EU White Paper

INSURANCE GUARANTEE SCHEMES

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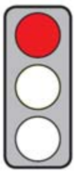
Centrum für Europäische Politik

MAIN ISSUES

Objective of the White Paper: The Commission wishes to provide policyholders with comprehensive protection that is harmonised at EU level for the event of insurance companies becoming insolvent.

Parties Affected: Policyholders and insurance companies.



Pros: –

Cons: (1) There is no objective reason that might justify mandatory guarantee schemes for insurance products: Their risks cannot be compared to those of banks. Besides, insurance companies themselves have an interest in – voluntary – guarantee schemes.

(2) Compulsory mutual credit borrowing between national guarantee schemes also threatens to destabilise solid insurance companies and thus threatens customer confidence.

CONTENT

Title

White Paper COM(2010) 370 of 12 July 2010: **Insurance Guarantee Schemes**

Brief Summary

► **Background**

– Insurance guarantee schemes protect consumers against the risk that their claims will not be met in the event that their insurance company becomes insolvent.
– In all EU Member States there are national deposit guarantee schemes (deposits for banks) and investor compensation schemes (for security paper investors) based on EU law. The protection of policyholder claims, however, has not yet been regulated at EU level.
– Life insurances are under protection in nine Member States (DE, ES, FR, LV, MT, NL, PL, RO, UK). Protection for insurances other than life insurances exists in seven Member States (ES, FR, IE, DK, MT, RO, UK). In thirteen Member States (AT, BG, CY, CZ, EE, GR, HU, LT, LU, PT, SE, SI, SK) there are no guarantee schemes at all.
– There are significant differences in the coverage amount and funding between the national schemes. The same applies to subject matter with cross-border relevance.

► **Commission's objectives**

– The Commission wishes to establish protection for policyholders that is as comprehensive as possible and harmonised for all EU Member States for the event of an insurance company becoming insolvent.
– The harmonised EU framework for guarantee schemes should
  - ensure a "comprehensive" and "even" protection for policyholders, whereby deductibles for the claimants and compensation caps should also be possible,
  - eliminate existing distortions of competition between insurance companies,
  - minimise incentives for insurers to take excessive risks,
  - reduce the likelihood of taxes being spent by obliging insurance companies on financing the guarantee schemes themselves,
  - be cost-efficient, i.e. ensure the balance between the costs of guarantee schemes and the benefits they provide to claimants,
  - increase policyholder confidence and "market stability".

► **Legal form and level of guarantee schemes**

– The Commission wishes to set out an EU legal framework for guarantee schemes in the form of a legally binding Directive.
– The Commission deems a "single EU-wide insurance guarantee scheme" ideal but is aware that currently there does not seem to be "sufficient political support for this idea". Therefore, it promotes setting up national guarantee schemes.

► **Function of guarantee schemes**

– In the event of insolvency, it first of all has to be ascertained whether or not the affected insurance policies can be transferred to solvent insurers.
– If this proves impossible or cannot be financed, the guarantee schemes are to compensate the policyholders for their losses within a pre-defined period of time.

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- **Guarantee schemes' scope of protection**
  - Although the Commission claims that there "might be good arguments" for not introducing the protection to all types of non-life insurances (e.g. motor insurance), it still proposes that the EU legal framework apply to both life insurances and non-life insurances. The Commission justifies this for "reasons of practicability and fairness".
  - Reinsurances or pension funds are not included.
  - The Commission wishes to protect all natural persons. Apart from that, only "selected legal persons" such as "micro and small undertakings" are to be protected in order to keep the financial burdens low.

- **Funding guarantee schemes**
  - The Commission prefers an "ex-ante-funded scheme" through compulsory levies to be paid by insurance companies in anticipation of possible bankruptcies. If necessary, all insurance companies are to be obliged to pay additional ex-post contributions.
  - The coverage level of guarantee schemes is to be 1.2% of insurance premiums. The amount of the compulsory levies is to reflect the individual insolvency risk of each insurance company. However, the Commission may set caps for individual contributions in the form of percentage values of the contributing member's premiums

- **Mutual borrowings between guarantee schemes**
  The Commission intends to create a "mutual borrowing facility", through which solvent national guarantee schemes should provide financial support to other distressed systems.

- **Home country principle**
  The home country principle is to apply to national guarantee schemes. Thus the subsidiaries of an insurance company that are established abroad are equally covered by the guarantee scheme at home. According to the Commission, this is reasonable mainly because the supervision of insurance companies is accomplished in the respective home countries.

Statement on Subsidiarity by the Commission

The Commission does not address the principle of subsidiarity.

Policy Context

In February 2009, an expert group headed by Jacques de Larosière submitted a report (Larosière report) on how to overcome existing gaps in the financial market regulation containing, amongst other things, also recommendations for "the setting-up of harmonized insurance guarantee schemes" in all Member States (Recommendation No. 5).
Deposit guarantee schemes and investor protection schemes exist in all EU Member States. In 2009, minimum coverage sums to the amount of 100,000 € were introduced for bank deposits (Directive 2009/14/EC; see CEP Policy Brief). In October 2010, the EU Commission proposed an amendment [COM(2010) 368; see CEP Policy Brief] to this Directive, namely that deposit guarantee schemes may compensate for a *maximum* of 100,000 € and, if needed, grant credits to each other. This proposal has become the subject of controversial discussions in both the Council of Ministers and the European Parliament.
Following the establishment of the new European Insurance and Occupational Pensions Authority (EIOPA) [(EU) No. 1094/2010; see CEP Policy Brief] of November 2010, the EIOPA may assess the need for a harmonised "European network of national insurance guarantee schemes" (Art. 26). Moreover, the Commission wishes to examine whether or not policyholders can be better protected through EU-wide rules against the insolvency of insurance companies and hereby promotes the "important role" and "appropriate powers" for the new European supervisory authorities (Recital 37).
The Solvency II Directive (2009/138/EC; see CEP Policy Brief), which according to the Commission's latest amendment proposals is to enter into force on 1 January 2013, already provides for an extensive supervision of insurance companies reducing the likelihood of an insurance company's insolvency. Within the same Directive, the Commission is asked to "review the adequacy of existing guarantee schemes in the insurance sector and make an appropriate legislative proposal" (Recital 137). However, in January 2011 the Commission proposed amendments to the Solvency II Directive [COM(2011) 8, "Omnibus-II"; see CEP Policy Brief], enabling the Commission to temporarily suspend important rules of the Solvency II Directive.
The Commission has conducted a consultation on its ideas presented in the White Paper; the results of the feedback are summarized here.

Options for Influencing the Political Process

Leading Directorate General: DG Internal Market and Services

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

A legal obligation to establish and fund guarantee schemes for insurance companies is an intervention into entrepreneurial freedom; it calls for convincing justification.

The arguments in favour of bank deposit guarantee schemes – also introduced under EU law – **cannot simply be transferred to insurance companies**.

Although it cannot be ruled out that a large number of policyholders might cancel their insurance policies due to a loss of confidence, the impact on the solvency of insurance companies is less dramatic than in the case of a "bank-run". Firstly, many insurance companies, in particular non-life insurances such as motor vehicle insurances, liability or term life insurances do not have any deposits which must be compensated for. Secondly, the termination of policies – other than the termination of bank deposits – is often possible only on an annual basis and related to high deductions. Thirdly, reserves and the often significant time gap between the contribution payment and the claim becoming due for payment mitigate negative solvency impacts of contract terminations.

Furthermore, there is significantly less danger of a chain reaction with insurance companies than there is with banks. While banks are often under considerable mutual payment obligations, the insolvency of one insurance company does not normally really affect other insurance companies directly. Hence, insurance guarantee schemes are not mandatorily required, neither for ensuring the stability of the financial market nor for the prevention of massive liquidity problems.

The only convincing reason justifying the establishment of insurance guarantee schemes is, at best, the avoidance of a massive loss of confidence, which could lead, as a result of a lack of demand for insurance, to the collapse of the insurance market. The establishment of guarantee schemes must therefore not be prescribed by the legislator: **Insurance companies themselves have an elementary interest in maintaining customer confidence in their products – if necessary through the establishment of *voluntary* guarantee schemes**. The creation of voluntary guarantee schemes, also in Germany, proves that the market is capable of generating this sort of solution itself.

The confidence created through such guarantee schemes constitutes on the one hand a public good, so that each individual insurance company is given the incentive to not participate in the costs of a voluntary guarantee scheme, which makes the setting up of voluntary schemes more difficult. On the other hand, however, this problem can be solved by making it transparent to customers which insurance companies participate in a voluntary guarantee scheme. Also, in this way the question of which insurance company customers (natural or legal persons) attach importance to a guarantee scheme and for which insurances (life or non-life insurances) can be answered more precisely than with a general and statutory guarantee obligation.

A general *statutory* obligation to participate in an insurance guarantee scheme, and with that an EU Directive which introduces a legally binding guarantee scheme, **is** therefore **to be rejected**.

Compulsory insurances, such as motor vehicle insurances, **are an exception**. Despite the competition among insurance providers, market discipline is restricted, as customers may not go completely uninsured. However, even with these insurance companies insolvencies are unlikely due to the existing and future supervision scheme (Solvency I and II). Nonetheless, it is important to point out the planned option of the EU Commission to temporarily suspend parts of the Solvency II Directive through delegated acts (see CEP Policy Brief).

In particular, the **mutual borrowing between guarantee schemes** is also to be rejected, for it **could put solid insurance companies at risk and thus endanger customer confidence in hitherto stable insurance markets**.

An ex-ante funding (whether voluntary or statutory schemes) increases the credibility of the protection. Ex-post schemes suffer from the fact that insolvent insurers do not have to pay their own contributions to guarantee schemes and are therefore given incentives to run too high a risk.

Impact on Efficiency and Individual Freedom of Choice

The decision on whether or not to introduce an obligatory guarantee scheme and how it is shaped should at least be left to the Member States to decide. Only then can the customers' different preferences in Member States be reflected. In this case customers could – due to the proposed home country principle – also choose at cross-border level between an insurance company that is a (mandatory) member of a guarantee scheme and an insurance company without any scheme membership. The prerequisite for this is the transparency of the offered protection. Though even in this context it would be preferable to do without any mandatory schemes at all; for different national requirements could lead to unequal competitive conditions in the European internal market.

The home country principle reduces administrative costs, since insurance companies must not be members in several guarantee schemes but only in the country of their business seat. Yet the White Paper leaves open the question of whether or not this also applies to legally independent foreign subsidiaries of an insurance company.

Impact on Growth and Employment

No significant impact.

Impact on Europe as a Business Location

No significant impact.

Legal Assessment

Legislative Competence

The EU can base the legislative measures following on from this White Paper on Art. 53 (1) in conjunction with Art. 54 (1) TFEU (provisions to take up or exercise entrepreneurial activities) – as with the Directive on deposit guarantee schemes.

Subsidiarity

In order to prevent a massive loss of confidence in insurance companies it is not necessary to establish an EU-wide harmonized level of protection for policyholders. In view of the individual consumer preferences which differ from Member State to Member State, consumer-tailored national measures would be more suitable to meet their demands.

Proportionality

Currently not assessable.

Compatibility with EU Law

Unproblematic.

Compatibility with German Law

Insurance guarantee schemes are statutorily regulated in Germany.
Life and private health insurance companies are obliged to participate in guarantee funds, with the exception of burial and retirement funds [§ 124 (1) German Insurance Supervision Act – "VAG"]. This task is performed by the company Protektor AG (for life insurances) and the company Medicator AG (for health insurances). Both were originally set up as voluntary rescue funds. Pension funds can become voluntary members of guarantee funds. (Art. 124 (2) VAG)
Although not required by EU legislation, German automobile insurance companies are obliged to be members of the "compensation fund for damages from automobile accidents" in order to protect policyholders from insolvency (§§ 12 et sqq. German Compulsory Insurance Act); the association "Verkehrsopferhilfe e.V." fulfills this role.

Conclusion

A mandatory guarantee scheme obligation applicable to all insurance products should be waived. For the risks cannot be compared to those of banks, a loss of confidence in the insurance market does not entail any systemic risks for the financial market. Moreover, insurance companies themselves have an elementary interest in maintaining customer confidence in their products – if necessary by setting up voluntary guarantee schemes. Only in the case of compulsory insurances are statutory national guarantee schemes justifiable. Otherwise, the decision as to whether or not a mandatory guarantee scheme is to be introduced and what form it should take should at least be left to Member States to decide. The proposed home country principle, if sufficiently transparent, would enable policyholders to choose freely the desired protection level. The compulsion for mutual borrowing between national guarantee schemes threatens to destabilize solid insurance companies and thus to endanger customer confidence.