Insurance guarantee schemes

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PURPOSE: to present a White Paper on insurance guarantee schemes (IGS) whic sets out a coherent framework for EU action on IGS protection for policy holders and beneficiaries, in order to guard against the need for taxpayer involvement.

BACKGROUND: Insurance Guarantee Schemes (IGSs) provide last-resort protection to consumers when insurance undertakings are unable to fulfil their contractual commitments. They thus protect people against the risk that claims will not be met if their insurance company becomes insolvent.

Although not at the root of the crisis the insurance sector has proved far from being immune. Some important European insurers have reported particularly severe losses and have been forced to important injections of new capital.

Of the 30 EU-EEA countries, only 12 operate one or more general insurance guarantee schemes. This means that, measured in terms of gross written premiums, one third of the entire EU-EEA insurance market is not covered by any IGS in the event of an insurance company going bankrupt. Some 26% of all life insurance policies and 56% of all non-life insurance policies are unprotected.

Where IGSs are in place, they differ frequently in coverage. The lack of harmonised IGS arrangements in the EU hinders effective and equal consumer protection. This may lead to a loss of consumer confidence in the relevant markets and may ultimately put at risk market stability. It may also impede the functioning of the internal insurance market by distorting cross-border competition.

In order to remedy the existing regulatory loopholes and inconsistencies caused by the fragmented IGS landscape in Europe, the Final Report (Recommendation 5) of the de Larosière Group recommended setting up harmonised IGSs throughout the EU.

The same recommendation is included in the Preamble to the recently-adopted Solvency II Framework Directive. Furthermore, the Commission announced in its Communication of 4 March 2009 ‘Driving European recovery’ that it would review the adequacy of existing guarantee schemes in the insurance sector by the end of 2009 and make appropriate legislative proposals.

CONTENT: this White Paper raises a number of issues in relation to the introduction of a legally binding EU solution for Insurance Guarantee Schemes (IGSs) which provide last-resort protection to consumers when insurance undertakings are unable to fulfil their contractual commitments and to ensure a fair and comprehensive level of consumer protection in the EU as well as to guard against the need for taxpayers to foot the bill in case an insurance company is to collapse.

The Commission proposes **introducing a Directive** to ensure that all Member States have an IGS that complies with a minimum set of design requirements.

The Commission sets out its **preferable options** as follows:

Level of centralisation and role of the IGS: the idea of setting up a single EU-wide IGS covering all life and non-life policies written and purchased within the European Union has not gather sufficient political support. It may be considered at a later stage.

The Commission advocates the establishment of an **IGS as a last-resort mechanism** in each Member State. An IGS with the wider role of preventing insurance insolvencies would be able to guide a troubled insurer through its financial difficulties, enabling it to stay in business. It follows that IGS may step in when other protection mechanism have failed in order to prevent or mitigate the impact of an insurer's collapse.

Geographical scope: the Commission advocates harmonising the geographical scope of IGSs on the basis of the '**home country**' principle.The main advantage of the home country principle is its consistency with the 'home country control principle' which makes it easier to handle insurance default cases. Home country supervisors are responsible for prudential regulation, including solvency requirements, and for starting the winding-up process. Moreover, the home country principle is also in line with the deposit guarantee scheme in the banking sector and with the investor protection scheme in the securities sector.

Policies covered: the Commission advocates that IGSs should cover both **life and non-life insurance policies**. It does not extend to **pension funds** as defined by Directive 2003/41/ECor to **reinsurance**.

Eligible claimants: the Commission advocates that IGSs should cover **natural persons and selected legal persons**.

Funding: For an IGS to work effectively, appropriate fund-raising mechanisms are crucial. The Commission advocates that IGSs should be funded on the basis of ***ex-ante*** **contributions by insurers, possibly complemented by *ex-post* funding arrangements in case of lack of funds**, which should be calculated according to the individual risk profiles of the contributors. An appropriate target level for funding should be set, with a suitable transition period.

The Commission is ready to consider harmonised compensation limits and other reductions in benefits, provided that appropriate coverage of policyholders and beneficiaries is guaranteed for all relevant classes of insurance and in all Member States.

The Commission advocates that IGS should at least and within a pre-defined period of time compensate policyholders and beneficiaries for losses when an insurer becomes insolvent.

The Commission calls upon all interested parties to provide their views on these options by 30 November 2010.