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POLICYHOLDER PROTECTION FUNDS: RATIONALE AND STRUCTURE

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I. Introduction

The protection of policyholders against insolvency of insurance companies is one of the primary objectives of insurance regulation. In order to achieve this goal, a range of regulatory and supervisory measures are normally established to ensure financial and managerial soundness of insurance companies, and supervisory authorities are expected to do their best to avoid the failure of supervised companies.

It is sometimes inevitable, however, that some insurance companies will encounter serious financial difficulties. In spite of all possible supervisory measures, insurance companies can become insolvent. In order to protect the interests of policyholders in the event of insolvency of an insurance company, certain special regulatory arrangements are normally established. These arrangements can be divided into two groups: those included in the winding-up procedure and those outside of it. The former type of arrangement is used in most jurisdictions, but typically vary considerably in detail across jurisdictions, largely depending on idiosyncrasies of the judicial insolvency procedures of respective jurisdictions as well as the specificity in the insurance regulatory frameworks. In addition to these measures, in many jurisdictions, policyholder protection funds (or guarantee schemes) have been established to provide certain protection for policyholders outside of the winding-up procedure.

The remainder of this document analyses the rationale and structure of policyholder protection funds. It consists of five sections. The next section provides an overview of policyholder protection funds. A distinction is made between a fund for a specific class of insurance and a general fund. The third section reviews the arguments regarding the merits and drawbacks of general funds. The fourth section discusses the key aspects of the structure of such funds. The last section provides concluding remarks.

II. Overview

When an insurance company becomes insolvent, policyholders face potential financial losses as their claims may not be fully met. In order to protect policyholders under such a situation, a fund to compensate their losses is often created. Such schemes may be designed to collect necessary contributions or levies (referred to as "contributions" hereafter, otherwise specified) in the event that an insurance company goes bankrupt. Without building up a fund, these schemes are sometimes called policyholder guarantee schemes. In this paper, however, the phrase "policyholder protection funds" includes such schemes.

Policyholder protection funds are fairly common among OECD countries. At least 21 countries have one or more such funds. These funds can be classified into two types. The first type includes the funds that focus on the policyholders of one or a few branches of insurance. In the second type, the funds cover most of the insurance contracts subscribed to by the participating insurance companies. The former type is often referred to as a fund for a specific class of insurance, while the latter is a general fund.

A fund for a specific class of insurance is normally established in association with compulsory insurance. The typical example is a fund for compulsory motor vehicle liability insurance. In many OECD Member and non-Member countries, car drivers or owners are legally required to purchase liability insurance, which aims principally at protecting victims of car accidents by ensuring minimum indemnification for any damage or loss of income. The goal of this regulation would not be achieved when the insurer is insolvent and therefore unable to pay the claim. Funds for compulsory motor vehicle liability insurance are established to compensate the losses of the victims under such circumstances. The funds also step in when the driver responsible either cannot be identified or is uninsured and thus no insurance protection is available for the victim. This type of policyholder protection fund is considered, therefore, to exist mainly for protection of accident victims. Special protection for the victims may also be rationalised by the fact that they are "involuntary" creditors for the particular insurance companies and, thus, had no prior option to select the insurers. In this context, the funds pay the full amount of the claims in principle.

Among Member countries, at least fourteen countries have funds that cover compulsory motor vehicle liability insurance exclusively. Some countries, like Belgium, Finland, France and Spain, have a fund that covers other branches of compulsory insurance (such as workers' compensation insurance and hunting insurance).

In contrast to a fund for a specific class of insurance, a general fund covers a wide range of insurance classes, both compulsory and non-compulsory, including most of the products of an insurance company if not particularly specialised. Such a fund is created to ensure the payment of claims to policyholders when a company becomes insolvent and unable to meet its financial obligations.[1] While the benefit of a fund for a specific class of insurance in ensuring the protection of the beneficiaries is widely recognised, the necessity of creating a general fund is not agreed upon internationally. Among Members, nine countries, namely Canada, France, Ireland, Japan, Korea, Norway, Poland, the United Kingdom and the United States, are known to have established such funds to date.[2] Hereafter a "policyholder protection fund" means a general fund, otherwise specified.

III. Policyholder protection funds: benefits and drawbacks

1. Benefits of policyholder protection funds

Protection of non-professional policyholders

The primary objective of policyholder protection funds is to protect the interest of policyholders, especially individual or non-professional policyholders in the event of bankruptcy of an insurance company. The funds are expected to serve as the final safety net for policyholders, when, in spite of all possible supervisory measures, bankruptcy occurs.

Policyholders are the creditors of insurance companies. Creditors usually extend credit after checking the credibility of a debtor and are responsible for their credit decisions; i.e., they have to submit themselves to the negative consequences. However, it is difficult to expect non-professional policyholders, typically individuals, to assume this responsibility in full. This is because there is a considerable amount of information asymmetry between such policyholders and insurers with regard to financial soundness of the insurers. The financial and managerial situation of insurance companies is much more technical and complex than that of ordinary companies. Non-professional policyholders can hardly be expected to verify the credibility of an insurance company sufficiently. Moreover, their financial capacity is usually limited. Therefore, if such policyholders are given to the full responsibility as creditors of insurance companies, they would refrain from getting insurance, which would deter the development of the insurance market.

This argument provides a rationale for the establishment of special regulations and supervision for insurance companies, which are essentially intended to provide a monitoring function for policyholders so as to protect them from the negative consequences of their credit decisions. Stringent insurance

1. Some funds may also compensate the losses sustained by the beneficiaries of compulsory insurance when no insurance protection is available for reasons other than the insolvency of the relevant insurer.

2. In addition, the Netherlands is in the process of introducing a policyholder protection fund for life insurance. The relevant law was enacted as of 13 December 2000. It will come into force when a Royal Decree is made. However, details of the scheme are not available at this moment.

regulations should be set up and supervisory authorities should take all possible steps to ensure the financial soundness of insurance companies. However, regulation and supervision may not always be perfect in avoiding the bankruptcy of an insurance company. Policyholder protection funds can provide the final safety net for policyholders in such extraordinary cases and, thereby, supplement supervision as a means of protecting the interests of policyholders.

Maintenance of public confidence

The insurance industry is built on the public's confidence in the business, which is in fact vulnerable. Policyholder protection funds can help to maintain the public's confidence in the insurance business and, thereby, help to sustain the sound development of the industry.

Non-professional policyholders not only have limited ability to evaluate appropriately the financial soundness of insurance companies, but also they have little incentive to do so. Because of the technical and complex nature of the financial situation of insurance companies, the cost of gathering sufficient information to make a wise decision is significantly high. Under this circumstance, each policyholder is inclined to rely on the efforts of someone else who engages in the same type of transaction. More practically, most non-professional policyholders select insurance companies based on a belief in the financial soundness of the company and the industry as a whole, beliefs which do not necessarily have a firm ground.

Against this backdrop, suppose an insurance company goes bankrupt and its policyholders suffer losses. Without the ability to appropriately assess the risks of individual companies, the general public may lose their confidence in the soundness of other insurers. Knowing the possibility of damages in the event of a company's insolvency, the public may be discouraged from seeking insurance, which would again affect the industry as a whole and lower the social welfare.

More dynamically, the bankruptcy case of a given insurer may cast doubt as to the soundness of other insurers and induce a run on them. Such a run was actually observed in some countries, particularly on companies of poor reputation. A run could put the remaining insurers in a serious liquidity crisis, and possibly force them to go bankrupt. Policyholder protection funds can protect policyholders against damages caused by the insolvency of an insurance company, keep the public's confidence in the industry at large, prevent a contagion of bankruptcy, and thereby contribute to the sound development of the insurance industry.

This line of reasoning is in fact analogous to the argument for the banking sector, which usually has a deposit insurance scheme. It should be noted, however, that the risk of bankruptcy contagion is likely to be smaller for the insurance sector. Bank deposits can be withdrawn in full amounts with minimum losses, if any. Depositors may need to accept some disadvantages, such as earning lower interest or giving up favourable future interest, but are more inclined to withdraw their deposits swiftly when they think the bank might go bankrupt. In contrast, the cancellation of insurance contracts results in a loss of risk transfer. Also policyholders usually incur losses due to cancellation deductions. Eventually, policyholders are more likely to give a second thought before taking an immediate action. Moreover, repayments of insurance products are usually made less quickly than bank deposits. Insurance companies should have more time to build liquidity for repayments so as to meet their obligations. Therefore, this argument probably has weaker grounding for insurance than banking.

Development of competitive markets

It is also argued that the establishment of policyholder protection funds contributes to the development of competitive markets. Policyholder protection funds prepare a smooth exit mechanism for incompetent insurers from the market, which supports dynamics in the marketplace.

Competitive markets experience failures. The failure of an insurance company affects policyholders significantly. They would suddenly face risks they thought had been transferred to a third party. They may be able to get insurance from another insurer, but the coverage could be more expensive. They may also suffer financial damage as repayments during the liquidation proceedings could be substantially less than the face value of the claims. Even in the event that policyholders do not suffer financial losses, they are likely to suffer from a shortage of liquidity, as liquidation repayments take time, sometimes years. A policyholder protection fund can alleviate significantly the difficulties that policyholders might face in the event of the failure of an insurance company.

Without such a safety net, the supervisory authorities would be inclined to try to prevent the failure of insurance companies at any cost. This is especially true for a larger insurance company because of the huge number of policyholders that would be affected by its failure and the associated enormous social impact. This is sometimes described as the “too big to fail” situation. Insurance authorities would be inclined to place more stringent regulations to minimise such a failure and to mobilise all possible supervisory measures to rehabilitate companies when they are found to be distressed, steps which could work effectively to restrict competition in the market.

Policyholder protection funds make it possible to handle bankruptcy cases without exposing policyholders to risks of severe losses. Having the safety net, the supervisory authority may let a financially impaired insurer go bankrupt without taking extraordinary measures that often disturb the efficient functioning of the market. Policyholder protection funds therefore can serve to help develop dynamic and pro-competition insurance markets.

A level playing field across sectors

Last but not least, policyholder protection funds are an important tool for preparing a level playing field for insurance companies and banks. In recent years, the insurance and banking sectors have converged. Cross-selling is increasingly common in many countries. At the product level, banks sell financial derivatives that effectively provide guaranty against certain risks, and insurance companies, especially life insurance companies, offer products that have significant savings elements. Insurance companies and banks are competing more and more directly.

This development in the financial markets creates a momentum towards the convergence of regulation of the two financial industries, though it is not obvious at this moment. Such a movement may be found in the recent trend to create a consolidated financial supervisory authority as well as consolidated supervision. In the same context, it is argued that insurance policyholders should be protected by a safety net system as bank depositors are, and that insurance companies should have a similar back-up as deposit insurance in order to compete with banks.

2. Drawbacks of policyholder protection funds

Moral hazard

The most important argument against policyholder protection funds is the moral hazard problem that they may raise for policyholders, insurers and supervisors. When there is a safety net, consumers may be less inclined to assess the financial situation of the insurer that they contract with and to make a prudent selection. Even worse, they may seek the cheapest products regardless of the risk associated with the insurer, because of the belief that they will not suffer from the negative consequences of their choice in the event that the risk materialises, i.e., the insurer goes bankrupt.

The lack of risk averse behaviour on the part of consumers is likely to give incentives to insurance companies for increased risk-taking. They may try to expand high risk-high return investments in the use of the funds gathered by quite attractive insurance products. This is the typical behaviour of financial institutions such as insurance companies and banks when they experience financial distress.

Moreover, some observers stress the moral hazard in the supervisors. When there is a safety net to protect the interests of policyholders faced with insurance insolvency, the insurance authorities may feel less pressure for strict supervision to avoid any possibility of insolvency. This could lead to a loosening in the financial discipline of the companies and an increase in moral hazard in the industry as a whole, which may cause several insurance bankruptcies at once, resulting in *de facto* bankruptcy of the protection fund itself.

It should be noted, however, that moral hazard may be an endemic nature of the insurance as well as banking sectors, for which the authorities conduct supervision for the benefits of policyholders and depositors. As often discussed, even without a safety net, there could be moral hazard behaviours particularly on the part of insurers when they face financial difficulties and policyholders when they rely on supervision. The issue, therefore, is how much the establishment of a safety net may fortify the incentives for such behaviours.

Financial burden on soundly managed insurers

As seen below, policyholder protection funds are financed by contributions collected from the member companies. Therefore, the establishment of the funds imposes new financial burdens for insurance companies covered by the fund. This raises the following two arguments against setting up such systems:

The first argument focuses on the fact that policyholder protection funds intend to subsidise the mismanagement by one member company at the expense of other members that run their business in a prudent manner. Under this mechanism, prudently managed companies, which avoid effectively being in financial distress, need not only to contend with reckless competitors that offer aggressive pricing to attract customers, but also to compensate for the eventual failures of such competitors. This situation could seriously undermine sound and fair competition in the industry.

The second argument is that the financial burden to finance policyholder protection funds could weaken the financial soundness of member companies. This weakening could be significant in some cases. In the extreme, a company might become insolvent because of the payment of contributions to the fund. Moreover, one may see that this system contains a structural problem. Insurance insolvency is apt to occur when the economy moves adversely to the interests of the insurance business. As all the companies are more or less financially troubled during such a circumstance, the burden to cover the losses incurred by one bankruptcy case might possibly lead to another insolvency, which could trigger a chain reaction of insurance insolvency because of the safety net system. It can be argued that policyholder protection funds are meaningful only for special cases in which a company goes bankrupt due to particular mismanagement, while other members remain economically sound in the favourable economic environment.

Unfair competition across jurisdictions

Related to the argument above, some maintain that the burden on member companies to support the safety net system, which should cover not only the cost for compensation paid to policyholders but also various administrative costs to operate the system, would affect their competitiveness relative to the insurers located in jurisdictions that do not have such a system. The recent advancement of telecommunication technology in general, and a growing use of the Internet in consumer service businesses including insurance, has dramatically increased consumers' direct access to service providers outside of the jurisdiction in which they live, thereby intensifying competition across borders. Under this situation, the establishment of policyholder protection funds may create a serious disadvantage to the member insurers.

This argument, however, is usually countered by the view that the existence of a safety net should benefit the member companies in attracting consumers. Practically, it seems difficult to determine which effect is more dominant, as these effects are not measurable and likely to differ depending on customers, products and other factors.

3. Observations

Obviously, it is not possible to conclude decisively whether policyholder protection funds should be established or not. The importance of the benefits and drawbacks mentioned above should differ among jurisdictions, which have different histories, market environments, regulations and cultures. Consequently, there is no one answer that fits all jurisdictions. However, three observations can be made in this regard.

First, one should note that a policyholder protection fund constitutes only a part of policyholder protection in the event of insolvency of an insurance company. Therefore, its necessity largely depends on the protection provided for policyholders particularly on the judicial insolvency procedure for insurance companies. Some jurisdictions provide relatively strong protection to policyholders in the liquidation procedure. Countries like Germany and Italy grant policyholders a special claim on the assets of the failed insurance company corresponding to the technical provisions over any claims lodged against the insurance company. Other countries, including Canada, France and Norway grant policyholders a general claim to all the assets of the company over any other claims than those that are given higher priority by bankruptcy provisions of the national law concerned (typically employees' claims and tax liabilities).[3] There are also some countries like the United Kingdom[4] that do not grant any particular privileges to policyholders, which

3. In the United States, policyholders have been granted the second priority only after the expenses of administration in the insolvency proceedings of insurance companies since *U.S. v. Fabe* (1993).

4. Japan was one of the countries that did not grant any special privileges to the claims of policyholders, but recently amended the Insurance Business Law to grant a general privilege over ordinary claims to policyholders.

are treated equally with other ordinary claimants. Protection of policyholders with policyholder protection funds is more important for jurisdictions that grant weaker privileges to policyholders in the insolvency procedure of insurance companies.

In other words, policyholder protection funds may not need to be introduced if the interests of policyholders are well protected in the insolvency procedure of insurance companies. For example, in Spain, the Commission for Winding-Up of Insurance Undertakings (*Comision Liquidadora de Entidades Aseguradoras*) is expected to act as liquidator in the insurance insolvency proceedings to facilitate the process and protect the interests of policyholders. The Commission can also buy up the claims of policyholders at the price equivalent to the estimated dividend to the given claim from the insolvency proceedings. This provides up front liquidity for policyholders and in many instances improves considerably payments to the policyholders, as policyholder protection funds usually intend to do.

Second, it is noteworthy that those countries that have recently introduced policyholder protection funds have experienced one or more bankruptcies of larger insurance companies around the time the legislation was introduced. This suggests that such incidents highlighted the limitation of supervisory efforts to prevent insolvency of insurance companies, and urged strongly for the preparation of a contingent safety net system in the event of future cases (or even in order to handle the current cases). Given the difficulty in abolishing a safety net system once introduced, the establishment of policyholder protection funds will probably continue to increase in the long run.

Third, increasing attention has recently been given to establishing a level playing field between the insurance and banking sectors, reflecting the deepening convergence of the two segments of the financial industry. For example, in France, the introduction of a policyholder protection fund was explicitly coupled with the reform of the deposit insurance system. These two measures were explained to have one mission: compensate depositors in the case of bankruptcy of the bank or policyholders in the case of bankruptcy of the insurance companies in accordance with the same principles of simplicity, equality and efficiency.[5] Given further convergence, establishing a safety net for policyholders, especially of life insurance, equivalent to the one for depositors may have more support.

Furthermore, this argument could lead to the establishment of a common safety net system that covers both sectors. Korea has already moved in this direction. With the enactment of a new law in January 1998, the Insurance Guarantee Fund was merged into the Depositor Insurance Fund that is managed by the Korean Deposit Insurance Corporation. Also, in the United Kingdom, the creation of a single Financial Services Compensation Scheme is under public consultation.[6] In either case, however, separate accounts are set up for different lines of business to avoid cross subsidisation.

IV. Structure: comparative analysis

As seen above, policyholder protection funds clearly have both benefits and drawbacks. When their establishment is determined, therefore, their structure should be designed carefully to provide protection effectively and efficiently and to limit the deficiencies at a possibly minimum level. This section analyses the major aspects of the structure of the funds that require due attention in designing the schemes, referring to the existing funds to the extent possible. These aspects include the coverage, functions, contributions and governance.

5. Communiqués de presse, 18 juin 1999

6. UK Financial Services Authority has issued a series of consultation papers on this subject. The most recent and comprehensive one is Consultation Paper 58 “Financial Services Compensation Scheme Draft Rules”, July 2000.

1. Coverage[7]

Insurance branches covered

By definition, policyholder protection funds (i.e., general funds) should cover a wide range of insurance products. Various branches of insurance are normally divided into two sectors: life (and health) insurance and non-life (property and casualty) insurance. Given the difference in the nature between the two sectors (particularly, the former is normally a long-term business while the latter is generally short term) and also reflecting the segregation policy in most countries, the existing funds cover only one of two sectors. In Canada, Japan and the United States[8], two funds have been established to cover the respective sectors. France and Poland have created one fund that covers life insurance. The Polish fund also covers compulsory non-life insurance, while France has set up a fund separately from the compensation scheme for compulsory liability insurance. By contrast, Ireland has established only one fund that covers all non-life insurance products, including the compulsory ones. In Norway there have been two funds created -- one covering all non-life insurance classes except for credit insurance and the other is for credit insurance only. In Korea and the United Kingdom, there is a single fund for all insurance classes (and other financial products as well in the case of Korea), but it has two separate accounts for life and non-life insurance businesses respectively that are operated in principle independently in order to avoid any cross subsidy between the two sectors.[9]

Moreover, the existing funds do not necessarily cover all the insurance branches of the sector they cover. In accordance with the objective to protect non-professional policyholders, certain insurance products that are designed particularly for corporations are often excluded from the coverage of the funds, as corporations should normally be able to get sufficient information on the products and the companies and assess appropriately the risks involved. Reinsurance and marine insurance are typical examples of the branches that are usually not covered by policyholder protection funds. In the Japanese system, the branches covered by the funds are positively listed to limit the protection to those largely targeted at individual customers such as life, motor vehicle liability, fire and disability insurance. The Policyholders Protection Scheme of the United Kingdom does not cover insurance policies underwritten at Lloyd’s, mainly because Lloyd’s has its own compensation scheme internally.

7. One of the issues related to the coverage of policyholder protection funds is whether a fund should extend its protection to foreign policyholders or domestic policyholders of a foreign insurer. However, this paper does not cover this issue.

8. Except for the State of Wisconsin, which has established a single fund covering both life and non-life insurance.

9. Some policyholder protection funds established in other countries also have separate accounts that cover different insurance branches to limit cross subsidy among them. The question of how insurance branches should be segregated is not examined in this paper.

Eligibility of claimants

In order to limit the protection by policyholder protection funds to those who really need it, some funds do not allow corporations to ask for compensation for their claims. In the United Kingdom scheme, only individuals and partnerships comprised of individuals are eligible for protection, except for compulsory insurance for which corporations are also entitled. This eligibility for compensation is expected to be modified under the Financial Services Compensation Scheme that will integrate various financial service customer protection schemes including the Policyholders Protection Scheme, so as to include small businesses but exclude large partnerships.[10] The Irish fund also excludes from its protection claimants who are not natural persons unless they have a liability to a natural person or a natural person has a liability to them.

Other funds do not have particular eligibility restrictions according to the nature of the claimants. It may be because the limitations on the insurance branches to be protected and the caps on the compensations should work effectively to limit the benefit that larger corporations can get from the safety net systems and, thereby, to discourage the moral hazard behaviour on their part.

Limitations on compensations

Most of the existing policyholder protection funds have certain limits on the compensation that the funds guarantee to pay for claimants in the event of insurance insolvency.[11] This intends to reduce the moral hazard problem by requiring policyholders to share losses so as to urge them to make prudent decisions in selecting insurers.

Actual limitations on compensation vary significantly across the existing funds, as summarised in Table 1. There are largely two types: payment ceilings and partial payments (sometimes called as “co-insurance”). Countries like Canada, France, Korea and the United States have adopted the former method. Many of the funds adopting this method set a fixed amount limitation on a policyholder basis, not on a policy basis. This is probably because a ceiling on a policy basis can easily be overcome by dividing the insurance into pieces. It is noted, however, that the operational cost could be higher for the policyholder-based approach than for the policy-based one, as the former requires all the policies of a policyholder to be added up in determining the amount to be paid. Moreover, dividing insurance into pieces may incur more loss than doing the same for other financial products, which would discourage policyholders from doing so. The table shows that the level of the ceiling differs across jurisdictions and sectors.

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10. UK Financial Services Authority Consultation Paper 24 “Consumer compensation: a further consultation”, June 1999

11. For example, the guarantee arrangement for non-life insurance companies in Norway does not currently have any explicit limitations on the compensations for claimants. The Banking, Insurance and Securities Commission (Kredittilsynet) is now proposing a legislative amendment to put in place the following limitations:

    - The guarantee scheme should not include insured risks within blue water hull insurance, energy insurance, aviation insurance and accepted reinsurance. Moreover large commercial risks within non–marine insurance should be excluded given that some specified criteria are fulfilled.

    - Claim amounts exceeding 20 million NOK (approximately 2.4 million Euro) should not be covered by the guarantee scheme.

    - The guarantee scheme should not cover more than 90 per cent of a single claim, except for the claims arising from housing insurance which should be fully covered.

Japan and the United Kingdom do not have a fixed limit on the amounts paid to each policyholder or policy by the funds. Instead, they restrict compensation to 90 percent of the claims. An exception is applied to compulsory insurance for which the claims are guaranteed in full. This is because compulsory insurance schemes normally aim at ensuring a minimum indemnification, which should not be reduced in the event of insolvency of an insurer. As mentioned above, the funds for a certain compulsory insurance usually pay the full amount of the claims.

Table 1 **Limitations on compensation**

	Fund for life insurance	Fund for non-life insurance
Canada	CAD 200,000 (USD 130,000) but CAD 60,000 in cash value[1)]	CAD 250,000 (USD 160,000)[2)]
France	70,000 Euro	--
Ireland	65% of the claim but not more than IRL 650,000 (825,000 Euro)	--
Japan	90% of the claim	90% of the claim[3)]
Korea	50 million won (USD 39,000)	50 million won (USD 39,000)
Norway	--	No limit
Poland	--	50% of the claim but not more than 30,000 Euro
UK	90% of the claim	90% of the claim[3)]
US	USD 300,000 but USD 100,000 in cash value[4)]	USD 300,000[4)]

Note: 1) Death benefits under life insurance policies. 2) For a single event. 3) 100% for compulsory insurance. 4) Quoted from the NAIC model acts

Although a ceiling and partial payment for compensation share the same objective of restricting the moral hazard problem that policyholder protection funds may raise, they have different focuses. The former puts emphasis on prevention of moral hazard behaviour by large policyholders, while providing full protection for small ones. It should also contribute to limiting the cost of handling a case, which alleviates the financial burden for member companies. By contrast, the latter requires all policyholders, including small ones, to share the consequences of their selection of an insurer. It therefore seeks to reduce moral hazard of all consumers, companies and supervisors and to enhance market discipline on the management of insurers. Interestingly, the proposed new scheme in the United Kingdom plans to cover 100 percent of the claims of non-compulsory general insurance up to GBP 2,000 (approximately 3,200 Euro[12]), while parts of the claims exceeding that amount and claims of life insurance continue to be subject to 90 percent protection.[13] In contrast, Ireland and Poland have both ceilings and partial payment limitations.

In spite of the limitations indicated in the table, in Korea, the insurance products were protected in full until December 2000. The Japanese schemes were also expected to compensate 100 percent of the claims against insurers that were found insolvent by March 2001, after which the coverage has reverted to 90 percent. In these countries, the insurance claims, in effect, had been fully protected by supervisory measures to avoid any bankruptcy of insurance companies until recently when one or more large companies went bankrupt.

12. The exchange rates used in this paper referred to those as of 16 March 2001: 1 Euro = GBP 0.626, IRL 0.788, FF 6.56, NOK 8.18, and USD 1 = CAD 1.56, JPY 123, 1288 won.

13. UK Financial Services Authority Consultation Paper 58 “Financial Services Compensation Scheme Draft Rules”, July 2000

2. Functions

Payment of compensations

The fundamental objective of policyholder protection funds is to compensate losses of policyholders in the event of insolvency of an insurer. A basic operation of the funds is, therefore, to pay out compensation to the eligible insurance claimants after an insurance company is declared insolvent. Upon payment, the rights of the claimants are automatically assigned to the funds to the extent of the amounts paid. The funds then recover the payments, at least partially, during the judicial insolvency procedure.

All or part of the operation is often commissioned to one or more member companies. It may benefit the policyholders, as it is likely to facilitate their ability to obtain similar insurance from the companies carrying out the operation.

Continuation of insurance contracts

In the case of life insurance, the funds in Canada and the United States may assume the covered insurance contracts of the insolvent company, administer those contracts and pay claims up to the covered amounts. This is because, owing to the long-term nature of the products, policyholders are considered often better off if their contracts are continued rather than having contracts immediately terminated and receiving compensation in cash. In contrast, property and casualty insurance is generally short term. Therefore, the continuation of the contracts is considered less important than the efficient handling of the insolvency cases. The claims for events that occur before the date of the bankruptcy or for a certain period (usually 30 to 45 days) afterward are covered by the funds, but the remaining contracts at the end of the period are terminated and paid off. The policyholders are therefore required to make similar insurance arrangements with other companies if they want to be continuously insured.

Some countries put more emphasis on the continuation of insurance contracts in protecting policyholders. In Japan, when there is a member company that is willing to receive the transfer of all or part of the insurance portfolio of the insolvent company, the policyholder protection funds, either of life or non-life insurance companies, are expected to give financial aid to the receiving company to ensure or facilitate the transfer. This seems to be based on the belief that portfolio transfer is the most effective and efficient way to protect the interests of policyholders in the event of insurance insolvency. In order to alleviate the moral hazard problem, the insurance contracts to be transferred may be modified to decrease the benefits up to the level protected by the funds and also to lower the implied rates of return if they are too high. In the case where such a receiving company cannot be found, the funds are expected to undertake the insurance contracts of the insolvent company, administer them and pay claims to the extent that they are covered. The United Kingdom scheme may also make payments to the insolvency practitioner or the insurer receiving the portfolio transfer for facilitating the deal. Similar payments can be made by the Canadian life insurance fund and the Korean fund.

It is probably desirable to prepare options in carrying out the protection of policyholders in the event of insurance insolvency and select the most appropriate operation according to a given case. However, this selection is likely to be difficult. Generally speaking, portfolio transfer may provide better protection to policyholders, but sometimes requires substantial financial aid to match the assets with the liabilities to be transferred. As applied in the United Kingdom, the principle of selecting the most cost efficient operation may need to be established, though it may then raise another question for what should be included in the "cost".

3. Funding

Funding methods

Policyholder protection funds are normally financed by the contributions collected from (or levies imposed on) member companies. The contributions of respective member companies must be assessed in a fair manner and collected in such a way as to avoid imposing excessive burden on the companies.

There are largely two ways as to raise funds for the schemes: pre-funding and post-funding. In the former case, the contributions are collected regularly from member companies to build up a fund in preparation for future insolvency cases. Until disbursed to protect the interests of policyholders of an insolvent company, funds in the schemes are invested in safe and liquid assets, typically government bonds. In the latter case, the contributions are called for only when the fund actually needs to pay for policyholders, and therefore no fund or pool of money is accumulated in the schemes.

Pre-funding has some merits. First of all, it serves to handle insolvency cases relatively quickly, as funds for compensations for policyholders are always ready. This is especially important in dealing with the bankruptcy of a larger insurer, for which a considerable amount of funds needs to be mobilised within a short period. Second, the existence of a sufficient amount of funds for policyholder protection ensures the visibility of a safety net and thus contributes to the maintenance of public confidence in the industry. It can be stated, however, that the ready-to-use funds may induce moral hazard behaviour of consumers, companies and supervisors. Moreover, because of its visibility, the lack of sufficient funds may adversely affect public confidence. Third, pre-funding can provide better predictability for member companies concerning future financial burdens.

Post-financing has different advantages. First, it requires virtually no administration costs (such as fund management costs for pre-funded scheme) until an insolvency case comes out, and thus is less costly. Second, post-financing allows member companies to retain funds until these funds become of immediate necessity. The companies should be better off using the funds for their business than pooling them in a policyholder protection scheme that principally invests in safe, but less profitable, assets.

There is no common practice internationally in this respect. France, Japan and Korea have adopted pre-funded schemes, but Ireland, Poland, the United Kingdom and the United States[14] have post-funded arrangements. The Canadian schemes have employed a post-financing method, but have recently introduced a prefund mechanism. The funding mechanism of the Norwegian schemes is in effect a combination of pre-funding and post-funding methods. It is essentially a pre-funded scheme, as member companies are required to set aside the contributions each year until the accumulated sum (labelled as "provision for the guarantee arrangement") reaches the prescribed level. However, the individual companies retain and manage the funds pooled in them respectively (i.e., the assets corresponding to the provision) until the board of the guarantee scheme calls for payment of the contributions to use for protecting policyholders of failed insurers, as is the case of post-funded schemes. This mechanism is partly introduced in the French scheme, which allows member companies to retain one half of the amount of their contributions until the funds become necessary in actuality. It perhaps aims to incorporate the advantages of post-funding into a pre-funding scheme, though it might also run the risk of a lack of readiness of sufficient funds for policyholder protection.

14. The exception is the New York State fund for property/casualty insurance, which employs a pre-funded structure.

Even with the current diversity, a slight tendency may be observed in favour of pre-funding, because the countries that introduced a policyholder protection fund most recently (i.e., France, Japan and Korea) preferred a pre-funded scheme. Moreover, as stated above, the funds in Canada have recently incorporated a prefund mechanism in their essentially post-funding arrangement. This is explained to intend that the funds become more capable of handling a large insolvency case quickly.[15] With such a mechanism, these funds can be viewed as operating effectively on a pre-financing basis.

From the viewpoint of contributing companies, however, the difference between the two methods may not be so significant. On the one hand, pre-funded schemes do not require member companies to make contribution, once the fund reaches a predetermined level. After this point, member companies become obliged to pay only when the fund goes below the level due to the payments for policyholders, as they would do under post-funded schemes. On the other hand, under the latter schemes, member companies may also be required to pay contributions for several years because of the cap explained below. They may have to continue to pay more if other cases come out during that period, as they would do under the former schemes.

The level of funds needed to accumulate in a pre-funded scheme varies across sectors and countries, largely reflecting the size of companies covered by the respective schemes. The French fund (for life insurance) expects to build up FF 1.8 billion (approximately 270 million Euro; including the parts retained in the member companies), which can normally be reached in three years. In Japan, the level is set at JPY 400 billion (approximately USD 3.3 billion) for the life insurance fund, and JPY 50 billion (approximately USD 410 million) for the non-life one. These amounts are considered sufficient to cover a few insolvency cases of average-sized companies in each sector. Each non-life insurance company in Norway has to augment the provision for the guarantee arrangement until it amounts to 1.5 percent of the overall earned gross premiums for direct insurance during the last three years. The prefunds set up in the Canadian schemes seem much smaller. A prefund of the non-life insurance fund (PACCIC) amounts to almost CAD 30 million (approximately USD 19 million), which resulted from a special levy collected from member companies during 1998 to 2000. The target level of a prefund of the life insurance fund (CompCorp) is set at CAD 100 million (approximately USD 64 million). The relatively low levels suggest that these funds should only cover the payments at an initial stage in advance of the collection of contributions from member companies on a post-financing basis (i.e., the amount of money necessary to handle an insolvency event is assessed and collected when the event occurs).

Especially when a larger company fails, a large amount of funds need to be used to protect the interests of policyholders. In order to deal with the case swiftly, policyholder protection funds are normally able to borrow from member companies or from other credit institutions. This is indispensable particularly for the post-financing schemes, which do not have funds in advance. Member companies are usually required to provide financing up to certain limits that are often prescribed as the equivalent to the maximum amounts of the annual contributions or their multiples.

15. In the case of the non-life insurance fund (PACCIC), the creation of a prefund was linked with its decision to pay out claims for unearned premiums, which it did not do initially, in order to help the policyholders replace their insurance quickly.

Assessment of contributions

The contributions of respective companies are normally calculated based on gross or net premiums.[16] This seems reasonable, considering that the burdens of contributions are at least partly passed on to policyholders, the direct beneficiaries of the scheme, in the form of increased premiums. Premiums received are also an adequate indicator of the payment capacity of insurance companies on a flow basis. In Japan, however, the assessment of the contributions takes into account not only premium incomes but also technical reserves, in order to reflect the payment capacity of the companies on a stock basis as well. The French scheme depends only on technical reserves in the assessment of the contributions. Interestingly, the life insurance fund in Canada (CompCorp) has recently changed its formula to calculate contributions. It was previously based on the five-year average premium but it now uses the new base calculated from the required capital that the company with the authority.

In a pre-funded scheme, member companies are normally required to pay in the prescribed contributions each year. In contrast, under a post-financing system, the annual contributions vary considerably from year to year, depending on the level of funds needed to deal with bankruptcy cases. Basically, the amount used for the operation of the scheme is shared among member companies based on gross or net premium incomes. However, the existing post-funded schemes have a cap on annual contributions in order to avoid an excessive burden on surviving member companies. The prescribed rates for contribution for the existing pre-funding schemes and the caps for assessments under the post-funding arrangements are indicated in Table 2.

In the assessment of the contributions, Korea provides an interesting example. Reportedly, in the Korean system, the assessment takes the risk factor into account. Insurance companies are categorised into three groups according to their respective financial soundness. The companies in the least risky group enjoy 5 percent discount in their contributions, while the contributions for those in the most risky category are increased by 5 percent. The risk-based assessment of the contributions is similar to the one for deposit insurance in the United States. It is intended to avoid placing an unfair burden on soundly managed companies and to give incentive to member companies to improve their financial soundness. There are, however, arguments against this approach, which include that it may increase insolvency cases by imposing a heavier burden on less profitable companies.

16. The definition of "gross" or "net" premiums varies across jurisdictions. This paper does not analyse the details.

Table 2 **Assessment of annual contributions**[1)]

		Fund for life insurance	Fund for non-life insurance
Pre-funding	France	0.05% of technical provisions	--
	Japan[2)]	JPY 40 billion (USD 330 million) for all the member companies	JPY 5 billion (USD 41 million) for all the member companies
	Korea[3)]	0.3% of premium income	0.3% of premium income
	Norway	--	1% of gross premium income
Post-funding (caps)	Canada[4)]	1.33% of capital required[5)]	0.75% of premium income[6)]
	Ireland	--	2% of gross premium income
	Poland[7)]	n.a.	
	UK	1% of gross premium income	1% of net premium income
	US	2% of gross premium income	2% of net premium income

Note: 1) A term "premium income" is not strictly defined below and may differ among jurisdictions. Therefore, it is not appropriate to compare the figures directly across the jurisdictions. 2) Due to a series of insolvencies of both life and non-life insurance companies in the last few years, these figures are increased to JPY 46 billion (for the life insurance fund) and JPY 6.5 billion (for the non-life one) for the time being. 3) The rate was raised from 0.15 percent as of June 2000. 4) With a prefund mechanism, both funds in Canada can also be classified to pre-funding. The figures referred to concern the assessments for the fund to be paid for policyholders. 5) Subject to the floor of a proportionate share of CAD 100 million. Special assessments could also be levied if necessary to replenish the prefund or to prepare for potential future commitments. Capital required is equal to the one filed with the authority after some adjustments for this assessment purpose. 6) Also subject to the floor of a proportionate share of CAD 10 million with a cap of 1% of premium income. 7) The law says that the rate shall be specified by the regulation by the Minister of Finance.

Government support

Although policyholder protection funds are in principle financed by member insurance companies, in some countries, governments may support funding of the funds. For example, the Irish legislation stipulates that the government may advance to the Insurance Compensation Fund proper sums to enable the Fund to make necessary payments for policyholder protection, and such advances have been made in the past.[17]

Japan and Korea have recently introduced some government support measures in the face of serious crisis in the insurance industry. In order to combat with such a crisis in the last few years, Japan has set up the scheme where the government guarantees borrowing by the policyholder protection corporations to facilitate their fund raising for policyholder protection.[18] In addition, responding to a series of failures of life insurance companies, the government declared its intention to support the life insurance fund by providing up to JPY 400 billion (approximately USD 3.3 billion), if the fund needs to pay for dealing with the failures beyond JPY 560 billion (approximately USD 4.6 billion) to be accumulated with the

17. The Irish government provided a grant of IRL 30,000 to establish the Insurance Compensation Fund in 1964. More recently, even after the introduction of a levy on member insurance companies, advances were made of IRL 100 million in 1985 and IRL 32 million in 1993.

18. This scheme was introduced as a temporary measure applicable until March 2001, but the deadline has been lifted for the Life Insurance Policyholders Protection Corporation.

contributions from member companies.[19] Similarly, the Korea Deposit Insurance Fund can raise funds to deal with insolvency cases of financial institutions including insurance companies by issuing government guaranteed bonds.[20] The experiences in these countries suggest that under such crisis situations, the government may be required to support the safety net, as the industry is probably unable to meet the immediate costs of a series of bankruptcies. It should also be noted that these measures, coupled with explicit blanket guarantees of insurance policies, would be necessary in the process to move from the implicit full guarantee tradition to the new regime of limited coverage safety net.[21]

Another form of government support for funding of policyholder protection funds is tax deductibility of the contributions that member companies pay into the funds. As these contributions are normally recognised as expenses and thus reduce corporate taxes that the company has to pay, part of the costs for protecting policyholders are effectively passed on to the government and thereby to the taxpayers.

Moreover, in the United States, some state laws allow insurance companies to recoup the contributions through the use of premium tax credits, typically amortised over five years, while other state laws provide for recoupment through an increase in rates or a surcharge added to policies. The use of premium tax credits is much more prevalent with regard to life/health insurance companies, where rates for many products are fixed over a long term.

4. Governance

Organisation

Policyholder protection funds are normally founded by member insurance companies as non-profit legal entities.[22] The funds are organised in accordance with specific legal provisions that stipulate basic elements of the funds such as the objective, coverage, functions, funding and governance, though the details are determined by regulations, by-laws, memoranda and so on.

The funds are normally administered by a board of directors or governors.[23] Members of the board are either elected at the meetings of members or appointed by the authority. The actual composition of the boards differs among jurisdictions and funds. The boards usually consist of the directors who represent member insurance companies. In addition, many boards also include independent directors who are expected to represent public or consumer interests. For example, the board of the Canadian Life and Health Insurance Compensation Fund (CompCorp) comprises independent directors only. Both of the Japanese Policyholders Protection Corporations have a board in which independent directors consist of the majority. In some cases, the insurance commissioner or his representative sits on the board.

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19. This government support arrangement is a temporary measure that is available until March 2003.

20. By the end of 1999, the Korea Deposit Insurance Fund raised 43.5 trillion won with government guaranteed bonds, all of which has been used to handle the cases of insolvent financial institutions. However, the Fund expects to recover these funds by rehabilitating those institutions under its control and selling them off in due course.

21. A Background Paper (June 2000) produced by Financial Stability Forum Working Group on Deposit Insurance discusses the issues related to the transition from blanket guarantee to limited-coverage safety net systems in the context of deposit insurance.

22. An exception is the Insurance Compensation Fund in Ireland, which was established with a grant made by the Minister of Finance.

23. The exception is the Irish fund, which is administered by the Accountant of the High Court, acting under the control of the President of the High Court.

Some funds establish one or more committees in addition to the board of directors. The function of these committees varies. For example, CompCorp has the Industry Advisory Committee and the Asset Review Committee. The Property and Casualty Insurance Compensation Corporation (PACICC) of Canada forms the Advisory Committee on an ad hoc basis to handle a given insolvency case. The two Policyholder Protection Corporations in Japan have the Steering Committee that provides advice on the critical operations of the Corporation and the Asset Evaluation Committee. The Insurance Guarantee Fund in Poland has the Fund Council that supervises the affairs of the Managing Board.

The discretionary power of the funds and their boards also varies across jurisdictions, but is largely limited to operational decisions. The funds are legally obliged to provide protection for policyholders in the event of insolvency of member insurers. In some cases, the funds are authorised to decide whether or not to take actions for protecting the interests of policyholders when a member company is not found insolvent but seriously impaired. When there are multiple options available for handling a case (such as direct payment of compensation or financial aid to portfolio transfer), the funds may have discretion to select one. Moreover, various other decisions as to practical operations are also naturally the responsibility of the funds. When necessary to carry out their duties, they may enter into contracts to commission some operations, take legal actions and make concessions to recover their funds, employ staff, borrow money, and so on.

Membership

Policyholder protection funds can be designed with either compulsory or voluntary membership. One may argue that even under voluntary membership, the insurance companies should have strong incentive to participate in the fund, as it enhances their credibility with the public. In reality, however, the most, if not all, of the existing funds have compulsory membership, under which any insurance company conducting one or more lines of insurance business covered by a fund has to be a member of the fund. In Japan, the Policyholder Protection Funds established in 1996 had voluntary membership. The Funds were, however, abolished by the law in 1998 that has created the Policyholder Protection Corporations which adopted compulsory membership.

Two reasons can be pointed out for compulsory membership. The first is to ensure the protection of policyholders of insurance, who may unintentionally choose an uncovered insurance company under voluntary membership. This could happen if the company is allowed to drop out of the fund at any time. Given the cost for policyholders to switch their contracting insurance companies, the policyholders of the company might suddenly be left outside of the safety net due to the company’s arbitrary decision to drop out of the fund.

The second reason is to avoid the adverse selection problem. Risky companies have a strong incentive to participate in the safety net scheme as they can enjoy significant enhancement of their credibility. On the contrary, soundly managed companies, which have already established a good reputation in the market, have less incentive to be a member, because they may find the cost of the participation (i.e. contributions) to be heavier than the benefit. As a result, the fund with voluntary membership may attract risky companies only, which is likely to create a serious financial problem to the fund in the end. In consequence, once the decision has been made to introduce policyholder protection funds in spite of their drawbacks mentioned above, there is a strong case for compulsory membership.

Co-operation with the supervisory authorities

Another important governance issue is the relationship of policyholder protection funds with the insurance authorities. Although normally established as independent entities from governments, the funds need to be operated in close co-ordination with supervisory authorities in order to carry out effective policyholder protection. Usually there is a good working relationship between a fund and the supervisor. Besides, some jurisdictions prepare certain formal arrangements to institutionalise effective co-operation between the two.

One such arrangement is the involvement of the supervisor in the decision making of the fund on important issues. In the United States, for example, the insurance commissioner may be a member of the board, or have the right to attend all board meetings. In Canada, the insurance regulatory authority is entitled to convene and participate in meetings of the board and the advisory committees of CompCorp. In the Polish scheme, a representative of the supervisory body becomes a member of the Fund Council when bankruptcy of an insurance company is declared. In addition, approval from, or consultation with, the supervisory authority is often legally required for important operational and managerial decisions by the funds.

Relation with judicial insolvency procedure

Policyholder protection funds function in the wake of insolvency of an insurance company. Although some funds are expected to handle a case regardless of court actions if a company is not insolvent but seriously distressed, the commencement of the judicial liquidation or reorganisation of a member company always triggers the operation of such funds.

Conceptually, the operation of the funds to protect the interests of policyholders can be carried out separately from the judicial procedure. It would be desirable when the supply of liquidity for policyholders is highlighted as a benefit of the funds in addition to compensation for losses.[24] The funds may pay out compensation to policyholders up front, and then participate in the judicial procedure as a creditor with the rights assigned from policyholders. Practically, however, the operation of the funds needs to be implemented in close co-ordination with the judicial procedure. For example, insurance claims protected by the funds should also be found eligible in the judicial procedure.

In many instances, the supervisory authorities are expected to play a role in co-ordinating the operation of the funds and the judicial proceedings. In some cases, the two procedures are directly linked. In Ireland, only liquidators appointed by the High Court can apply for and receive from the Insurance Compensation Fund, the funds to be distributed in the liquidation proceedings under the Court.

24. Up front provision of liquidity is often emphasised as an important merit of deposit insurance systems. In the case of insurance, however, it may be less relevant, as insurance payments or repayments in cancellation of the contracts usually take some time.

V. Conclusions

The establishment of policyholder protection funds (i.e. general funds) is clearly beneficial in promoting the protection of policyholders, supplementing insurance supervision in the event of insurer insolvency. However, there are also drawbacks that cannot be neglected, which perhaps accounts for the fact that only a limited number of countries have introduced such funds.

In recent years, however, there seems to be a trend towards creation of these funds, mostly triggered by the failure of one or more larger insurance companies in the countries. It has probably also driven by the convergence of financial service sectors, especially between insurance and banking that is usually equipped with a deposit insurance scheme. Given the difficulty of abolishing a safety net system and the deepening convergence of financial markets and perhaps of financial regulations, this trend is likely to continue.

When established, policyholder protection funds should be designed carefully to minimise any drawbacks, particularly the moral hazard problem and the burden on soundly managed member companies. However, the actual structure of the existing funds can differ considerably in various important aspects such as coverage, functions, funding and governance.