POLICYHOLDER PROTECTION SCHEMES: SELECTED CONSIDERATIONS

For the International Forum on Insurance Guarantee Schemes, 13 May 2014

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- Some caveats:
  - The paper was issued in 2012, after a lengthy coordination process within the OECD's Insurance and Private Pensions Committee
  - Some data may be out of date
  - It mainly covers OECD members

Background to the paper

- OECD's Insurance and Private Pensions Committee (IPPC) agreed to examine policyholder protection schemes on a cross-sectoral, comparative basis, as part of a broader work programme on effective and efficient financial regulation.
- This paper updated work carried out previously by the IPPC on policyholder protection schemes (2001) and incorporates some comparative analysis with banks and private pension funds.
- The objective of this paper is to assess the merits of establishing policyholder protection schemes in the insurance sector, and consider appropriate design features for such schemes.

- **Moral hazard and cross-border aspects were of particular interest to the IPPC.**
- **Selected topics analysed:**
  - the rationale for a scheme;
  - funding and levies;
  - product coverage and membership;
  - coordination with other resolution mechanisms; and
  - cross-border aspects.

What is a policyholder protection scheme?

- **Policyholder protection schemes :**
  - "provide compensation to policyholders in the event of an insurer insolvency/failure and/or revocation of licence, thus guaranteeing, in part or in full, due payment of benefits or covered claims."
- **Strictly speaking, policyholder protection schemes have an explicit, guaranteed amount of coverage.**
  - However, for discussion purposes, this paper includes those countries with other forms of protection (*e.g.*, tied assets, priority status in insolvency, guarantees dependent on actuarial calculations or technical reserves) that, while providing enhanced policyholder protection, do not contain an explicit guaranteed amount (*e.g.*, Austria, Japan life insurance, Spain, and Switzerland).

Rationale and features

- **The establishment of a policyholder protection scheme reflects a judgement to provide guaranteed levels of protection for policyholders in the event of an insurer insolvency and spread the costs of such guarantees through the insurance system .**
- **First and foremost means of consumer protection in the financial system is to have a *sound legal and regulatory framework*, particularly *sound prudential regulation*.**
- **However, in some circumstances, financial institutions, including insurers, can fail, leaving customers vulnerable to economic loss and possible social hardship given the uncertain outcome of insolvency proceedings.**

Existing PPSs (● scheme with explicit guaranteed coverage, and ○ the amount of coverage depends on final recoveries from the insolvent insurer

	General schemes (life and non-life)	*General schemes covering life*	*General schemes covering non-life*	*Special scheme (selected non-life)*
Australia			●	●
Austria[a.]		○		●
Belgium				●
Canada		●	●	
Chile				
Czech Republic				●
Denmark			●	●
Estonia				●
Finland				●
France		●	●	●
Germany		●		●
Greece		●		●
Hungary				●
Iceland				
Ireland				
Israel				●
Italy				●
Japan		○[d]	●	
Korea	●			
Luxembourg				●
Mexico				
Netherlands				●
New Zealand				
Norway			●	
Poland		●		●
Portugal				●
Slovak Republic				●
Slovenia				
Spain[c.]	○			
Sweden				
Switzerland[e.]		○	○	●
Turkey				●
United Kingdom	●			
United States[f.g.]		●	●	●[f.]

Whether or not to have a PPS

- There are many countries with some form of a policyholder protection scheme, although coverage is often limited and, in many cases, restricted to a particular line of insurance.
- Countries which have comprehensive coverage of the insurance sector often tend to be those with larger financial systems or have experienced a severe financial crisis, which may not have necessarily stemmed from the insurance sector.
- The number and severity of insolvencies in the insurance sector, as well as their expected likelihood, will often influence the decision to establish a policyholder protection scheme.
- European Commission has issued a White Paper (2010) which proposes the establishment of an insurance guarantee scheme in each member state.

Rationale for the establishment of a PPS (1):

- ***A level of protection* against the effects of an insurer insolvency, (*e.g.*, Greece)**
  - When an insurance line is *mandatory* in nature (*e.g.*, motor insurance for owners of vehicles, fire insurance for those with mortgaged property)
  - Where insurance lines have specific features, particularly a *strong social and/or savings element,* there may be a significant expectation of protection.
  - The potentially *large exposure* facing a policyholder if an insurer solvency occurs (*e.g.*, loss of property or fire insurance coverage, in the event of a natural disaster or fire)

Rationale for the establishment of a PPS (2):

- **The needs of policyholders and *the speed at which payments can be made* (*e.g.*, claims payments, redemption of funds)**
  - If insolvency procedures do not permit payments to be made to policyholders quickly, households may be adversely impacted, depending on the insurance policies held (*e.g.*, life insurance policies that include funeral costs, motor insurance for repairs to be carried out, or marriage/birth insurance.
- **PPSs form an important part of the consumer protection regime in the financial sector.**

Rationale for the establishment of a PPS (3):

- ***Minimising potential taxpayer exposure*** **to insolvencies and involving the industry in failure resolution.**
- ***Level playing field considerations*** **with other non-insurance products may motivate the establishment of a policyholder protection scheme.**

Argument against establishing a PPS:

- ***Regulatory and supervisory framework for insurers*, combined with the *low frequency of insurer insolvencies* (and more so for large insurers) make a policyholder protection scheme redundant.**
- **Some jurisdictions provide relatively *strong protection to policyholders in the liquidation procedure of insurers (e.g.*, Germany, Italy, and Spain).**
- ***Potential costs* of establishing a policyholder protection scheme and the extent of any potential moral hazard effects would be expected to increase the frequency and/or severity of insurer insolvencies.**

Argument against establishing a PPS:

- In a small and concentrated insurance market where the failure of one insurer would have a large impact, a *policyholder protection scheme may prove inadequate* in covering policyholder claims.
  - A structural approach (*e.g.*, portfolio transfers) may be more appropriate and efficient means to protect policyholders and wind down the failed insurer.

Contagion in the insurance sector

- **Compensation scheme instill confidence in the industry, and thereby prevent any possible contagion.**
- **A "run" by policyholders may occur when an insurer sells products that are "banking" in nature (*i.e.*, containing a savings element and redeemable on demand), as was the case of Ethias in Belgium.**
- **However, policyholder "runs" may be limited in the insurance sector by the generally longer term time horizon of life insurance policies and the fact that there are penalties if the insurance contract is cancelled.**
  - The life sector might be susceptible to contagion effects in that the bankruptcy of a given life insurer could cast doubt on the soundness of other life insurers and may induce a gradual yet sustained "run" on insurers, perceived to be vulnerable.
- **Conglomeration of financial institutions might also give rise to intra-group contagion.**

Membership

- **Policyholder protection schemes in most OECD member countries require the participation of insurers whose lines are protected.**
  - Compulsory membership ensures consistency of treatment/protection of all insurers and consumers, and the prevention of adverse selection that would occur when protection is not uniform among all insurers.
- **The only exception is Spain, all non-life insurance policyholders are charged a premium for the funding of the overall scheme, which applies to both life and non-life policies.**

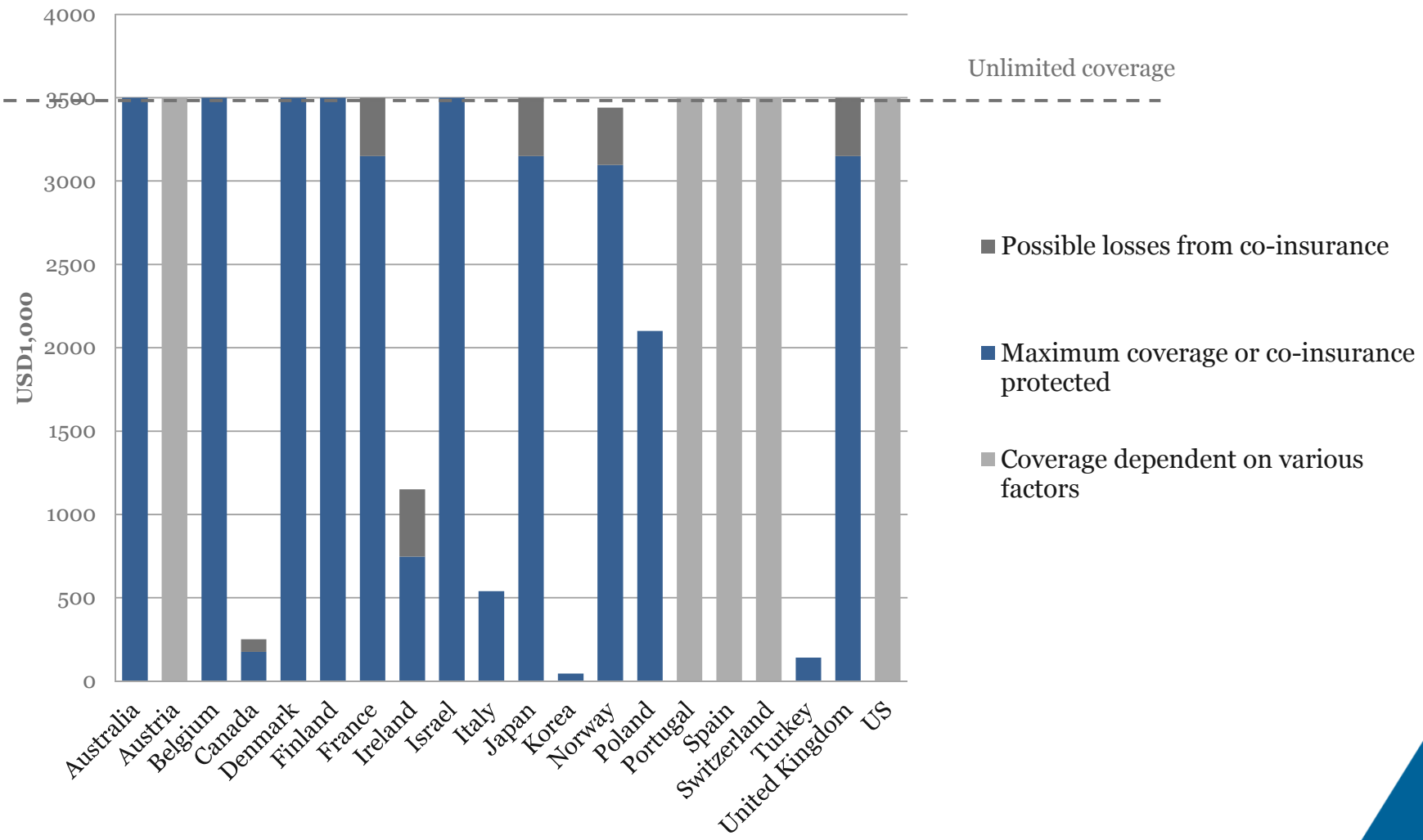
Moral hazard

- Moral hazard may be endemic to compensation schemes in insurance, or any other risk-sharing mechanism where there is asymmetric information.
- Policyholders may decide to ignore factors surrounding the financial condition or reputation of an insurer

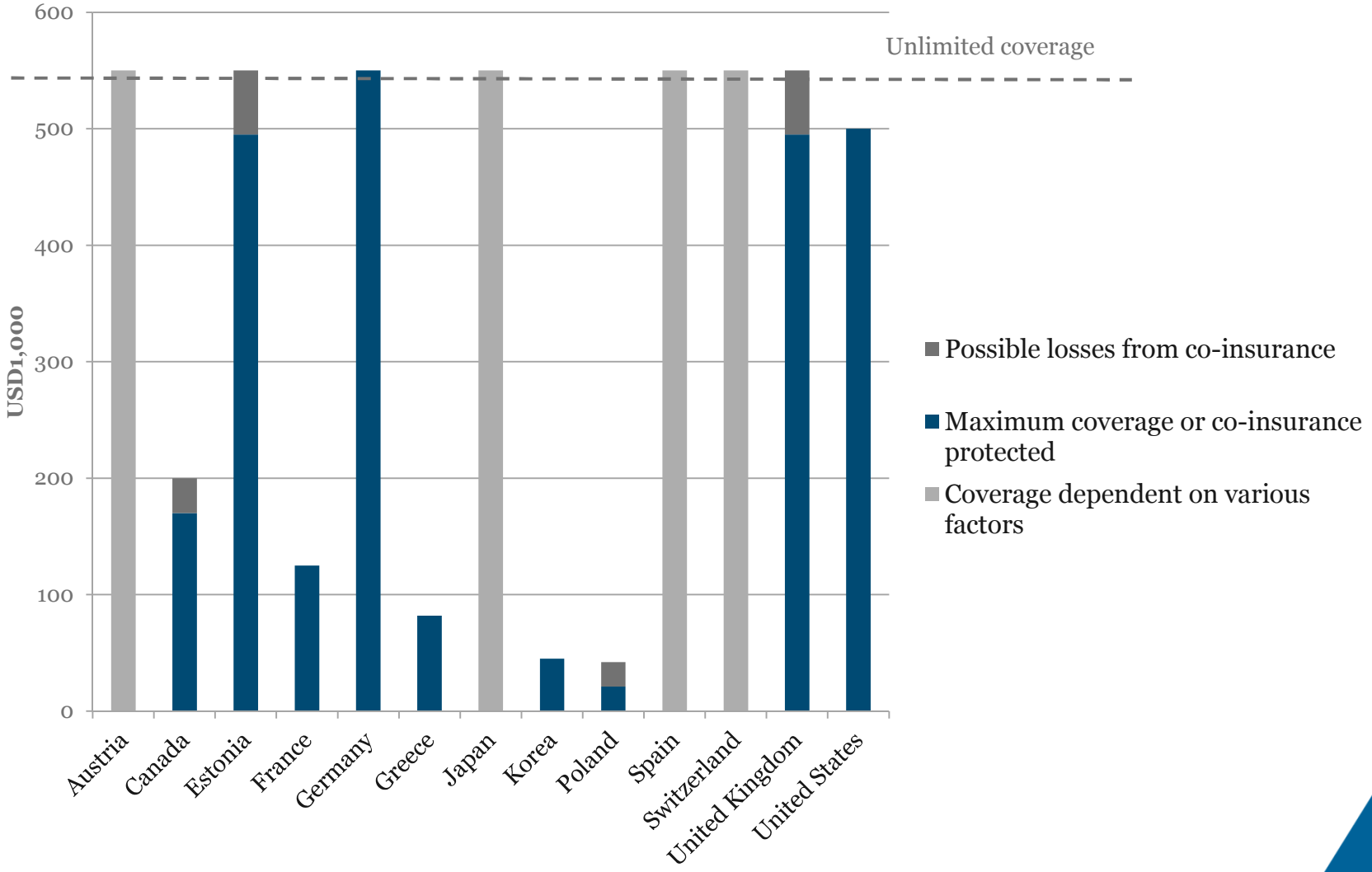
Moral hazard of…

- **Consumers: may be less inclined to assess the riskiness of an insurer, but make decisions based solely on attractive (*i.e.*, cheaper) premiums or higher returns (for saving products).**
  - However, it is unrealistic to expect that consumers to exert market discipline.
- **Insurance companies: With a PPS guaranteeing liabilities, costs could be shifted to the scheme, effectively providing a subsidy for the riskiest insurers and creating an incentive risk taking.**
  - However, insurers with a higher franchise value (*i.e.*, higher market value to book value ratio) may take less risk because there more to lose in an insolvency.
- **Financial authorities: prone to engage in regulatory forbearance, as there may be less political or reputational fallout arising from the failure of a financial institution as policyholders are protected.**
  - PPSs enhance the credibility of authorities' commitment to close an institution, and limit governmental exposure to bail out costs

Measures to limit moral hazard
--Coverage levels for non-life schemes--



--Coverage levels for life schemes --



--Coverage levels--

- The extent of unlimited payment coverage may be due to policies often being transferred to another insurance undertaking, making the possibility of a payout less likely.
- PPSs may be viewed as the *provider/guarantor of last resort*, providing a backstop should it prove difficult to transfer liabilities.
- To the extent that co-insurance is provided may reflect expected recoveries in the event of an insolvency.
- A balance between offering an adequate level of coverage for most policyholders, and limiting coverage levels in order to minimise the costs of the policyholder protection scheme needs to be struck.

--Co-insurance--

- Co-insurance: a situation in which the policyholder also shares the burden of an insurer's failure.
- Used when there is a defined, maximum coverage level (*e.g.*, Canada, Estonia, France, Ireland, Japan, Norway, Poland, United Kingdom).
- The level of co-insurance varies between 50% and 90%.

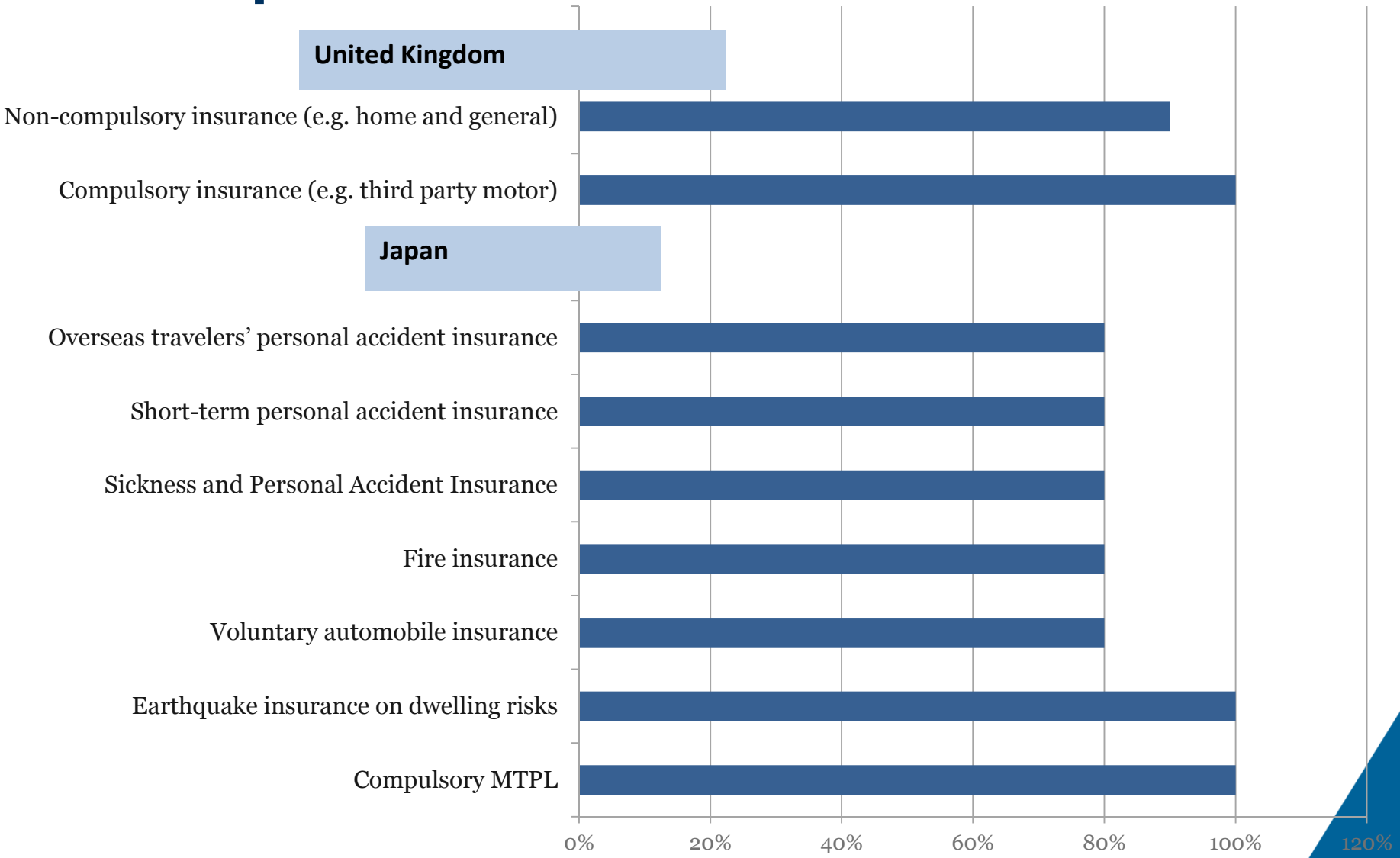
--Coverage and co-insurance: by product features--

	Short-term	Long-term	Social	Investment	Savings	Mainly corporate
Life Insurance						
Death		X	X		X	
Annuities		X	X	X	X	
Personal injury	X		X			
Accidental death		X			X	
Disability due to accidents or to sickness	X		X		X	
Marriage insurance, birth insurance		X	X		X	
Life insurance linked with investment funds		X		X		
Permanent health insurance	X		X			
Tontines		X		X		
Capital redemption operation		X		X		
Non-Life Insurance						
Accident (industrial injury & occupational diseases)	X		X			X
Sickness	X		X			
Land vehicles	X					X
Railway rolling stock	X					X
Aircraft	X					X
Ships	X					X
Goods in transit	X					
Fire and natural forces	X		X			
Other damage to property	X					
Motor vehicle liability	X		X			
Aircraft liability	X					X
Liability for ships	X					X
General liability	X					X
Credit	X					X
Suretyship	X					X
Miscellaneous financial loss	X					
Legal expenses	X					X

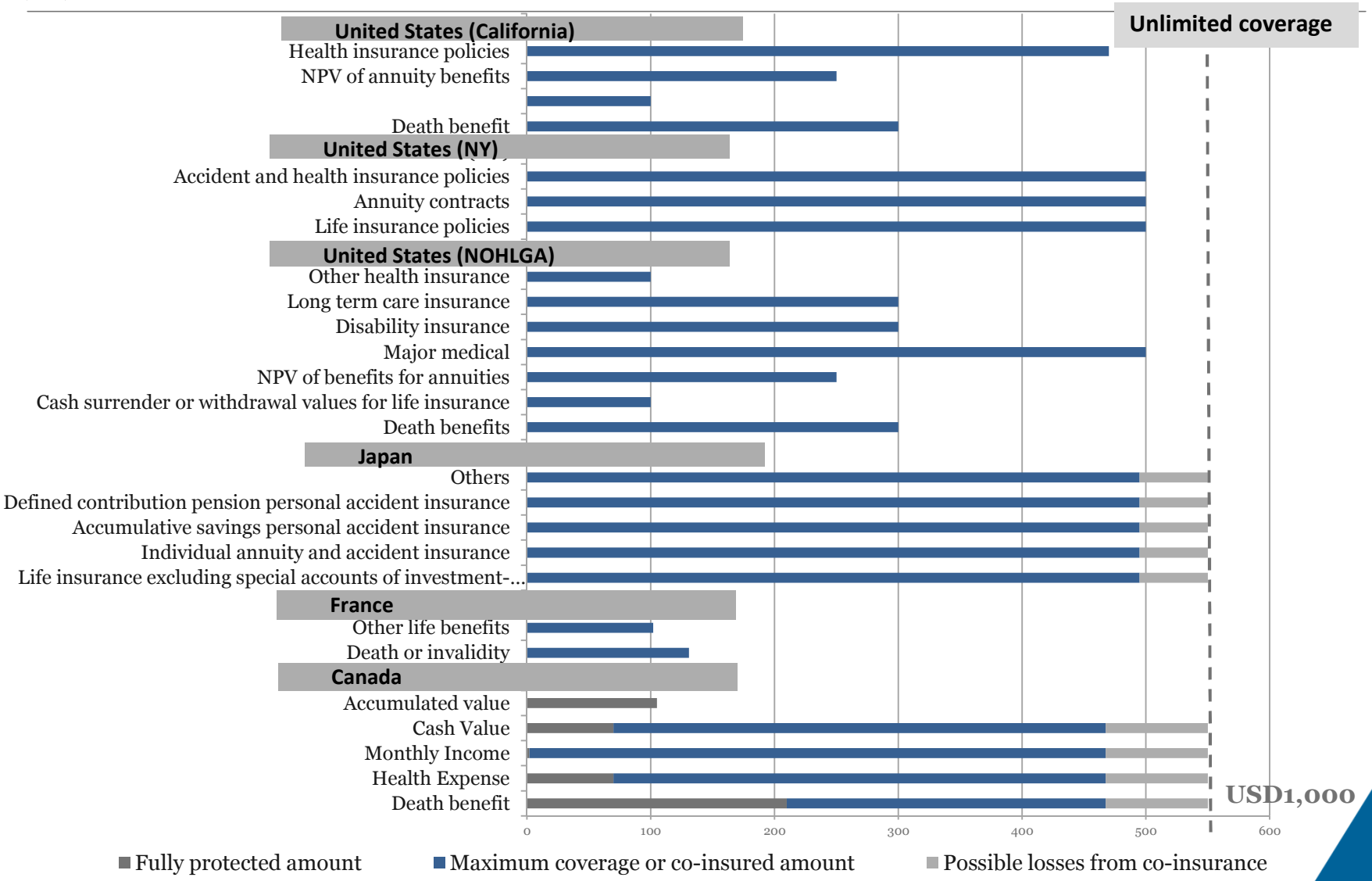
--by product features--

- The short-term nature of *non-life* products: compensation for claims may be sufficient
- Long-term *life products*: payouts may be over a longer period, and for products having an important social component, continuity of contracts could be an important element.
- *Social element*, the expectation of a full payout may be strong.
- Products with a *saving or cash value element* may need to be considered in light of deposit insurance.
- Products that require *prompt payment :* products with a savings or investment component, there may be an expectation of relatively prompt access to accumulated funds

--Co-insurance levels for non-life lines in the United Kingdom and Japan--



--Coverage in life lines--



Funding

- **Funding of a PPS is considered to be a key element that can affect the moral hazard of insurers.**
- **In terms of OECD member countries' practices, both *ex ante* and *ex post* funding are equally used, and some combine *ex ante* and *ex post* funding.**
- **The key determinant of the funding approach should be the *sustainability of funding*.**

Ex ante funding– the facts--

- ***Ex ante* funded schemes: Canada, Denmark, Estonia, France, Germany, Israel, Italy, Japan, Korea, Norway, Poland, Portugal, Spain, Turkey.**
- **Charging an annual levy which can vary depending on the level of funding.**
  - Italy has a high funding requirement at 5% of premiums or 0.5 euros per policy
  - Estonia, Greece, Israel, Japan, Korea, Poland, and Turkey charge annual levies as a percentage (0.038% to 2%) of gross premiums.
  - Australia charges levies for its motor scheme depending on the number and types of cars insured.
  - The Canadian life protection scheme assesses members based on their share of total capital required among members (using a three-year moving average).
  - Denmark also uses the number of policies for its non-life levies.
  - France charges a percentage of mathematical provisions (0.15%) as levies.
  - Germany uses net reserves (0.02%).
  - Ireland, Norway and United Kingdom base contributions on premium income.
  - Portugal charges the total amount of wages (0.15%) which are insured for its workers' compensation insurance.

Ex ante funding– the facts--

- **A large number of *ex ante* schemes have the power to impose additional contributions (*e.g.*, Canada, Denmark, France, Germany, Korea, Poland).**
  - The Estonian scheme can take out a loan in the event of insufficient funding, which would be funded *ex post*.
  - The Japanese schemes are able to tap government funding if the funds are depleted and the annual levy proves to be insufficient.
- **In Spain, *ex ante* funds are collected from policyholders, not insurers.**
  - Non-life insurance policyholders are charged 0.15% of premiums for the purpose of the policyholder protection scheme.
- **The Swiss MTPL scheme also collects *ex ante* funds from policyholders, although this is done together with insurance premiums, with a fixed amount per annum.**

Ex ante funding– the pros and cons-

Pros	Cons
• *Ex ante* funding helps to build up funds during normal (non-emergency) times in *counter-cyclical* fashion. • PPS with *ex ante* funding can play an active role in facilitating the transfer of the portfolios of a failed insurer if there is a provision for the schemes to provide possible *financial assistance* to those insurers taking over the portfolios. • May be better suited to handling a situation of *multiple insurer failures*, if such a situation were to arise.	•However, a key drawback is that *ex ante* funding tie up funds that could have been used for other productive purposes, creating opportunity costs. •*Ex ante* funding is likely to be reflected in the pricing of insurance products, hence shifting costs to current policyholders. •A possible risk where the scheme is run by the public sector, is that the funds might be appropriated by the government for another purpose.

Ex post funding—the facts--

- ***Ex post* schemes: Australia, Belgium, Finland, Ireland, Poland, United Kingdom, United States.**
- ***Ex post* funding can based on:**
  - gross premiums of each insurer (Finland, Poland)
  - premium income (Ireland and United Kingdom)
  - net reserves (Germany (private health))
  - Some countries do not have a predetermined method (Austria, Belgium)
  - United States (NAIC) recommends basing levies on marketshare in the state, with a cap set at a level of 2% of annual average premiums

Ex funding: pros and cons

Pros	Cons
• Enables the industry to spread the collection of funds over a number of years. • Increase the monitoring effects, as stakeholders bear the bankruptcy costs. • Incentives for financially strong insurers to press for effective regulatory oversight. • More appropriate for products where claim payments are typically made over time.	• Riskier insurers that end up failing will not have contributed to the funding. • Creates funding needs from the industry just when the insurance market may be facing difficulties.

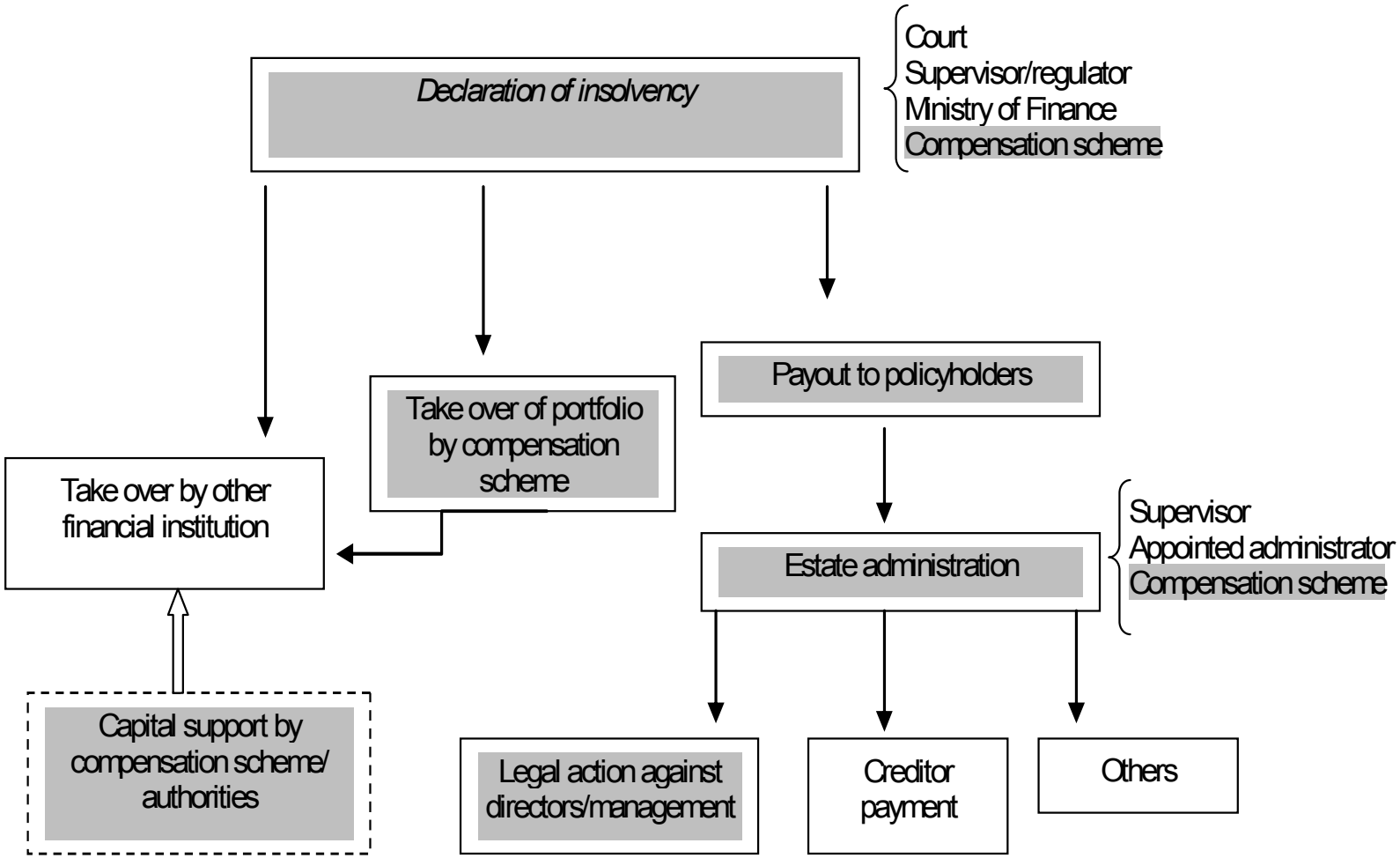
Additional contributions for funding

- ***Ex post* or *ex ante* schemes that can demand additional contributions:**
  - Belgium, Canada, Finland, Estonia, Finland, France, Greece, Ireland, Israel, Japan, United Kingdom, United States
  - Japanese scheme can benefit from governmental capital support
  - Korean scheme from funds of the deposit insurance
- **Often have a role in supporting the portfolio transfer of a failed insurer or in maintaining the continuity of contracts.**
- **The possibility of additional contributions is likely to become increasingly important as governments seek assurances from the industry to maintain confidence in the insurance sector and ensure adequate consumer protection, while limiting recourse to public financial assistance.**

Position within the resolution framework

- **Resolution of an insurer will vary depending on whether there is a dedicated insolvency framework for insurers, or whether the general corporate insolvency framework applies.**
- **Further, the stipulated involvement of the regulator/supervisor changes the manner in which the resolution is directed and its intervention powers**

Procedures during the insolvency of an insurer



International and cross-border issues --Treatment of non-resident persons

- **It is generally assumed that a policyholder is domiciled in the same jurisdiction as the insurer.**
- **The status of a non-resident's status may become important when:**
  - a previously resident person moves abroad and becomes a non-resident, or
  - the policyholder purchases an insurance contract while travelling to another country
  - increasing number of persons who purchase financial products overseas via the internet or brokers
- **Many countries ban cross-border solicitation of residents, but not transactions abroad that are initiated by the purchaser.**
- **The underlying assumption is *caveat emptor*, including not being able to benefit from consumer protection or coverage by PPS**

--Treatment of branches--

- **Home state principle:**
  - when the policyholder protection scheme covers policies issued by a domestic insurer that participates in the scheme, including its branches abroad.
  - Denmark, France, Germany, Ireland, Israel, and Spain
  - Many EU countries have a home state principle
- **Host state principle:**
  - when all insurers operating in the country, regardless of where they are headquartered, are required to participate in the scheme
  - Australia, Austria, Belgium, Estonia, Finland, Greece, Italy, Japan, Korea, Norway, United Kingdom and United States
  - Most non-EU countries have a host country principle

--Treatment of branches--

- Coverage is not even across the EU, which could lead to situations where there is uneven protection and burden in an insurance insolvency.
- Countries with large insurance groups, if not subject to home state principle, may find uneven protection of their products in each country.
- United Kingdom and Greek system are based on the location of the risk.
- Unless all countries that engage in cross-border insurance transactions have a compensation scheme, a host country principle may provide better protection and certainty for policyholders in general.
- There is a great deal of uncertainty with regards to the treatment of non-residents, and branches.

Conclusion

- **Main objective of PPS is protecting consumers, and promotes public confidence in the insurance industry.**
- **A PPS can protect policyholders against the detrimental effects of an insurer failure, particularly for most vulnerable and/or for those insurance lines or products with an element of social protection.**
- **Protection provided by a PPS can potentially lead to moral hazard, distorting the incentive structure of financial institutions operating in the field.**
  - Moral hazard can be limited through such mechanism as maximum coverage level and premium settings
- **Consideration should be given to tailoring policyholder protection schemes according to the lines being protected**

- **It is important that funding has a certain degree of flexibility to enable sufficient and sustainable funding for future or past events, regardless of ex ante or ex post funding.**
- **There is a lack of information on the extent and nature of cross-border transactions in insurance**
  - Even for EU countries where there is a greater likelihood of cross-border transactions taking place
- **Greater attention should be paid to the overall resolution framework when considering a PPS, including the creation of a seamless and integrated process.**

IPPC and IFIGS

- In the work programme of the IPPC for 2015-2016, many delegations have expressed a clear interest in the OECD looking further into policyholder protection schemes and in particular in the context of insurer insolvency.
- Thus, OECD is very interested in working together with the IFIGS to develop work outputs that are relevant to our mandates.

THANK YOU.

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