This solution would be based on a home member state approach. It would imply that the general guarantee scheme of the home member state of the insurance undertaking would have to compensate victims of motor accidents in all Member States in the case of winding-up. (8 Members States, 1 EEA-country and 3 ACs were in favour of this approach).

- (b) A second option would be to extend the scope of the current Motor Guarantee Funds in order to cover also claims arising from compulsory motor insurance in case of winding-up of the insurance undertaking. This option would be based on a host Member State approach, which is the same principle under which the motor guarantee funds are functioning according to the motor directives. 4 Member States and 4 ACs favoured this approach. In this case the motor guarantee fund may have a claim against the general guarantee scheme covering the insurance undertaking in the home Member State.
- (c) Finally, a third option would be that the Motor Guarantee Funds cover claims arising from compulsory motor insurance in case of winding-up of the insurance undertaking on a home member state basis. This solution would involve a major change of the host principle under which motor guarantee funds have been set up according to the current motor insurance directives.

With regard to the above-mentioned options, the Commission Services would not recommend a solution as option c) which would involve a major change in the philosophy of the motor guarantee funds. Any selected solution should not hinder the functioning of the current mechanism of guarantee funds as provided for by the motor insurance directives and be compatible with the principles of a future harmonised Community system of general insurance guarantee schemes.

- 3.1.2. The same issue needs to be addressed for compulsory non-motor insurance. Most Member States, EEA countries and some accession countries favour the inclusion of claims arising from compulsory non-motor insurance in case of winding up of the insurance undertaking within the scope of the future harmonised Insurance Guarantee Schemes.

The Commission Services' preliminary impression is that the claims arising from compulsory non-motor insurance in case of winding up of the insurance undertaking should be covered on a home Member State approach within the framework of a future directive on insurance guarantee schemes.

3.2. Reasons for setting-up insurance guarantee schemes

- 3.2.1. The Commission Services do believe that there are **strong arguments in favour** of setting up insurance guarantee schemes in the Member States and carrying out a minimum harmonisation of such schemes at a Community level (see [MARKT/2525/03](#)):
- The protection offered by guarantee schemes to insurance creditors will be more flexible and faster than winding-up procedures. Therefore, thanks to the guarantee schemes the consumer will get quicker compensation.

- Guarantee schemes ensure at least a minimum compensation in case that there will not be enough assets left to pay insurance claims within the winding-up proceedings. Therefore, thanks to the guarantee schemes the consumer will get sure compensation.
- As new guarantee schemes are being set up by Member States the negative effects of the lack of harmonisation increase. Indeed, in case of a winding up of an insurance undertaking the absence of harmonisation will lead to lack of protection for a large number of policyholders, gaps and overlaps in the coverage of the existing schemes and lack of equivalent treatment between the insurance creditors. Inconsistencies can be found in claims covered, policyholders covered, amounts paid, and home or host member-state approach. All this leads to great consumers' confusion.
- The EU will soon be formed by 25 Members. Guarantee schemes will contribute to reinforce the confidence between supervisors, which is a main element for mutual recognition and home country control.
- In the case of long-term savings products (e.g. some life insurance products) consumer's confidence is particularly important.
- Certain life insurance products are very similar to some banking operations. It is extremely difficult to justify that two similar saving products are not protected in the same way. Consumer protection should not depend on the fact whether a product has been sold by a bank or an insurance undertaking.
- Recently, consumer confidence has been hit by some "crisis"-cases within the insurance industry. This confidence will be even more destroyed if claims are not met in the case of a winding-up. Confidence will be reinforced by guarantee schemes.
- Since some of the cover provided by social security is shifting nowadays towards private insurance, a reliable protection and a safety net are needed to ensure consumers' confidence and to avoid the loss of savings.
- Guarantee schemes are also an important means to foster consumer's confidence in cross-border business.
- Political pressure to introduce a guarantee scheme will immediately raise once there is a winding-up.
- Member states which have already set up insurance guarantee schemes seem to have positive experience in this regard. This also applies to the banking and securities sector.

- The lack of harmonisation might also affect the level playing field among the insurance undertakings in the different Member States and between the insurance sector and the other financial sectors which have guarantee schemes.

3.2.2. The Commission Services believe that the well-known objections in this area cannot disqualify guarantee schemes basically. As the American experience and the thesis by Dr. Horsch show, the possible negative effects can be limited by a certain design of the scheme. Even the concentration of some markets with respect to respectively the market share of some companies does not disqualify the setting-up of guarantee schemes. It has to be accepted that insurance failures exceeding a certain size may require some kind of intervention at political level. However, the financing of the scheme would be a matter left to national legislation in the event of future EU harmonisation. A future directive would just provide the broad framework for such a scheme. The detailed design of the scheme would be left to the Member States to ensure that they can design the system according to their national needs within the framework given by the Directive.

4. QUESTIONS FOR CONSIDERATION:

Delegations are kindly invited to answer the following questions:

- 4.1. Do you agree that the findings of the questionnaire and of the research conducted by the Commission Services show that the benefits of a guarantee scheme would outweigh the costs?
- 4.2. Do you think that the general insurance guarantee scheme of the home Member State should cover claims arising from compulsory motor insurance in case of winding-up of the insurance undertaking, or do you think that such cover should be provided by the relevant local motor guarantee fund?
- 4.3. Do you think that the general insurance guarantee scheme of the home Member State should cover claims arising from compulsory non-motor insurance in case of winding up of the insurance undertaking or do you think that such cover should be provided by another relevant body in the country of the situation of the risk?
- 4.4. Do you agree that the working group should start to work on a very first outline of possible legal provisions covering the different aspects of insurance guarantee schemes subject to future harmonisation?