MILLIMAN BRIEFING NOTE

EIOPA Consultation on National Insurance Guarantee Schemes

A summary of EIOPA's proposal for a harmonised approach to National Insurance Guarantee Schemes, which follows on from its Opinion on an EU-wide Recovery and Resolution Framework

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In July 2018, the European Insurance and Occupational Pensions Authority (EIOPA) issued a discussion paper on resolution funding and national Insurance Guarantee Schemes (IGSs) across the EU. This proposes a harmonised approach to national IGSs where the landscape is currently highly fragmented. (Re)insurance companies should be aware of the potential costs and benefits which could accompany any future harmonised approach.

On 30 July 2018, EIOPA published a discussion paper[1] on resolution funding and national insurance guarantee schemes. The discussion paper is open for comments until 26 October 2018. This exercise is a follow-up to the EIOPA opinion[2] (the Opinion) recommending a harmonised recovery and resolution framework for all insurers across the EU that was published in July 2017.

Recovery and Resolution

The Financial Stability Board (FSB) states that a recovery plan '*identifies options to restore financial strength and viability when the firm comes under severe stress*.' It defines resolution as '*when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so*'.

When EIOPA published its opinion on the need for a harmonised recovery and resolution framework in July 2017, including the development of pre-emptive Recovery and Resolution Plans (RRPs), it noted that it planned to continue its work in the field of recovery and resolution for insurers. In particular, in relation to:

- the potential harmonisation of resolution funding and
- the potential harmonisation of insurance guarantee schemes (IGSs)

EIOPA is of the view that both are "*essential elements of the resolution*" of failing (re)insurers. The discussion paper issued on 30 July 2018 is the next stage of EIOPA's work in this area.

EIOPA Survey

IGSs provide protection to policyholders when insurers are unable to fulfil their contractual commitments either by paying compensation to policyholders for their claims, or by securing the continuation of their insurance contract[3].

EIOPA conducted a survey of Member States to determine whether national IGSs exist and to collate details of their design where they are in place. This has highlighted many differences between Member States in terms of both the existence of these schemes and their design features.

In particular, the survey found that:

- 20 Member States out of 31 respondents have in place one or more national IGSs, but there is no harmonised approach and noticeable differences exist in design features, such as scope, coverage and funding. There are 26[4] IGSs in total.
- 13 Member States noted their IGSs have limits to the amount of compensation paid per claim or per policyholder.
- Currently most IGSs only compensate policyholders for losses in the event of liquidation, while 8 out of 25 schemes have other tasks allocated to them, such as funding a portfolio transfer, taking over and

[1] https://eiopa.europa.eu/Publications/Consultations/EIOPA-CP-18-003_Discussion_paper_on_resolution_funding%20and.pdf
[2] https://eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-17-148_Opinion_on_recovery_and_resolution_for_%28re%29insurers.pdf
[3] European Commission, White Paper on Insurance Guarantee Schemes (2010)
[4] Note that while there are 26 schemes for some questions there are less than 26 responses as the question may not have been relevant to every scheme.

administering insurance policies, funding a bridge institution, etc.

- Approximately half of the schemes allow for payments to be made to natural persons only, with the other half covering both natural persons and Small and Medium-Sized Enterprises (SMEs).
- In some cases, there are provisions in law whereby the entire contribution payable to the IGS can be passed on to the policyholder premium, whereas in other cases it is covered by the insurer.
- Approximately half of EU IGSs have a maximum on the contributions an individual insurer would have to pay per annum.
- 10 schemes require ex-ante funding, 6 require ex-post funding, and 8 are on the basis of a combination (such as some ex-ante funded with the ability to require additional funding ex-post to cover shortfalls).
- Approximately half of the schemes have the power to raise additional funding from insurers should shortfalls arise, such as through increases in annual contributions, while the remainder do not.
- 50% of EU IGSs calculate contributions on the basis of written premiums, with the remainder being calculated with reference to technical provisions or other measures.
- 8 schemes are on the basis of the 'home-country' principle, 8 are on the basis of the 'host-country' principle and 8 have a combination of home and host-country principles, as defined below.

Home-Country and Host-Country Principle

The home-country principle entails the IGS within a Member State only covering risks within that State, whether they are written by domestic or foreign insurers.

The host-country principle entails the IGS within a Member State covering only policies written by companies headquartered in that Member State.

Therefore, under the host-country principle, some policyholders within the Member State would not be covered by the IGS, but they might be covered by another Member State's IGS where the insurer is headquartered, if that Member State also operates on a host-country principle.

For example, in Ireland the IGS (known as the Insurance Compensation Fund) operates on a home-country basis, i.e. it covers everything written to Irish policyholders, whether from a domestic or foreign insurer, but does not cover policies sold by Irish insurers to foreign policyholders.

National IGSs

EIOPA's survey found that the primary role of IGSs is to compensate policyholders for their losses in the event of insurance failures, hence providing an additional level of protection for policyholders. Compulsory compensation schemes to cover uninsured drivers for motor insurance are outside the scope of the EIOPA opinion and hence are not considered further here[5].

The IGS landscape is currently highly fragmented across the EU, leading to concerns regarding the protection of policyholders, recourse to public finances and a potential lack of level playing field between insurers and between insurers and banks/investment firms.

In addition to the EIOPA survey results, a number of interesting case studies from across Europe are outlined in the discussion paper. They illustrate the fragmented landscape and the lack of clarity in particular in cases where cross-border insurance has been written. This can lead to a situation where policyholders who have purchased insurance from a foreign insurer may not be protected in the same way as those who have purchased similar insurance from a domestic insurer.

Resolution Funding

Resolution funding refers to the means of financing the costs associated with resolving failing insurers.

When an insurance company fails, the resolution costs can include paying compensation to policyholders to the extent that such costs cannot be covered by assets, as well as operational costs (such as arranging a portfolio transfer, setting up a bridge institution[6], temporarily taking over and administering policies, etc.).

The question arises as to where that funding should come from. In the past, it has sometimes come from national IGSs and other sources. According to the EIOPA paper, "*Over the course of the financial crisis, European insurers received a total of approximately EUR 6.5 billion from public authorities*". It is not clear if all of this public financing was used purely for resolution

[5] The Motor Insurers' Bureau of Ireland (MIBI) is an example of such a compensation scheme.

[6] According to the Bank Recovery and Resolution Directive, bridge institution involves the transfer of shares and/or other ownership instruments or assets/rights/liabilities, to a bridge institution which is wholly or partially publically owned and has been created in order to maintain critical functions as an interim solution until the institution is ultimately sold.

purposes. Nevertheless, as recommended by the FSB, the EIOPA paper suggests that there is a need to have adequate funding arrangements in place to reduce the likelihood that recourse to public finance (i.e. taxpayer funding) will be required. EIOPA therefore determines that the sources of funding are the following:

1. Assets and liabilities of the failing insurer
2. National resolution funds
3. National IGSs

In relation to option 1 above (assets and liabilities of the failing insurer), the assets of a failing insurer should serve as the first means of funding the resolution costs. However, the assets might not be sufficient to fund the liabilities and the resolution costs. As per the EIOPA Opinion on a harmonised recovery and resolution framework, EIOPA has reiterated that national regulators[7] should have powers to restructure, limit or write down liabilities, including (re)insurance liabilities – subject to strong and adequate safeguards.

In terms of safeguards, policyholders currently rank very highly with regards to claims on the assets of the business, with only employees and public bodies having a higher ranking in certain Member States. In addition, EIOPA lists other safeguards to these powers, such as ensuring the allocation of losses to policyholders would be a last resort only, following any possible recourse to an IGS, with all other feasible measures having already been exhausted.

The EIOPA survey found that currently, only a small number of national supervisory or resolution authorities are empowered to restructure, limit or write down the liabilities of insurers. EIOPA has already stated in its Opinion that it recommends that national supervisors or resolution authorities have these powers, which are similar in concept to those outlined in the Bank Recovery and Resolution Directive (BRRD) for the banking sector whereby customers are not immune from absorbing losses in resolution scenarios.

In terms of option 2 above (resolution funds), these can typically be employed to fund resolution actions, such as securing continuity of insurance coverage and payments by the transfer of insurance policies to a bridge insurer or other insurer or use of any other resolution powers.

The EIOPA survey found that Romania is the only Member State that has a resolution fund. The Netherlands is the only other in the process of adopting the required legislation to establish a resolution fund, as part of its recovery and resolution framework which will come into force in 2019. As part of this, all insurers will contribute to the resolution costs of a failing insurer on an ex-post basis. This is in contrast to the Romanian resolution fund where all life insurers pay 0.25% of premiums and all non-life insurers pay 0.4% of premiums on an ex-ante basis, with a ceiling of €11m on the fund.

The EIOPA survey found that option 3 (national IGSs) are far more widespread within the EU, although only a few can be employed to fund resolution actions.

EIOPA advises Member States to ensure they have in place adequate and sufficient funding arrangements for insurers to ensure an orderly resolution process and maintain financial stability, recognising that this might require a combination of different sources of resolution funding.

The focus of EIOPA's current consultation is on the potential need for a harmonised approach to national IGSs across the EU.

EIOPA's Proposals

The discussion paper contains proposals regarding resolution funding and, more specifically, national IGSs.

The discussion paper proposes that one option to resolution funding is that the policyholders absorb some of the losses, and it recommends that policyholders should be made aware of this measure, which may be exercised in exceptional circumstances. The paper gives an example of including this as a clause in an insurance contract.

EIOPA is considering **minimum harmonisation** with regards to policyholder protection through the **establishment of a European network of national IGSs**.

EIOPA is of the view that it would benefit policyholders, the insurance market and more broadly the financial stability in the EU.

However, the paper notes that EIOPA has not yet reached a definitive conclusion on the potential need for a European network of national IGSs.

This would be a system of national IGSs and potential underlying EU regime laying down rules and/or standards for national IGSs.

EIOPA is not considering maximum harmonisation, which would consist of establishing a single EU-wide IGS, at this time. EIOPA is of the view that this is unlikely to happen in the near future.

[7] Specifically, Resolution Authorities, as recommended by the EIOPA Opinion. According to the EIOPA Opinion, Member States should have in place a designated administrative resolution authority for insurers to ensure an orderly resolution process as well as to avoid confusion or potential conflict among various authorities.

Of course, notwithstanding any harmonisation of IGSs, there will still be differences in policyholder protection across the EU due to differences in national insolvency laws and the claim hierarchy.

The paper notes the arguments for and against harmonisation through a European network of national IGS, as outlined in the following table:

	Arguments in favour of
Status Quo	(A) Risk of contagion[8] in insurance industry is less pronounced
	(B) Sufficient protection mechanisms already in place
	(C) Potential costs of IGSs
	(D) Moral hazard effects[9]
European network of national IGSs	(A) More equal and effective policyholder protection
	(B) Distribution of insurance failure costs to the industry
	(C) Increase in consumer confidence and choice
	(D) Level playing field across Member States

Notwithstanding the preliminary nature of EIOPA's conclusions, it would appear that EIOPA is firmly of the view that some form of harmonisation would be beneficial. The questions in the discussion therefore focus more on the specific design features that an IGS should have.

Potential Impacts on Insurers

Where no national IGS is currently in place, a harmonised approach to national IGS across all insurance sectors and Member States could lead to a requirement for insurers to pay contributions towards the IGS.

For example, Ireland currently has one IGS, the Insurance Compensation Fund (ICF). The ICF covers a broad range of non-life insurance, excluding health and dental insurance in particular. Ireland does not have any IGS in relation to life insurance. This contrasts with the UK, which has a Financial Services Compensation Scheme covering both life and non-life insurance, as well as France, which has a life insurance scheme and two non-life insurance schemes (one covering motor and construction liabilities, with the other covering medical liabilities).

The cost of the ICF is financed through contributions received from non-life insurance companies up to a maximum of 2% of the aggregate of the gross premiums received by that insurer (whether authorised in Ireland or in another Member State) in respect of policies issued in Ireland. If a similar arrangement were to be put in place for the life insurance industry in Ireland, insurers would need to consider how they will meet this cost (e.g. as a loading to the premium).

Equally, any changes in the design of existing national IGSs due to the introduction of a harmonised EU approach will also impact on insurers. Looking at the survey results outlined above, insurers currently contributing to an IGS could see the following types of changes, all of which could have implications for the contributions paid by insurers and/or policyholders (whether directly or indirectly):

- A change to the basis of calculation in terms of whether written premiums, technical provisions or another measure is used (e.g. in Ireland contributions are up to 2% of written premiums for risks within the country)
- IGSs could move from only covering personal customers to including SMEs, or vice versa (e.g. in Ireland only personal customers are covered by the ICF unless a commercial policyholder due compensation is also an individual)
- Contributions could be required ex-ante or ex-post or a combination of these which could be different to the current position (e.g. in Ireland contributions to the ICF are ex-ante)
- Guidance could be given on limits to compensation paid per policy or per claim from IGSs (e.g. in Ireland the ICF limits payments to 65% of liabilities due to a policyholder, up to a maximum of €850,000 per policy[10]).
- A consistent approach may be taken by all Member States with regards to whether insurance companies contribute to a scheme which covers all risks within the State including those written from another Member State, or a scheme which covers all risks written by

[8] In banking, contagion risk is the risk of a large number of consumers withdrawing their money from a troubled bank which could result in a loss of consumer confidence and harm other banks and financial stability as a whole. According to the discussion paper, although a run on insurers in the form of mass lapses by policyholders is a possibility, it is far less likely to occur.

[9] Potential moral hazard considerations outlined in the discussion paper include insurers being incentivised to take on excessive risks given that the costs of a potential failure would be borne by the whole industry and/or policyholders.

[10] There is currently a proposal to increase the ICF coverage to 100% for third party motor insurance claims in Ireland.

insurers headquartered within the State, whether at home or in another EU Member State.

The EIOPA proposal to make policyholders aware of the possibility that they may have to absorb some of the losses as part of a resolution in itself could negatively impact consumer confidence. For example, a policyholder being required to cover a portion of the liability arising out of an injury claim may in some cases be equivalent to the driver only being partially insured. This is similar in concept to the developments in the banking sector whereby the BRRD introduces the ability for personal customers to absorb some losses during resolution. However, the overarching impact of insurance guarantee schemes should generally be to increase consumer confidence in a similar way that the Deposit Guarantee Scheme in the banking sector guarantees up to €100,000 deposits for personal customers, which should help mitigate any concerns in this space.

In terms of the arguments for a harmonised approach to national IGSs, the paper states that a harmonised network of national IGSs could increase consumer confidence and choice. It could also potentially reduce the risk of double burdening insurers with cross-border activities which participate in IGSs located in their home and host jurisdictions. It could improve the level playing field that exists in some cases between domestic and foreign insurers, and between insurers competing with other sectors, such as investment firms. From a consumer perspective, clear, efficient, appropriately funded IGSs could reduce delays in the process of paying claims to policyholders.

Stakeholders can respond to the questions outlined in the EIOPA discussion paper until 26 October 2018.

Other EIOPA work

EIOPA has continued its work on systemic risk and macroprudential policy in insurance, publishing a report in July 2018 entitled "Other potential macroprudential tools and measures to enhance the current framework"[11] which includes a discussion on pre-emptive recovery and resolution planning.

The report focuses on Global Systemically Important Insurers (G-SIIs) but it also highlights the risk of collective failures[12] of non-systemically important institutions as a result of exposures to common shocks.

This report reiterates EIOPA's opinion as stated in July 2017 that "*according to EIOPA, the requirement for insurers to develop and maintain recovery and resolution plans in a pre-emptive manner should be one of the building blocks of a harmonised recovery and resolution framework*."

It is therefore clear that EIOPA continues to push the industry and national regulators on the topic of recovery and resolution for all insurers, which has, in some Member States, contributed to new national laws in this space and, in others, has led to regulatory expectations in this area.

How Milliman can help

Milliman can assist you with all aspects of your recovery and resolution planning work, as well as wider risk management activities, including advice on:

- Development and review of recovery and resolution plans
- Benchmarking against local and international best practice
- Recovery and resolution planning toolkits and templates
- Developing recovery options including innovative capital management solutions, restructuring and reinsurance deals, as well as insights based on our experience of implementation of such measures
- Review and enhancement of Risk Management Frameworks and Own Risk and Solvency Assessments (ORSAs)

For further information please contact your usual Milliman consultant or one of the consultants listed below.

[11] https://eiopa.europa.eu/Publications/Reports/EIOPA%20Other%20potential%20macroprudential%20tools.pdf

[12] Collective failures here refer to a number of insurance companies failing at the same time due to common exposures or interconnections.

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