CEIOPS
Committee of European Insurance and Occupational Pensions Supervisors

CEIOPS-DOC-96/10

CEIOPS' Comments on the European Commission's White Paper on Insurance Guarantee Schemes

The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) is the Level 3 Committee for the insurance and occupational pensions sectors under the so called "Lamfalussy Process". CEIOPS is composed of high level representatives from the insurance and occupational pensions supervisory authorities of the European Union Member States. The authorities of the other Member States of the European Economic Area (Norway, Iceland and Liechtenstein) and the European Commission participate in CEIOPS' activities as observers. CEIOPS is involved in both Level 2 and 3 Lamfalussy activities by:

- providing advice to the European Commission on drafting of implementation measures for framework directives and regulations on insurance and occupational pensions , and
- issuing supervisory standards, recommendations and guidelines to enhance convergent and effective application of the regulations and to facilitate cooperation between national supervisors

CEIOPS welcomes the European Commission's public consultation on its White Paper (WP) and impact assessment (IA) on Insurance Guarantee Schemes. CEIOPS would like to point out that, similar to its report in 2009 ("2009-Input)[1], there are different views among its members as to whether the benefits of broadly defined guarantee schemes in insurance outweighs its cost. CEIOPS appreciates that a great number of the proposals in the White Paper are similar to the recommendations presented by CEIOPS in its abovementioned 2009-Input. CEIOPS' current comments will therefore only underline possible differences with the EC's positions and provide comments on new issues or on topics where new information is available.

Several new regulatory developments should be taken into account in this context, in particular the recently-adopted Solvency II Framework Directive and the Green Paper on Pension Funds. Solvency II redefines the solvency environment of insurance companies in Europe. It will have a direct impact on their probability of default and therefore on the probability of intervention of the guarantee funds. An Insurance Guarantee Schemes Directive (IGSD) proposed by the European Commission should therefore take into account the impact on the probability of failure of individual financial institutions under the new supervisory regime. Annex 1 gives further considerations on Solvency II and the IGS.

[1] CEIOPS Input to EC work on IGS_June 2009.pdf

©CEIOPS 2010

CEIOPS' five most important considerations with regard to the WP and IA are:

1. The EC should consider combining different criteria (policies, eligible claimants, caps and other claim reductions) for determining the scope of a minimum IGS across Europe.

2. The EC should recognise the fundamental differences between the banking and insurance sectors in establishing an IGSD.

3. An IGSD should leave room for national choices, e.g. with regard to the size of undertakings that gain coverage from the IGS, as well as funding questions, organisational questions and scope of application for a portfolio transfer.

4. Should criteria for funding be included, a step by step approach is recommended.

5. An EU-IGSD should explicitly state how claims in Motor Insurance are guaranteed. Current problems in the home/host approach should, if possible, be repaired.

Elements of the EC proposed approach

1. Nature of possible EU action

The Commission proposes to establish at EU level a coherent and legally binding framework on IGS protection, applicable to all policyholders and beneficiaries, by means of a directive as defined in Article 288 TFEU.

CEIOPS recognizes that a directive is an appropriate instrument to ensure a minimum harmonisation and, thereby, a certain level playing field for the benefit of all policyholders and beneficiaries.

2. Level of centralisation and role of the IGS

The Commission advocates the establishment of an IGS as a last-resort mechanism in each Member State.

The EC's option reflects CEIOPS' 2009-recommendation 2: "The preferred option is for a guarantee scheme of last resort set up by individual Member States for life and non life insurance, leaving some flexibility to choose among a number of techniques to find the best possible solution in each individual case."

3. Geographical scope

The Commission advocates harmonising the geographical scope of IGSs on the basis of the 'home country' principle.

©CEIOPS 2010

In 2009, CEIOPS expressed an identical preference for the home state principle. This allows for Companies, their branches and services business to be covered by the IGS in the state where the company is authorized.[2]

The Solvency II Directive also introduces a new split of competencies between home and host supervisors for the supervision of cross border groups. CEIOPS would therefore welcome the EC to take this into account in designing its coherent framework of Insurance Guarantee Schemes.

4. Policies covered

The Commission advocates that IGSs should cover both life and non-life insurance policies. Excluded are reinsurance and occupational pension funds.

Contrary to the White Paper, CEIOPS recommended in 2009 to give Member States the option to exclude particular insurance classes from the coverage of IGS. Full coverage in respect of certain insurance classes - particularly marine, railway, transport and aviation insurance - may result in the significant increase of the costs of functioning of IGS. Additionally, some insurance classes (such as class 16 "miscellaneous financial loss" or more generally – credit insurance) entail high risks of moral hazard. In the context of the minimum harmonisation approach presented by the Commission, one can therefore wonder whether insurance guarantee funds financed by the insurance sector (i.e. by insurance undertakings, but also ultimately by policyholders) should cover such classes. Other products like travelling insurance in case of bad weather or reimbursement in case of product failure could also be challenged. The potential costs of coverage in respect of those insurance classes may also be difficult to assess.

If certain risks would be included in the scope of the IGS cover, limitations could be necessary with respect to certain eligible claimants (e.g. other than natural persons) or percentage reductions or caps (co-payments) on the amount. Those co-payments may effectively reduce the cost of functioning of IGSs. They can also provide a moral incentive for holders of large policies to favour prudent insurers.

Additionally, CEIOPS would like to indicate that there may be issues relating to the unit-linked life insurance which need to be considered.

The Impact Assessment Document of the European Commission (IA) explains that the preferred scope of coverage is life and selected non-life insurance, as per analysis from the so called Oxera Report[3]. It would be helpful if the IA explained in more detail the rationale for the range of types of insurance included within the scope of the scheme. This would help establish economic arguments for selecting types of insurance policy that should be included within scope.

---

[2] Recommendation 10:"CEIOPS expresses a preference for the home state principle so that companies are covered by the IGS in the state where the company is authorised. This includes the company's branch and services business throughout the EEA."

[3] http://ec.europa.eu/internal_market/insurance/guarantee_en.htm#oxera

 ©CEIOPS 2010

The White Paper does not cite Motor Compulsory Insurance (MI) when referring to the minimum scope of the national IGSs. Only in the IA, it is mentioned that there is no necessity to intervene at the EU level, because "Member States have voluntarily extended over time to the case of defaulted insurance undertakings their already compulsory guarantee schemes for motor insurance".[4]

It seems that the EC prefers MI IGSs to work independently.

CEIOPS wonders if keeping two separate systems is desirable, especially taking into account the voluntary aspect of coverage by Motor Guarantee Funds in case of insurance failure. From the viewpoint of a consumer this double system would be very confusing since MI is often offered together with other insurance products. It would be difficult to understand that the nature of protection differs depending on the type of contract offered by the same insurer.

Introducing one IGS that covers all claims in case of failure, including the MI undertakings, would correspond to the aim of achieving a coherent framework at the EU-level. Moreover, MI is the most common compulsory non-life-insurance in the EEA. CEIOPS is aware of the different approaches of the two systems. In its 2009-Input, CEIOPS recommended leaving the option to the MS to decide which national fund (motor or other) should provide compensation. If separate systems are kept, it would be important to strengthen the communication between the relevant guarantee providers. The most essential issue however is that coverage for MI undertaking's failures becomes part of the mandatory coverage.

A future IGSD in line with the recommended home country principle should provide for the simplest possible way for claimants to file their claims, regarding both motor insurance and other classes. It should also provide for the needs of claimants covered by an undertaking operating on a branch or freedom to provide services basis.

Considering the importance of MI, CEIOPS would like to invite the EC to continue the analysis of the three options presented in its former Working Papers.

5. Eligible claimants

The Commission advocates that IGSs should cover natural persons and selected legal persons.

As in 2009, CEIOPS considers that the IGSD should require Member States to provide cover, at the minimum, for all natural persons, both policyholders and other beneficiaries covered by the insurance contract. This would ensure protection for the most vulnerable claimants.

4 IA, Section 2.3.2.

©CEIOPS 2010

In addition, CEIOPS confirms its 2009 position to give the Member States the option to exclude from coverage insurance claims by some categories of persons as defined in Annex 1 points 7 and 8 of the Deposit Guarantee Schemes directive (directors, managers, qualified shareholders of the failed undertaking etc.), notwithstanding the fact that this exemption is proposed to be deleted in the DGS directive. This exemption remains appropriate in the insurance sector on policy grounds. Furthermore, the deletion in the banking sector is mainly based on practical reasons for faster payment which are not relevant for insurance products (See also comments under chapter 7).

With regard to legal persons, the IGSD should not require cover for all businesses regardless of their size, as it is proposed under the DGS Directive. Including larger enterprises among the persons eligible for protection runs the risk of moral hazard, in that these enterprises may not then carefully scrutinize insurers before entering into contracts with them. This means that the market would lose the disciplining effect of better informed participants in the market. In addition, the reason for deleting this exclusion in the proposed DGS Directive is mainly to speed up payments. This does not apply in the case of insurance company failures (see further under chapter 7). Member States should be left the option to exclude large companies from coverage, because of the cost of such cover and because large businesses, unlike consumers, do not need the protection of an IGS. We suggest that Member States should be allowed to decide what size of business to cover, if they decide to extend cover to small businesses. However we are aware of the various existing EU definitions of when a company or enterprise is considered large, or not small. If the Commission decides to include a definition in the IGSD, we suggest that the Commission should choose a definition which will ensure that cover is directed at businesses which are small.

The Impact Assessment recommends coverage of consumers and SMEs. It would be helpful to have more detail on the rationale for the different types of eligible claimant. A further point to consider is the interaction of eligibility with the scope of coverage in terms of types of policy covered, since some types of insurance will only be applicable to consumers or SMEs.

Finally, any provisions in the IGSD relating to the coverage of small businesses must be capable of being applied to:

- businesses with a non-corporate legal structure;
- bodies without an economic purpose for their existence; and
- bodies which take out insurance on behalf of a number of natural persons, for example a body which insures a house on behalf of all the tenants in the house.

6. Funding

The EC advocates that IGS should be funded on the basis of ex-ante contributions by insurers, possibly complemented by ex-post funding arrangements, in case of lack of funding.

©CEIOPS 2010

CEIOPS is in favour of a funding mechanism that is consistent with the minimum harmonisation approach. CEIOPS would therefore like to confirm its 2009 recommendation, namely to leave the funding arrangements to the Member States.

However, ex ante funding does help moral hazard concerns by ensuring that a failing institution would have made some contributions to the fund.

In answering CEIOPS questions on funding, EC stressed that there are significant data restrictions which make it hard to calibrate the funding need for an IGS. This is important, because it emphasises that further work will have to be done. CEIOPS therefore welcomes the EC intention to do more research on possible funding mechanisms for an IGS in the insurance sector. It would be important to take account of the differences between the banking and insurance sector. While ex-ante funding is considered needed to achieve immediate payment to depositors, the same argument is not valid for the insurance sector.

As already mentioned in its 2009-Input[5], CEIOPS is of the opinion that any discussion on funding should begin with determining what is going to be harmonised and what level of protection will be provided. In this reaction, CEIOPS highlights the need for a consistent step by step approach to determine how the funding of a minimally harmonised IGS should look like. CEIOPS also adds remarks on the levy for financing the IGS.

Step by step approach

If the EC wants to develop further principle for funding, we propose the following steps in determining this mechanism for the IGSD:

(1) Point out (let EC and Member States decide on) **how the IGS system is going to look like,** in terms of
   a. Eligible claimants (e.g. if legal persons are allowed, by which definition)
   b. Policies covered
   c. Level of protection (incl. minimum and maximum boundaries, use of deductibles, etc)
   d. Preferred IGS-mechanism and coverage level per (sub-) sector

(2) Determine the criteria for the funding mechanism and rank them in order of priority (cost effectiveness, level of protection, degree of flexibility in contributions, moral hazard in relation to risk-based contributions, degree of independence, suitability for cross border activity, etc).

(3) Determine relevant scenarios for compensation needs
   a. Consistent with minimum harmonisation and 'filling in the gaps' (with and without existing schemes and funding)

[5] 2009-Input, Par V.2.3, p.26

©CEIOPS 2010

b. Worst case and best case scenario's in compensation needs
c. The impact of Solvency II on funding needs, using the results of QIS5 as an indication.
d. The impact of existing and new early intervention mechanisms.

(4) Exploring different funding foundations (metrics):

a. **Ex ante levy**: volume based metrics (Gross Written Premiums, Technical provisions / surrender value to estimate Liabilities); risk based metrics (solvency position, profitability, quality of assets, etc); or a combination of volume and risk based metrics.
b. **Ex post levy**

(5) Decide if ex ante funding has an added value compared to ex post funding; or to leave this choice to Member States (minimum harmonisation).

Foundation of levies for insurers

The EC expresses in the White Paper a preference to use Gross Written Premiums as a foundation for funding the IGS. Gross written premiums might be used for initially funding an IGS in case of establishing ex ante Guarantee Funds, because they are simple and plain, and reflect that big insurers have more (administrative) costs in case of default.

To estimate the liabilities relevant for future compensation (or portfolio transfer), CEIOPS recommends investigating further if other criteria, such as technical provisions or surrender values, would be a more appropriate foundation. In general, CEIOPS states that life and non life, and also the subsectors in life and non life, differ too much to use a broad criterion as gross written premium as similar basis for all guarantee funding.

In exploring possible funding schemes, the proposal for future risk based premium seems too complicated and not aligned with the principle of minimum harmonisation of IGSs across Europe (EEA). A logical approach in determining risk based contributions could comprise a formula build up of i) a general component reflecting risk of the insurance sector in general; ii) a component which reflects the risk of the Line of Business (LoB) or subsector and iii) an individual *add on* or reduction.

Since some conclusions on funding seem somewhat premature, CEIOPS would like to ask the EC to bring the topic of funding again to the research table.

7. Portfolio transfer and/or compensation of claims

The Commission advocates that IGS should at least and within a pre-defined period of time compensate policyholders and beneficiaries for losses when an insurer becomes insolvent. The Commission also strongly encourages, but does not advocate as an express proposal, portfolio

©CEIOPS 2010

transfer where reasonably practical and justified in terms of costs and benefits. The Commission notes that this may apply particularly to life insurance products which, because they are long-term, are difficult to substitute under the same conditions (i.e. using compensation paid in relation to the original policy).

Portfolio transfer / payment of compensation

It is important for CEIOPS that the IGSD allows Member States to provide IGS protection either by the payment of compensation or through portfolio transfer, depending on the type of product and what is practicable in the circumstances of the particular failure. For life insurance in particular, portfolio transfer is the preferred option in terms of consumer protection where it is cost effective and practicable. Portfolio transfer can also be an efficient approach for some types of general insurance contracts where a particular type of contract which is a specialist form of insurance can be transferred in bulk to another insurer specialising in that class.

Speed of payment

The White Paper does not appear to discuss the timing issue nor the implications in cases where the IGS is seeking to arrange a portfolio transfer. A prescribed period for payment of claims could hinder a portfolio transfer and this situation must be avoided as it will not be in consumers' interests. The Impact Assessment briefly mentions the speed of payment.

CEIOPS recommended in 2009 that IGS should be required to make payments as soon as practicable after the claim has been assessed.[6] In addition, CEIOPS recognized that there may be significant variations on what is desirable for different types of product; shorter pay outs could be justified for third party liability insurance, compulsory insurance and health insurance. CEIOPS also explained some of the difficulties in making compensation payments within a particular period in the case of the failure of an insurance company.

The Impact Assessment could further develop the rationale for options for the speed of payout and the costs and benefits of these options. Issues to consider are, for instance, average time to handle claims (and the costs of speeding this up); to relate payout speed per subsector to possibilities to enhance consumer confidence.

[6] Recommendation 12: "CEIOPS recommends that IGS should be required to make payments as soon as practicable after the claim has been assessed. There may be significant variations on what is desirable for different types of product; shorter pay outs could be justified for third party liability insurance, compulsory insurance and health insurance."

 ©CEIOPS 2010

ANNEX I - IGS in relation to Solvency II and other regulations

Solvency II

An IGS does not stand on itself. There is a relationship with other guarantee schemes (mainly DGS). Furthermore, guarantee schemes are connected to supervisory powers and measures as well, and to early intervention schemes.
CEIOPS would like to express the view that the future relation between the Insurance Guarantee Scheme and the upcoming Solvency II framework needs further analysis. This is also important in assessing the need for, and impact of, an IGS.

CEIOPS is aware that SII will not introduce a zero-failure environment, as a 0.5% risk tolerance level is fixed. However, solvency capital levels will likely be adjusted to reflect more accurately the risk profile of the undertakings. It can therefore be expected that the probability distributions of the underlying risks in the portfolio will shift in the direction of reducing solvency capital requirements, either by writing less risky business or reducing risks on the investment portfolio. In addition, the future supervisory powers will be more responsive to changes in the risk profile. These behavioural changes will obviously have an impact on the default probability (PD) and loss given default (LGD). QIS5 results could be used to assess the remaining level of capital buffers under SII, in order to define appropriate funding levels of the IGS. An IGS adds an additional and ultimate layer of policyholder protection after other layers have been exhausted (technical provisions for covering expected future payouts, solvency buffers to cover unexpected losses, ladder of supervisory interventions as well as portfolio transfers as part of a winding up procedure).

CEIOPS feels that the EC is overestimating the funding burden for the industry because Solvency II and existing early intervention mechanisms (especially aimed at portfolio transfer) will be in place as well. This should be taken into account in determining the appropriate target level of protection and it should be included in the Impact Assessment as well.

Other regulations

Apart from Solvency II, default changes of insurers and interconnectedness between banks and insurers is changing because of enforcement of other regulations, especially Basel 3, measures aimed at significant financial institutions; new Authorities (ESA[7], ESRB[8]) and the future progress to be made by working in Colleges of Supervisors.

---

[7] European Supervisory Authorities (in Banking [EBA], in Insurance and Occupational Pension [EIOPA], in Securities and Markets [ESMA])
[8] European Systemic Risk Board

©CEIOPS 2010

To quantify this will probably be hard, but this may be reflected in the risk profile of insurers as well e.g. their counterparty risk in Pillar I, or better ability to control their risks in general (pillar 2).
The main consideration should be that also other regulations such as banking regulation as well as enhancing and harmonising the Deposit Guarantee Scheme, will in general have a positive effect on consumer confidence in- and stability of- the financial sector. The funding need for an IGS would in that case be overestimated, instead of underestimated.

Suggestions for further research

The WP on IGS leaves plenty of questions unanswered at this stage. Further consideration could be given to

- The combined impact of Solvency II on future guarantee schemes (e.g. on the key determinants, the probability of default and the loss given default)
- The effect of simultaneous introduction of risk based supervision (Solvency II) and risk based contributions in ex ante funded IGS.
- The need to use an individual risk factor in the levy after establishing Solvency II and/or the levy for cross border companies.

For further information:

Carlos Montalvo Rebuelta
CEIOPS Secretary General

Westhafentower, Westhafenplatz 1
60327 Frankfurt am Main
Tel + 49 69 95 11 19 00
secretariat@ceiops.eu

©CEIOPS 2010