SEOUL CENTER FOR FINANCE AND INNOVATION

IN COLLABORATION WITH

International Forum of Insurance Guarantee Schemes IFIGS

KDIC Korea Deposit Insurance Corporation

Establishing Efficient and Effective Insurance Guarantee Schemes

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Establishing Efficient and Effective Insurance Guarantee Schemes

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Acknowledgment

"Establishing Efficient and Effective Insurance Guarantee Schemes" helps fill a wide gap in the literature on guarantee schemes for failing insurers by sharing international best practice when designing critical aspects and by providing comprehensive guidance on their implementation. As experience indicates, guarantee schemes have the considerable potential to increase the level of confidence in insurance and improve the insurance sector's image.

The paper is a product of the Seoul Center for Finance and Innovation, the World Bank's Finance, Competitiveness and Innovation Global Practice (FCI) in the East Asia and Pacific (EAP) Region, based in Republic of Korea, and the FCI Global Unit on Long-Term Finance (EFNLT). It is part of a larger effort by the World Bank Korea Office to contribute to development policy discussions around innovation matters in the Region and around the world.

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Abbreviations

EAP	East Asia and Pacific
EFI	Equitable Growth, Finance, and Institutions Global Practice
EFNLT	EFI-FCI-Long-Term Finance (commonly the Global Unit on Long-Term Finance)
FCI	Finance, Competitiveness, and Innovation Global Practice
IAIS	International Association of Insurance Supervisors
IBNR	incurred but not reported
ICC	insurance contract creditor
IFIGS	International Forum of Insurance Guarantee Schemes
IGS	insurance guarantee scheme

Overview

A well-developed efficient insurance sector plays an important role in any economy. This role is supported by effective regulation and supervision with the aim of having a sound insurance sector that is growing, offering adequate covers, contributing to employment and investment, ensuring reduced exposure to poverty, and increasing shared prosperity.

These objectives go beyond merely protecting the interests of policyholders. They recognize that the insurance sector plays a much larger role in the economy, even for those who are not policyholders or beneficiaries.

Failure of insurers can undermine these objectives. Failure events might best be defined broadly and from a consumer perspective rather than through a literal analysis of a legal definition. It is clear that such events could have an adverse impact on both the policyholders and beneficiaries directly involved as well as the broader market. As a result, to the extent that it is possible to secure a most orderly resolution, these broader objectives will be better served.

It is not economically beneficial for a supervisory regime to guarantee no entity will ever fail. Excessively high capital levels would work against affordable insurance, overriding the pooling benefits of insurance for clients and reducing the motivation of effective risk management opportunities to the economy. Instead, regulatory and supervisory regimes act to reduce the probability of failure to economically and socially acceptable low levels. When a failure does happen, an orderly market exit will follow. To this end, regulation and supervision set and enforce prudential and market conduct standards, carry out assessment of risks, and make preemptive interventions.

As a result, the insurance sector maintains a high level of resilient providers with a well-developed system catering to orderly resolution.[2] To be considered orderly,[3] the resolution of insurers should include the following attributes:

→ *Be responsive to the variety of potential cases to which it could reasonably expect to be applied*. The potential for a resolution to be more or less orderly (or disorderly) will depend on

2 The Financial Stability Board published *Key Attributes of Effective Resolution Regimes for Financial Institutions* in October 2014 covering the broader financial sector and representing a revised edition of an earlier 2011 text that was more bank centric. It included a strong desire that resolution should be "orderly." It is available at http://www.fsb.org.

3 The Insurance Development Regulation and Supervision Community of Practice developed these criteria as part of seminars and group collaborative work in 2013.

the size of the insurer, the nature of the business conducted, the substitutability of products written, and the characteristics of the clients of the entity.

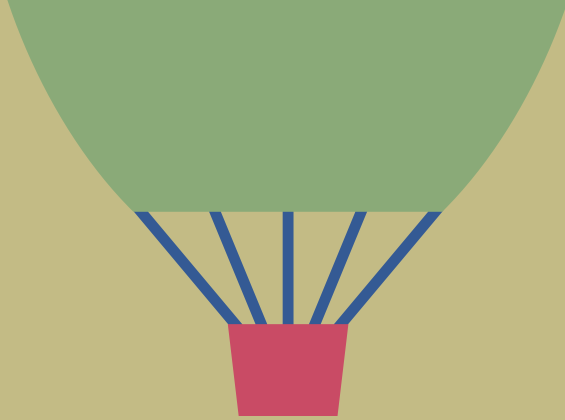
- *Be timely in that it responds to beneficiaries in a timely manner.* The precise nature of timeliness is likely to vary depending on the types of insurance and clients involved.
- *Maintains trust with both policyholders and beneficiaries of the entity in question and more broadly with the insurance sector.*
- *Is predictable, where a resolution is as planned as possible*. Without a plan, resolution is certainly unpredictable and more likely to be disorderly.
- *Is safe, in that the officers who carry out the resolution are able to do so without being in danger of physical risk*.
- *Addresses the need to provide sufficient continuity of cover.* Sometimes a system provides for some short-term continuity so that cover for unexpired risk can be arranged in a timelier fashion recognizing it may not be possible to organize substitution of product coverage immediately.

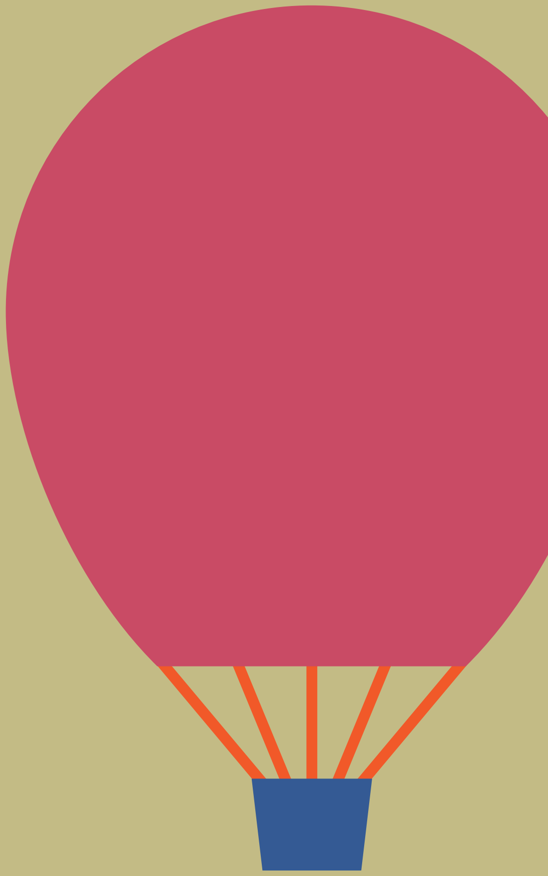
When developing these criteria, the contributors to this paper noted that voluntary exits will also be orderly. That said, few if any regimes can be sure that "involuntary exits" would meet these criteria. In fact, it is probably too optimistic to expect that an involuntary exit of an insurer would be completely orderly. Rather, the objective is that it should be as orderly as possible with the understanding that some element of disorder has to be accepted.

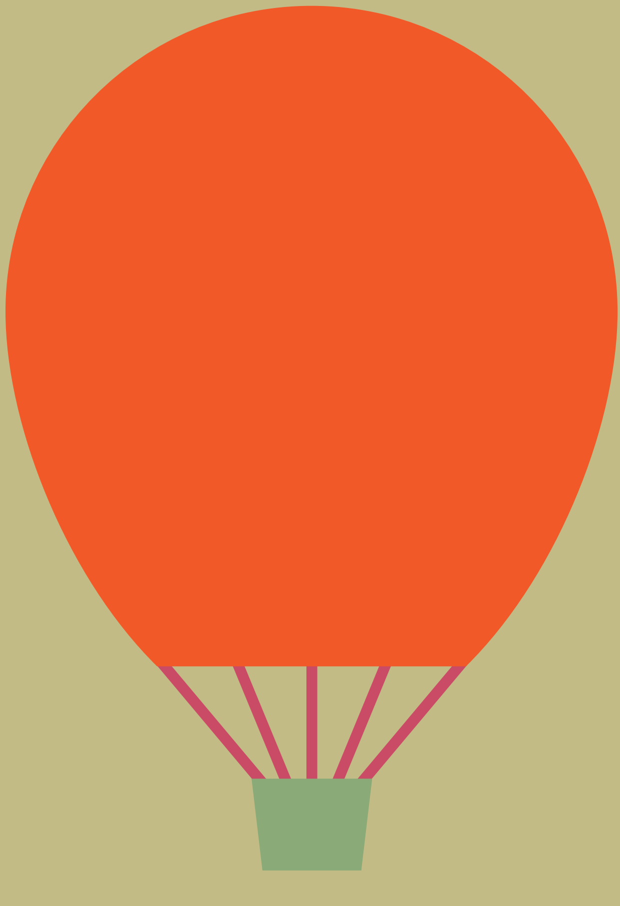
It is also noted that politics can add to the challenges of managing an insurer failure. Media and local politics can lead to significant pressure either regionally or nationally. While the normal activity of dealing with a crisis event is drawing heavily on the resources of the supervisory authorities, this additional layer of activity is usually not trivial. In some situations, political engagement is needed to secure the necessary mechanisms for resolution. Given the variety of actual situations that arise, it is often the case that politicians need to be engaged in the solution.

01

Introduction







1. Introduction

A guarantee scheme for insurers is an accepted benefit for the development of the insurance sector as a key tool in providing an orderly resolution of failing insurers and additional protection for insurance consumers at a reasonable cost. However, setting up a guarantee scheme requires a series of important decisions to be made for its efficient operation and the effective protection of insurance consumers without creating moral hazard among insurers or penalizing consumers that acquire insurance coverage from a well-run and prudent insurer, usually at a higher cost. After highlighting the rationale for establishing a guarantee scheme for the insurance sector, this paper summarizes international practice on critical features adopted around the globe to provide a complete guide on the choices to be made when establishing guarantee schemes. Choices based on international experience are meant to serve stakeholders in finding the best approach when establishing a guarantee scheme within their own distinctive environments rather than dictating the choices to be made.

Protecting consumers of financial products against insolvencies in the financial sector began with creating deposit insurance for banks. Governments saw the need to develop this type of protection to motivate consumers to keep their deposits in the banking sector with higher confidence and thus avoid runs on banks. These potential situations had been a source of creating, accelerating, and exacerbating systemic financial crises. In general, banks have more systemic risks than insurance businesses. The main idea behind a deposit insurance scheme is that the public's deposits, which are mainly personal accounts, remain protected up to a set limit and are made available very quickly following a bank's insolvency. The immediate availability of the deposits would be impossible without a deposit insurance scheme given the complexity of the liquidation of a bank, which requires several actors and considerable legal steps.

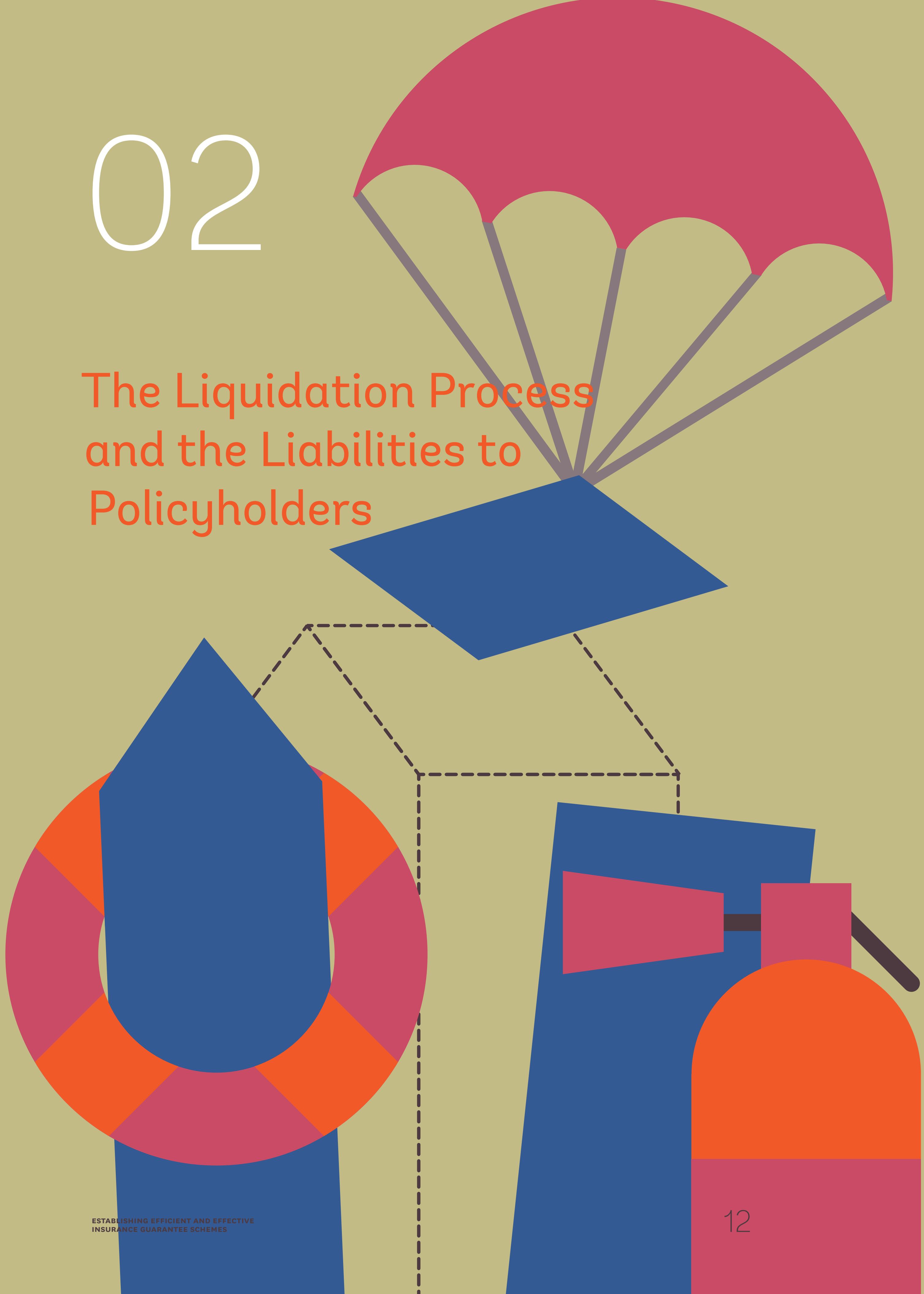
In most cases, urgent access to funds is not necessary for insurance consumers. Contrary to the strong motivation for developing deposit insurance for the banking sector, the need for immediate availability of the consumer funds held by an insurance company, although desirable, is not as critical as is in the case of a bank failure. This difference might explain the reason why the development of guarantee schemes for the insurance sector has been delayed. Even today, they are not as widespread as the deposit insurance practices for banks, which are present in almost all Organisation for Economic Co-operation and Development (OECD) countries (Schich and Kim 2011). As of 2021, 17 European Union Member States have insurance guarantee schemes in place, and their national schemes diverge from each other (Di Girolamo, Nan, and Petracco-Giudici 2021). The IFIGS has 26 member funds representing 21 nations.

The question of the need for a guarantee scheme for the insurance sector then arises. To answer this question, a look into the liquidating process of an insurance company and the liabilities that exist to policyholders provides guidance. In particular, the following two questions are to be considered:

- Is there an urgent need to gain access to the liquidated assets of an insurance company?
- Are the forfeited insurance receivables by the consumers of enough importance for policy makers to act?

02

The Liquidation Process and the Liabilities to Policyholders



2. The Liquidation Process and the Liabilities to Policyholders

Liquidating an insurance company does not happen overnight. Typically, the long-tail character of some insurance liabilities can involve a few decades until settled, making the liquidation process complex. Insurers also offer a range of other payments, including disability payments, income replacement, annuities, and essential medical services. As cutting off these payments could harm consumers, the liquidation of life insurers focuses on the continuity of coverage.

The balance sheet of an insurance company contains three types of liabilities to the policyholder or insurance consumers as follows:

→ *Unearned premium*. Policyholders have paid a premium in advance to obtain insurance coverage during a specific period. However, due to insolvency, the insurance company could not provide coverage for the entire period. An additional premium would be required for another insurer to take over coverage for the remaining period. That amount of additional premium, in theory, corresponds to the unearned premium. But in practice, the new insurer may require a higher premium to take on the unexpired risk than the proportion of the original premium, which remains unearned at the point of insolvency.

→ *Outstanding and unpaid claims*. These liabilities are generally more critical than the unearned premium because the amount of a claim can be significantly higher than the original premium. At the same time, fast access to claim payment is critical for the affected party, as substantiated by the fact that insurance was bought for the financial protection of such an event that otherwise would be too large to be assumed by the affected party in the form of self-insurance. There are also potential claims that, at the point of insolvency, have been incurred but not reported (IBNR).

→ *Saving component of a life policy*. Typical life insurance products offer the accumulation of policyholders' funds over the policy duration, which can be 50 or more years. These funds belonging to the insurance consumers can be substantial. In many cases, they are an individual's life-long savings.

Insurance guarantee schemes (IGSs) have the following important roles when protecting typical insurance liabilities:

→ *Role of the guarantee scheme with respect to unearned premium*. While losing part of the paid premium is not acceptable for any insurance consumer, the economic impact on insurance consumers is limited in amount. Thus, the need to be fully refunded for the loss of the unearned premium does not justify implementing a guarantee scheme for the insurance sector. More critical in this case is the availability of coverage to complete the insured period. This can be of vital importance, for instance, when the insurer's insolvency occurs in the middle of a hurricane season or when a hurricane is heading toward the now uninsured area. There are also instances where continued coverage is required for consumers' livelihoods; for example, insurance for drivers is required for them to operate. Providing continued protection in those circumstances is essential and can be addressed through a good resolution process that enables portfolio transfers. Now, carrying out the portfolio transfer often requires access to funds to pay the accepting insurer, and here is where a guarantee scheme's provision of such funds becomes important.

- *Role of the guarantee scheme with respect to outstanding and unpaid claims.* Immediate access to funds to cover the losses arising from the insured event is necessary, similar to bank liquidations providing the motivation that led to the creation of deposit insurance for banks.
- *Role of the guarantee scheme with respect to the saving component of a life policy.* Protecting these liabilities is necessary to motivate long-term savings with confidence and prevent poverty in old age within the segment of responsible people using the insurance sector to save for retirement.

Over the years, IGSs have provided important benefits to insurance consumers and thus supported trust in the industry. In addition, these schemes, where established, have played an important role in protecting policyholders from the negative effects of insurance company insolvencies, which is vital for preserving the public trust in the insurance sector (see table 2.1).

TABLE 2.1. INSURANCE GUARANTEE SCHEMES AND INSOLVENCIES ENGAGED

JURISDICTION	SCHEME	NUMBER OF FAILURES	MOST RECENT FAILURE
AUSTRALIA	Australian Prudential Regulation Authority	1	2009
CANADA	Property and Casualty Insurance Compensation Corporation	14	2003
CANADA	Assuris	4	2012
DENMARK	Danish Guarantee Fund for Non-life Insurers	5	2020
ECUADOR	Corporación de Seguro de Depósitos, Fondo de Liquidez y Fondo de Seguros Privados	2	2018
GERMANY	Protektor Lebensversicherungs-AG Sicherungsfonds für die Lebensversicherer	1	2003
ISLE OF MAN	Policyholder Compensation Fund	0	n.a.
KOREA, REP.	Korea Deposit Insurance Corporation	15 life 5 non-life	2013

JURISDICTION	SCHEME	NUMBER OF FAILURES	MOST RECENT FAILURE
MALAYSIA	Malaysia Deposit Insurance Corporation	0	n.a.
NORWAY	Norwegian Non-life Insurance Guarantee Scheme	2	2018
POLAND	Polish Insurance Guarantee Fund (formerly, Policyholder Protection Fund)	1 life 7 non-life	2021
ROMANIA	Policyholders Guarantee Fund	2 life 12 non-life	2021
SINGAPORE	Singapore Deposit Insurance Corporation	0	n.a.
SPAIN	Consorcio de Compensación de Seguros	307	2023
TAIWAN, CHINA	Taiwan Insurance Guaranty Fund	4 life	2016
UNITED KINGDOM	Financial Services Compensation Scheme	0 life 25 non-life	2021
UNITED STATES	National Conference of Insurance Guaranty Funds[1)]	650	2022
UNITED STATES	National Organization of Life and Health Insurance Guaranty Associations[2)]	100+	2022

SOURCE: Data from member surveys conducted by the IFIGS.
NOTE: 1) provides national assistance and support to the property and casualty guarantee funds located in each of the 50 states, the District of Columbia, and Puerto Rico; 2) coordinates the efforts of life and health insurance guarantee associations in all 50 states and the District of Columbia

03

Features of Insurance Guarantee Schemes

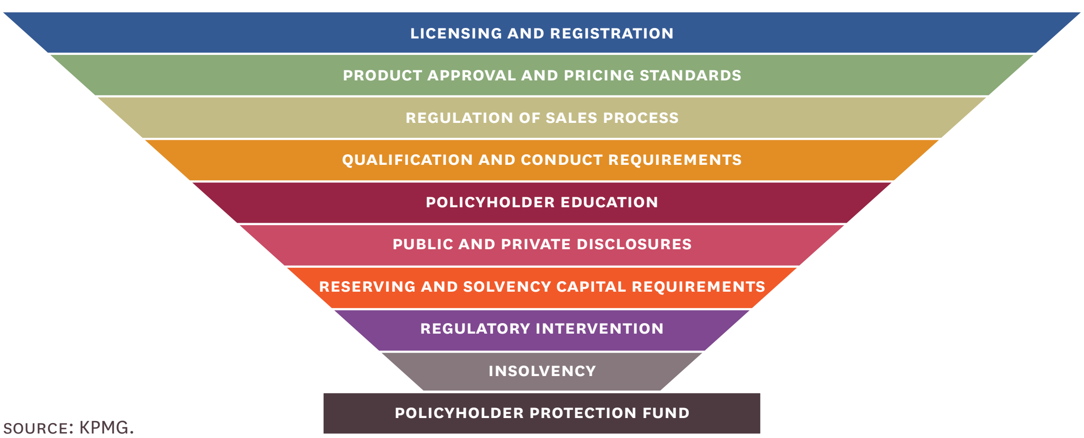
3. Features of Insurance Guarantee Schemes

The IGS or program is a system that is formed to protect insurance contract creditors (ICCs) and relevant third parties when insurers experience nonviability (OECD 2013). The form of protection for these schemes varies depending on the program objectives and type of insurance policy. The form can be among the following (Mortlock 2016 [points 7, 25]):

- Settlement and payment of claims and benefits for insurance policies issued by insurance companies experiencing insolvency, where the claim occurs before the insurance company's insolvency or until a specific time or coverage limit after the insolvency.
- Provision of continued protection under the insurance policy until a specific time or coverage limit giving policyholders time to get a replacement insurance policy.
- Financing the transfer of an insurance policy to another insurance company or an intermediary insurance company established by the public-private partnership implementer agency or the IGS itself, especially long-term insurance policies.
- Returns of premiums for protection of insurance policies that have ceased running.
- Payment of benefits (by annuity or whole) on life insurance policies.

The guarantee scheme conceptually provides only essential protection even though practices in some countries offer more benefits. It will only offer protection, acting as last resort protection, when the insurance company is in liquidation. The ongoing ICC protection responsibility remains within the remit of the supervision and regulatory authorities (figure 3.1).

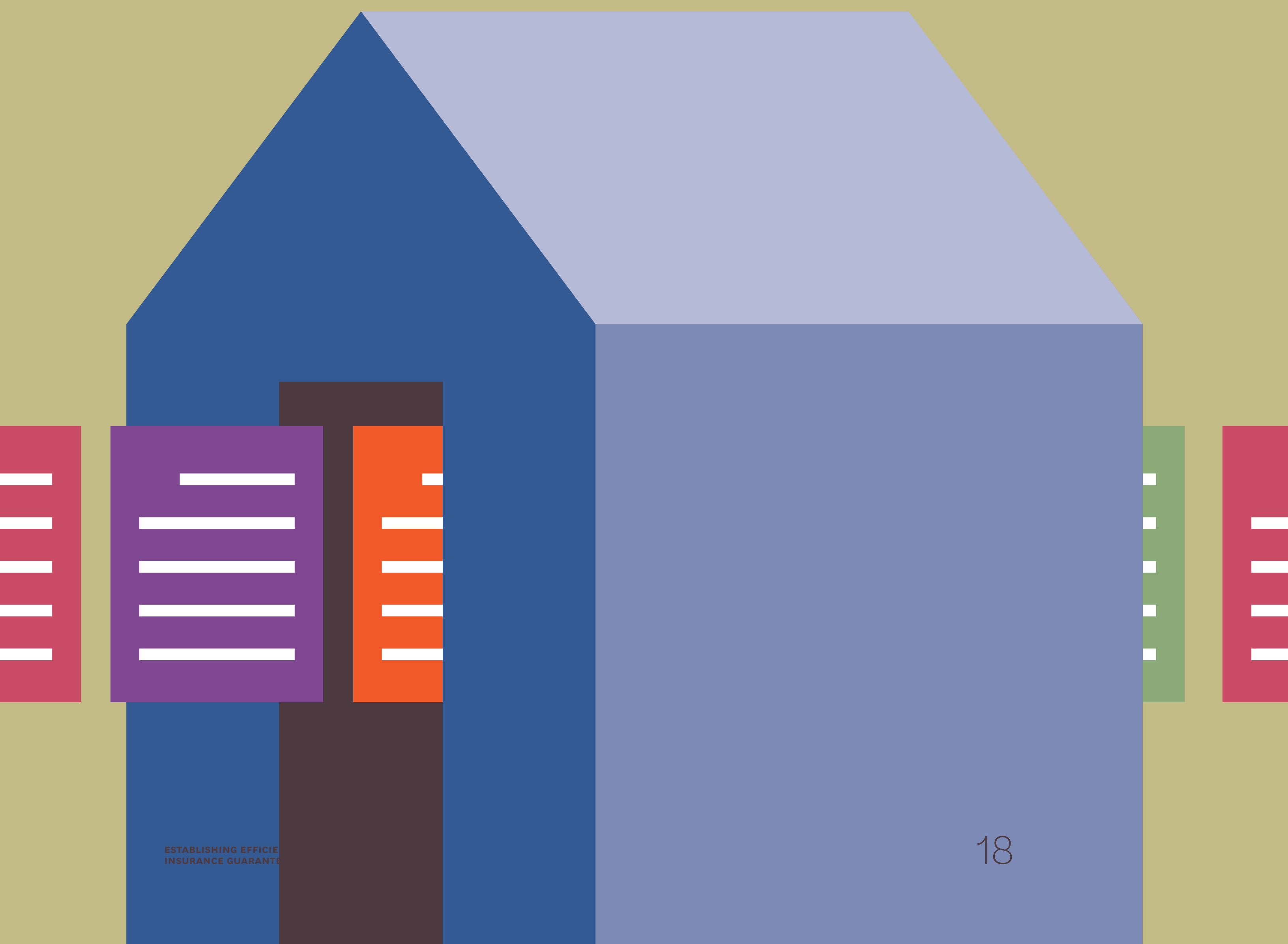
FIGURE 3.1. INSURANCE CONTRACT CREDITORS PROTECTION STRUCTURE



SOURCE: KPMG.

04

The Establishment of Insurance Guarantee Schemes



4. The Establishment of Insurance Guarantee Schemes

The main trigger for establishing an IGS has been the failure of insurance companies (Oxera 2007). In the United Kingdom (UK), the recession of the mid-1970s caused failures in the secondary banking and insurance markets, which left consumers without protection. In 1975, the UK government acted to protect people with the establishment of the Policyholder Protection Board, which is one of the predecessors of the Financial Services Compensation Scheme. Similarly, in France, the failure of life insurance company Europavie led to the establishment of Fonds de Garantie des Assurances de Personnes in 1999. Between 1998 and 2003, a series of failures of companies providing compulsory insurance gave rise to the establishment of Fonds de Garantie des Assurances Obligatoires de Dommage in 2003.

Another motivation leading to the establishment of an IGS in several jurisdictions has been the recognition of the need to improve the protection of insurance consumers against insolvency in the sector. In Malaysia, the Takaful and Insurance Benefits Protection System was part of the Enhanced Financial Consumer Protection Package that was introduced as an exit strategy from the Government Deposit Guarantee in 2010.

Some countries established guarantee schemes as public bodies, while others were established by statute but are privately administered. In cases where the scheme is a public body, the scheme is either operated by the supervisory authority, as is in Latvia and Romania, or by a separate public entity, as in Belgium, Ireland, Italy, and Malta. Where the scheme is a privately administered entity, some are set up as limited liability companies, while others are established as private foundations or trusts (Oxera 2007). See table 4.1. Either way, there is a mechanism to involve or represent the member companies, which is by including industry representatives in the governance function management committees.

TABLE 4.1. ESTABLISHMENT DATES AND LEGAL STRUCTURE OF INSURANCE GUARANTEE SCHEMES

JURISDICTION	SCHEME	ESTABLISHMENT	LEGAL STRUCTURE
AUSTRALIA	Australian Prudential Regulation Authority	2008	Government legislated and administered
CANADA	Property and Casualty Insurance Compensation Corporation	1989	Government legislated and privately administered
CANADA	Assuris	1990	Government legislated and privately administered

JURISDICTION	SCHEME	ESTABLISHMENT	LEGAL STRUCTURE
DENMARK	Danish Guarantee Fund for Non-life Insurers	2003	Government legislated and privately administered
ECUADOR	Corporación de Seguro de Depósitos, Fondo de Liquidez y Fondo de Seguros Privados	2008	Government legislated and administered
FRANCE	Fonds de Garantie des Assurances de Personnes	1999	Government legislated and privately administered
FRANCE	Fonds de Garantie des Assurances Obligatoires de Dommage	2003	Government legislated and privately administered
GERMANY	Protektor Lebensversicherungs-AG Sicherungsfonds für die Lebensversicherer	2004	Government legislated and privately administered
IRELAND	Insurance Compensation Fund	1964	Government legislated and administered
ISLE OF MAN	Policyholder Compensation Fund	1991	Government legislated and administered
KOREA, REP.	Korea Deposit Insurance Corporation	1996	Government legislated and administered
LATVIA	Fund for the Protection of the Insured	1998	Government legislated and administered
MALAYSIA	Malaysia Deposit Insurance Corporation	2005	Government legislated and administered
MALTA	Protection and Compensation Fund	2004	Government legislated and privately administered
NORWAY	Norwegian Non-life Insurance Guarantee Scheme	1989	Government legislated and administered
POLAND	Polish Insurance Guarantee Fund	1991	Government legislated and privately administered

JURISDICTION	SCHEME	ESTABLISHMENT	LEGAL STRUCTURE
ROMANIA	Policyholders Guarantee Fund	1995	Government legislated and administered; the fund's organization and operation are established by its own statutes approved by the board of the Financial Supervisory Authority, on a proposal by the board of directors of the fund
SINGAPORE	Singapore Deposit Insurance Corporation	2006	Government legislated and privately administered
SPAIN	Consorcio de Compensación de Seguros	1984	Government legislated and administered
TAIWAN, CHINA	Taiwan Insurance Guaranty Fund	2009	Government legislated and administered
UNITED KINGDOM	Financial Services Compensation Scheme	2001	Government legislated and privately administered
UNITED STATES	National Conference of Insurance Guaranty Funds	1989	Not-for-profit corporation; for the most part, the property and casualty guarantee funds are private entities that are enabled by state statute
UNITED STATES	National Organization of Life and Health Insurance Guaranty Associations	1983	Voluntary association of its member guarantee associations; most state guarantee associations are private entities enabled by their state statutes

SOURCE: IFIGS 2021.

An IGS is typically established by way of legislation.[4] In some jurisdictions, special provisions are added under the existing insurance supervisory law. In others, a special law is enacted establishing the IGS. One approach is for the primary legislation to be kept succinct, describing only the membership requirements, the obligations, and the scheme's management in principle. The details are best left in secondary legislation. Other jurisdictions include all of the detailed requirements in the primary law without any secondary legislation or regulation. The best approach will vary for each jurisdiction. This topic is revisited in appendix A under item 12.

4 In Germany, Protektor started as a private initiative of the insurance industry without any separate legal base. It was then followed by a governmental scheme.

The establishment of a guarantee scheme can take several years, but there are exceptions. It is important to note that following the decision to establish a guarantee scheme, there is a timeframe to consider until it becomes operational. In many jurisdictions, the process can take anywhere from one to three years, sometimes even up to five years. Yet when the schemes are established in the face of existing or impending insolvencies, the process has been expedited.

In Denmark, following an insolvency case in August 2002, the legislation was presented to the Parliament in March 2003, with the guarantee scheme becoming operational by October 2003. Similarly, in Spain's case, the law establishing the guarantee scheme was passed on July 11, 1984. In the following months, the guarantee scheme was commissioned to liquidate 14 insurers, and the next year, 1985, 13 more. The initial funding was done with funds from other activities of the Consorcio de Compensación de Seguros not related to the liquidation activity.

Mandatory membership in IGSs is the norm. In theory, they can be designed with either compulsory or voluntary membership. However, most, if not all, of the existing schemes have mandatory membership. An insurance company conducting one or more lines of insurance business covered by a scheme must be a member of the scheme (see table 4.2).[5] The main reasoning for compulsory membership is to ensure the protection of policyholders of insurance who may unintentionally choose an uncovered insurance company and to avoid anti-selection. Anti-selection occurs when aggressive companies have a strong incentive to participate in the scheme as they benefit from the credibility provided by the guarantee scheme. Well-managed companies, having already established a good reputation in the market, have less incentive, resulting in the membership of the scheme being composed of primarily risky actors.

TABLE 4.2. COMPARISON OF MEMBERSHIP REQUIREMENTS AND MEMBER COUNT IN INSURANCE GUARANTEE SCHEMES

JURISDICTION	SCHEME	MEMBERSHIP	MEMBER COUNT
AUSTRALIA	Australian Prudential Regulation Authority	Compulsory; all general insurers licensed by APRA are covered by the FCS	95, including other financial institutions
CANADA	Property and Casualty Insurance Compensation Corporation	Compulsory	190
CANADA	Assuris	Compulsory	63
DENMARK	Danish Guarantee Fund for Non-life Insurers	Compulsory	340 · 56 Danish non-life insurance companies · 284 EU/EEC non-life companies operating in Denmark

5 All members responding to the questionnaire of the IFIGS indicated that membership in the implemented schemes in their jurisdictions is mandatory.

JURISDICTION	SCHEME	MEMBERSHIP	MEMBER COUNT
ECUADOR	Corporación de Seguro de Depósitos, Fondo de Liquidez y Fondo de Seguros Privados	Compulsory	30, including other financial institutions
GERMANY	Protektor Lebensversicherungs-AG Sicherungsfonds für die Lebensversicherer	Compulsory except for specific pension funds; voluntary if the business is comparable to life insurers	104
ISLE OF MAN	Policyholder Compensation Fund	Compulsory	13
KOREA, REP.	Korea Deposit Insurance Corporation	Compulsory	321, including other financial institutions, 24 life, and 21 non-life
MALAYSIA	Malaysia Deposit Insurance Corporation	Compulsory	92, including other financial institutions, 25 life, and 25 non-life
NORWAY	Norwegian Non-life Insurance Guarantee Scheme	Compulsory	20 • 7 life • 13 non-life
POLAND	Polish Insurance Guarantee Fund	Compulsory	29 Non-life
ROMANIA	Policyholders Guarantee Fund	Compulsory	92, including other financial institutions, 25 life, and 25 non-life
SINGAPORE	Singapore Deposit Insurance Corporation	Compulsory	~ 100
SPAIN	Consorcio de Compensación de Seguros	Compulsory	199
TAIWAN, CHINA	Taiwan Insurance Guaranty Fund	Compulsory	65+, including other financial institutions • 21 life • 20 non-life
UNITED KINGDOM	Financial Services Compensation Scheme	Compulsory	455 total: • 116 life • 318 non-life • 21 composite
UNITED STATES	National Conference of Insurance Guaranty Funds	Compulsory for industry membership in property and casualty guarantee funds	2,448 non-life
UNITED STATES	National Organization of Life and Health Insurance Guaranty Associations	Compulsory for industry membership in life and health guarantee associations	1,540, which includes life and health companies and property and casualty companies that write some life and health business

SOURCE: Data from member surveys conducted by the IFIGS.
NOTE: APRA = Australian Prudential Regulation Authority; EEC = European Economic Community; EU = European Union; FCS = Financial Claims Scheme.

In the case of branches of foreign companies operating in a jurisdiction, if the branch is underwriting direct business in the jurisdiction, the membership requirement is applicable. It should be noted that in the case of the European Union, under the freedom of service agreement and as the supervision is based on the home state principle, branches domiciled in the European Union are not required to be members of a host jurisdiction.

IGSs are typically financed by the contributions collected from (or levies imposed on) member companies. In funding, there are two mechanisms: ex ante (pre-funding) and ex post (post-funding). In the former, member companies' contributions are regularly collected to build up a fund in preparation for future insolvency cases. All members contribute, including those that may go into liquidation in the future, which seems more equitable. Until disbursed to protect the interests of ICCs of an insolvent company, funds in the schemes are invested in safe and liquid assets, typically government bonds. In the ex post case, the contributions are called for only when the fund needs to pay for ICCs, and therefore no fund or pool of money is accumulated in the schemes. Both mechanisms are used in examples worldwide, including cases combining the two funding mechanisms.

A look across practices in countries where such funds are established reveals that both pre-funding and post-funding are equally used, and some combine pre- and post-funding (see table 4.3). The contributions of respective companies are usually calculated based on gross or net premiums and may include an element related to claims reserves.[6] This basis could serve as a proxy of the exposure to the IGS in solvency cases. Premiums received are also an adequate indicator of the payment capacity of insurance companies on a flow basis.

TABLE 4.3. COMPARISON OF FUNDING MECHANISMS OF INSURANCE GUARANTEE SCHEMES

JURISDICTION	SCHEME	MECHANISM
AUSTRALIA	Australian Prudential Regulation Authority	Ex post
CANADA	Property and Casualty Insurance Compensation Corporation	Ex post
CANADA	Assuris	Ex post
DENMARK	Danish Guarantee Fund for Non-life Insurers	Mixed
ECUADOR	Corporación de Seguro de Depósitos, Fondo de Liquidez y Fondo de Seguros Privados	Ex ante
GERMANY	Protektor Lebensversicherungs-AG Sicherungsfonds für die Lebensversicherer	Mixed
ISLE OF MAN	Policyholder Compensation Fund	Ex post
KOREA, REP.	Korea Deposit Insurance Corporation	Ex ante
MALAYSIA	Malaysia Deposit Insurance Corporation	Ex ante
NORWAY	Norwegian Non-life Insurance Guarantee Scheme	Ex post
ROMANIA	Policyholders Guarantee Fund	Ex ante

6 An insurer in run-off will have little to no premium income but may have substantial claims reserves, which are at risk of falling on the insurance guarantee scheme.

JURISDICTION	SCHEME	MECHANISM
SINGAPORE	Singapore Deposit Insurance Corporation	Ex ante
SPAIN	Consorcio de Compensación de Seguros	Ex ante
TAIWAN, CHINA	Taiwan Insurance Guarantee Fund	Ex ante
UNITED KINGDOM	Financial Services Compensation Scheme	Ex post
UNITED STATES	National Conference of Insurance Guaranty Funds	Ex post
UNITED STATES	National Organization of Life and Health Insurance Guaranty Associations	Ex post

SOURCE: IFIGS.

A critical aspect for the credibility of a guarantee scheme is its financial capacity. In the initial stages, a government guarantee is recommended for the scheme to be able to deal with any unexpected (or indeed foreseen) early large insolvency. As the guarantee scheme matures, sufficient assets to support medium-size insolvencies should be available. Additional assets should be available if needed in the form of pre-established lines of credit, governmental guarantee, ability to request extraordinary contributions from the industry, and reinsurance. Table 4.4 provides an overview of the level of assets held by the different guarantee schemes.

TABLE 4.4. PRE FUNDED INSURANCE GUARANTEE SCHEMES: LEVEL OF ASSETS HELD AS A PERCENTAGE OF THE LIABILITIES OF THE THREE LARGEST MEMBER COMPANIES

JURISDICTION	SCHEME	LEVEL OF ASSETS HELD
AUSTRALIA	Australian Prudential Regulation Authority	Less than 20%
CANADA	Property and Casualty Insurance Compensation Corporation	Less than 20%
CANADA	Assuris	About 2.6%
ECUADOR	Corporación de Seguro de Depósitos, Fondo de Liquidez y Fondo de Seguros Privados	Less than 20%
FRANCE	Fonds de Garantie des Assurances de Personnes Fonds de Garantie des Assurances Obligatoires de Dommage	Less than 20%
GERMANY	Protektor Lebensversicherungs-AG Sicherungsfonds für die Lebensversicherer	6% of the liabilities of the largest three member insurers plus all assets of the failed insurer
ISLE OF MAN	Policyholder Compensation Fund	0 (entirely post-funded)
KOREA, REP.	Korea Deposit Insurance Corporation	Less than 20%
MALAYSIA	Malaysia Deposit Insurance Corporation	Less than 20%
NORWAY	Norwegian Non-life Insurance Guarantee Scheme	Less than 20%
ROMANIA	Policyholders Guarantee Fund	Less than 20%
SINGAPORE	Singapore Deposit Insurance Corporation	Less than 20%
SPAIN	Consorcio de Compensación de Seguros	Less than 20%
TAIWAN, CHINA	Taiwan Insurance Guarantee Fund	Less than 20%

SOURCE: IFIGS 2020.

An IGS may be set up only to compensate policyholders or beneficiaries for their losses (compensation of claims). On the other hand, it may also be empowered to ensure the continuity of insurance policies by having them transferred to a solvent insurer or by taking them over directly (portfolio transfer), particularly in life insurance products.

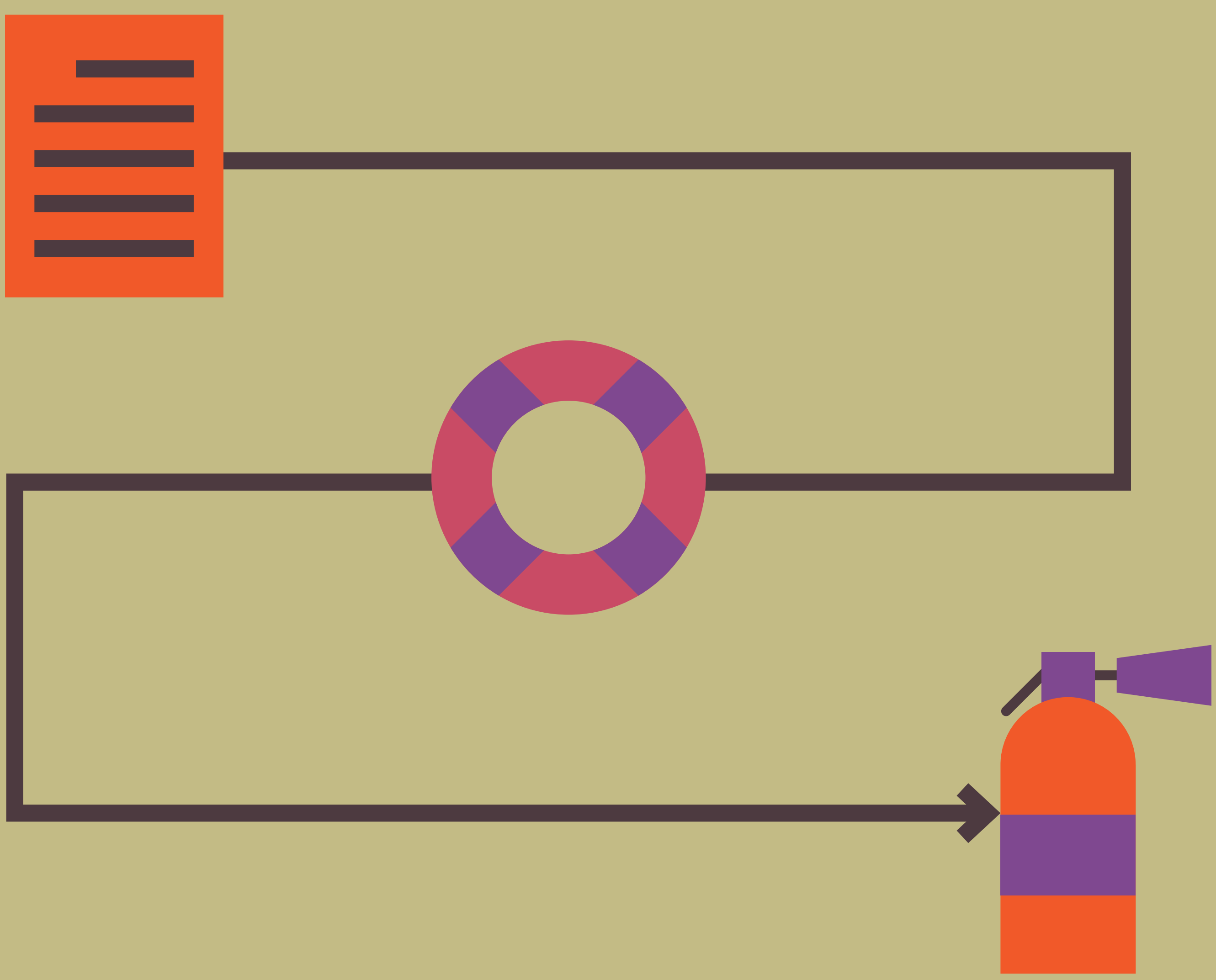
Insurance products are commonly grouped into life (and health) insurance and non-life (property and casualty) insurance. Given the difference in nature between the two sectors (mainly, the former usually is a long-term business while the latter is generally short term), the existing schemes largely cover only one of the two sectors. Yet there are some jurisdictions where a scheme covers both life and non-life insurance.

It is important that guarantee schemes cover insurance products that are consumed by ordinary (nonprofessional) policyholders. On the other hand, certain insurance products designed mainly for larger corporations are often excluded from the coverage of the schemes, including products for marine, aviation, satellite, and other entities. Corporations are expected to be able to get sufficient information on the products and the companies and appropriately assess the risks involved.

At a minimum, all policies by retail customers; mandatory policies; or policies for social protection, hardship, or third-party victims should be covered. Similarly, since reinsurance is consumed by insurers that are assumed to be able to assess the reinsurers' insolvency risk, no reinsurance companies or members of the guarantee schemes are covered, as reported by the IFIGS. This fact highlights the importance of assessing the financial soundness of reinsurers operating in the country by the supervisor and the insurers, as a failing reinsurer could lead into insolvencies of one or several insurers and thus burden the guarantee schemes.

05

Role of the Resolution Regime



5. Role of the Resolution Regime

An effective resolution framework is critical for the safety net created by an IGS. The success of an IGS depends on many factors, both internal and external. While the internal factors relate to the structuring of the system based on sound mechanisms that draw from best practices and the state of the local market, external factors, such as the efficiency of the overall resolution framework, are equally important. The more protection offered to ICCs during the resolution phase, the less burden is eventually placed on the guarantee scheme. Regular corporate bankruptcy procedures are designed to protect creditors, not the ICCs or the financial system's stability when a financial institution fails.

Furthermore, however robust the general resolution framework of jurisdiction is, due to the complexity inherent in the resolution of an insurance company, specialized insurance resolution regimes are established to do the following:

- Protect the ICC.
- Reduce the systemic impact of a potential failure.
- Afford control to the authorities.
- Shift the financial burden away from the taxpayers.
- Let existing shareholders bear losses.
- Reduce moral hazard and increase market discipline.

The assigned responsibilities to the resolution authority are considerable and require operational independence, legal protection for the staff, and high accountability standards. An effective resolution regime having adequate specialized resources and transparent processes is expected to entail the following:

- Allow the authorities to take control of the failing institution at an early stage of its financial difficulties.
- Empower the authorities to use a wide range of tools to deal with a failing institution without the consent of shareholders or creditors.
- Establish a practical and specialized framework for the resolution of the institution that assigns a central role to the authorities.
- Ensure clarity as to the regime's objectives and clearly define the scope of judicial review.
- Promote information sharing and coordination among all authorities involved in supervision and resolution, including IGSs.

Given the importance of supporting the effective protection of ICCs, several countries have implemented specialized resolution regimes, as indicated in table 5.1.

TABLE 5.1. SPECIALIZED RESOLUTION REGIMES ACROSS JURISDICTIONS

JURISDICTION	SPECIALIZED RESOLUTION REGIME
AUSTRALIA	Yes
CANADA	No
DENMARK	Yes
ECUADOR	No
FRANCE	Yes
GERMANY	Yes
ISLE OF MAN	No
KOREA, REP.	No
MALAYSIA	Yes
NORWAY	No
ROMANIA	Yes
SINGAPORE	Yes
SPAIN	Yes
TAIWAN, CHINA	Yes
UNITED STATES	Yes

SOURCE: IFIGS 2020.

The structure and roles of resolution authorities vary across jurisdictions. The supervisory authority may act as the resolution authority, the IGS may be required to serve as the resolution authority, or several authorities may be tasked jointly. In any case, certain resolution powers may be exercised or overseen by the courts. Nonetheless, each jurisdiction should have a designated administrative authority or authorities responsible for exercising the resolution powers (see table 5.2). If there are multiple resolution authorities with respective mandates, roles and responsibilities should be clearly defined and coordinated.

TABLE 5.2. RESOLUTION AUTHORITIES

JURISDICTION	RESOLUTION AUTHORITY
AUSTRALIA	Supervisor
CANADA	Supervisor plus scheme
DENMARK	Supervisor plus scheme
GERMANY	Scheme
KOREA, REP.	Scheme
MALAYSIA	Scheme
ROMANIA	Supervisor
SINGAPORE	Supervisor

JURISDICTION	RESOLUTION AUTHORITY
SPAIN	Minister of Economy through supervisor
TAIWAN, CHINA	Supervisor
UNITED STATES	State supervisor

SOURCE: IFIGS 2020.

When the guarantee scheme is not the resolution authority, it is critical that the procedures and interactions between the authority and the scheme are clearly established. If a resolution is handled through the involvement of both the resolution authority (which may or may not be the supervisor) and the guarantee scheme, it is important that these procedures and interactions are established formally, preferably through legislation.

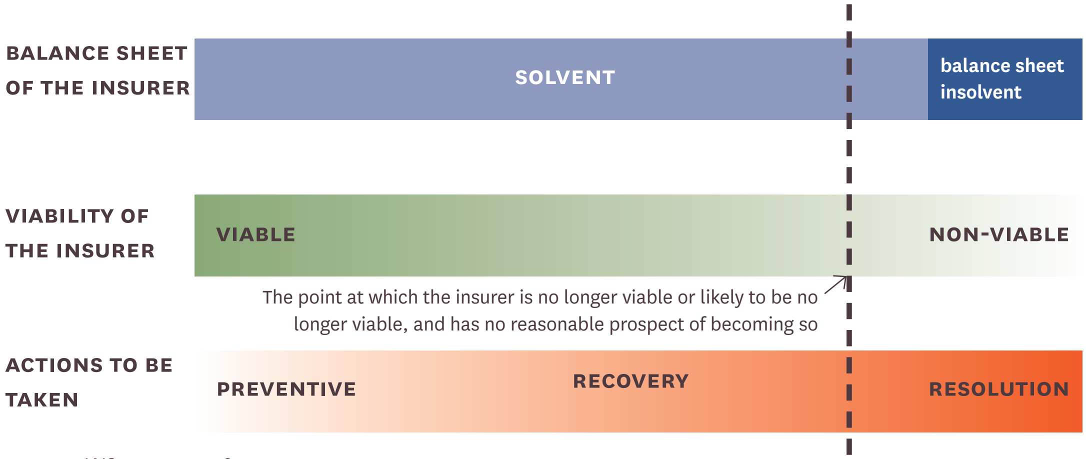
Even in jurisdictions where the scheme is not the resolution authority and not formally part of the resolution process, a memorandum of understanding between the resolution authority and the guarantee scheme is advised to ensure the resolution plan with the utmost protection to the ICC is devised, as is the case in Ecuador, Romania, Singapore, and the United States. In Canada, the interactions between the regulator and the IGSs are documented in the "Guide to Intervention for Federally Regulated Property and Casualty Insurance Companies" (OSFI 2018).

Resolution should be initiated when an insurer is no longer or is not likely to be viable and has no reasonable prospect of becoming so. The resolution regime should provide timely and early entry into resolution before a firm is balance-sheet insolvent and before all equity has been entirely wiped out.

"No reasonable prospect of a return to viability" means there are no measures the insurer could reasonably take, including recovery measures identified in its recovery plan or supervisory early intervention measures, that are likely to restore the insurer to viability in a reasonable timeframe, considering the circumstances and risks to financial stability and ICCs associated with the insurer's nonviability. Therefore, the assessment of nonviability should not require proof that the insurer is insolvent. Relying exclusively on criteria closely aligned with insolvency or likely insolvency would not meet the test of timely and early entry into the resolution.

No uniform, single fixed point of nonviability can be defined as the time and place for applying resolution measures in all circumstances. Whether to use resolution measures and what type of measures will depend on the factual circumstances of the resolution scenario. The concept of nonviability should permit the exercise of resolution powers. Examples of nonviability could be that regulatory capital, assets backing technical provisions, or other prudential requirements fall below specified minimum levels; the insurer will be unable to pay liabilities as they fall due; the insurer's access to market-based funding sources is seriously impaired; the insurer depends or would depend on official sector financial assistance to sustain operations; and recovery measures have failed or in all likelihood the proposed recovery measures will not be sufficient. See figure 5.1.

FIGURE 5.1. DETERMINING NONVIABILITY



SOURCE: IAIS 2019, pp. 126-127.

Powers of the resolution authority should have certain features that distinguish them from powers used for regular supervisory purposes and from regular corporate insolvency regimes. A list of exemplary powers derived from best practices follows:

- Remove and replace the senior management and directors.
- Appoint an administrator to take control, operate, or resolve the firm.
- Continue, assign, or terminate contracts.
- Purchase or sell assets or write down debt.
- Override rights of shareholders, including requirements for approval by shareholders of transactions to permit a merger, acquisition, sale of substantial business operations, or recapitalization.
- Establish a temporary bridge institution to take over and continue operating certain critical functions and viable operations.
- Undertake a portfolio transfer moving all or part of the insurance business to another insurer without the consent of each policyholder.
- Discontinue new business writing while administering existing contractual policy obligations for in-force business (run-off).

The resolution authority should be the party authorized to initiate the resolution of an insurer. In many jurisdictions, all resolution actions, including insolvency, may be initiated only by the insurance supervisor or resolution authority. However, in some, the insolvency process can be initiated by another person, such as a creditor through the court. In such cases, at a minimum, the legislation should ensure prior coordination between the initiator and the supervisor. Otherwise, the legislation should ensure the supervisor may challenge the initiator's action.

The resolution powers may be exercised by the resolution authority directly or through an appointed administrator with appropriate objectives. The resolution authority should be able to apply one or a combination of resolution powers, with resolution actions being either combined or sequential, and apply different types of resolution powers to other parts of the business. The resolution framework should ensure that compensation is the only remedy obtainable from a court through judicial review of resolution measures taken by resolution authorities acting within their legal powers and in good faith.

The resolution framework should support the objective of protecting ICCs. A resolution regime should respect the legal system's claims hierarchy, yet ICCs should still receive high priority in the resolution process so that they rank above unsecured creditors. Mechanisms, such as IGSs, may mitigate the need to absorb losses by ICCs. In some jurisdictions, a higher priority (over ICCs) may be given to a limited number of other categories of claims. These may include claims by the following:

- Liquidators, such as claims for expenses arising from the liquidation procedure.
- Employees.
- Tax or fiscal authorities.
- Social security systems.
- Claims on assets subject to rights in rem (through collateral, lien, or mortgage).

Further:

- In some jurisdictions, ICCs receive higher priority but only on a determined part of the insurer's assets, such as technical provisions. In these cases, ICC claims are generally subordinate to liquidation expenses for this portion of the insurer's assets.
- If the resolution regime is designed to allow for the run-off of a failed firm with the support of the IGS, it is likely to be necessary to afford priority to key suppliers to the firm, such as utilities, information technology support, and telecommunications.

The resolution framework, in principle, should observe the principle of equal (pari passu) treatment of creditors of the same class. Yet a specialized resolution regime should permit departure from the pari passu principle where necessary: to protect financial stability by containing the potential systemic impact of the insurer's failure and maximize the insurer's value for the benefit of all creditors.

However, if there is a departure from the pari passu principle (for broader resolution objectives), a proper safeguard should be provided; for example, no creditors worst-off principle. For instance, considering two categories of ICCs of equal rank (pari passu), one may be covered by an IGS while the other is not. In this case, the regime should strive to protect the noncovered ICC class. Similarly, two categories of creditors may rank equal (again pari passu), but one is a direct ICC while the other is a cedant. Then the regime must protect the direct ICC. These are good examples of the intricacies and complexity of the resolution of an insurance company, showing why the general resolution regime would fall short.

06

Recommendations for Implementing a Guarantee Scheme

6. Recommendations for Implementing a Guarantee Scheme

Implementing a guarantee scheme for the insurance sector requires several steps that need careful analysis.[7] The analysis should be informed by open discussions between the government and the industry representatives. The government should consider the advantages and disadvantages of the different options to develop the guarantee scheme and then invite industry to provide input. The industry association or similar body representing industry members will be able to give feedback on the technical aspects of the insurance business relevant to creating the guarantee scheme. The industry is also in a position to bring specific areas to the government's attention where, because of established ways of doing business in the country or for other reasons, it might be essential to customize some features of the guarantee scheme plan to take these aspects into account.

Table 6.1 presents a high-level overview of the critical points for discussion and decision-making regarding establishing a guarantee scheme. It is conceptual. Several decision points could be considered in parallel or in a different order. The numbers on the left side of table 6.1, if any, are cross-references to the discussion in table 6.2 and appendix A. Table 6.2 and appendix A provide more information on findings and implications concerning each main subject. The precise wording for table 6.1 is in the context of a IGS, but the decision points are essentially the same for a life IGS.

TABLE 6.1. KEY DECISIONS IN ESTABLISHING A GUARANTEE SCHEME

ITEM NO.	KEY DECISIONS	RECOMMENDATIONS
	Is a guarantee scheme needed?	Yes, a decision has been taken after full assessment of costs and benefits
11	Structure of the guarantee scheme	Separate entity or division of the deposit insurance entity or the supervisor
12	Nature of required legislation	Minor amendment to insurance law possible or new law similar to the law establishing the deposit insurance entity

7 This section has been adapted from previous work done through a World Bank technical assistance project by Lawrie Savage and Rodolfo Wehrhahn under the leadership of Neni Lestari, Senior Financial Sector Specialist.

ITEM NO.	KEY DECISIONS	RECOMMENDATIONS
5, 10	Establishing a guarantee scheme in a healthy market	If not the case, the guarantee scheme should facilitate a soft landing for any currently insolvent insurer
3, 6	Avoiding legacy costs to the guarantee scheme	Affected policyholder payouts based on available assets of insolvent insurers
1, 4, 9	Relationship with supervisor	Close communication required
10, 13	Powers of the guarantee scheme	Complementary to the resolution authority for insurers; for example, power to own bridge insurer, sell or reinsure parts of the business
7, 8	Coverage limits for policyholders	Consistent with the country's economic levels; for example, for homeowners cover 80% of the price of an average house
14	Types of policies to be covered	All polices except those that apply only to large businesses
15	Basis of funding (post event, pre-event, or hybrid)	Type to be determined based on the country's conditions and its idiosyncrasy
2, 14	Level of funding (prefund basis)	Based on the experiences of some jurisdictions: 1% to 2% of direct premium written and flat fee to start but moving to risk based over time

SOURCE: World Bank.
NOTE: For details on recommendations, see table 6.2 and appendix A.

TABLE 6.2. BEST EXPERIENCE AND THE IMPLICATIONS FOR THE GUARANTEE SCHEME

ITEM NO.	BEST PRACTICE	IMPLICATION
1	A guarantee scheme is not a substitute for strong and effective supervision.	The supervisor should constantly improve its supervision to ensure a high level of observance of the insurance core principles of the International Association of Insurance Supervisors.
2	Guarantee schemes must operate efficiently and at low cost because ultimately it is the industry consumer who pays.	The usual international fee is a few percentages of the premium or of the claim reserves for run-off companies. This amount should be sufficient to deal with most cases of future winding down situations (i.e., life and general insurance). Otherwise, other sources of funding might be necessary. It is a public policy objective of each jurisdiction if the cost of insurance scheme should be passed on from the industry to the consumers.
3	A guarantee scheme requires mandatory membership by all licensed insurers.	A necessary and recommended condition to have a seamless policyholders protection scheme. At the same time, the acceptance as members of the guarantee scheme of any currently insolvent company with doubtful viability requires a bespoken treatment of them that does not burden the industry or the taxpayers as they exit the market.

ITEM NO.	BEST PRACTICE	IMPLICATION
4	With early supervisory intervention, and the guarantee scheme as a creditor of the insurer's estate, claim costs will be low and the guarantee scheme will primarily act as a financing vehicle.	Adequate communication protocols between the guarantee scheme and the supervisor are critical and should be developed.
5	A guarantee scheme should only be established when the industry is healthy.	This is the ideal situation but sometimes postponing the guarantee scheme creation is not acceptable from the legal and the support of policyholders. In those cases, working through the guarantee scheme on cleaning the market as or with the resolution authority appears to be the best option.
6	A guarantee scheme should not be used to bail out existing shareholders or help poorly managed insurers get back into the market.	Once the insurer is transferred to the guarantee scheme is to exit the market. Shareholders will be the last priority creditors.
7	Moral hazard must be minimized. Consumers must have an incentive to buy insurance from strong, well-managed insurers.	Full compensation of the policyholders will only be possible when sufficient assets from the failing insurer are available. Otherwise, the maximal compensation should be at a cost for the policyholders. Some exceptions based on public policies should be considered, such as third-party injury claims and death benefits. Moral hazard mitigation is important and discussed in detail in the references.
8	Maximum benefits under a guarantee scheme should target the situation of average policyholders.	This is based on economic conditions and on a fair treatment of consumers; for example, covering a homeowner's policy claim up to the average cost of the insured houses in the country.
9	The effectiveness of a guarantee scheme will be enhanced through close cooperation between the guarantee scheme and the insurance supervisor.	See no. 4.
10	The guarantee scheme relationship and interaction with the resolution authority for the insurance industry.	Significant and critical communication between the guarantee scheme and the resolution authority for an effective winding down of an insurer is necessary. Separating the payments to affected policyholders from the actual winding down of the insurer can create a conflict of interest and become costly. Minimizing liquidation costs is important.

SOURCE: World Bank.
NOTE: See appendix A for more details.

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Appendices

Appendix A. Additional Details on the Items

Item numbers refer to items in tables 6.1 and 6.2 in the World Bank paper titled "Establishing Efficient and Effective Insurance Guarantee Schemes."

ITEMS 1, 4, 9, AND 11: RELATIONSHIP WITH FINANCIAL SUPERVISORY AGENCY

The interests of the guarantee scheme and the insurance supervisory agency should coincide. Therefore, there must be a constructive working relationship between the two organizations. This does not have to be specified in legislation. Still, the government ministers involved can stipulate to their agencies (the guarantee scheme and the insurance supervisory agency) that they should develop and enter into a memorandum of understanding about how they will work together in the best interests of insuring the public and the interests of citizens having claims against insolvent insurers. Such an agreement often provides that when an insurance company reaches an agreed-upon risk level as assessed by the supervisory agency, the agency will begin to confer with the guarantee scheme on a confidential basis about the insurer concerned. This enables the guarantee scheme to begin to devise a plan for how it will proceed should the subject insurer be removed from the market by the supervisory agency.

It also permits senior management of the guarantee scheme and the supervisory agency to jointly consider any possible actions or strategies that could conceivably lead to an outcome that would be more beneficial to policyholders than the insolvency route. For example, suppose the insurance law is in keeping with international standards. In that case, the supervisory agency should have the power to take control of an insurer that is on the verge of becoming nonviable. It may be possible to move the "not quite balance-sheet insolvent" insurer into the guarantee scheme's bridge insurer for rehabilitation action. This could be an option that is less expensive for the industry to finance compared with having to deal with an insurer that has become insolvent.

ITEMS 7 AND 8: COVERAGE LIMITS FOR POLICYHOLDERS

Suppose the guarantee scheme covers homeowners up to a level somewhere in the range of 50 to 80 percent of the value of an average home. In that case, compensation will still be viewed as a significant benefit for the policyholder. Still at the same time, they will be incentivized to invest care and attention in selecting an insurer (that is, avoidance of hazard). It is usually accepted that a desirable objective of a guarantee scheme is to provide coverage to those who typically lack the resources to pay for the expertise that would be needed to avoid insuring with poorly managed or financed insurance companies. On that basis, huge corporations and wealthy individuals can be expected to retain advisers who assist them in selecting a quality insurance coverage provider.

One of the ways this desired result will be obtained is through the limits of coverage. For example, a multibillion-dollar corporation will not receive a material benefit by having a guarantee scheme coverage of up to a maximum of $100,000 (supposing that that is 80 percent of the value of an average home). This is because such a corporation will require insurance coverage for its different risks, hundreds of times a maximum $100,000 payout by a guarantee scheme. On the other hand, for a small "mom and pop" type of business or an individual, $100,000 of coverage will generally be quite adequate.

ITEMS 5 AND 10: ESTABLISHING THE GUARANTEE SCHEME IN A HEALTHY INSURANCE MARKET

In a typical insurance market, and as past experience has shown there may be a few insurers that are or soon will be candidates for a guarantee scheme's services. The advice generally provided by consultants is (1) put in place a modern system of risk-based insurance supervision (i.e., a supervisory framework that meets international standards); (2) gain experience with the new system and develop its credibility; (3) using the provisions of the supervisory law, remove from the market any insurers that appear not to be viable; and (4) establish the guarantee scheme and bring it into operation. The idea of putting the formation of a guarantee scheme after the supervisory modernization and market cleaning activities is that other things being equal, a newly formed guarantee scheme should not be burdened by the costs of legacy situations, nor should their clean-up costs be paid for by the insurance industry through the guarantee scheme assessment process.

ITEMS 3 AND 6: AVOIDING THE LEGACY COSTS TO BE PASSED TO THE GUARANTEE SCHEME

Cases from jurisdictions where the guarantee scheme has been established with ongoing insolvencies provide valuable lessons follow:

- In France, the ongoing cases were handled through portfolio transfers without intervention from the prospective scheme, while in Germany, Protektor took on the insolvent company's business.
- In Denmark, following an insolvency case in August 2002, legislation was presented to the Parliament in March 2003 with the guarantee scheme becoming operational by October 2003. However, as the legislation was being reviewed by the Parliament, the industry association took on the task of covering the insolvent company's customers as if the guarantee scheme had been established, in light of the promise of repayment from the scheme after establishment.
- Similarly, in Spain's case, the guarantee scheme was commissioned to liquidate 14 insurers within months of its establishment.

In the case of existing legacy insolvency, to avoid having the guarantee scheme bear these costs, an extraordinary limitation on the protection can be introduced. The proceedings of selling the existing assets of each of the failing insurers should be the only benefit that the policyholder should receive. With this limitation, the amount paid to the policyholders could be as low as 30 percent of the liability in extreme insolvency cases. This limitation will ensure that the industry, through future guarantee scheme assessments, will not be burdened with legacy insolvencies.

Notwithstanding the extraordinary benefit limitation in case of legacy insolvencies, there are important advantages to the guarantee scheme winding down the insurers as follows:

- Right after the guarantee scheme or the resolution authority takes complete control of the insurer's assets, the guarantee scheme would pay out to the policyholders an initial amount corresponding to the estimated value of the insurer's assets under a fair valuation. Thus, policyholders can get part of their money immediately back and do not need to wait several years to see any payment.
- The payments are made from the liquid assets of the insurer and from the guarantee scheme assets corresponding to the industry assessments and probably a loan from the government if they deem the preceding to be insufficient. It should be noted that having access to funds immediately indemnifies policyholders in the form of industry assessments, and the government loan allows the guarantee scheme to sell the illiquid assets at a much better price over time and not in a rush at a discount. The industry assessments and the government loan should have been paid back in full when all assets were sold.

ITEM 12: NATURE OF REQUIRED LEGISLATION

The changes to the insurance law to establish the relationship between the guarantee scheme and the insurers are dealt with by minor changes to the insurance law. In most countries, the insurance law has been amended with the addition of a few simple provisions somewhat along the following lines.

- Every licensed insurer insuring risks that fall within a class of business for which the government minister has authorized activity by a guarantee scheme shall become and remain a member of such guarantee scheme that may be designated by order of the minister.
- A guarantee scheme shall not be designated under subsection 1 unless, in the opinion of the minister, it has the authority to levy an assessment on each of its members. Subsection 1 does not apply (i) to a company that may reinsure but may not otherwise insure risks; and (ii) in respect of a class of insurance for which the minister has not designated a guarantee scheme.

Many rules are required for the guarantee scheme's administration and operation but do not have to be included in the legislation. Instead, the constating documents for the guarantee scheme and its bylaws can specify how it must operate daily. Bylaws typically cover subjects that include the location of the head office, appointment of an auditor, meeting calling, rules of corporate governance, conditions of membership, and the required quorum for meetings.

The memorandum of operation or similar document provides all the detailed operational rules for the organization, including rules governing the appointment of agents to carry out insolvencies, details of the plan coverage, rules regarding payments to claimants (as well as the detailed mechanism by which the guarantee scheme will be compensated out of the estate of the insurer over time for claim payments that have been made to claimants up front under the plan), the mechanism for levying costs on the industry, and requirements for indemnifying board members and guarantee scheme employees.

An important point to keep in mind is that both the bylaws and the memorandum of operation can come into effect only when the responsible authority has approved them. And no changes can be made by the guarantee scheme board or by member insurers without the responsible authority's prior approval. In this way, the bylaws and memorandum of operation take on legal significance in limiting the guarantee scheme's activities and rules of operation to those approved by the appropriate regulatory authorities.

ITEM 13: POWERS FOR THE GUARANTEE SCHEME

To a significant extent, the desirable powers for a guarantee scheme, as described in this section, are also some of the most potent reasons for governments to establish guarantee schemes. Governments are adopting the guarantee scheme concept mainly because of the powers that can be conferred and the wide range of options for dealing with failing institutions that are made available.. Note that some powers might reside within the resolution authority for insurers should the guarantee scheme not be the designed resolution authority. An IGS should have the necessary powers to meet insurers' obligations (to the limits specified by the scheme's bylaws or other documentation that establishes the scheme's coverage limits) to policyholders and other eligible claimants promptly (whether by funding payments or continuity, as appropriate, and subject to its mandate and powers).[8]

BRIDGE INSURER

An essential power for a guarantee scheme (or for the resolution authority) is the power to own a bridge insurer.[9] This is an insurance company owned by the guarantee scheme and held ready to take over the business (assets and liabilities) from an insolvent insurer and service policies. In contrast, the guarantee scheme itself works to find buyers for assets, liquidate liabilities, and do other things that add value to the ultimate proceeds available from the insolvent insurer. In short, the bridge insurer enables an insolvent insurer to be kept on life support. At the same time, the guarantee scheme can assess the nature of the assets and liabilities and the marketable qualities of various lines of business, and generally all things required to maximize the value of the insolvent company. The guarantee scheme might even decide to inject some capital into the insolvent insurer (passing it through the bridge insurer, which has become the owner of the insolvent company) to continue operating some parts of the company.

In short, through its wholly owned bridge insurer, the guarantee scheme can exercise any options that would typically be open to the controlling shareholder of a corporation. The greater the value preserved, the less the amount the guarantee scheme will ultimately raise through the insurance industry and consumers. In the absence of a bridge insurer, an insolvent company instantly begins to lose whatever value it might potentially have had. Knowledgeable employees and expert specialists will be gone immediately, and customers will quickly move their coverage to other insurers to protect their positions. Brokers will also move with haste, arranging to market the products of

8 IFIGS Framework Guidance 13.

9 The bridge insurer should be subject to special capital requirements, which are permitted to remain at a minimal level, as long as the guarantee scheme backs all bridge insurers. This enables the bridge insurer to operate with levels of capital that are specifically matched to its business activities at a point in time. For example, there may be significant periods when it is dormant, and its capital level is kept near zero. The guarantee scheme backs all bridge insurers. This enables the bridge insurer to operate with levels of capital that are specifically matched to its business activities at a point in time. For example, there may be significant periods when it is dormant, and its capital level is kept near zero.

different insurers. In short order, the only option for the guarantee scheme becomes a traditional liquidation, which requires years to complete and with substantial cost, all of which means that at the end of the day, claimants receive little or nothing.

MODIFICATION OF BENEFITS IN CASE OF A PORTFOLIO TRANSFER DECISION

Consider a situation where the main reason for the insolvency of Insurer X is charging premiums that were far below the rates being charged by other companies in the market. If other companies believe they must charge considerably more than Insurer X, they are likely correct. Insurer X may have been motivated to follow this strategy because it will increase market share and cash for short-term liquidity as brokers and direct clients move their coverage to an insurer that appears to be offering bargain rates. But with bargain rates, how will there be enough funds to pay claims? Believe it or not, many insurers have adopted this “increase market share and cash flow” strategy over the years, often ending as insolvent companies. (It is the insurance parallel of a deposit-taking institution raising its interest rates on deposits much higher than competitors’ rates. Typically, money will pour into that institution as consumers are attracted to the high rates. Of course, the bank may not be able to generate the investment yields it requires to sustain the high payout rate on deposits, so financial stress or even insolvency may result.) The justification for a downward modification of policy benefits is that Insurer X was selling insurance at an unconscionably low rate. Suppose a guarantee scheme compensates Insurer X policyholders. In that case, it means that policyholders of other guarantee scheme member insurance companies will be subsidizing, through their assessments, the policyholders of the insolvent insurer.

Another situation where a modification of benefits might be appropriate would be a case where the guarantee scheme is just being established, and there are insurers in the market that are already insolvent. Without a guarantee scheme, such firms would ultimately have to be liquidated. Their policyholders would receive a small fraction of their claim amounts and only after the long period required to complete the formal liquidation process. A guarantee scheme could take over the moribund firms and pay off their claimants. The difficulty is that the cost of a guarantee scheme takeover of several insolvent firms at one time may well generate financial stress or even insolvency for some insurers remaining in the market that have to bear the costs through their guarantee scheme assessments. However, managing the cost of taking over several insolvent insurers simultaneously would allow the guarantee scheme to modify the payout terms. For example, suppose it could be accurately estimated that if these insolvent insurers were closed and then liquidated over the years, claimants might receive 50 percent of what they are owed. In that circumstance, it would be pretty beneficial for a guarantee scheme to do the job quickly, reducing payouts to a level of, say, the smaller of the plan limit or 50 percent of the amount owed (or even some smaller percentage if it were felt that they underpaid for their coverage in the first place). Rather than receiving their settlement years in the future, they would receive the estimated ultimate amount of the payout (or some lesser amount) immediately. For most claimants, this would be a considerable improvement in their situation.

Continuing with this example, suppose that instead of immediately paying off 50 percent (or a smaller amount) of the claim amounts of the insolvent companies, the guarantee scheme settled the outstanding claims based on payments spread evenly over a period of, say, three years. From a claimant’s perspective, receiving funds gradually is better than not receiving them. Precise calculations would be called for before developing any particular plan. Still, the point is that the guarantee scheme should have the power to modify benefits because it dramatically increases the flexibility of response in terms of determining the best course of action in particular cases. In the case of an insurer that is already insolvent, modification of benefits and timing of payments may provide a good solution for claimants while still holding the total cost to a level that the members of the guarantee scheme can reasonably absorb.

POWER TO REQUIRE CERTAIN ACTIONS FOR INSOLVENT INSURERS: SALE OF THE COMPANY, REINSURANCE OF PORTFOLIO, AND OTHER TRANSACTIONS

Sometimes there can be an opportunity for a guarantee scheme (or the resolution authority) to deal with an insolvent situation by entering into a transaction that would benefit claimants and lowers costs for the industry. However, for their own reasons, existing shareholders of the insolvent company or other interested parties may attempt to block such a transaction. In cases like this, the guarantee scheme should have the explicit power to act on behalf of the claimants who will benefit from the financial protection provided by the guarantee scheme and the industry members who will bear the expense of guarantee scheme actions. The guarantee scheme should thus have the authority to require the sale of all or any part of the business of the insolvent insurer, reinsure its insurance portfolio or any part thereof, or enter into any other transactions on behalf of the insolvent insurer that the guarantee scheme believes will be to the benefit of the plan, its members, and/or the public.

POWER TO BENEFIT FROM A GOVERNMENT LINE OF CREDIT

Exceptional circumstances can arise from time to time. For example, suppose there was a significant earthquake in the region, leading to a surprising number of insurer insolvencies within a short period. A power of the guarantee scheme, with government support, should be that if it has temporarily exhausted its resources because of extraordinary circumstances, it should be able to draw on a government line of credit so that payments to citizens under the plan do not have to be interrupted. Over time there will be additional assessments of industry members, funds will be accumulated, and the line of credit will be paid down. Probably it would be perceived very negatively by both the public and the international markets if a quasi-government organization such as a guarantee scheme were unable to meet the contractual obligations it has agreed to.

ITEM 14: TYPES OF POLICIES TO BE COVERED

The guiding principle of providing coverage to the appropriate group of citizens leads to selecting the types of policies that will be covered. There are lines of insurance protection that are of interest only to corporations. For example, corporations but not individuals (or mom- and pop-type businesses) are the only purchasers of products such as fidelity insurance, surety insurance, aviation insurance, satellite insurance, marine insurance, boiler and machinery coverage, and so forth. By excluding these types of “corporate only” policies, the guarantee scheme’s mandate becomes more focused on ordinary consumers who require guarantee scheme protection.

These comments apply in full to general insurance. However, almost all comments also apply to a life IGS. Nevertheless, one area of special consideration for life IGSs concerns monthly income policies and unit-linked or investment fund type policies. Life guarantee schemes typically cover these types of policies. Concerning monthly income policies, the life guarantee scheme would generally continue to pay a percentage of the monthly income benefit, perhaps 75 percent of the benefit, up to some annual maximum amount. The annual maximum amount could be tied to the level of deposit coverage offered by the country's deposit insurance program.

For investment fund type products, the segregation of assets is central for their protection in case of insolvencies. In these types of products, the policyholder is entitled to units of an investment fund. The usual approach requires that the investments be held in segregated accounts of the life insurer, similar to trust accounts. In this case, the policyholder retains direct ownership of these funds. In the event of the insolvency of the life insurer, these funds would be remitted directly to the policyholder. They would not be taken over by a liquidator or a guarantee scheme resolution authority. If the insurance law does not currently provide for segregated funds for life insurers, it might be something that should be considered.

ITEMS 2 AND 15: BASIS OF FUNDING THE GUARANTEE SCHEME

Guarantee schemes, like deposit insurers, are generally funded by industry members. The rationale for industry funding is that industry members are the ones who profit by selling the products under the aegis of a government-issued license. Therefore, when products are sold by an industry member who ultimately cannot meet its obligations, it should be the industry rather than the government that will stand behind the commitments provided under the guarantee scheme rules. Guarantee scheme coverage is also very much to the benefit of all remaining industry members, whose reputations would otherwise be badly tarnished by the "bad press" that will undoubtedly surround the insolvent member. Guarantee schemes in different jurisdictions have found that an annual assessment of between 1 percent and 2 percent of direct premium written should be sufficient to fund a guarantee scheme over time. Whether funding is on a prefund basis, a post-fund basis, or is a hybrid type, the expected practical range for funding should be a few percentage points of the direct premium written (or of the claims reserve for insurers in run-off), depending on the circumstances of the jurisdiction; for example, financial system structure and characteristics; legal framework; macroeconomic conditions; and prudential regulation, supervision, and resolution regime. The assessment amount would be a part of the cost of doing insurance business for the industry. Depending on the public policy objective of each jurisdiction, it may be passed along to policyholders but should be done so with an almost insignificant impact on individual policyholders. By paying a very slight additional premium, all insurance consumers benefit by having the guarantee scheme insurance plan coverage in place. Insurance companies can be assessed based on a flat fee, such as 1 to 2 percent.

However, a fundamental principle of insurance is that premiums should be based on risk. Therefore, the guarantee scheme's total amount needed to be raised could be funded based on premiums related to the supervisor's estimated probability of insolvency for each insurer or some other risk assessment method. Insurers who are well capitalized and judged to be at low risk of insolvency would pay lower premium rates than insurers assessed as being higher on the risk spectrum. This risk-based assessment will need some technical calculation and specific knowledge of the supervisor's risk assessment framework. On the other hand, the government and the industry may feel that it would be best to start the guarantee scheme using the flat rate, with the possibility of moving to a proper risk-based approach at a later stage. As a final point on the subject of assessments, the guarantee scheme governing documents should stipulate a maximum rate that can be assessed in any year to provide the industry with the comfort that an annual evaluation will never be greater than the sector's ability to pay. This ties in with the importance of the guarantee scheme having the power to draw on a government line of credit during periods when industry assessments are insufficient to keep the guarantee scheme fund in a favorable position.

Glossary

capital adequacy: The adequacy of capital resources relative to regulatory capital requirements.

claims reserve: Reserve set aside to meet future payments associated with claims incurred but not yet settled at the time of a given date.

deposit insurance: Deposit insurance or deposit protection is a measure implemented in many countries to protect bank depositors, in full or in part, from losses caused by a bank's inability to pay its debts when due. Deposit insurance systems are one component of a financial system safety net that promotes financial stability.

incurred but not reported (IBNR): IBNR is a type of reserve account for claims that have transpired but have not yet been reported to an insurer.

insurance contract creditor (ICC): ICCs are the natural or legal persons affected by the policies issued by an insolvent insurer and include policyholders, the insured, beneficiaries, and injured third parties.

liquidation: A process to terminate operations and corporate existence of the entity through which the remaining assets of the insurer will be distributed to its creditors and shareholders according to the liquidation claims hierarchy. Branches can also be put into liquidation separately from the insurance legal entity they belong to.

long-tail liability: Liability for claims that do not proceed to final settlement until a length of time beyond the policy year. High IBNR claims contribute to this tail effect since these losses are usually not settled until several years after the expiration of the policy in question.

pari passu: A Latin term that literally means "with an equal step" or "on equal footing" and refers to ranking equally and without preference. Applied in a legal context, pari passu means that multiple parties to a contract, claim, or obligation are treated the same.

portfolio transfer: Transfer of one or more policies together with, when relevant, the assets backing those liabilities.

recovery plan: A plan developed by an insurer that identifies in advance options to restore its financial condition and viability under severe stress.

regulatory capital: Surplus of assets over liabilities evaluated in accordance with regulation in a particular jurisdiction.

resolution: Actions taken by a resolution authority toward an insurer that is no longer viable or is likely to be no longer viable and has no reasonable prospect of returning to viability.

resolution authority: A person that is authorized by law to exercise resolution powers over insurers.

resolution plan: A plan that identifies in advance options for resolving all or part(s) of an insurer to maximize the likelihood of an orderly resolution, the development of which is led by the supervisor and/or resolution authority in consultation with the insurer in advance of any circumstances warranting resolution.

run-off: A process under which an insurer ceases to write new business and administers existing contractual obligations. A solvent run-off is the process initiated for an insurer who is still able to pay debts to its creditors when the debts fall due. An insolvent run-off is the process initiated for an insurer who is no longer able to pay debts to its creditors when the debts fall due.

solvency: Financial soundness of an insurer, including the ability to meet its obligations to policyholders when they fall due. Solvency includes capital adequacy, liquidity, technical provisions, and other aspects addressed in an enterprise risk management framework.

technical provisions: The amount that an insurer sets aside to fulfill its insurance obligations and settle all commitments to policyholders and other beneficiaries arising over the lifetime of the portfolio. They include the expenses of policy administration, reinsurance, and the capital required to cover the remaining risks.

unearned premium: An unearned premium is the premium amount that corresponds to the time period remaining on an insurance policy.

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