Group of governmental experts on insurance solvency

POLICYHOLDER PROTECTION FUNDS

(Note by the Secretariat)

This document is circulated for discussion under item 6 of the agenda of the 16th Session, to be held on 28 November 2000.
POLICYHOLDER PROTECTION FUNDS

Summary and Questions

1. Policyholder protection funds (or guaranty schemes) are fairly common among Member countries. However, many of them focus on specific branches of insurance, in particular, compulsory ones. This type of funds steps in not only when the insurer becomes insolvent, but also when the responsible insurer cannot be identified. It is understood that these funds are usually intended to supplement the compulsory insurance system by providing protection to the beneficiaries. In contrast, only a limited number of Member countries have introduced policyholder protection funds that provide protection in the event of bankruptcy of a member company to policyholders of generally all the branches of insurance of that company.

2. The lack of internationally common practice regarding the latter type of policyholder protection funds (referred to simply as “policyholder protection funds” or “the funds” hereafter in this section unless otherwise specified) reflects diverse views concerning the benefits and drawbacks of the funds. On the one hand, the establishment of such funds may be rationalised by four reasons. First of all, non-professional policyholders, especially individual ones, should be protected even when an insurer goes bankrupt in spite of all possible supervisory efforts. Second, protection of the interests of policyholders in the event of insurance insolvency contributes to the maintenance of the public confidence in the insurance industry that is important for social welfare but vulnerably rely on the people’s perception. Third, such funds prepare a smooth exit mechanism for incompetent insurers and thereby contribute to the development of competitive markets. Last, given the increasing convergence between insurance and banking sectors, a safety net system similar to deposit insurance is necessary to prepare a level playing field for both sectors.

3. On the other hand, three drawbacks are often highlighted in the arguments against policyholder protection funds. The first is that the safety net system would create a serious moral hazard problem in customers, insurers and the supervisors. The second shortcoming of the funds is the financial burden their use imposes on member companies, which would affect the latter’s financial soundness. It might eventually undermine the sound development of the industry and even provoke a crisis situation. Third, the financial burden would weaken the competitiveness of member companies relative to insurers outside of the jurisdiction that are not subject to such funds.

4. Despite the strong arguments against policyholder protection funds, the number of countries that have introduced such funds has increased especially in recent years. This trend seems to be driven by the experience of one or more large insurance insolvencies within the countries and also by increased attention to convergence of the insurance (especially life insurance) and banking sectors.

Q1: What are the most important benefits and drawbacks of policyholder protection funds? Under what situations or conditions do the benefits outweigh the drawbacks?

Q2: Do Delegates observe a trend towards the establishment of these funds? What are the driving forces? Do Delegates think this trend will continue?
5. When introduced, policyholder protection funds are carefully designed to pursue their objective effectively while limiting the drawbacks. However, the actual structure of the existing funds varies to a large extent. First of all, the coverage of the protection provided by the funds is normally restricted in order to contain the moral hazard problem. For example, certain branches of insurance that are exclusively used by professional corporate customers, such as reinsurance and marine insurance, are normally excluded from coverage. In some countries, corporate policyholders are not eligible to claim for the compensation from the fund. Moreover, there is usually some limitation on the claims covered by the funds in the form of a ceiling and/or partial guaranty, except in the case of compulsory insurance for which no limitation is normally applied.

6. Second, the basic function of policyholder protection funds is to pay out the covered claims to the claimants. However, policyholders, especially those of life insurance, may be better protected if the insurance contracts are continued. The funds for life insurance are often able to secure the continuation of the covered insurance contracts by assuming and administering the contracts of the failed company or by providing financial aid to facilitate portfolio transfers to one or more member companies. In some countries, the funds for property and casualty insurance are also able to conduct such operations.

7. Third, policyholder protection funds are normally financed by contributions (or levies) collected from member companies. The contributions of respective member companies need to be assessed in a fair manner and in such a way as to avoid excessive burdens on the companies. The contributions are usually calculated based on gross or net premium incomes. There are pre-funded and post-funded schemes. In the former, the contributions are raised regularly to accumulate funds for future insolvency cases. In the latter, member companies become liable for contributions only when funds are needed to handle actual cases. The contributions under post-funded schemes therefore fluctuate from year to year, but normally a cap is set for the annual amounts. In some cases, the government supports the funding of the funds, directly by providing a guaranty for the funding to alleviate the financial burden on member companies, or indirectly through tax deductions for the companies’ contributions.

8. Finally, policyholder protection funds are usually organised by member companies as non-profit legal entities. The membership is normally compulsory; i.e., any company that includes a covered branch of insurance in its business must be a member of the fund. However, practical governance structures and arrangements vary among the funds. There should be certain formal or working mechanisms to ensure close co-operation between the funds and the supervisory authorities in dealing with any cases. The operation of the funds is usually separated from, but co-ordinated with, the judicial insolvency procedure.

Q3: How should the coverage of policyholder protection funds be set to ensure adequate protection of policyholders while minimising the moral hazard problem?

Q4: Do Delegates consider that the funds should be able to preserve covered insurance contracts? In what situations may the provision of financial aid by the funds be adequate?

Q5: How should the contributions be assessed for respective member companies? How should they be collected? Should the government provide special support for the funding of the funds?

Q6: What are the key issues for the organisational and governance structure of policyholder protection funds? What sort of arrangements should the funds have with supervisors?
POLICYHOLDER PROTECTION FUNDS: RATIONALE AND STRUCTURE

I. Introduction

9. The protection of policyholders against insolvency of insurance companies is one of the primary objectives of insurance regulation. It can be best achieved by preventing the companies from becoming insolvent. Therefore, 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.

10. It is sometimes inevitable, however, that some insurance companies encounter serious financial difficulties. In spite of all possible supervisory measures, insurance companies can become insolvent. Thus, 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 in the winding-up procedure and those outside of it. The former type of arrangement is used in most jurisdictions. Such arrangements vary considerably across jurisdictions, however, largely depending on the peculiarity of the judicial insolvency procedures of respective jurisdictions as well as the specificity in the insurance regulatory frameworks. In addition, in many jurisdictions, policyholder protection funds (or guarantee schemes) have been established to provide certain protection for policyholders outside of the winding-up procedure.

11. 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

12. When an insurance company becomes insolvent, policyholders will possibly suffer 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 an insurance company goes bankrupt. These schemes are sometimes called policyholder guarantee schemes. In this paper, however, “policyholder protection funds” includes such schemes.

13. 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.

14. 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 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 amounts of the claims in principle.

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

16. 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. 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, eight countries, namely Canada, France, Ireland, Japan, Korea, Poland, the United Kingdom and the United States, have established such funds to date.\(^1\) 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

17. 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 the possible supervisory measures, bankruptcy is inevitable.

18. 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 subject to the full responsibility as creditors for insurance companies, they would abstain from getting insurance, which would deter the development of the insurance market.

\(^1\) Reportedly, the Netherlands plans to introduce a policyholder protection fund for life insurance. The relevant law has already been submitted to the Parliament for its deliberation and is expected to come into force in the beginning of 2001.
19. 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 regulations should be set up and supervisory authorities should take all the 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**

20. 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.

21. 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.

22. 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.

23. 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.

24. 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

25. 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.

26. Competitive markets create 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 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 may face in the event of the failure of an insurance company.

27. 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.

28. 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, which often disturb the efficient functioning of the market. Policyholder protection funds therefore can serve to develop dynamic and pro-competition insurance markets.

A level playing field across sectors

29. 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 ones, offer products that have significant savings elements. Insurance companies and banks are competing more and more directly.

30. 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

31. 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, consumer 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 they will not suffer from the negative consequences of their choice in the event that the risk materialises, i.e. the insurer goes bankrupt.

32. 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 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.

33. 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.

Financial burden on soundly managed insurers

34. 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.

35. 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 the competitors. This situation could seriously undermine sound and fair competition in the industry.

36. 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

37. 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 particular, 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.

38. This argument is, however, 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

39. 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.

40. 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 in 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 the United States 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). There are also some countries like the United Kingdom that do not grant any particular privileges to policyholders, which 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.

41. 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.

---

2 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.
42. 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. Given further convergence, establishing a safety net for policyholders, especially of life
insurance, equivalent to the one for depositors may have more grounds.

43. 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. In either case, however,
separate accounts are set up for different lines of business to avoid cross subsidisation.

IV. Structure: comparative analysis

44. 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.

1. Coverage

Insurance branches covered

45. 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, two funds have been established to cover the respective
sectors. France and Poland have created one fund that covers life insurance, though also having the funds
for compulsory liability insurance. In contrast, Ireland has established only one fund that covers all non-
life insurance products, including the compulsory ones. 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.

3 Communiqués de presse, 18 juin 1999

4 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.
46. 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 are normally 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.

Eligibility of claimants

47. 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 compensations 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. 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.

48. 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 their moral hazard behaviour.

Limitations on compensations

49. All 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. 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.

50. Actual limitations on compensation vary significantly across the existing funds. There are largely two types: payment ceilings and partial payments. Some 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 be easily 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. The level of the ceiling differs across jurisdictions and sectors. Some funds have a complicated setting for the ceiling, but at the risk of over-simplification, the general level of the ceilings are CAD 200,000 (approximately USD 132,000, but CAD 60,000 in cash value) in Canada, 70,000 Euro in France and USD 300,000 (USD 100,000 in cash value) in the United States concerning life insurance and CAD 250,000 (approximately USD 164,000) in Canada and USD 300,000 in the United States for non-life
insurance. The Korean scheme applies a limit of 50 million won (approximately USD 44,000) for all insurance products (per claimant).

51. 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 the compensations to 90 percent of the claims. The 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 amounts of the claims.

52. 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 different focuses. The former puts emphasis on prevention of the 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, while parts of the claims exceeding that amount and claims of life insurance continue to be subject to 90 percent protection. In contrast, Ireland and Poland have both ceilings and partial payment limitations. In the Irish scheme, which covers non-life insurance only, each claimant can receive from the fund 65 percent of the claim and up to IRL 650,000 (approximately 825,000 Euro). The Polish fund, which only covers life insurance, may pay to claimants 50 percent of the claims but not more than 50,000 Euro.

53. In Korea, the insurance products were protected in full as of March 2000. The Japanese schemes are also expected to compensate 100 percent of the claims until March 2001, after which the coverage will revert to 90 percent. In these countries, the insurance claims had been in effect fully protected by supervisory measures to avoid any bankruptcy of insurance companies until recently when one or more large companies went bankrupt.

2. Functions

Payment of compensations

54. 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.

55. 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. The Irish fund (only for non-life insurance) is particularly designed to provide the liquidator of a bankrupt insurer with funds to meet liabilities arising under insurance policies.

5 The US figures are quoted from the NAIC model acts.
to the extent protected. The liquidator then makes disbursements to policyholders in the judicial procedure.

Continuation of insurance contracts

56. 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 the similar insurance arrangements with other companies if they want to be continuously insured.

57. 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, 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 (CompCorp).

58. 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

59. 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 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 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 raised only when the fund actually needs to pay for policyholders, and therefore no fund or pool of money is accumulated in the schemes.

60. 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 the 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 the future financial burdens.

61. 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 by using the funds for their business than by pooling them in a policyholder protection scheme that principally invests in government bonds.

62. There is no common practice internationally in this respect. France, Japan and Korea have adopted pre-funded schemes, while Ireland, Poland, the United Kingdom and the United States have post-funded ones. A slight tendency may be observed in favour of pre-funding, the countries that introduced a policyholder protection fund recently preferred a pre-funded scheme. Moreover, the fund for property and casualty insurance in Canada has changed its funding method from post-funding to pre-funding with the view to become more capable to handle a large insolvency case. The French scheme is distinctive in this respect. It is essentially a pre-funded scheme and thus the contributions are collected in advance. However, member companies can retain a half of the amount of their contributions in their own assets and thus use the funds for their business until these funds become necessary for policyholder protection. This is in effect a combination of pre-funded and post-funded methods, seeking for the advantages of both.

63. 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.

64. 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 500 billion (approximately USD 4.6 billion) for the life insurance fund, and JPY 50 billion (approximately USD 460 million) for the non-life one. These amounts are considered sufficient to cover a few insolvency cases of average-sized companies in each sector.

65. 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.

Assessment of contributions

66. The contributions of respective companies are normally calculated based on gross or net premiums. 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.

67. In a pre-funded scheme, member companies are normally required to pay in the prescribed contributions annually. The contributions are 0.3 percent of premium incomes in Korea and 0.05 percent of technical provisions in France. In Japan, the total amount of the contributions raised from all member companies each year is predetermined to be JPY 50 billion (approximately USD 460 million) for life insurance companies and JPY 5 billion (approximately USD 46 million) for non-life ones and then allocated to respective companies according to premium incomes and technical reserves.

68. Under a post-financing system, in contrast, 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.

69. 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.

Government support

70. Although policyholder protection funds are in principle financed by member insurance companies, in some countries, governments may support funding of the funds. The Korea Deposit Insurance Fund can raise funds to deal with insolvency cases of financial institutions including insurance companies by issuing government guaranteed bonds. By the end of 1999, the Fund raised 43.5 trillion won with government guaranteed bonds, all of which has been used to handle the cases of insolvent financial institutions.

---

6 The definition of “gross” or “net” premiums varies across jurisdictions. This paper does not analyse the details.
7 The rate was raised from 0.15 percent as of June 2000.
8 These figures will be applied on and after the fiscal year 2001 (beginning at April 2001). Until then, they are set at JPY 56 billion and JPY 6.5 billion, respectively.
institutions. However, the Fund expects to recover these funds by rehabilitating these institutions under its control and selling off in due course. Japan also has a similar scheme for its policyholder protection funds, though it is only available until March 2001. In addition, the Japanese government is expected to support the life insurance fund by providing up to JPY 460 billion, if the fund needs to pay for dealing with the failures of life insurance companies beyond JPY 500 billion to be accumulated with the contributions from member companies. In both countries, these government support measures have been introduced in the face of serious crisis in the insurance industry. Under such a situation, government may need to support the safety net, as the industry is probably unable to meet the immediate costs of a series of bankruptcies.

71. Another form of government support for funding of policyholder protection funds is tax deduction of the contributions that member companies pay into the funds. As these contributions are normally recognised as expenses and thus reduce corporate tax that the company has to pay, part of the costs for protecting policyholders are effectively passed on to the government and thereby the taxpayers. Moreover, in most states of the United States, the contributions made by insurance companies are tax deductible in full amounts.

4. Governance

Organisation

72. Policyholder protection funds are normally founded by member insurance companies as non-profit legal entities. 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.

73. The funds are administered by a board of directors, who are elected at the meetings of members. 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. 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.

74. 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.

75. 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

76. 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.

77. Two reasons can be pointed out for compulsory membership. The first reason 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.

78. 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

79. Another important governance issue is the relationship of policyholder protection funds with the insurance authorities. Although 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.

80. One such arrangement is the involvement of the supervisor in the decision making of the fund on important issues. For example, the insurance commissioner is often a member of the board in the United States. 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 has been declared.

81. In addition, approval from, or consultation with, the supervisory authority is often legally required for important operational and managerial decisions by the funds. However, in the United States,
the board of directors of the funds may make recommendations to the commissioner in order to aid in the detection and prevention of insurer insolvency.  

Relation with judicial insolvency procedure

82. 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.

83. 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. 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.

84. 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.

V Conclusions

85. 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.

86. 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.

87. 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.

---

9 NAIC model acts

10 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.