



EUROPEAN COMMISSION

Brussels, 12.7.2010  
SEC(2010) 841

**COMMISSION STAFF WORKING DOCUMENT**

**SUMMARY OF THE IMPACT ASSESSMENT**

*Accompanying document to the*

**WHITE PAPER**

**on Insurance Guarantee Schemes**

{COM(2010) 370 final}  
{SEC(2010) 840}

## **Introduction**

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

Unlike the banking and securities sectors, the insurance sector is not covered by any European legislation on guarantee schemes. At present, only 12 Member States have one or more IGS covering life and/or non-life insurance policies, and there are significant differences between the national schemes in terms of their design.

The Impact Assessment presents an analysis of losses that can be passed on to policyholders (or to taxpayers, if public authorities intervene) in the event of insurance failures in the EU. Notwithstanding existing IGS, this may, in extreme cases, result in losses being passed on to EU policyholders (or taxpayers) up to EUR 41.3 billion for life insurance and EUR 5.9 billion for non-life insurance over a one-year time horizon. In a cross-border context, losses not absorbed by existing IGS may amount up to EUR 820 million for life insurance and EUR 140 million for non-life insurance.

### **1. Problem definition**

The lack of harmonised IGS arrangements in the EU hinders effective and equal consumer protection and may impede the functioning of the internal insurance market by potentially distorting cross-border competition. This assessment is heightened by the fact that, despite the introduction of a more risk-related EU solvency regime (Solvency II), insurers can fail, and policyholders in general are unable or find it very difficult to fully and correctly process important and complex risk-related information. There are two important consequences:

First, losses made by failing insurance undertakings and passed onto policyholders (or taxpayers) may affect the latter in various ways: in a domestic context losses may decrease policyholders' wealth or weaken public finances; this may further decrease consumers' confidence in the insurance and financial markets, which may ultimately slow down the real economy and disturb financial markets. In the specific EU cross-border context, relevant losses may also undermine consumer confidence in the Internal Market and may even trigger potential disputes between Member States on the allocation of failed insurers' losses.

Second, the mismatch between consumers' risk preferences and insurers' risk of default leads to suboptimal allocation of costs linked to insurance failure, either to unaware consumers or taxpayers. This also implies the risk of competitive distortions between insurers in the EU Internal Market.

### **2. Subsidiarity analysis**

Only EU action can ensure that all policyholders and beneficiaries acquiring insurance policies in the EU benefit from equal and comprehensive protection in the event that an insurance undertaking defaults. EU action also ensures a level playing field for insurers and thereby promotes further integration within the EU Internal Market. In many areas (e.g. coverage, geographic scope, and funding), Member States alone cannot sufficiently harmonise their different IGS design features; this can therefore be better achieved at EU level.

### 3. Objectives

The overall objectives of EU action on IGSs are, first, to ensure a high degree of protection of policyholders and beneficiaries, which sufficiently reduces the risk of substantial losses to policyholders or taxpayers arising from non-payment of claims by insurers. Second, EU action should contribute to establishing an even level of protection for policyholders, who may acquire insurance products from domestic or foreign insurers within the EU, in order to foster the effective functioning of the Internal Market for insurance services.

In addition, the relevant action should serve more general objectives such as avoiding competitive distortions, reducing adverse incentives, ensuring cost efficiency and ensuring market confidence and stability.

### 4. Policy options

The Impact Assessment Report examines and discusses a series of policy options for setting up a coherent framework for EU action on IGS protection of policyholders and beneficiaries based on minimum harmonisation.

#### Scope of possible EU intervention

Doing nothing would mean that Member States continue to take very different national approaches to IGSs, including a total absence of IGSs in some Member States. These differences generate uneven and insufficient levels of policyholder protection in a number of Member States.

While strengthening prudential supervision, partly by introducing more risk-based solvency requirements and a robust system of governance, should enable insurers to manage their risks correctly and professionally, these mechanisms cannot guarantee a zero-failure environment.

Ensuring that policyholders are better informed (about the existence of an IGS and the level of protection it provides) might, in principle, help policyholders to choose between insurers. They would be able to compare not only the prices of the policies offered by different companies but their quality (in terms of the risk of the company becoming insolvent). However, the adoption of a *caveat emptor* approach is likely to be mostly ineffective due to policyholders' unawareness of and the difficulty of correctly processing important but complex risk-related information. Although enhanced transparency measures at EU level might foster trust-based relationships between policyholders and insurers, it is nonetheless very unlikely that the great majority of policyholders would fully understand and appropriately process the complex risk-related information they receive.

Giving consumers legal priority during liquidation procedures runs the risk that assets will be insufficient to protect policyholders, giving rise to uncertainty about whether they will be compensated or not. In addition, winding-up procedures tend to be lengthy and expensive.

Implicit or explicit guarantees issued by public authorities have the obvious drawback of using taxpayers' money and thereby affecting public finances.

For statistical reasons, a high level of security for consumers can normally be best achieved by combining relatively low solvency requirements with a guarantee scheme rather than having relatively high solvency requirements without a guarantee scheme. A guarantee

scheme can in fact ‘centralise’ coverage of losses that exceed a company’s solvency (*tail risk*) thereby reducing the variability of these losses (and as a consequence the funding needed to absorb them) if a large number of insurers take part in the scheme. Furthermore, a guarantee scheme may spread the funding needed to provide protection against these excess losses among a higher number of consumers and therefore provide the same level of protection at a lower cost.

#### Size of the guarantee (IGS funding needs)

The target fund of an IGS is influenced by many parameters, among which two appear to be the most important: the probability of default for insurers and the level of targeted security for policyholders. Evidence suggests that the probability of default for insurers, in general, oscillates between 0.1% and 0.5% depending on market conditions. Besides the probability of default by insurers, IGS needs for funding or financial endowments are mostly influenced by the level of security provided to consumers: the higher the security provided by an IGS, the higher its financial endowment or funding needs. A key decision is therefore the level of security that an IGS is expected to provide to policyholders. According to the Commission’s preliminary conclusions, the preferred option would ensure a high level of protection under normal market conditions while equally ensuring a sufficiently high level of protection in times of market stress.

#### Nature and legal instrument of possible EU action on IGS

Remedying current shortcomings by means of ‘soft law’ instruments such as recommendations, communications, guidelines and codes of conduct could be a flexible alternative to immediate legal commitments. However, because these lack binding legal force, they would depend on a voluntary commitment from Member States. Even if Member States were willing to abide by the proposed guidelines, the process of national convergence risks being a time-consuming one, potentially producing uncoordinated outcomes.

The introduction of a legally binding EU-wide approach to IGSs, instead, is more likely to ensure the introduction of a coherent and harmonised set of rules to protect policyholders and beneficiaries in the EU. Due to the complexity of the issue, an EU Directive is preferable to an EU Regulation, as it gives more flexibility to Member States.

#### Scope of harmonisation

There are many ways in which an IGS can be designed. Given the lack of any EU legislation so far and the existing, very fragmented landscape of IGS protection in the Union, the Commission supports an EU approach based on minimum harmonisation. In other words, a minimum set of features needs to be organised within a coherent EU framework:

Level of centralisation: should an IGS be created at national or at European level?

Role: should an IGS operate as a last-resort protection mechanism or have a wider role?

Geographic scope: should an IGS operate on the home or host state principle (or on a combination of the two)?

Policies covered: which classes of insurance (life, non-life, etc.) should be covered by the IGS?

Eligible claimants: which claimants (natural persons, legal persons, etc.) should benefit from an IGS?

Timing of funding: should the IGS be funded *ex-ante* or *ex-post* (in advance or after the event, or a combination of the two)?

Nature of scheme intervention: should the IGS reimburse claims, or should it also be designed to secure the continuity of policies?

On the basis of the preliminary analyses of this Impact Assessment, the Commission's tentative preferences for EU action on IGS protection include the following options:

Level of centralisation: an IGS in all Member States appears to be the most preferable option, due in particular to its consistency with the existing national micro-prudential supervisory framework;

Role: the role of an IGS should be that of a last-resort protection mechanism;

Geographic scope: the 'home state principle' appears to be the preferable policy option, because of its consistency with the existing supervisory framework;

Policies covered: covering life and non-life policies would ensure comprehensive protection of policyholders and beneficiaries. There might be good arguments for limiting IGS protection to specific classes of non-life insurance policies only; however, for reasons of practicability and fairness it might be difficult to split IGS coverage into too many sub-regimes.

Eligible claimants: covering natural persons and selected legal persons (including SMEs) is likely to strike the best balance between the objectives of comprehensive consumer protection and cost-effectiveness.

Timing of funding: as a general rule, IGSs should be financed *ex-ante* in order to have funds readily available and to avoid moral hazard issues. Moreover, this is more likely to avoid the pro-cyclicality associated with *ex-post* funded schemes. In case of necessity funds may be complemented by *ex-post* contributions.

Nature of scheme intervention: The Commission strongly encourages portfolio transfer where it is reasonably practicable to do so and justified in terms of costs and benefits. However, last-resort consumer protection in the event of insurance failure must be ensured. If all other means have been exhausted, IGS should at least compensate policyholders and beneficiaries for their losses.

The main options identified as preferable by the Commission will be subject to consultation of all interested parties including Member States. These will be invited to submit comments to allow the Commission to reassess and possibly update its initial findings on the various policy options. A further impact assessment will accompany the resulting proposals, analyse in more detail the various options for IGS design features, and finally select the optimal combination for a coherent policy framework for EU-wide IGS protection.

## **5. Expected impacts**

### Policyholders

Action taken at EU level can be expected to benefit policyholders by increasing their protection in the event that insurers are unable to fulfil their commitments. On the other hand, introducing IGSs throughout the EU will also have a cost for policyholders, as insurers will pass on part of their contributions to consumers, which will increase premiums.

To illustrate this point: if, for example (compared to a situation where no IGS existed), IGSs are set up in each Member State, based on the home state principle and covering life and non-life policies, (up to the 99th percentile and based on a scenario of PD=0.1%), this would require EU policyholders to contribute to the creation of funds worth EUR 13 billion. This currently corresponds to 1.24% of annual gross written premiums. Applying this target level over, for instance, a 10-year horizon would translate into an annual contribution of 0.124% of gross written premiums by each contributing company/policyholder.

These funds should be considered additional premiums which policyholders pay to insure themselves against the insolvency of their insurer. The payments made by each policyholder can be considered to be roughly equivalent to the expected value of the losses they would avoid in the event that their insurer defaulted.

The financial cost to policyholders of paying these amounts in advance can be computed assuming a cost of capital of 6% (in line with Solvency II quantitative impact studies). For an IGS with a funding endowment of 1.24% of annual premiums this would translate into financial costs of 0.08% of annual gross written premiums.

#### Insurance companies

EU action on IGSs will affect insurers in different ways, depending on whether they operate in Member States that already have an IGS or not. In countries where no IGS has yet been set up, introducing such a scheme would require insurers themselves to pay for the contributions, if they were not able to pass on these extra costs to consumers.

For insurers, unlike policyholders, these contributions constitute a financial cost in themselves (and not an early payment), as losses hitting insurers in the event of default only depend on capital, not on premiums paid.

#### Taxpayers

The introduction of IGSs in all Member States can be expected to benefit taxpayers by reducing the need to use their money in the event that insurers default. Based on the practical example set out above this would save taxpayers up to EUR 13 billion in the period stated. EU action on IGSs will affect taxpayers in different ways, depending on whether they are resident in a Member State that already has an IGS or not.

#### Existing IGS schemes

EU action will affect existing IGSs to the extent that the framework set up at EU level will differ from the national IGS framework already in place.

Most existing IGSs would be affected in terms of the size of funds and some of them would also have to introduce *ex-ante* funding elements. A few schemes would need to modify their geographical scope and start operating on the basis of the home state principle. A few existing IGSs would be requested to enlarge the scope of their protection to life insurance or to expand their definition of eligible claimants.

#### Small and medium-sized enterprises (SMEs)

Action taken at EU level can be expected to benefit small businesses by increasing their protection in the event that insurers are unable to fulfil their commitments. On the other hand,

introducing IGS protection for SMEs throughout the EU will have an impact on SMEs, as insurers will pass part of their contributions on to SMEs, which will increase their premiums. The payments provided by each SME can be considered roughly equivalent to the expected value of the losses they would avoid if their insurer defaulted. Moreover the impact on SMEs will depend to whether they are already protected by any existing IGS in the various national frameworks.

### Supervisory authorities

Supervisory authorities in Member States that do not have an IGS in place yet may get involved in their set-up and possibly also start managing them, while those authorities that already manage an IGS would have to ensure that their scheme is compliant with the proposed design features. A more detailed analysis of the impact on supervisory authorities will be considered in the impact assessment accompanying the follow-up to the White Paper.

### International impact

The impact on third country insurers can be expected to be the same as for EU-EEA insurers.

### Environment

The environmental impacts are expected to be marginal.

### The economy

The proposed policy options are expected to generate two main advantages for the economy. First, they will ensure a level playing field that avoids competitive distortions between domestic and non-domestic insurers. Second, they will reduce the risk of allocating losses to policyholders and taxpayers in a sub-optimal fashion.

### Social Welfare

The policy options proposed will improve social welfare through:

- increased protection of policyholders;
- less use of taxpayers' money;
- improved redistribution of insurance default losses.

## **6. Follow-up measures**

The Impact Assessment clearly supports a legally binding EU solution for IGS protection based on minimum harmonisation.

It identifies the Commission's preferred choices, which will be clearly set out in the White Paper on Insurance Guarantee Schemes. The Commission will call upon all interested parties to provide their views on these options. The Commission will carefully evaluate the feedback received and take it into account when coming forward with the legislative proposal. The legislative proposal will be accompanied by another impact assessment.

Specific monitoring actions will be identified at that stage.