INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

ISSUES PAPER ON POLICYHOLDER PROTECTION SCHEMES

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About the IAIS

The International Association of Insurance Supervisors (IAIS) is a voluntary membership organization of insurance supervisors and regulators from more than 200 jurisdictions in nearly 140 countries. The mission of the IAIS is to promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders and to contribute to global financial stability.

Established in 1994, the IAIS is the international standard setting body responsible for developing principles, standards and other supporting material for the supervision of the insurance sector and assisting in their implementation. The IAIS also provides a forum for Members to share their experiences and understanding of insurance supervision and insurance markets. In addition to active participation of its Members, the IAIS benefits from input in select IAIS activities from Observers representing international institutions, professional associations and insurance and reinsurance companies, as well as consultants and other professionals.

The IAIS coordinates its work with other international financial policymakers and associations of supervisors or regulators, and assists in shaping financial systems globally. In particular, the IAIS is a member of the Financial Stability Board (FSB), founding member and co-parent of the Joint Forum, along with the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), member of the Standards Advisory Council of the International Accounting Standards Board (IASB), and partner in the Access to Insurance Initiative (A2ii). In recognition of its collective expertise, the IAIS also is routinely called upon by the G20 leaders and other international standard setting bodies for input on insurance issues as well as on issues related to the regulation and supervision of the global financial sector.

This paper was prepared by the Market Conduct Subcommittee in consultation with IAIS Members and Observers.

The publication is available on the IAIS website (www.iaisweb.org).

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Annexes

Introduction

1. Jurisdictions have different ways of protecting policyholders against the inability of an insurer to pay claims when they become due, for example because of insolvency.

2. The Insurance Core Principles (ICPs) call for jurisdictions to put in place sound regulatory and supervisory frameworks that reduce the risk of harm to consumers by helping to maintain fair, safe and stable insurance markets for the benefit and protection of the interests of policyholders, and contribute to the stability of the financial system.[1]

3. As part of such frameworks, most jurisdictions apply strict solvency regulations to insurance companies operating within their borders, thus protecting liabilities with technical provisions and additional assets. Where an insurer is experiencing difficulties, solvency regimes trigger intervention to differing degrees depending on the seriousness of the situation. Supervisory action aims to minimise the likelihood of an insurer becoming insolvent or going bankrupt. Some jurisdictions provide added protection for policyholders and ensure the priority of policyholder claims in the event of an insolvency through additional mechanisms within the supervisory framework such as the ring-fencing of assets (e.g. tied assets) that support insurance liabilities.[2] This is consistent with ICP 12 (Winding-up and exit from the market) which stresses supervisory objectives of:

- protecting policyholders in the event of winding-up proceedings of insurance entities, and
- establishing winding-up procedures aiming at minimising the disruption to the timely provision of benefits to policyholders.

4. Compared with other areas of the financial services sector, the insurance industry has emerged from the crisis that started in 2007 comparatively unscathed. In jurisdictions with strong regulatory and supervisory frameworks, the collapse of an insurer writing traditional insurance business is unlikely. Nonetheless insurers have failed in the past, and some have got into difficulty due to non-insurance activities. The impact on policyholders can be severe, and there is a risk of wider disruption in the financial services sector, and consumer detriment. To mitigate the impact on policyholders and the general economy, jurisdictions are encouraged to be prepared for such an event.

5. Solvency regimes do not create a zero-failure environment and may not protect consumers from losses in the event of a failure. When failures do occur, governments can come under strong pressure to provide a safety net. In light of this, many jurisdictions have established one or more policyholder protection schemes (PPSs)[3] to provide a minimum layer of protection to policyholders in the event that the safeguards within the supervisory regime are not sufficient.

6. PPSs are usually collective industry-funded schemes[4] that are seen as last-resort mechanisms, providing a basic level of protection to policyholders (although some models are more comprehensive) when all other corrective and preventive measures have failed. PPSs are designed to protect policyholders and beneficiaries in the case of the insolvency of an insurer, serving as backstops against claims. Whilst PPSs' objectives focus on providing a minimum level of protection to policyholders, where the design of the PPS includes such functions, they can also contribute to the objectives of resolution regimes by:

- facilitating the continuation of insurance

1 See IAIS, Insurance Core Principles, October 2011, Introduction, paragraph 1.

2 Other approaches within the supervisory framework are described in Annex I.

3 Also known as insurance guarantee schemes (IGS), guarantee funds or policyholder protection funds.

4 In a few cases part or all of the funding of the PPS is borne by policyholders (e.g. PPSs in Greece and Spain respectively).

- providing financial support to an insolvent insurer and/or an entity which intends to purchase an insolvent insurer or to which insurance policies will be transferred from an insolvent insurer
- aiding in portfolio transfers
- working as a bridge institution where no immediate purchaser of an insolvent insurer can be found.

Whilst the paper discusses the above functions of PPSs, and acknowledges that these can contribute to insurer resolution, it is not the intention of this paper to discuss resolution regimes, including the roles and responsibilities of resolution authorities.

7. Where protection mechanisms - be they through a PPS or through other means such as tied assets or preferred claims - are in place, policyholders have increased protection in the event of a failure. As such, PPSs contribute to maintaining public confidence[5] and stability in the insurance industry and the financial system; and this is enhanced where protection is provided in a transparent manner. A PPS also clarifies the obligations of the government and other safety-net participants and limits the scope for discretionary decisions that may result in arbitrary actions, and in so doing supports consumer confidence.

8. Where inadequate protection mechanisms are in place, governments may resort to discretionary ad hoc measures or put explicit but limited guarantees in place. This is unlikely to be an optimal solution and can be costly to all taxpayers, regardless of whether or not they are policyholders.

9. Insurance supervisors need to be aware of the PPSs that apply to insurers and policyholders within their jurisdiction. Where PPSs exist, their effectiveness is enhanced through close cooperation between the PPS and the insurance supervisor, which is sometimes formalised in a cooperation agreement. Whilst PPSs need to be operationally independent, involvement of the insurance supervisor in the governance of the PPS can help to ensure that the objectives of both are aligned. Cooperation and coordination between the two is particularly important where an insurance supervisor assesses an insurer as high risk, and in taking action in the case of a distressed insurer. These issues are discussed further in the paper.

10. This paper provides an overview of the features of PPSs and the functions they can perform. It is intended to serve as a source of information to insurance supervisors, including where the establishment of a policyholder protection scheme is being considered or where an existing scheme is being modified. This paper also discusses necessary conditions and challenges associated with such schemes to ensure that where they are established they are consistent with the objectives of the ICPs. Moreover, the paper discusses issues that arise in financial conglomerates and for insurers operating in more than one jurisdiction, where there is interaction between PPSs, and between PPSs and other protection plans (for example for deposit taking institutions and securities) and insurance supervisors. Annex I briefly describes mechanisms within the supervisory framework, such as tied assets, that can be used to provide effective protection to policyholders. Annex II includes case studies and examples of aspects of the operation of PPSs; Annex III summarise functions that PPSs in selected jurisdictions perform; and Annex IV provides selected reference material.

Policyholder protection schemes

11. When considering the establishment or design of a PPS, the particularities of a jurisdiction's insurance sector should be taken into account. This includes determining the need for a scheme, who the fund is intended to protect, and the size and concentration of the insurance market (including the nature, scale and complexity of insurers operating within

[5] Assuming that the public is sufficiently aware of the PPS.

the market). The jurisdiction's traditions, culture and legal regime should also be considered. These factors vary between jurisdictions.

12. The policyholders of insurers that are members of a PPS should benefit from the protection offered by a PPS. In that regard, insurers support the cost of PPSs, so that the cost of the failure of an insurer is borne by the industry and indirectly by its policyholders.

13. When designing a PPS, jurisdictions may consider:

- how it will be organised and governed
- whether its membership should be compulsory (e.g. as a licensing requirement) or voluntary
- whether its membership takes a home or host approach
- whether protection is dependent upon the location of the risk or business/contract
- what will be the basis of funding (e.g. ex-ante (before the fact) or ex-post (after the fact))
- whether and how to assess contributions (e.g. using a flat-rate or a risk-based approach)
- which classes of insurance should be covered, and whether specific classes or products (including reinsurance) are excluded
- whether compulsory lines of insurance may be differentiated from others in terms of funding, claim coverage or governance
- whether protection covers only individual consumers (including those covered by group insurance schemes) or extends to small businesses or any other commercial consumers
- whether any exceptions are appropriate (e.g. directors of an insolvent insurer)
- what type of coverage to provide (e.g. implicit coverage/full guarantee or explicit coverage/limited guarantee)[6]
- whether the scheme will provide continuity of cover, or payment of compensation, or both
- the coverage of claims and deductibles to be borne by the policyholders, and whether and how losses are shared between the insurers and policyholders
- how claims will be handled
- a dispute resolution procedure to resolve any disputes that may arise
- a framework for cooperation of the PPS with relevant supervisory authorities, including the sharing of sensitive information
- potential pre-warning mechanisms whereby the PPS is made aware of the potential distress of an insurer
- whether, and in what circumstances, the scheme is granted powers of intervention (e.g. in order to minimise risk of claims compensation payments being made when an insurer is still viable)
- how the PPS will communicate with stakeholders

[6] Where coverage is 'implicit', coverage limits do not apply and losses are therefore considered to be fully guaranteed; 'explicit coverage' refers to arrangements under which the PPS covers a loss up to specified limits (i.e. coverage is limited).

- whether the PPS will make information regarding the insurer publicly available before as well as after failure
- arrangements that will apply in the case of liquidation/administration, including the priority of claims by the PPS, the relationship with the liquidator etc.
- whether the PPS has a role in recovering funds as a creditor of the estate, or from third parties.

14. A PPS can cover life insurance and non-life insurance in a single scheme or in different schemes. In some jurisdictions health insurance is subject to a separate scheme.

15. In a number of jurisdictions smaller schemes exist for specific classes of insurance. These schemes might be concerned with compulsory insurance (e.g. motor insurance) and/or contain a significant element of social protection (e.g. workers' compensation). Sometimes these schemes also protect third parties in cases where no insurance cover exists. Although such schemes are sometimes seen as fulfilling a role similar to the PPSs described in this paper,[7] this paper does not aim to deal specifically with these types of scheme. This paper is concerned with general PPSs covering life, non-life and health insurance systems only.

Determining factors in establishing a PPS

16. Before establishing a PPS, jurisdictions should consider not only the benefits (some of which are discussed in the introduction), but also the related risks and issues.

Moral hazard

17. The existence of a PPS can cause distortions in the market such that:

- insurance companies may engage in excessive risk-taking, knowing that the policyholders would be protected if their firm becomes insolvent (insurer moral hazard)
- policyholders may be less vigilant in choosing and monitoring the financial health of an insurer, if they know that they will not incur losses (or their losses will be limited) if the insurer becomes insolvent (policyholder moral hazard)
- supervisors and/or policymakers may be less rigorous, knowing that a fallback mechanism is available if an insurer fails.

18. The existence of a PPS should not be a substitute for consumers taking steps, as appropriate to make well-informed decisions in selecting a policy or for insurers to have robust risk management frameworks in place.

Possibility for arbitrage

19. For lines of insurance for which PPSs are not mandatory, consumers may choose to purchase products from insurers that are covered by PPSs, instead of from insurers or other financial institutions which are not – creating an uneven playing field with the potential for arbitrage, assuming that policyholders are aware of the coverage offered by the relevant PPS. [8]

20. Having all financial services sectors covered by protection schemes may help to promote a level playing field across the sectors through comparable treatment for comparable products (e.g. mutual funds covered by an investor protection scheme; investment-related insurance products covered by a PPS), although in some cases different coverage types apply between sectors.

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7 Such schemes are often public, and sometimes considered as part of a jurisdiction's social security system.

8 It may also be noted that in such situations the claimant is not necessarily involved in the selection of the insurer and policy.

Market concentration

21. Where there is concentration in the market, there is a risk that PPSs may not be able to fulfil their commitments – for example where one major insurer in a jurisdiction becomes insolvent, or several large insurers become insolvent at the same time – resulting in a crisis in confidence in the financial sector. In these cases, governments may need to provide lending to the PPS, which would later be recovered from industry. Effectively, the PPS would be given an implicit guarantee from the government/taxpayer.

Costs vs benefits

22. Jurisdictions should also weigh the costs of a PPS against the benefits, bearing in mind that these costs may ultimately be passed on to policyholders and could affect the competitiveness of member insurers and their ability to offer affordable products.

Other factors

23. PPSs are sometimes established in response to an insurance failure. If a jurisdiction is considering setting up a PPS at the time of, or closely after, the failure of an insurer, there are potential risks that need to be considered. For example, if the insurance failure is indicative of a general weakness in the financial health of the industry, the impact of funding requirements on the sector will come at a time when the industry can least afford it.

<u>Australia</u>

The Royal Commission on the failure of HIH Insurance Group recommended that a permanent PPS be established. In response to the Royal Commission, the Government stated that the precise design of any guarantee warranted closer consideration. A permanent PPS for non-life insurance policyholders was later announced by the Treasurer on 2 June 2008, alongside a similar scheme for authorised deposit-taking institutions.

24. Most PPSs are compulsory. Compulsory membership alleviates any confusion as to who benefits from PPS protection. In the case of a voluntary PPS, there would need to be clear and prominent disclosure as to whether policies are covered by the PPS and what the level of coverage is.

25. Some jurisdictions have decided not to introduce a PPS for insurance, often because of the nature of their insurance market. These jurisdictions may have decided that a PPS would not have sufficient added value in protecting policyholders (e.g. mechanisms within the supervisory regime are considered to be sufficient), that consumer interests are less at risk (e.g. where the market is predominantly business to business insurance), or that a PPS could not function effectively in the market (e.g. due to market concentration).

<u>Finland</u>

Finland has a collective guarantee only in respect of occupational pension insurance and statutory non-life insurance (such as motor vehicle liability and workers' compensation), which it considers part of the social security system. It explored the possibility of introducing a PPS for the life insurance sector in the 1990s, deciding against this due to the structure of the Finnish insurance market, and the availability of other protection mechanisms. It found that the concentrated structure of the market would either result in contributions being insufficient to build up an adequate fund, or have the risk that high contribution levels cause financial difficulty for the insurers.

<u>Guernsey</u>

Guernsey has no PPS due to the nature of the market, which consists predominantly of captive insurers which do not have third party policyholders. With only a small number of commercially active life and non-life insurers the cost of any insurer failure would fall disproportionately on the remaining firms and the contributions required would be prohibitive, such that it may cause firms to leave the market. Alternative requirements are in place to protect policyholders of life insurers whereby assets representing at least 90% of policyholder liabilities must be held in trust to meet the insurer's obligations to policyholders. The effect of this trust is to take the assets out of the insolvency estate of the insurance company so that they would not be available to meet any other obligations of the company. The trustee is required to report quarterly to the supervisory authority on the value of assets held in the trust. Any large withdrawals of funds must also be reported to the supervisory authority.

Spain

In Spain, the Consorcio de Compensación de Seguros (CCS) operates a general winding-up scheme that protects policyholders and beneficiaries of life and non-life insurers against financial loss in the case of an insurer insolvency. Strictly speaking this is not a PPS, as it does not guarantee a predetermined level of protection, although the CCS protection reaches on average 95% of the amount of claims. The fund is financed by a surcharge on the premiums of policyholders of non-life insurance contracts, which is collected by the insurers and passed on to the CCS.

Organisation and establishment

26. Usually legislation is enacted to establish a PPS, specifying:

- how it will be organised and governed
- to whom it will be accountable
- who should bear the cost of funding (the industry, the policyholders, or a combination).

The legislation may or may not specify operating rules.

27. The organisation can be a public system (a governmental body, a public entity, or a governmental agency) or a private system (an independent organisation where employees are not public servants). Usually these private organisations are not-for-profit entities. It can be part of an existing organisation or a new entity.

Canada

Two private Canada-wide PPSs were created by the industry, in recognition of consumer and regulator preferences, in 1989 and 1990 respectively - Assuris for life insurance and the Property and Casualty Insurance Compensation Corporation (PACICC) for non-life insurance. All life insurers and property and casualty insurers licensed in Canada are required to be members of these PPSs, unless specifically exempted by provincial laws or regulations.

Germany

The German guarantee scheme for life insurance ("Protektor") was founded as a private guarantee fund in 2003 after the Mannheimer Lebensversicherungs AG became insolvent (see Annex II). "Protektor" took over the portfolio of this life insurer. In 2004, Germany amended its Insurance Supervision Act to include a requirement for a Federal Special Fund for life as well as for substitutive health insurers.[9] Both Federal Special Funds require mandatory membership for German life/substitutive health insurers and German branches of non-EEA life/substantive health insurers. By statutory order of the Federal Ministry of Finance, duties and powers of these statutory funds were delegated to "Protektor" (life insurers) and "Medicator" (substitutive health insurers).

US

Every state has adopted statutes that create privately operated PPSs in that state – one to provide coverage for the failure of a life/annuity/health carrier, and another to protect consumers from failed property and casualty companies. The activities of the state guaranty associations are coordinated by national, private umbrella organizations – the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and National Conference of Insurance Guaranty Funds (NCIGF) – which provide a process, facilities and staff to coordinate and support the activities of the member guaranty associations, particularly in connection with the insolvencies of insurers writing business in multiple states.

9 Substitutive health insurance can be described as "private insurance for health costs, which substitutes for cover which would otherwise be available from a social insurance or publicly financed insurance group or employer's scheme." [Source: OECD]

28. Whether the PPS is run by the public or private sector, the insurance industry usually bears the implementation and on-going costs. Some of these costs are indirectly passed on to the policyholder through premiums.

> <u>US</u>
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> In the United States, insurers usually do not pass costs on to policyholders because many state legislatures have provided a "premium tax offset" to insurers for the levies a member pays to that state's PPS. Such states have allowed the tax offsets in recognition of the practical difficulties that prevent an insurer from recovering levies from any other source.

29. The PPS should be set up using a legal structure that, under local law, provides it with adequate legal protection against any public or private use of the fund for purposes other than those for which the PPS has been created. The PPS and its staff should also have legal protection when acting in good faith.

30. PPSs can be implemented on a sectoral or a general basis. A PPS can be part of a larger financial protection scheme offering different compensation plans or programs in different financial sectors (which may also cover deposits-taking, securities, and mutual funds). For example, Korea and the UK have integrated schemes where the insurance scheme is combined with the deposit and investor protection schemes. This facilitates consumers' awareness of the overall protection scheme and avoids uncertainty over which organisation protects which products. Integrated schemes can also offer economies of scale and other efficiencies, such as funding and resources.

31. Where protection is offered by different schemes for different sectors some financial institutions may be subject to different schemes in respect of different products (e.g. where an entity both provides insurance and takes deposits). For these schemes to operate effectively, the mandate of each PPS should be clear and cooperation arrangements should be in place.

> <u>Canada</u>
>
> In the province of Québec, life insurers are allowed to receive deposits from their clients. Therefore, two protection plans are available: the AMF deposit insurance scheme applicable to eligible deposits and the Assuris protection plan applicable to eligible insurance policies written by life insurers.
>
> If an insurer receiving deposits experiences difficulties that undermine its ability to meet commitments to policyholders and depositors, appropriate measures and intervention options would be taken jointly by the AMF and Assuris, within their respective mandates.

32. Clarity in mandates and responsibilities, including those of the supervisor, generally help resolve difficulties. Issues concerning the sharing of information, the distribution of powers and responsibilities and the co-ordination of intervention are complex and should be handled in a clear and explicit manner, particularly in order to promptly identify institutions with problems and to use intervention powers.

Governance

33. The mandate and responsibilities of a PPS, particularly with respect to its involvement in rehabilitation and resolution of distressed insurers, should be clear.

34. There is a variety of ways that a PPS can be run. In general, however, a well-run PPS would have effective governance that takes into account the need for independent oversight and includes:

- solid internal control functions
- effective management
- a proactive and integrated method of assessing the risks to which it is exposed

- policies and processes to manage conflicts of interest.

35. The decision-making bodies of the PPS are usually the board of directors and senior management, including a chief executive officer.[10] They are responsible for governance of the PPS and are accountable to the PPS's stakeholders.

36. The board is often elected by the members (typically the relevant insurers licensed to conduct business in that jurisdiction). The size and composition of the boards vary by jurisdiction. Board members can include representatives from the insurance industry as well as public members and/or representatives of insurance supervisors. Many PPSs employ a permanent executive to oversee daily operations. They have the authority to make decisions about the PPS. The board of directors can establish board committees to fulfil specific governance roles.

<u>Canada</u>

Assuris' board of directors is composed of between nine and 12 (currently ten) members and PACICC has no less than five and no more than 15 directors. They are selected for their knowledge and experience in the insurance sector and in insolvency management and are elected at the annual general meeting. Unlike PACICC, all of Assuris's directors are independent from insurers.

For both PPSs, an industry advisory committee offers advice on insurance matters of strategic importance.

<u>UK</u>

Directors of the Financial Services Compensation Scheme (FSCS) are appointed by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) as the overseeing bodies. The non-executive directors are appointed in the public interest and are independent, acting in the best interests of the scheme, and may have insurance industry experience. The FSCS has an audit committee and a risk committee.

<u>US</u>

The operations of each state PPS are governed by a board of directors elected in accordance with the enabling legislation, plan of operations, and bylaws of the PPS. The board members are drawn from the insurance industry, although in some states, the state regulator may also sit on the board.

Daily operations of a PPS are primarily the responsibility of an executive director, sometimes referred to as an "administrator" or a "manager," engaged on behalf of the PPS by its board of directors. Depending on the activity level of the PPS, the administrator/manager may supervise staff of varying sizes; the administrator/manager also typically oversees work done for the PPS by counsel or other professional advisors.

37. Board members are chosen for their knowledge and experience in the financial sector and technical areas important to insurance and insolvency management. They also need to understand the activities of the PPS, the industry and the environment in which the PPS operates. Other skills, such as in consumer affairs or finance, can be equally important. In order to avoid conflicts of interest, independence criteria are used. Where a director has an interest in an individual insurer, this could create a potential conflict that needs to be managed.

38. Clear and transparent documentation within a PPS is important in facilitating good governance. PPSs normally document intervention guidelines that are followed when an insurer experiences difficulties. These guidelines set out intervention options and other measures that can be taken. The document clearly defines the primary roles and responsibilities of the main parties involved. Where the PPS has intervention powers, these should be included in a publicly available statement of a PPS's mandate and powers.

39. Involvement of the insurance supervisor in the PPS's governance will help to ensure sufficient alignment of the supervisory objectives and those of the PPS. This is also important for ensuring a clear mandate for the PPS.

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[10] This may not apply in all cases, For example, in Australia the PPS is administered by the supervisor.

40. PPSs' financial risk management and investment policies are, in general, conservative to avoid putting capital at risk and because funds have to be available promptly in the event that an insurer fails.

> UK: Extract from FSCS Annual Report and Accounts 2011-2012
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> *Financial risk management*
>
> FSCS's operations carry a variety of financial risks that include treasury risk and the effects of credit, liquidity, interest rate and currency risks. The principal financial instruments comprise HM Treasury loan arrangements, bank overdrafts and loan facilities, cash and short-term money market deposits.
>
> Other instruments, such as trade receivables and trade payables, arise directly from operations, but FSCS holds no financial derivatives. Related risks are managed in accordance with board-approved policies that are closely monitored, regularly reviewed and, where appropriate, externally benchmarked.
>
> Throughout the year, monies were placed mainly with the Bank of England. FSCS maintains a balance between readily available funds to meet cash flow requirements and flexibility in placing money-market deposits over periods not exceeding six months.
>
> HM Treasury borrowing facilities and commercial bank overdrafts, loan facilities and finance leases are also available for use. Given FSCS's funding arrangements, interest rate risk is presently considered to be low, and no instruments are currently in place to further mitigate any such risk.
>
> Where liabilities arise in a currency other than Sterling, these are covered by equivalent currency deposits, placed on terms that conform to board-approved policies. It is FSCS policy not to engage in speculative transactions of any kind.

Funding and contributions

41. There are several options for funding a PPS. Payments can be made into the fund before (ex-ante) or after (ex-post) the event, or a hybrid arrangement could be put in place. Initially the government may provide part of the funding. Clarity of responsibility for the funding, including the government's role, is an important part of the structure of the PPS. Eventually, however, the PPS is likely to apply a levy on its members. The levy could be a fixed amount or assessed based on the insurer's risk profile.

42. Funding arrangements should be formalized. Efficient funding is critical to maintaining public confidence in the insurance market. Inadequate funding could delay or jeopardise the resolution of an insolvent insurer. Funding levels can be established by:

- the PPS itself
- the law
- rules set or reviewed by the supervisor.

In the case of ex-post funding arrangements, amounts may be assessed at a level that is specific to the needs of a given insolvency.

Ex-ante funding

43. With ex-ante funding arrangements, insurers pay assessments with a view to accumulating and maintaining a fund that can be used in the event of an insurer becoming insolvent. Under this method funds can be built up slowly, and will be available immediately. This method may help to mitigate moral hazard as all relevant insurers (including the insolvent insurer) contribute to the funding. It may also reduce potential adverse knock-on effects of levying funds on the industry after the event (i.e. their impact on capital). Ex-ante funding arrangements provide opportunities to smooth the assessments paid by insurers over the course of a business cycle.

44. With ex-ante funding it is difficult to predict exactly how much funding will be needed to cover future insurer insolvencies. Collecting funds in advance results in (i) an opportunity cost of tying up funds that could be used for other purposes and (ii) increased administrative and governance costs associated with maintaining a permanent fund. As the amount of funding needed can be unpredictable – in particular, during a financial crisis – ex-ante funding tends to be conservative. As a result, when a need arises, the PPS may not have adequate funds, and additional assessments will be required. In this regard a PPS may need access to emergency liquidity to meet urgent costs (e.g. annuity payments) or unexpected costs. Where a fund is maintained, an important consideration will be appropriate protection of the assets of the fund, including the legal protection discussed in paragraph 29.

Ex-post funding

45. With ex-post funding arrangements, solvent insurers pay assessments after the insolvency has occurred. Under this method, solvent insurers have access to the funds until levies are required. This means that, until required, they form part of the insurers' assets and are able to be used for purposes other than funding the PPS (e.g. to earn interest or pay other liabilities), and do not incur costs to maintain a permanent fund. As there is no permanent fund, this negates the risk of funds potentially being used for other purposes and thus of not being available to the PPS when needed.

46. As assessments are paid after an insolvency has occurred, assessments upon solvent insurers can be less predictable since they are not based on a pre-determined formula. With ex-post funding, the insolvent insurer does not contribute into the ex-post fund that compensates its own policyholders. If an insolvency is a result of a systemic problem (such as an underperforming stock market), then some insurers may also be in a weakened condition and may not have the funds needed to pay some or all of the assessment upon them.

Spain

CCS's winding-up activity adopts an ex-ante system. Resources for CCS's winding-up are funded from a tax-type surcharge levied upon all policyholders (except for life policies), at a rate of 0.15% of the premium. In spite of the public legal nature of the CCS, its assets are independent from those of the state. CCS operates an equalisation reserve.

US

PPSs draw from several sources of funding to pay claims, including (1) the assets remaining in the insurance company (which are usually substantial and provide the primary source of funding payments to consumers in most insolvencies), and (2) ex-post assessments collected from member insurance companies. This funding mechanism was designed to use as much of the failed company's remaining cash as possible. The PPSs levy assessments on viable insurance carriers only to the extent that a shortfall remains after the available estate assets have been exhausted. In that case, the PPS assesses the healthy insurers who do business in that state, up to state-specified coverage limits (e.g., $300,000 for life insurance benefits) and annual limits (which are typically 2% of net direct written premium received in the year prior to the assessment for property and casualty insurance companies, and 2% of average annual premiums received during the three years prior to the assessment for life and health insurance companies).

A combined funding approach

47. PPS arrangements in some jurisdictions use a combination of both ex-ante and ex-post funding.

Korea The Korean PPS, which provides comprehensive coverage for all financial sectors, is funded mainly on an ex-ante basis. For insurance companies, a 0.15% levy of the arithmetic mean of liability reserves and premium revenue is required every year. The operator of the PPS, the Korea Deposit Insurance Corporation (KDIC) also levies a 'special contribution' on newly insured financial institutions which is a specific proportion of its paid-in-capital or equity capital. In addition to the ex-ante funded PPS, the Korea Insurance Business Acts requires non-life insurers to guarantee claims payments to third parties in respect of mandatory insurance contracts such as automobile insurance and pollution liability insurance, issued by a non-life insurer that becomes insolvent. Non-life insurance companies pay a contribution based on a proportion of earned premiums and liability reserves to the Non-life Insurance Association (NLIA) to guarantee the payment of insurance claims to a third party, if these cannot be met by an insolvent non-life insurer. This represents an ex-post funding arrangement. The NLIA may borrow funds from the government, the KDIC, or any other financial institution after approval from the Financial Services Commission (FSC). Non-life-insurance companies may guarantee the repayment of funds borrowed by the NLIA. Singapore Singapore operates separate PPSs for life insurance (PPF Life Fund) and general insurance (PPF General Fund). These are pre-funded (ex-ante) PPSs through the collection of levies from participating insurers based on aggregated protected liability (life) or gross premium income (non-life) in respect of the insured policies. Where the cost of failures exceeds the fund size, post-funded (ex-post) levies can be imposed. A target fund size is set up for both funds: for the PPF Life Fund, 0.61% of the aggregate protected liabilities, and for the PPF General Fund, 1.51% of the gross premium income. If each fund achieves or exceeds its target fund size, the Monetary Authority of Singapore (MAS) and the Singapore Deposit Insurance Corporation (SDIC) may conduct a joint review of the levy rates.

48. Under both methods, in setting the assessment amount, the number and capacity of insurers has to be taken into consideration. Funding of PPSs is not based on scenarios in which there is a system-wide financial catastrophe.

Assessing funding needs

49. When considering capacity and/or the appropriate funding mechanism for a policyholder protection scheme, it is essential to understand the nature of the claims arising under the covered products (life products versus non-life products) as well as the form of the last-resort mechanism (claims payment or business continuity through portfolio transfer).

50. A life insurer may need to make regular payment of benefits (e.g. annuities) to customers, and thus require instant liquidity (i.e. a loan facility may be required); however, many or most of its liabilities will not become due for a number of years after the company fails, which means that claims assessment and settlement are spread over many years and payments are made gradually. For that reason, less liquidity is required to meet the covered liabilities of a failing insurer than in the case of, for example, a bank whose consumer liabilities consist primarily of deposits contractually available to the consumer on demand.

51. For a non-life insurer, contracts are typically short-term and do not have an investment element.[11] In such cases, in contrast to life insurance, the policyholder can more easily switch from one insurer to another. Nevertheless, some short term liquidity may be

[11] Certain non-life insurance products can have features (such as guaranteed renewability, return of premiums, etc.) that create longer term commitments and risks for the insurer. There are also products such as single premium consumer credit and lenders mortgage insurance that cover risks over a period much longer than one year and thus create long term risk for the insurer.

required, for example to meet payments falling due under life policies, or for non-life insurance hardship cases.

<u>US</u>

Under the United States system, even a financial crisis of unprecedented proportions, involving insurers with unusually large shortfalls of assets to liabilities, could be addressed by using the assessment capacity of PPSs that would develop in the years following the initiation of receivership proceedings. Because a significant proportion of the insurers' liabilities would mature in future years, a resolution plan could provide for the "runoff" of those liabilities (i.e. payment of the liabilities from the receivership estate, "topped up" or enhanced as necessary by the PPSs, over the years in which the liabilities would by their terms mature). Such a runoff would only be paid from the assessment capacity of the PPSs in the years in which the payments would be made—not all in the year in which the receiverships commenced. In addition, PPSs have the ability to borrow today against future assessment capacity, in the event a liquidity need might arise.

52. If a risk-based contribution approach is used it may encourage insurers to mitigate risks to which they are exposed. However, since higher contributions are paid by insurers with high risk profiles, this approach could make the financial situation worse for insurers already in difficulty. Also, since insurers' risks will need to be assessed, this approach can add to the costs of implementation and operation.

Funding issues

53. Contributions by insurers to PPSs are in addition to solvency and other capital requirements. Therefore the PPS has to be aware of the impact of imposing financial assessments on insurance companies, and consequentially on consumers, while also recognising the need to ensure that funds are sufficient.

54. Under some systems, a PPS has the ability to abate or defer an assessment on an insurer if payment of the assessment would endanger the insurer's ability to fulfil its contractual obligations.

55. In the event that there are insufficient funds available to cover losses of more than one insurer at a time, PPSs require a plan for rebuilding an ex-ante fund in the event that the fund is drawn down. Sometimes government assistance is provided on a temporary basis. Also PPSs usually have substantial borrowing capacity, which includes lenders other than the government (see below).

56. Conversely, when contributions are assessed by a PPS ex-post, the PPS may refund any surplus to the industry if the cost of the resolution, including total compensation of the claims and fees, is lower than the amount collected. Refunds may also arise from recoveries from the estate of the insurer.

57. In some jurisdictions contract conditions may be modified to achieve the fairest solution among policyholders at the time of insolvency. The assumed interest rate may be adjusted prospectively to the market rate. As the funding comes ultimately from policyholders of other insurers, such contract condition changes are considered fair; otherwise the costs would be assessed solely from newly issued contracts. In addition, it may significantly reduce the funding needs from the industry or from the government and may help the orderly resolution of large life insurance insolvencies.

<u>Canada</u>

Assuris (life PPS) and PACICC (non-life PPS) are funded through contributions paid by members and are based primarily on regulatory capital requirements and also the premium income of insurers operating in Canada.

Assuris has fixed administrative assessments as well as three types of assessments that are based on the national premium income of each insurer:

- Specific assessments to cover funding needs and to fund the liquidity fund
- Loan assessments on a repayable basis to cover funding needs

- Extraordinary assessments to be levied where other assessments are inadequate to enable the corporation to cover funding need.

Assuris maintains a liquidity fund of liquid assets that can provide immediate support to the policyholders of a troubled member. When the board authorizes the corporation to make a financial commitment to a troubled member, a separate fund is established for those costs and obligations. Assessments on members to cover funding needs in connection with the troubled member are recognized as revenue in the separate fund. Assuris also has an administrative fund for income and administrative expenses not directly associated with an insolvency.

PACICC generally operates on an ex-post assessment basis. A few years ago, however, it adopted a temporary method of funding on an ex-ante basis to build up a compensation fund. Also PACICC has a line of credit, to obtain funds quickly if needed.

Germany

While approaches to PPS contribution mechanisms in the EU are heterogeneous, only Germany has a risk based approach – in respect of contributions to "Protektor". There are three categories based on the insurers' own funds and solvency which lead to different risk factors. These are used to assess contributions to the fund each year.

UK

The FSCS is funded by levies on all firms authorised by the FCA and the PRA. The FSCS's costs are made up of management expenses and compensation payments. For the purposes of funding the FSCS compensation costs, the FSCS levy is split into eight broad classes:

- deposits
- life and pensions
- general insurance
- general insurance intermediation
- life and pensions intermediation
- investment intermediation
- investments, and
- home finance.

The first three classes are referred to as the PRA classes, while the last five are referred to as the FCA classes.

Each firm's contribution is calculated on the tariff base applicable to the relevant class. Each firm contributes proportionally. A threshold for each class is set by the PRA and FCA by reference to what a particular class (taken as a whole) can be expected to afford in a year. The threshold sets the maximum that the FSCS can levy for compensation in any one year. The model operates on the basis that a class will meet the compensation claims from defaults in that class up to the threshold.

The amount that can be raised by levy in the year will vary depending on the funding class. Only FCA classes will receive support from other classes and so for PRA classes the amount that the FSCS can levy in any year is the individual class limit. For FCA classes it is the amount of the relevant FCA retail pool.

For intermediary failures the FCA retail pool will be contributed to by all FCA classes as well as the FCA provider contributor classes (which mirror the PRA classes). This gives FSCS access to £1.05bn in the event of a failure.

For an investment provider failure, the FSCS has access to £790m (the FCA provider contribution classes will not be required to contribute to an investment provider failure).

Borrowing powers

58. Some PPSs have borrowing powers that enable them to continue to perform their role when the funds available within the scheme are insufficient. PPSs can draw from "internal" or "external" sources. With respect to "internal" borrowing, a single PPS may have different accounts relating to the different types of insurance products it covers. A PPS may have governing laws or rules that permit borrowing between multiple accounts held by the PPS. Additionally, some PPSs have the authority to look to "external" sources of funding, taking third party loans secured by future levies or other collateral. In either case, such borrowing ability effectively increases the financial capacity by providing access to additional sources of funding.

Japan

In Japan, insurance policyholder protection schemes (Life Insurance Policyholders Protection Corporation (LIPPC) and Non-life Insurance Policyholders Protection Corporation (NIPPC)) may borrow from financial institutions, including banks, up to an amount stipulated in the law, where necessary, in order to perform their role in providing their financial assistance.[12] The borrowing is subject to approval from the Commissioner of the Financial Services Agency (FSA) and the Minister of Finance. The government may guarantee borrowing up to an amount approved by parliament. It should be noted that this "public support" is available only for the life insurance policyholder protection scheme at present. (See also Annex II.)

Korea

Korean PPSs operated by the KDIC can obtain additional funding through issuing bonds and borrowing, when necessary for resolution of insolvent financial institutions, from various entities including the government, the Bank of Korea, and insured financial institutions.

UK

The PPS has access to commercial or other borrowing facilities (currently £750m) and the potential to borrow from the UK National Loans Fund (this facility provides a substantial funding backstop but is not guaranteed). A more detailed discussion of the funding arrangements for the UK's Financial Services Compensation Scheme is provided as an example in Annex I.

US

In practice, individual state PPSs' capacity has seldom been approached in an insolvency. In the rare cases when they may be approached, the PPSs have the ability to borrow against the security of future assessments to meet current needs.

Coverage

59. In determining a PPS's coverage a jurisdiction needs to strike a balance between what can be expected by policyholders and what a PPS can be expected to cover. Factors to consider will include seeking to ensure that the PPS provides a minimum level of protection to policyholders, without resulting in overreliance on the PPS (and the moral hazards described in paragraphs 17-18), and excessive costs.

60. In setting up its coverage, a PPS may consider measures such as loss-sharing between the insurer and policyholder, or deductibles.

61. Consideration needs to be given to what insurance products and investment-related insurance products (if offered by insurers) are covered or not covered by the PPS. Coverage may be considered more important for certain types of products than for others. Those with a social element (e.g. provision for old age security) or an investment guarantee may be considered to have a greater need for protection than more commercially-based products.

12 All member insurers are required to pay a contribution to the scheme in advance, the amount of which is determined based on the amount of technical provisions and insurance premiums.

PPSs could define exclusions for specific products, for some design features of specific products or for some classes of insurance (e.g. marine and aviation).

62. It is important that a PPS's coverage is easily understood by the public. Explanations on where there is different coverage for different types of products and what is covered when there are different compensation schemes in place (e.g. for life insurance products, non-life insurance products and other products such as deposits and securities) should be clear.[13] In general, most jurisdictions require insurers to disclose whether a policy is covered by a PPS, although some jurisdictions prohibit such disclosure for advertising and sales purposes.[14] Understanding of a PPS's coverage by the public and a jurisdiction's approach to disclosure are important in addressing the potential for policyholder moral hazard.

<u>US</u>

To avoid moral hazard, most states prohibit insurance agents and companies from using the existence of PPSs in any advertising or to induce the purchase of a policy. The reasoning behind this is that consumers could be led to believe that their policy is fully guaranteed no matter what happens to the insurer. However, while the existence of a PPS is not allowed in the advertising and selling of policies in the United States, information on the applicable PPSs is required in the policy documents provided to policyholders.

63. PPSs need to make clear whether coverage limits apply by contract or by policyholder. For example, if a policyholder has several contracts with the same insurance company, the PPS should explain if its protection limit is intended per policy or for the whole portfolio. PPSs should inform consumers if protection differs depending on whether the insurer is domestic or foreign, and whether the location of the risk affects the coverage.

64. Most jurisdictions establish who are eligible claimants and decide whether some claimants have priority over others for payments.

65. To discourage moral hazard, it is usual to limit payment levels. In addition to individual coverage limits PPSs may set aggregated limits, or require the policyholder to bear a proportion of the loss. A limit may be established per insolvency; coverage may be an absolute amount, a percentage of the value, or a combination of both.

66. In establishing coverage limits of a PPS, jurisdictions should consider factors such as:

- whether the limits will enhance confidence in the insurance industry
- the significance of the risk insured (i.e. the impact of reduced coverage could be more detrimental to some insurance types, such as annuities and employers' liability)
- the importance of risk coverage to the insured (e.g. critical illness insurance)
- whether the insurance protects third parties (e.g. liability insurance)
- whether a policyholder could be 'locked in' to a policy and unable to react to the deteriorating financial health of its insurance provider by moving the policy elsewhere (without incurring disproportionate costs)
- the impact of levies on the industry implied by high coverage levels
- the longevity of approach (i.e. the impact of frequent review of/change to coverage levels)
- how operating costs can best be contained
- the extent to which protection is offered by other protection schemes in respect of comparable products in other sectors (i.e. deposits and investments)

13 See ICP 19.13.1.

14 This is discussed in ICP 19 (Conduct of Business) – see 19.5.15 and 19.13.1.

- the extent of political pressure on the government to provide coverage.

67. Certain products or classes of products can be excluded from coverage. Jurisdictions usually eliminate large commercial policies (e.g. classes such as marine, aviation, and reinsurance). A PPS's purpose is usually to protect the interest of individuals and sometimes small business policyholders. Large commercial risks are more difficult to assess and could be too costly for a PPS to cover.

68. Normally limits on their coverage reflect the PPS's objectives and are set using relevant data (e.g. features of insurance products, concentration of players in the market). If the PPS's objectives change or, for instance, when the inflation rate is high or when new products are launched, its coverage limits may need to be reviewed. Some PPSs make automatic indexed adjustments to their coverage limits.

<u>Canada</u>

Ideally, in the event of insurer insolvency, in-force insurance contracts are transferred to a solvent insurer.

Assuris' proportional protection for life insurers provides at least 85% of the promised benefits of policies. Benefits are covered up to 100% if they do not exceed prescribed limits (Monthly income $2,000, health expense $60,000, death benefit $200,000, cash values $60,000). Proportional protection does not apply to deposit-type products issued by life insurers. These amounts are fully covered if they do not exceed $100,000.

PACICC's protection for non-life insurers provides a maximum of $250,000. PACICC protection covers all unpaid claims for losses arising from a single occurrence at the time the insurer is placed in liquidation. PACICC also reimburses 70% of the unexpired portion of the premium, to a maximum of $700 per policy.

<u>Germany</u>

In Germany, the portfolio will be transferred to the safety fund which fulfils or retransfers the portfolio. However, BaFin can reduce an insurer's liabilities for life insurance contracts in accordance with its financial situation.

<u>US</u>

PPSs pay covered claims within the limits set by individual state laws and the insurance contract. Claim caps allow the system to have sufficient money to pay claims and ensure "capacity" needed to serve all claimants. The PPSs play no role in setting coverage caps.

With respect to property/casualty coverage, typically, the claim limit for personal injury and property damages is $300,000 on covered claims, with some states covering as much as $500,000 to $1,000,000. One jurisdiction in the U.S. pays up to $5,000,000. Most PPSs pay 100% of statutorily-defined workers' compensation benefits.

With respect to life/health/annuity coverage, state PPSs offer coverage to resident policyholders as follows, with some states providing even more protection:

- fixed annuities: minimum of $100,000 in benefit protection and most states provide at least $250,000 in protection;
- health insurance: all states offer a minimum of $100,000 in coverage, however, most states provide $500,000 in coverage for medical insurance, $300,000 for disability insurance and $300,000 for long term care insurance;
- life insurance: up to $300,000 for life insurance death benefits and $100,000 for net cash surrender and net cash withdrawal values.

Functions of a PPS

69. The functions that a PPS performs differ between jurisdictions. [15] In some cases the PPS has a narrower function of paying claims in respect of an insolvent insurer. In other jurisdictions the PPS may also have a role in insurer loss minimisation, the rehabilitation of a distressed insurer or in resolution mechanisms that seek to ensure the continuation of insurance contracts. These other functions may include:

- providing financial support (to the distressed insurer or to another insurer which takes over the insurance business of the insolvent insurer)
- acting as a bridge institution.

70. The continuity of contracts can be an important element of protection for policyholders – especially life insurance – offering a more appropriate solution than claims/ongoing benefits payment by the PPS. In some jurisdictions PPSs are required to ensure continuity of contracts (such as through portfolio transfer).

UK

The PPS is obliged to secure continuity of insurance for life insurance (subject to certain conditions being met), and may do so for non-life insurance, by facilitating the transfer of business to another firm or by securing the issue of substitute policies.

US

With respect to contracts that the failed insurer has no right to cancel prospectively (e.g., annuities, most non-term life insurance contracts, and some types of health insurance contracts), the PPS must guarantee, assume, or reinsure the continuing insurance coverage. In other words, the PPS must make sure that the coverage continues, as long as the consumer pays any required premium.

Financial support

71. Financial support can be provided in the form of cash injections, lending, provision of guarantees, collateral, purchasing assets and capital injections.

72. Where their functions go beyond the payment of claims, to help rehabilitate or resolve a distressed insurer, PPSs can provide financial assistance to:

- the distressed insurer
- an insurer which acquires the distressed insurer or its insurance business.

73. Some jurisdictions allow PPSs to provide financial support for the resolution of life insurers only, or non-life insurers only, while in other jurisdictions support can be provided to both life and non-life insurers.

In Canada, France, Japan and Korea, for example, the PPS can provide financial support in the resolution of both life and non-life insurers, and in the UK, the FSCS can provide financial assistance to an insurer in financial difficulties if certain conditions are met. In Canada, an insolvent insurer as well as the succeeding company can be a recipient of financial support from PPSs.

In Germany the PPS cannot provide financial support in the resolution of an insurer. Similarly, in the United States, PPSs do not provide rescue or "bailout" financing for financially troubled companies.

Rehabilitation/recovery

74. Some PPSs can grant financial assistance to an insurer whose financial viability or solvency is at risk. Recovery assistance for an operating institution is normally provided when it is deemed to be less than the cost of winding-up the insurer, or if the winding-up of

15 Functions that PPSs in selected jurisdictions perform are summarised in Annex III.

the insurer might have an undesirable impact on the stability of the financial system. To minimise compensation risks, some PPSs can exercise special powers under which they enter into financial commitments with an insurer. These may take the form of loans, guarantees relating to the sale of assets, or other forms of guarantee or types of commitments that might include the acquisition of shares or assets, or the take-over of liabilities by the PPS or any of the insurer's subsidiaries. This assistance is generally contingent on changes to senior management or changes in the control of the insurer.

75. Sometimes for a rehabilitation process to be successful, the value of policyholders' claims/benefits has to be reduced, and in some cases policyholders are even prohibited from surrendering their contracts. Even with such measures, financial support may still be needed to revitalise the operations of the insolvent insurer.

Transfer of business

76. Some PPSs provide financial support to companies that succeed the insolvent insurer. This is allowed, for example, in Australia, Japan and Korea. Some jurisdictions limit the amount of financial support to a succeeding company to the corresponding additional administration costs or to the net cost that the PPS would have incurred in a payout.

Bridge institution

77. When an insurer becomes insolvent, and if a purchaser is not found immediately, either the insolvent insurer is put into liquidation or the insurer is managed on an interim basis until a purchaser of the insurer or its insurance business is found. Interim management on this basis can be referred to as acting as a "bridge institution". A bridge will normally be a short-term operation to preserve functions and franchise value pending a sale or transfer, and may involve the establishment of a separate insurer or be undertaken by the PPS itself. PPSs which serve as run-off companies may look for opportunities to enhance efficiency by transferring a portfolio to another insurer.

In France, Japan and Korea a PPS can be used as a bridge institution in the resolution of both life and non-life insurers, and in Canada only for life insurers.

The bridge institution function can be carried out by the PPS itself or by a subsidiary established by the PPS (as in Canada). Germany (life and health) allows only the PPS to work as a bridge institution, while Canada and Korea allow only PPS subsidiaries to do so. Japan allows both (in respect of life insurance).

In the United States, for non-cancellable contracts, such as life and annuity contracts, the PPS continues coverage based on the terms originally agreed between the policyholder and the (now-failed) insurer. This is often accomplished by the negotiation of an assumption reinsurance arrangement, under which a healthy carrier agrees to assume all or part of the policy liabilities of the failed insurer in exchange for a transfer of assets to support the liabilities. In other cases, the PPS simply assumes the covered liabilities of the insolvent insurer for whatever period is required for the liabilities to run off. A combination of both approaches can also occur, in which the PPS assumes the covered liabilities for some period of time, after which a healthy carrier takes over the liabilities via assumption.

Claims payment

78. In jurisdictions where a PPS is in place, claims[16] are paid either to policyholders directly by the PPS or indirectly through the insolvent insurer, its successor (purchaser), or the liquidator. A PPS can help to facilitate the timely payment of claims more efficiently than through a formal insolvency procedure, and serve the interests of policyholders who may otherwise be negatively affected by delay in receiving payment.

16 i.e. compensation in respect of claims that the insurer is unable to pay.

79. The claims payment function differs according to the insurance product. Most (but not all) non-life products are short-term and can be resolved quickly. Some jurisdictions limit the payment period to a specified period after the insurer becomes insolvent. However, the longer term nature of life products means that claims payments may need to be made over a longer period; this poses a problem where another insurer cannot be found to take over the contracts. Also, claims in respect of certain types of non-life insurance (such as casualty and workers' compensation) can take a significant amount of time to resolve.

80. Some PPSs make direct payments to policyholders; others do not. If a purchaser is found for the insolvent insurer during the payment period, then the insurance contracts are transferred to the purchaser. Once the contracts are moved, they are managed by the purchaser. Where policyholder claims are dealt with through an insolvency procedure, the respective roles of the liquidator and the PPS should be clearly understood. It may be helpful if the liquidator is required to assist the PPS in handling claims.

81. Where the PPS is subrogated to the rights of the policyholder, subrogation rights of the PPS should be clearly specified. A PPS has subrogation rights when it pays money or provides coverage to a policyholder in respect of an insurer's liability. The PPS is subrogated to the policyholder's former right to collect against the insurer, or against other parties who may have caused or contributed to the loss. This means that the PPS receives whatever amount the policyholder was entitled to receive under the contract. The preferential treatment of insurance claims over most other creditors in a winding-up means that the PPS has a better chance of recovering claims payments, thus reducing the cost to the industry through levies needed to recover a shortfall. If recoveries under subrogation rights exceed the claims payments made, the balance can be passed on to policyholders.

Australia

Following the failure of HIH Insurance Group, the PPS administrator was responsible for the scheme's day to day administration, including managing the call centre and website; receiving applications and assessing their eligibility; coordinating the claims management and payment process; and reconciliation of the proof of debt with the liquidator.

Canada and Japan

Life and non-life insurance claims are paid to policyholders indirectly usually through the insolvent insurer. In Canada, a PPS is subrogated to the rights of the policyholders.

Korea

Life and non-life insurance claims are paid to policyholders directly by a PPS.

Spain

In its winding-up activity, CCS is subrogated to the rights of the policyholders and pays them directly.

US

The function of a PPS is to process, adjudicate and pay claims coming due in much the same way that the insurer would have done, had it not failed. Essentially, the PPS "steps into the shoes" of the insolvent company to pay claims consistent with a state's insurance code and, by law, policyholders are at the "head of the line" of an estate's creditors. Covered policyholders are paid promptly by means of the PPS mechanism.

Triggers

82. The trigger(s) for the involvement of a PPS may depend on the functions that the PPS serves. Often the trigger is tied to an insolvency proceeding for an insurer or an indicator of an insurer in a distressed financial condition. It is important that the insolvency regime recognises the role of the PPS in the insolvency proceedings and that the trigger(s) for a PPS are made explicit (such as in the enabling legislation or operating rules) so as to have understanding and certainty as to when a PPS becomes involved.

Insolvency proceedings

83. Insolvency proceedings of an insurer may be triggered by events initiated by different parties depending on the insolvency (legal) regime - the debtors, creditors, the supervisors, the PPS or the insolvent insurer.

84. PPSs have to understand what and who can trigger insolvency proceedings - not only for all the potentially different types of member insurance companies, but also for other entities of a financial group to which an insurer may belong.

Early intervention by a PPS

85. Often a PPS's involvement in the case of a troubled insurer occurs before insolvency proceedings begin. The effective intervention of a PPS can help to reduce the cost of an insurer insolvency, where appropriate in light of the supervisory framework, insolvency regime and the supervisor's intervention powers.

86. There is often a prolonged period of negotiation with a troubled insurer before events trigger an insolvency. At first the PPS and supervisor may work with the insurer to try to find a solution to keep the company solvent. During this period, however, the PPS may work on grouping segments of business and developing deals so that some or all policies can be transferred to other insurers immediately after the company is placed into liquidation. The aim is to have an orderly and cost effective resolution, ensuring that policyholders' claims can be paid.

<u>Canada</u>

For both Canadian PPSs, trigger events are the issuance of a winding-up order that initiates insolvency proceedings for an insurer covered by a protection plan. Liquidation of an insurer may be triggered by various events initiated by different parties (debtors, creditors or supervisors). With respect to life companies, guides to intervention, as agreed with the primary regulators, outline Assuris' involvement at various stages prior to insolvency.

<u>Germany</u>

BaFin can order an entire portfolio including the underlying assets to be transferred to the respective guarantee scheme where:

- an audit of the insurer´s management and financial position concludes that the insurer will no longer be able to meet its insurance obligations in full, but it appears to be in the best interests of the insured that a liquidation is avoided, or
- the insurer notifies BaFin that it has become insolvent and other measures seem insufficient.

<u>Spain</u>

The trigger for the CCS to commence winding-up activities comes from the Ministry of Economy and Competitiveness (nationwide insurers) or the Autonomous Regional Government (local insurers).

<u>US</u>

By statute, PPSs are "triggered" once a state court finds that an insurance company is insolvent and orders it into liquidation, assuming the failed insurer is a "member insurer" of the PPS. As a practical matter, however, PPS involvement should begin even earlier so that the PPS can immediately undertake its statutory duties upon liquidation. This calls for involvement as soon as it appears that there is a significant possibility of liquidation, which point may be reached even before the insurer is under administrative supervision or in conservation or rehabilitation.

Cross-border issues

Cooperation between PPSs

87. Many insurers sell their products on a cross-border basis via a local branch or on a services basis. In these cases the insolvency of the insurer affects policyholders of the home and host jurisdictions. Depending on the arrangements, PPSs may cover policyholders in one or in several jurisdictions, including where a PPS's coverage is on the basis of the location of risk. Coverage for cross-border business needs to be understood by the PPS, the relevant supervisors, and policyholders. Where policyholders in more than one jurisdiction are concerned, cooperation agreements between PPSs are important, including agreements on the handling of claims.

88. Where cooperation between PPSs is necessary, the framework for this cooperation should be clearly defined, with specific powers and responsibilities established.[17]

89. Although details of a cooperation agreement depend on the specific circumstances in the jurisdictions and will vary, typically they include:

- requirements for regular updates, such as providing basic information about the PPS
- requirements for ad-hoc communication in cases of insolvency (e.g. classes of insurance concerned, number of policyholders, compensation details)
- distribution of tasks regarding claims handling on a cross-border basis, such as specifying a point of contact for policyholders in their home jurisdiction regarding claims, claims assessment and compensation on behalf of the other scheme
- reimbursement and handling fees, covering costs arising from participating in the compensation process on behalf of another scheme
- provisions for the sharing and protection of confidential information
- resolution of disputes between schemes.

European Union

Article 26 of the EIOPA Regulation[18] stipulates that EIOPA may contribute to the assessment of the need for a network of Insurance Guarantee Schemes which is adequately funded and sufficiently harmonized. In June 2011 EIOPA published a report on the Cross-border Cooperation Mechanisms between Insurance Guarantee Schemes in the EU, and in May 2012 it published a report on the role of Insurance Guarantee Schemes in the Winding-Up Procedures of Insolvent Insurance Undertakings in the EU/EEA.

In this report, Member States were asked whether a foreign insurance undertaking (third country[19] insurance undertakings or those established in Member States or both) with branches could become a member of an IGS in their jurisdiction (either on a voluntary or compulsory basis). Eight Member States reported that insurance undertakings from non EEA third countries can (sometimes subject to certain conditions) become a member of an IGS, either on a voluntary or compulsory basis. As regards insurance undertakings from EU/EEA Member States, a few Member States require that branches of these insurance undertakings become members of the host-state insurance guarantee scheme, only where the insurance guarantee scheme from the home state does not provide equivalent protection to policyholders established in the host Member State.

17 In May 2013 the International Forum of Insurance Guarantee Schemes (IFIGS) was launched to facilitate and promote international cooperation between insurance guarantee schemes and other stakeholders with an interest in policyholder protection. The IFIGS aims to strengthen relationships between insurance guarantee schemes around the world and provide a platform for exchanging ideas and discussing common issues.

18 Regulation no 1094/2010 of the European Parliament and of the Council

19 i.e. outside the EU/EEA.

Home and host jurisdiction responsibilities

90. Where the PPS of the home jurisdiction protects all policyholders irrespective of whether the insurance contracts concern policyholders of the home jurisdiction or a host jurisdiction sold via a branch or on a services basis (so-called home-jurisdiction system), it is important for the PPS to:

- communicate relevant information to all policyholders concerned, including those in the host jurisdiction(s), filing claims[20]
- put in place a claims handling procedure that ensures adequate and timely payments for home and host jurisdiction policyholders.

91. Claims handling between the PPS and policyholders in the host jurisdiction could be facilitated by a PPS in the host state, serving as a point of contact. This does not mean that the host necessarily has to make a prepayment. These arrangements should be set out in an agreement between both PPSs, taking into account the legal systems of the jurisdictions concerned and cooperation mechanisms between supervisors.

92. Where the PPS of a home jurisdiction of an insolvent insurer does not protect policyholders in host jurisdictions, policyholders in the host jurisdiction may be protected there by a local PPS.

93. There are cases where the PPSs of both the home and host jurisdictions are responsible for covering policies sold on a cross-border basis. In these cases local legislation requires the insurer to be a member of both schemes. This ensures that all holders of policies sold on a cross-border basis are protected. Where this is the case agreements are needed specifying:

- how tasks will be distributed and how compensation costs will be split
- who will be responsible for responding to policyholder claims in the host jurisdiction
- what will be the levels of compensation, deductibles, etc.
- how policyholders in all jurisdictions will be treated fairly
- what will happen if one PPS advances compensation on behalf of another, and what formal agreements are needed or guarantees to ensure repayment
- what happens when one scheme compensates policies and the other one is designed to take over the portfolio of the insolvent insurer (mainly in the case of long-term insurance)
- resolution procedures in respect of any disputes that may arise concerning claims handling and payout of compensation involving more than one PPS.

94. Funding mechanisms might also take into account the financial participation of foreign insurers or branches in the PPS. When they are members of the PPS, they may be required to participate in its funding. This is closely related to the choice of a home- or host-jurisdiction supervisory principle. Under a home-jurisdiction supervisory principle, branches of foreign companies are not required to become members of the home jurisdiction's PPS. This could result in policyholders of the branch not being covered by PPS protection unless the head office also operates a home-jurisdiction PPS approach. However, this situation can be mitigated through voluntary or mandatory membership of all insurers operating in a given jurisdiction.

20 In the EU, PPSs communicate on an informal basis.21 As defined in ICP 23: Group-wide supervision (paragraph 23.2.1)

95. A consequence of doing business internationally, and given the different approaches to PPS design and scope in different jurisdictions, is that potentially the same insurance products are covered by more than one PPS. This can be expensive for insurers as they may be required to pay levies in more than one jurisdiction. Cooperation between jurisdictions should be considered where there is the possibility of multiple coverage, to avoid unnecessary costs.

Example: An insurance company, domiciled in jurisdiction A, has a branch in jurisdiction B.

If both A and B have a PPS that covers the portfolio in B, this results in multiple coverage and multiple cost in respect of the portfolio in B.

As a solution, a dispensation could be given in respect of the insurance company in A, allowing it not to be required to provide PPS coverage for its insurance portfolio in B if an equivalent PPS is in place for the insurance portfolio in B. Only if there is no PPS in jurisdiction B should A integrate the branch portfolio within its PPS coverage. A and B would treat the cross border aspect reciprocally by means of the same harmonisation rule. As a result PPS coverage would be available for all policyholders and multiple coverage eliminated.

Insurance groups, conglomerates and contagion risk

96. An insurance group generally exists where there are two or more entities of which at least one has a significant influence on an insurer.[21] Different entities of an insurance group may be covered by different PPSs. Also as noted above, international insurance groups may participate in PPSs in many jurisdictions.

97. In the case of the insolvency of an insurer within an insurance group, consumers may have difficulty in understanding what coverage levels apply for different products offered by different entities of the group, as coverage may not be the same for each product. Also, different views could exist regarding the protection needs of consumers of different products, depending on which protection plans are involved. Appropriate measures should be taken by PPSs and other protection plans to make the position clear.

98. Where relevant, PPSs should document how they will cooperate with other protection mechanisms regarding the protection available to insurers that are part of a financial group.

99. When a financial conglomerate[22] or any entities of its group are in trouble, all protection plans involved may become interconnected. The failure of an entity that is part of a conglomerate may cause financial distress or even insolvencies in other entities of the group and may therefore affect more than one protection plan. In particular, if the group owns a bank or other financial institution, upheavals in non-insurance business may spread to the entire group, including its insurance operations. The solvency of insurance entities within the group may be put at risk from failures in other parts of the conglomerate.

100. When designing a PPS jurisdictions may take into account the jurisdiction’s approach to dealing with financial contagion risks. Although financial stability matters may not be a main objective of a PPS, increased contagion risk could place more pressure on the PPS’s obligations.

101. Whilst PPSs for insurance products and protection plans for other financial products have their own procedures for handling troubled institutions, the impact of contagion risk may mean that normal procedures may be disrupted. A sudden event in one part of the conglomerate could trigger instability elsewhere and undermine the confidence of consumers and stakeholders in other parts of the conglomerate. In extraordinary circumstances this could result in disturbances in the insurance market and the entire

21 As defined in ICP 23: Group-wide supervision (paragraph 23.2.1)

22 “Any group of companies under common control or dominant influence, including any financial holding company, which conducts material financial activities in at least two of the regulated banking, securities or insurance sectors”, as defined in the Joint Forum’s Principles for Supervision of Financial Conglomerates (2012)

financial system. Where such a crisis develops events could quickly move matters out of the hands of protection schemes and into the hands of government. To mitigate this a PPS should have legal protection that ensures its funds can only be used for the purposes for which it has been created. It will enhance consumer confidence if this is done in a transparent manner.

102. Domestic and cross-border cooperation and coordination in crisis management may help to minimise distortions.[23] Effective group-wide supervision may be beneficial and help to facilitate the effective functioning of the PPSs involved.

Supervisory considerations

Cooperation between PPS and insurance supervisor

103. Clear roles and responsibilities for those involved in the case of a distressed insurer are important. PPSs and the relevant supervisory authorities should cooperate fully, including in cases where there are cross-border issues, contingency planning and scenario exercises. This will be particularly important where the PPS has a role in the insolvency of the insurer or has functions that go beyond making compensation payments. Information exchange procedures should be put in place when the PPS is established. Some jurisdictions have pre-warning mechanisms, whereby the PPS is made aware of the potential wind-up of an insurer (or other regulatory intervention) that could result in a call on its resources. These coordination mechanisms can be formal or informal. In either case, confidentiality agreements will be needed between the different bodies to allow confidential information to be exchanged.

104. In some jurisdictions, the insurance supervisor and PPS may undertake joint monitoring of insurers whose risk is assessed as high. In some cases the PPS may become directly involved in some aspects of supervision in respect of an insurer that is considered at risk.

105. In some jurisdictions the framework for cooperation and coordination between the PPS and insurance supervisor is formalised through a Memorandum of Understanding.

Canada

OSFI has published a Guide to intervention of federally regulated life insurance companies. The objective of the Guide is to promote awareness and enhance transparency of the framework for intervening with federally regulated life insurance companies. The Guide outlines the types of involvement that an insurance company can normally expect from OSFI by summarising the circumstances under which certain intervention measures may be expected and describing the coordination mechanisms in place between OSFI and Assuris and other pertinent parties.

Québec

The Autorité des marchés financiers (AMF) has also published Intervention guidelines for Québec-chartered life insurers and member companies.[24] The Intervention guidelines will guide stakeholders in choosing the actions and measures that can be implemented, either by the AMF or Assuris or jointly, as soon as a Québec-chartered life insurer and Assuris member company experiences difficulties that may jeopardise its ability to meet its commitments to its policyholders and other beneficiaries and, where applicable, its depositors.[25] The guidelines set out the respective responsibilities of, and cooperation between, the AMF and Assuris in respect of

23 See ICPs 25 (Supervisory Cooperation and Coordination) and 26 (Cross-border Cooperation and Coordination on Crisis Management)

24 Autorité des marchés financiers: Intervention guidelines for Québec-chartered life insurers and Assuris member companies, April 2013. See http://www.lautorite.qc.ca.

25 Life insurers in Québec are allowed to solicit and accept deposits. They must hold a licence to that effect issued by the Deposit Insurance Scheme of the AMF.

intervention in the case of life insurers licensed in Québec that are at risk of not being able to meet their commitments to policyholders.

European Union[26]

In its report on the Role of Insurance Guarantee Schemes in the Winding Up Procedures of Insolvent Insurance Undertakings in the EU/EEA, although only France reported the existence of a legal provision between the supervisor and the IGS, various Member States:

- suggested the existence (or potential existence if needed) of an informal flow of information between the supervisor and the IGS before the decision to wind up the insurance undertaking (four Member States);
- emphasised the absence of legal constraints to such flow of information, or the empowerment of the supervisor to deliver such information (four Member States).

Eight Member States reported an absence of a pre-warning system. Two Member States noted that the supervisory authority is required to warn the IGS of the withdrawal of the insurance undertaking's authorisation.

Korea

The Financial Supervisory Service (FSS), the Bank of Korea, and the Korea Deposit Insurance Corporation (KDIC) signed a MOU for exchange of financial information and cooperation in January of 2004. However, in the process of containing the 2008/09 global financial crisis, a need emerged for a better way of minimising systemic risks through early identification of and response to risk factors and enhancing cooperation amongst relevant organizations. Therefore, in September of 2009, this MOU was extended to the Ministry of Strategy and Finance (MOSF) and the Financial Services Commission (FSC), which are directly and indirectly responsible for the resolution of insolvent financial institutions, to reinforce the information-sharing mechanisms necessary for the smooth execution of each organisation's mandate.

In order to respond more efficiently to the rise in risk factors as a result of financial market developments, KDIC can request a joint examination of a weak financial institution with the FSS. The purpose of the joint examination is to establish a cooperative system amongst relevant organisations and to increase efficiency by minimising the administrative burden on insured financial institutions. Under the MOU, the KDIC can select insured financial institutions which are assessed as high risk or those requiring a review of their risk management practices. The FSS and the KDIC then can examine those institutions together and urge their management to address risk factors.

Singapore

The Deposit Insurance and Policy Owners' Protection Scheme Act (DIPPSA) explicitly requires the MAS to set levy rates and make necessary regulations addressing such issues as how to classify PPS scheme members into different categories, what criteria and procedures are needed for determining these categories, what is an appropriate size of PPS funds (in consultation with the SDIC) or other matters that the MAS considers necessary. The Act also requires the MAS to consult with the SDIC when it comes to amend or vary any regulations under this Act.

The principal functions of SDIC with respect to the PPS are levy collection, management of the PPS funds, making payments, and consumer education. In the event that policies are to be placed into run-off, the SDIC sets up a company to take over the policies and may outsource the administration of the policies to a third party. The MAS makes the decision on whether to trigger payouts using the PPS's funds.

UK

Memorandums of Understanding exist between the Financial Conduct Authority and the Financial Services Compensation Scheme, and similarly between the Prudential Regulation Authority and the Financial Services Compensation Scheme, which are publicly available and include matters such as: respective responsibilities; cooperation; information exchange; consultation; funding; budget and financial reporting.

106. If the insurance supervisor determines that the insurer's difficulties have deteriorated to such an extent that the insurer's solvency is seriously compromised, and that the insurer

26 See https://eiopa.europa.eu

may, in the short term, be unable to meet its commitments to its policyholders, various forms of action may be available that aim to secure the insurer's viability. The insurance supervisor and the PPS should coordinate in taking such action.

107. The insurance supervisor and the PPS should analyse the tangible and intangible costs, as well as other advantages and disadvantages of each intervention option. They should compare these with the costs that may arise from winding up the insurer, including the costs that may need to be borne by the PPS and, if relevant, by the insurance supervisor. Before determining which option to pursue the insurance supervisor and the PPS should ensure that it is in the interest of policyholders. Options that seek to ensure the continuity of insurance contracts (e.g. purchase-and-assumption transactions or portfolio transfers) will require the involvement of one or more sound institutions.

108. If the insurer's assets are insufficient for it to meet its commitments to policyholders, the insurer may need to be wound up. The insurance supervisor and the PPS should coordinate their involvement, and an efficient means of doing so may be through a joint working group. The working group may make recommendations for an orderly winding-up, in addition to serve as a forum for the coordination and exchanging information. It should be aware of the winding-up costs and the costs of compensating policyholders under the terms of the PPS.

109. If an insurer becomes insolvent, the PPS should collaborate with the liquidator to promote the rapid transfer of insurance policies to a solvent insurer to the extent possible. The insurance supervisor and the PPS should coordinate their work in the winding-up process and may possibly have an active role in the winding-up.

Insurance supervisor's role

110. Effective supervision and early intervention by the supervisor can help to reduce the likelihood of an insurer failing. Where an insurer does fail, the insurance supervisor will be concerned that policyholders' interests are protected and that the insurer can be resolved effectively. PPSs can contribute to both of these objectives; insurance supervisors therefore have a strong interest in the operation of PPSs that affect the policyholders and insurers under their jurisdiction.

111. As discussed in the introduction, PPSs help to support achievement of the supervisory objectives. For a PPS to be effective it needs to be supported by a well-functioning supervisory system; a PPS should not be seen as a substitute for a sound supervisory system.

112. Insurance supervisors need to be aware of the policyholder protection schemes that apply to insurance contracts issued by insurers under their responsibility. This will be particularly important in connection with crisis management plans, and may involve cooperation with supervisors in other jurisdictions, such as within the context of cross-border business or a supervisory college.

113. While PPSs are generally overseen by a board of directors, the insurance supervisor may also have oversight authority which may include:

- reviewing the PPS's plan of operation
- performing an audit of the scheme
- reviewing of financial statements and annual reports.

In some jurisdictions, appointment to the PPS's board and changes to its internal rules and policies are subject to the approval of the insurance supervisor. For example, in the UK the FCA and PRA also set the FSCS's rules and appoint its directors.

114. Where the PPS is separate from the supervisor it should be operationally independent, but nevertheless with a clear chain of accountability and appropriate cooperation.

115. In some jurisdictions the supervisor's risk assessment of insurers is used by the PPS, for example in setting the level of contributions to the fund, where these include a risk-based component.

<u>Singapore</u>

The Monetary Authority of Singapore's (MAS) risk assessment is a factor in determining the level of funding contributions. The deposit premium is discriminately levied based on risk categories of PPS members: low, medium low, medium high, and high. These categories depend on MAS's CRAFT[27] supervisory rating of the insurer.

<u>Korea</u>

The KDIC is planning to implement in 2014 a risk-based premium system as a way to help financial companies achieve sound management and to ensure fairness in charging premiums. The revised Depositor Protection Act (DPA) requires mandatory adoption of the risk-based premium system, which may take into account risk assessments performed by the insurance supervisor, the Financial Supervisory Services (FSS).

Conclusion

116. Where they exist, PPSs are part of the financial safety net, providing protection to policyholders in the event of an insurer's insolvency. They aim to provide benefit not only to individual policyholders but also to society and the economy, by promoting confidence in the insurance industry. PPSs can support the IAIS's objectives of developing and maintaining fair, safe and stable insurance markets for the benefit and protection of policyholders and contributing to global financial stability.

117. The features of a PPS aim to meet public objectives and to mitigate risks. When designing a PPS, factors such as how it will be funded and the kinds and extent of claims it will cover need to be considered. A PPS should be designed in light of the nature of the insurance industry in the jurisdiction, as well as the jurisdiction's cultural and legal framework. However, consideration should also be given to features that could give rise to risks such as reduced discipline and moral hazard for insurers, policyholders, supervisors and policymakers, for example, where high or no limits apply to the PPS's coverage. The costs of a scheme will also be a factor in an overall assessment of the contribution that a PPS may make in a jurisdiction.

118. Where a PPS's functions extend beyond claims payment, a PPS can be useful in facilitating the continuation of insurance policies and facilitating the transfer of these to a solvent insurer. These additional functions (which can include assisting in portfolio transfer, providing financial assistance, acting as a bridge institution) not only help to protect policyholders but can also contribute to the effective resolution of an insolvent insurer.

119. As PPSs are a last resort mechanism they should not be over-relied upon. In this context their effectiveness is supported by well-functioning supervisory and winding-up/liquidation regimes, as set out in the ICPs; the existence of a PPS should not be seen as a substitute for either of these.

120. It is important for insurance supervisors to understand the operation of PPSs that affect the insurers and policyholders under their jurisdiction. The supervisor often has a role in the governance and oversight of the PPS and this can help to ensure that the objectives of the supervisor and the PPS are aligned and mutually supportive. Close cooperation between

27 The Common Risk Assessment Framework and Techniques (CRAFT) was developed by the MAS to assess the risks of a financial institution and its internal controls and risk management.

the insurance supervisor and the PPS is also important; coordinated, early intervention in the case of a distressed insurer can help to minimise disruption, promoting the protection of policyholders and the efficient resolution of the insurer. In respect of cross-border business, close cooperation between supervisors regarding PPS arrangements in the relevant jurisdictions is important.

Protection mechanisms within the supervisory framework

1. The main purpose of policyholder protection schemes is to provide protection to policyholders in the event of an insurer's insolvency. In addition to the solvency requirements within the supervisory framework, many jurisdictions have established a policyholder protection scheme, or schemes, that operate outside the supervisory regime. Other jurisdictions choose to provide protection against an insurer's insolvency through mechanisms within the supervisory regime, such as through the ring-fencing of assets that support the insurance liabilities, or though providing preferential treatment for policyholder claims in an insolvency. As such measures fall within the supervisory framework such tools provide protection in a different way to a guarantee/protection scheme. Some of the mechanisms within the supervisory regime are described below.

Graphic 1: Protection mechanisms within and outside the supervisory framework

<table>
<tr><th colspan="6">Policyholder Protection Mechanisms</th></tr>
<tr><td colspan="6">Within the supervisory framework</td></tr>
<tr><td colspan="2">Tied Assets
(claims payment, bridge institution function)</td><td colspan="2">Preferred Claims
(claims payment function)</td><td colspan="2">Others
(e.g. segregated funds, collateral - function depending on instrument)</td></tr>
<tr><td colspan="6">Outside the supervisory framework</td></tr>
<tr><td colspan="6">Policyholder Protection Schemes (PPS)
(claims payment + bridge institution + sometimes financial support function)</td></tr>
<tr><td colspan="4">General PPSs covering: life, non-life, health insurance (the subject of this paper)
Ex ante / ex post funding
Different levels of coverage (limits)</td><td colspan="2">Third party liability insurance
(specific schemes for compulsory insurance (e.g. motor) or with a social element (e.g. workers' compensation))</td></tr>
</table>

Tied assets

2. Some jurisdictions require insurance companies to earmark and separately maintain assets to cover policy liabilities or classes of liabilities. This approach to protecting policyholders in the event of a failure is referred to as "tied assets". With this approach, if there is a failure, no special funding is needed, as the tied assets serve this purpose, effectively providing funding before the event. There is no separate accumulation of a fund, and hence no external levy towards a fund. The effective cost of this protection is supported directly by each insurer.

3. Generally the features of tied assets schemes are:

- the insurer's potential liability (technical provision) for each policy is estimated and a corresponding amount of assets is earmarked or "tied"
- the value of the assets is monitored to ensure that they always cover 100% of liabilities
- the tied assets can only be held in certain asset classes, with limitations on concentration and counterparty risks
- if regulations are breached or if interests of policyholders are violated, the regulator can block the tied assets, withdraw the licence of the insurer or put the insurer into bankruptcy
- in the event of a failure, the assets can be used to satisfy policyholder claims
- in the case of a portfolio transfer, the tied assets are also transferred.

4. Tied assets provide policyholder protection and:

- require no extra funding
- require no additional, external administration
- interact with the resolution framework
- can be transferred to another insurer, along with insurance contracts, assuring contract continuity.

5. With this approach, specific assets are set aside to compensate policyholders if an insurer becomes insolvent. If the level of technical provisions proves to be inadequate, or if the quality of assets supporting them deteriorates, there may be some risk of policyholders not being paid in full. However, the monitoring role of a) the insurer's internal control functions and b) the supervisor in this regard help to ensure that such level remains adequate. Only where these two levels of defence fail would there be a potential residual risk.

6. In some cases a tied asset approach is supported by the operation of a PPS for certain types of insurance, in particular compulsory insurance lines, providing an additional layer of protection for these types of cover.

Examples of tied asset arrangements

Austria

Austria has a guarantee scheme whereby certain policies are considered "protected". Technical reserves for the protected policy must be listed and maintained in the form of earmarked assets by the insurer. The assets are monitored by a designated trustee to ensure that the dedicated assets are indeed present and sufficient. Transactions of earmarked assets can only be made with the approval of the trustee. When an insurer becomes insolvent, these earmarked assets constitute a special fund in the bankruptcy procedure for the benefit of policyholders.

Switzerland

In Switzerland insurers are required to hold individual guarantee funds whose assets are earmarked, where if the insurer fails, policyholders have first priority over these tied assets. The tied assets have to cover all technical provisions and an additional safety margin – in respect of both life and non-life insurance – at all times. Tied assets can only be held in certain asset classes, with limitations on concentration and counterparty risks. The regulations on tied assets are strictly monitored by the supervisor. In addition to being used to discharge claims, tied assets may also be used in the case of a portfolio transfer, in which case the assets are also transferred. If regulations are breached or the interests of policyholders violated, the regulator can block the tied assets, withdraw the licence of the insurer or put the insurance undertaking into bankruptcy.

In Switzerland PPSs also apply for compulsory insurance including statutory pension insurance and workers' compensation, which are considered part of the social security system.

Segregated assets

7. In some jurisdictions funds that relate to specific types of insurance business, or to specific policies, are ring-fenced and held in separate accounts. These funds cannot be accessed to support other liabilities of the insurer.

Canada

Segregated funds are investment funds administered by Canadian life insurers. The assets in these funds are separate from the general funds of the insurer and are dedicated exclusively to the holders of units in the funds. In addition, where guarantees have been given for values at death or maturity, a reserve is held in the general funds of the company for the guarantees.

Guernsey

Guernsey has adopted the concept of a protected cell company (PCC) and an incorporated cell company (ICC). A PCC is one legal entity which is subdivided into a core, which contains the capital of the insurer as a whole, and individual cells, which can be capitalised separately or rely on the core for support. Legislation provides that the assets of each cell are segregated so that no claim against any one cell (or the core) is covered by funds from any other cell. Separate cells can be used, for example, to separate the life insurance funds relating to different policyholders within the PCC. An ICC also uses the cell concept, and provides an extra layer of legal protection as each cell is separately incorporated.

Preferred claims

8. Some countries grant policyholders a priority claim on the assets of the failed insurance company corresponding to the technical provisions.

European Union

Articles 76 and 275 of the Solvency II Framework Directive stipulate that (re)insurers establish technical provisions for all insurance obligations towards policyholders and beneficiaries which correspond to the amount they would have to pay if they were to transfer their (re)insurance obligations. In a winding-up proceeding insurance claims that are covered by these technical provisions take absolute precedence over any other claim against the (re)insurer.

US

In the United States, state receivership laws generally confer priority creditor status on claims against the "estate" of the failed insurer that arise from the insurer's direct policies of insurance. Since receiverships follow an "absolute priority rule," all claims at the insurance policy level must be paid *in full* before any payments may be made on lower-ranking claims, such as general creditor claims, claims in respect of subordinated financing, or equity claims.

Case studies and examples

An event resulting in the establishment of a PPS

The Mannheimer Case

The Mannheimer Lebensversicherungs AG (Mannheimer Life Insurance Company (ML)) was a subsidiary of the Mannheimer Holding and a life insurer with a long tradition (founded in 1922 as Kronos Deutsche Lebensversicherungs-Bank AG).

In the early 1990s ML significantly increased its capital-based life insurance business by continuously offering an attractive surplus participation to its policyholders. Between 1990 and 2000 ML´s premium income went up from €167m to €1.1bn and capital assets from 413m to 3.2bn.

Keeping an annual surplus participation of 7.5% and having high distribution costs, ML needed an annual 19% return on managed assets. As a result ML dissolved unrealised gains and increased its investment in the equity market from 13% in 1995 up to 44% in 2001.

The years 2000 to 2003 were characterised by a constant decrease in the share market due to the bursting of the dot-com bubble, the impact of the 9/11 terrorist attacks, balance sheet falsification by Enron and Worldcom etc. As a consequence ML suffered massive losses and could no longer provide assurance that its liabilities under insurance contracts could be fulfilled at all times.

At the end of 2002 the German Insurance Association (GDV) initiated the establishment of the Protektor Lebensversicherungs-AG (Protektor) as a non-compulsory rescue company. Protektor is a licensed life-insurer held by the German market life-insurers which are all members of the GDV. On 1 October 2003 the portfolio of ML was transferred to Protektor which continued the insurance contracts and consolidated the portfolio.

At the end of 2004 the German legislator legally prescribed the establishment of a Federal Special Fund for German life insurers and German branches of non-EEA life insurers. This fund protects the rights of policyholders, insured parties, beneficiaries and other parties entitled to receive payments under life insurance contracts. In 2005 the Federal Ministry of Finance entrusted Protektor with the tasks and powers of the Federal Special Fund for life insurers.

Example of protection scheme covering mandatory insurance

Motor guarantee schemes are compulsory in Europe. These schemes have to provide third party liability insurance, and many also cover insurer insolvencies.

In Germany the Association Verkehrsopferhilfe e. V. (VOH), an institution of German motor liability insurers, helps road accident victims by functioning as a guarantee fund in the case of accidents occurring in Germany which are caused by unidentified or uninsured motor vehicles or in which the car is used intentionally and unlawfully as a "weapon" or where the motor liability insurer becomes insolvent.

Furthermore, VOH helps road accident victims in the case of accidents occurring abroad in its function as Compensation Body according to the 4th EC Motor Insurance Directive. Final claim handling takes place on behalf of VOH either through motor liability insurers authorized in Germany or through claims settlement agencies granted substitute power of attorney by them. The main purpose of this scheme is the compensation of accident victims.

Developments in PPSs arrangements – Japan’s experience

In 1996, a policyholder protection scheme called “Policyholder Protection Fund” was established.

Some weaknesses in the scheme, however, were noted. Participation in the Fund was voluntary. Also, the Fund was available only when there was a successor insurance company. In other words, the Fund could not function as a bridge institution to which insurance policies of an insolvent insurer were transferred temporarily. These weaknesses became obvious when a life insurer, Nissan Mutual, became insolvent in 1997, which was the first case of an insurer insolvency in Japan.

To address these weaknesses, the Life Insurance Policyholders Protection Corporation (LIPPC) and Non-life Insurance Policyholders Protection Corporation (NIPPC) were established in 1998. Unlike the Policyholder Protection Fund, participation in the LIPPC and NIPPC is mandatory; also, the LIPPC and NIPPC may borrow funds from financial institutions, and it became possible for the government to guarantee borrowings of the LIPPC. Moreover, the LIPPC and NIPPC can function as a bridge institution where there is no successor insurance company.

Nevertheless, the insolvency of the insurer Toho Life Mutual, in 1999, revealed another problem with the scheme. As a result of Toho Life Mutual's insolvency, it became highly likely that the LIPPC's financial resources would be exhausted if another insolvency case were to occur. To resolve this, the financial resources of the LIPPC were increased (i.e. insurers were required to increase their contributions to the scheme) in 2000.

Along with the reinforcement of the policyholder protection scheme, resolution regimes for insurers have also been improved based on the experience of consecutive insolvency cases in the late 1990s. After that, financial assistance from the LIPPC has not been used in the resolution of life insurer insolvencies in most cases, partly because insurance contracts can now be modified in the case of insurer insolvencies.[28]

Precedent for prioritising policyholders' interests in a liquidation

Les Coopérants (Québec, Canada)

On January 3, 1992, Les Coopérants, a Québec chartered life insurer, headquartered in Montreal, was ordered into liquidation under the Winding-up Act. This first-ever insurer to go bankrupt in Québec had an undesirable impact on the stability of the Québec financial system. The liquidation of Les Coopérants posed a steep learning curve.

At the time Les Coopérants was declared insolvent it had individual insurance contracts with 222,000 policyholders and group insurance certificate holders numbering 600,000.

To protect policyholder interests, Assuris (formerly Compcorp) successfully established the precedent that policyholders should receive priority in the liquidation of a life company.

Assuris' support also included guaranteeing that all policyholder benefits would be fully protected. Assuris' final accounting of costs indicates that CDN$180 million was required to provide this support.

Les Coopérants was facing very important problems. In the previous years, its diversification strategy was too largely focused on investments other than insurance that were not profitable, particularly real estate and other financial sectors.

The «Inspecteur général des institutions financières» (IGIF) (replaced by the «Autorité des marchés financiers» in 2004) considered that the assets of this insurer were insufficient to provide adequate protection of the policyholders. IGIF took various actions to remedy the situation, notably:

- taking restructuring measures to correct the situation through the sale of some subsidiaries belonging to the financial group;
- seeking a financial partner for this insurer;
- in 1992, assuming the provisional administration of this insurer, revoking its licence and beginning the liquidation process. It encouraged third parties to acquire or take control of the assets and liabilities of this insolvent insurer.

Sources: Assuris and AMF

28 In an insolvency case, technical provisions may be reduced up to 90% in principle and assumed interest rates may be adjusted prospectively to the market rate.

Detailed example of funding arrangements

UK's Financial Services Compensation Scheme (FSCS)

The FSCS is the UK's statutory fund of last resort for customers of financial services firms, paying compensation to consumers if a financial services firm is unable, or likely to be unable, to pay claims against it. The scope of the FSCS is greater than insurance: the scheme covers deposits; life and pensions (provision and intermediation); general insurance (provision and intermediation); investment (provision and intermediation) and home finance (intermediation).

The FSCS is an independent body, set up under the Financial Services and Markets Act 2000 (FSMA). The FSCS does not charge individual consumers for using its service. It is funded by the financial services industry on a pay-as-you-go basis.

The FSCS is funded by two types of levy: a compensation levy and a management expenses levy. The compensation levy pays the claims of eligible consumers. There is a limit (or 'threshold') on the total amount that each class of firms can be required to contribute to costs in any given year. The thresholds are set by the regulatory authorities (the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA)), which do so aiming to strike an appropriate balance between affordability and potential funding needs.

Compensation costs

If the FSCS class thresholds for insurance provision are exceeded in a particular year then the FSCS can also obtain additional funding from commercial or other borrowing facilities including the UK National Loans Fund (NLF). The terms of any borrowing would be negotiated on a case-by-case basis.

Management costs

The management expenses levy relates to the money raised to fund the FSCS's annual operating costs. The levy comprises:

- a specific costs element – which currently comprises costs associated with a particular class and will be allocated to that class; and
- a base costs element – which relates to general costs of the FSCS (not dependent on the levels of claims received), such as costs associated with staff salary, rent etc. which is paid for by all authorised firms.

The FSCS annual management expenses levy is subject to annual consultation and the limit is approved by the PRA and FCA boards.

The roles PPSs play in cross-border insolvencies

Confederation Life Insurance Company

The liquidation of Confederation Life Insurance Company (Confed) was the largest and most complex liquidation of a life insurance company in North America. In August 1994, Confed's policyholder liabilities were approximately $12.4 billion worldwide and it had in excess of $10 billion of assets under administration in various funds. In addition to its life insurance business, Confed operated other financial services businesses in a number of jurisdictions. Over a million people depended on Confed for income support of all kinds, including life insurance, health and disability benefits, and pensions. Confed operated in the United States and the United Kingdom through both a branch and subsidiaries and in Bermuda and Cuba through branches. It sold commercial paper of hundreds of millions of US dollars and of subordinated notes in British pounds and Luxembourg francs. After the failure of concerted efforts to rescue Confed and avoid a liquidation, winding-up orders were made in August 1994.

For the United States, the Confederation Life receiverships began in Michigan and Georgia in August 1994 with approximately $6 billion of policyholder liabilities in the United States split about equally among life/annuities, structured settlements (pay-out annuities), and GICs.

By the end of 1999, all US policyholders in all policy blocks had been paid in full, and the liquidating trust for illiquid assets and the separate account (for the pay-out annuity block) were dissolved. Moreover, all U.S. guaranty associations had been repaid, with interest, for policy obligations they had incurred. Additionally, monies in the U.S. estates in excess of amounts needed to pay policyholders and to fund a contingent "Plan Reserve" were transferred to the Canadian estate to pay general creditors. For example, one U.S. liquidator made an initial $85 million payment to Canada in 2000 and a $30 million payment in 2002. Even after 2004, the U.S. estate still held substantial funds to make additional payments to the Canadian estate after tax uncertainties were resolved and the U.S. estate was closed.

Confederation Life is significant in part due to the structure of the resolution plan. Because of the huge contingent liabilities confronting US guaranty associations if the estate's assets proved insufficient to fund scheduled liabilities, the guaranty associations were permitted to participate fully with the receiver in management and oversight of the processes both for the orderly liquidation of assets and the transfer of liabilities to healthy carriers. Substantial technical and financial input from the guaranty associations helped produce an outcome where the ultimate net funding required from the guaranty associations was essentially de minimis, notwithstanding the large size of Confederation Life's liability "book." Stated differently, the case shows how early and effective involvement of the guaranty system in a resolution plan can help minimize the social costs of a liquidation.

Cooperation and reacting to changes in economic conditions – Executive Life of New York

The New York Superintendent of Insurance placed Executive Life of New York (ELNY), which maintained structured settlement contracts, in rehabilitation in 1991. A rehabilitation plan was approved in 1992. For the past 20 years, the plan has been administered by the New York Liquidation Bureau on behalf of the New York Superintendent of Insurance. While operating in rehabilitation, ELNY has continued to make 100% of scheduled benefit payments due under all of ELNY's annuity contracts.

Sustained periods of adverse economic conditions and the financial crisis that started in 2007 caused a negative impact on the ELNY rehabilitation. Continuation of the existing plan was found to be no longer feasible and a solution to handle the continuing contracts was needed.

The New York Superintendent along with the Liquidation Bureau and the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) worked together to create a payment structure that would provide optimum protection of settlement payments for consumers. A new special purpose not-for-profit captive insurance corporation named Guaranty Association Benefits Company was created to be the benefit provider. Funding from NOLHGA members along with money in the current liquidation will be used to maintain payments to policyholders. The majority of contracts will continue to make payments at 100%; however, a minority will see their payments reduced. Additionally, a consortium of life insurance companies have established a separate "hardship fund" of at least $100 million to provide certain ELNY payees with the opportunity to obtain additional financial support based upon need.

The efforts taken in the case of ELNY show the importance of cooperation among those involved with insurer insolvencies (supervisors, policyholder protection schemes, etc.) in order to protect the interests of policyholders, especially as challenges can and do arise over the lifetime of the receivership process.

Improving effectiveness and efficiency

Implementation of Uniform Data Standards (UDS) in the United States

The formation of property/casualty guaranty funds began in the United States in the early 1970s. By the mid-1980s, when guaranty funds were becoming a factor in the insolvency process, most still maintained books and records which were largely manual. As insolvencies became larger and encompassed multiple states, guaranty funds started to automate their systems. A uniform system was needed to allow timely and efficient transfer of claims data from the database of the now insolvent insurance company to the guaranty associations so that guaranty funds could begin servicing claims. Thus, the Uniform Data Standards ("UDS") claim format was developed and implemented in 1995.

After using the UDS system for a period of time, it was also recognized that the financial reporting by guaranty funds to receivers should be matched to the standardized claim reports, with the added elements of expense that were administrative in nature and therefore not included in the transaction based claim reports.

The UDS "D" Record was designed to standardize the claims-related and administrative expense data requested, providing for efficiency, reconcilability and ease of use by both guaranty funds and receivers. In December 2007, the new UDS "D" Record for financial reporting was approved by the National Association of Insurance Commissioners with reconciliation capabilities for historical, non-detailed segments and with new features for future reporting.

Benefits of UDS "D" Record implementation include the following:

For guaranty funds, standardised reporting

- reduces the variety of formats required to be completed
- increases the opportunity to automate the process
- reduces manpower needs to compile the report
- speeds up the preparation and issuance of the financial report

For receiverships, standardised reporting

- facilitates the compilation of financial data from multiple guaranty funds.
- speeds up reconciliation with the "C" Record and Revenue sections
- allows for review and analysis of claim costs
- allows for review and analysis of individual guaranty fund Proofs of Claims

Functions that PPSs perform in selected jurisdictions

	Australia	Canada	France	Germany[29]	Japan	Korea	Spain	Switzerland[30]	UK	US (most states)
PPS for life	N	Y	Y	Y	Y	Y	Y	Y[31]	Y	Y
PPS for non-life	Y	Y	Y	N	Y	Y	Y	Y[32]	Y	Y
Pay claims [life]	N/A	Y (directly/ indirectly via successor) Specified limits apply to different types of products.	Y (directly/ indirectly via successor)	N	Y (indirectly via insolvent insurer/ successor)	Y (directly) 5-year	Y (directly – 95% on average)	Y	Y	Y (directly/ indirectly via successor) Specific limits apply to different types of products.
Pay claims [non-life]	Y 1-year	Y (directly/ indirectly via successor) Specified limits apply to different types of products.	Y (indirectly via successor) 5-year	-	Y (indirectly via insolvent insurer/ successor)	Y (directly) 5-year	Y (directly – 95% on average)	Y	Y	Y (directly) Specific limits apply to different types of products.
Bridge [life]	Y (the supervisor may set up a bridge life insurer)	Y	Y	Y (PPS)	Y (PPS/sub-sidiary)	Y (subsidiary)	Y (in the case of a portfolio transfer)	Y	N	N
Bridge [non-life]	N	N	Y	-	Y (PPS/sub-sidiary)	Y (subsidiary)	Y (in the case of a portfolio transfer)	Y	N	N
Financial support [life]	N/A	Y (insolvent insurer/succes sor)	Y (successor)	N	Y (successor)	Y (successor)	N	N	Y (provided cost would not disproportionat	N

29 In Germany, a PPS exists for health insurance with similar details to the life insurance PPS for the purposes of this table.

30 For Switzerland the information represents a PPS for compulsory motor insurance, statutory pension insurance and workers' compensation insurance. Protection is generally provided through tied assets.

31 Pension insurance is considered part of the social security system.

32 Workers' compensation insurance is considered part of the social security system.

	Australia	Canada	France	Germany[29]	Japan	Korea	Spain	Switzerland[30]	UK	US (most states)
									ely exec payout in a liquidation)	
Financial support [non-life]	Y	Y (insolvent insurer/successor)	Y (successor)	-	Y (successor)	Y (successor)	N	N	Y (provided cost would not disproportionately exec payout in a liquidation)	N
Types of FS [life]	N/A	Lending, guarantee, collateral, reinsurance, asset acquisition, capital injection	Cash donation	-	Cash donation, purchasing assets	Lending, guarantee, asset acquisition, capital injection	N/A	N/A	N/A	N/A
Types of FS [non-life]	Administration costs only	Guarantees, financial support.	Cash donation	-	Cash donation, purchasing assets, collateral	Lending, guarantee, asset acquisition, capital injection	N/A	N/A	N/A	N/A

Selected reference material

- EIOPA: *Report on the cross-border cooperation mechanisms between Insurance Guarantee Schemes in the EU* (June 2011)
- EIOPA: *Report on the role of insurance guarantee schemes in the winding-up procedures of insolvent insurance undertakings in the EU/EEA* (May 2102)
- FSB: *Key Attributes of effective Resolution Regimes for financial Institutions (*October 2011)
- IAIS: *Insurance Core Principles, Standard, Guidance and Assessment Methodology* (2011 & 2012)
- IAIS: *Insurance and Financial Stability* (November 2011)
- IAIS: *Issues Paper on Resolution of Cross-border Insurance Legal Entities and Groups* (June 2011)
- OECD (2013): *Policyholder Protection Schemes: selected considerations*, OECD Working Papers on Finance, insurance and Private Pensions, No 31, OECD Publishing. doi: 10.1787/5k36l8sz94g0-en

Further information on some of the PPS organisations referred to in this paper may be found on the following websites:

- Assuris (Canada): www.assuris.ca
- Financial Services Compensation Scheme (UK) (FSCS): www.fscs.org.uk
- International Forum of Insurance Guarantee Schemes (IFIGS): www.ifigs.org
- Korea Deposit Insurance Corporation (KDIC): www.kdic.or.kr
- Life Insurance Policyholder Protection Corporation (Japan) (LIPPC): www.seihohogo.jp
- National Conference of Insurance Guaranty Funds (USA) (NCIGF): www.ncigf.org
- National Organization of Life and Health Insurance Guaranty Associations (USA) (NOLHGA): www.nolhga.com
- Non-life Insurance Policyholder Protection Corporation (Japan) (NIPPC): www.sonpohogo.or.jp.
- Property and Casualty Insurance Compensation Corporation (Canada) (PACICC): www.pacicc.com
- Protektor (Germany): www.protektor-ag.de/english/protektor/104.aspx
- Singapore Deposit Insurance Corporation (SDIC): www.sdic.org.sg