# INSURANCE GUARANTEE SCHEMES: INTERNATIONAL PRACTICES AND APPLICABILITY TO RUSSIA

7 NOVEMBER 2013

**Dr. Goetz Kuras, Partner**
**goetz.kuras@oliverwyman.com**

# Structure of presentation

# Financial sector guarantee schemes are common practice across the OECD

| Deposit guarantee schemes | Investor compensation schemes | Occupational pension compensation schemes |
|---|---|---|
| **Objective:**<br>• Protection from loss of deposits in bank failure<br>**Main features:**<br>• Covers retail customers and protects up to a limit<br>**Experience:**<br>• Vital role in avoiding bank-run in recent financial crisis<br>**Implementation scope:**<br>• Implemented in almost all developed countries<br>• Mandated by EU regulation | **Objective:**<br>• Protection from loss of assets in investment services company failure<br>**Main features:**<br>• Covers retail costumers from consequences of fraud/negligence<br>**Experience:**<br>• Helped maintain confidence in investment industry after a failure<br>**Implementation scope:**<br>• Implemented in many developed countries<br>• Mandated by EU regulation | **Objective:**<br>• Protection from loss of pensions in case of corporate failures/M&A<br>**Main features:**<br>• Covers employees and pensioners from consequences of insolvency/fraud<br>**Experience:**<br>• Instrumental in securing stability of several big DB cases in the UK and Japan in 2000-s<br>**Implementation scope:**<br>• Countries with important role of OPs |

# Insurance guarantee schemes have a similar role and are increasingly becoming a mainstream feature of developed insurance markets

## Insurance Guarantee Schemes (IGS)

**Objective:**

Guarantee partial (full), compensation (contract continuation) to policy holders (beneficiaries) in case of insurance failure

**Main features:**

- Often self-governed by industry
- High variance in guarantee, level, type of insurance and funding mechanism

**Experience[1]**

- Often set up as a consequence of failure of an insurer (e.g. Mannheimer Leben)

**Implementation scope:**

- Exist in two thirds of OECD countries

## Insurance guarantee schemes in selected OECD countries

| Country | Life IGS | Non-life IGS | Special non-life |
|---|---|---|---|
| Australia | | ✓ | ✓ |
| Austria | ✓ | | ✓ |
| Belgium | | | ✓ |
| France | ✓ | ✓ | ✓ |
| Germany | ✓ | | ✓ |
| Greece | ✓ | | ✓ |
| Japan | ✓ | ✓ | |
| Poland | ✓ | | ✓ |
| Spain | ✓ | | |
| UK | ✓ | | |
| US | ✓ | ✓ | ✓ |

1. Examples include: Mannheimer Lebensversicherung (Germany), Plus Forsiking A/S (Denmark), Chester Street and Independent Insurance (UK)
Source: OECD, Oliver Wyman analysis

# Next to customer protection, IGS have a broader socioeconomic role

| | |
|---|---|
| **Customer protection** | • Last resort protection for policyholder and beneficiaries claims<br>• Continuation of policyholder contracts and accumulated assets |
| **Industry growth** | • Establishing trust and confidence in the insurance industry<br>• Important aspect of promoting consumer demand |
| **Industry and economic stability** | • Stabilisation mechanism to pre-empt potential contagion from failing insurer spreading across the entire industry…<br>• Strengthening the role of insurers as "stabilising forces" in times of financial sector crisis |
| **State exposure** | • Shields the State (the taxpayers) from liabilities related to insurer insolvencies (e.g. "too big too fail" implicit guarantees)<br>• Sharing of cost of insurer insolvency by industry – potentially socialising cost to all insurance customers |

Source: Oliver Wyman analysis

# This role is particularly important for the life/pension sector which often administrates assets in excess of a nation's GDP

## Consequences for policy holder/beneficiary

**Investment/savings products:**

- Loss of substantial part of expected policy benefits (savings/investments), associated guarantees and future income (pensions)
- Loss of opportunity to find substitute provider/product (termination of policy with favourable terms)
- Long-winding process of company wind-up with no pay-outs and high uncertainty over several years

**Protection products:**

- Next to loss of pending claims, loss of unexpired portion of contract
- Replacement cover at higher price and meeting requirements (health)

## Consequences for industry/economy

- Can affect consumer confidence on an industry-wide basis
- Can inhibit sales of related savings and investment products
- May cause supply shortage (in the case of large company failures)[1]
- May cause panic termination of long term contracts (despite significant cost of termination to policy holder)
- May result in politically motivated ad-hoc changes to regulation (and negative consequences for industry performance)

1. Collapses of Insurance corporation of Ireland and Private Motorists Protection Association are notable due to their size and the level of intervention by the State in both cases
Source: Oliver Wyman Analysis

# Structure of presentation

# We already discussed the strategic arguments for setting up an IGS

| Customer protection | Industry growth | Industry and economic stability | State exposure |
|---|---|---|---|

- Protects policy holders and beneficiaries from impact of failing insurance companies
- Significantly improves speed of pay-outs versus winding down process
- Improves trust in the life insurance industry and thus accelerates growth
- Ensures contract continuation and assists in transfer of portfolios
- Ideally involves the industry in company failure resolution
- Supports industry and overall economic stability (where insurance has a major role in the economy)
- Reduces State exposure (even if there is no strict legal claim, reality may amount to implicit guarantee by the State)

# However, there are also a number of valid arguments against having an IGS

Actual need? | New risks?

| | |
|---|---|
| **Sufficiency of existing regulation** | **Existing regulation usually mitigates much of the risk of an insurance failure**<br>• Risk based prudential supervision framework<br>• Advanced company internal risk management capabilities and ethics<br>• Well resourced regulator and policy holder priority in wind-up |
| **Alternative protection mechanisms** | • **Austria:** Earmarking of policy holder assets monitored by designated trustee (any transactions require approval)<br>• **Switzerland:** Company individual guarantee funds (dedicated assets)<br>• **Spain:** MinFin agency as liquidator with special control power over assets |
| **Moral hazard** | **Increased risk taking as a result of additional protection:**<br>• Consumers opting for lowest price not caring about insurer financial stability<br>• Insurers taking on additional risk reducing underwriting discipline<br>• Regulator more likely to rely on the industry, conducting less oversight |
| **Competitive distortion** | **Creation of barriers to entry and shift in position of “weak insurers”**<br>• Mandatory IGS participation may be expensive and deter market entry<br>• Weak insurer products become enhanced due to additional layer of protection (moving funds from solvent to insolvent insurers) |
| **Cost and practicability** | **Additional administrative burden of operating an IGS**<br>• Needs to align with wider regulatory framework<br>• Funding of IGS (before or after trigger event), operating cost small and distributional |

# In reality, prudent IGS design can realise the benefits of an IGS and mitigate the associated risks

**Need to embed the IGS in the existing regulatory framework and existing market infrastructure**

**Sufficiency of existing regulation**

- Actually a prerequisite for an effective IGS

**Alternative protection mechanisms**

- Don’t create the same lever of trust in the insurance market and can be complementary

**Need to design the IGS in a way to mitigates the new risks it introduces**

**Customer protection**

**Industry and economic stability**

**Industry growth**

**Reduced State exposure**

Trade off

**Moral hazard**

**Competitive distortion**

**Cost and practicability**

IGS design, regulatory/prudential oversight and industry self-governed participation

# With this in mind an IGS becomes a protection scheme of last resort – it is not a replacement for sound regulation and market practice

**Supervisory activity**

**Supervisory authority monitors insurers' regulatory compliance:**

- Regular reporting/monitoring
- Mandate to enforce and impose sanctions including:
  - Restricting business activities
  - Imposing financial restrictions
  - Limiting the power of company's management

**Regulatory requirements**

**Requirements for enforcing effective prudential regulation include:**

- Transparent and consistent prudential regulatory framework (e.g. Solvency I, II or similar ones)
- Independent and effective regulator
- A clear set of regulatory objectives
- Strong professional Associations that influence regulatory process

**Structural conditions**

**Conditions for the effective functioning IGS include:**

- Efficient financial markets
- Symmetry in accessing information
- Sound and well-run insurers
- Strong professional associations (e.g. actuaries)

# Structure of presentation

# Smart IGS design covers the following six main elements

## Main design elements and options

**Type of insurance covered**

- Life and/or non-life
- Focus on specific insurance class

**Eligibility for guarantee**

- Policyholders and/or third parties
- Natural persons or more comprehensive coverage

**The limit of guarantee**

- Calculation of guaranteed amount
- Comp. limits, deductibles
- Co-insurance[1] (may vary between 50–90% in some cases)

**Nature of intervention**

- Payment of compensation
- Continuity of policies (e.g. portfolio transfer)

**Organization structure**

- Single or multiple IGS for different classes of insurance
- Private versus public management
- Relationship with supervisory authority
- Outsourcing, staffing

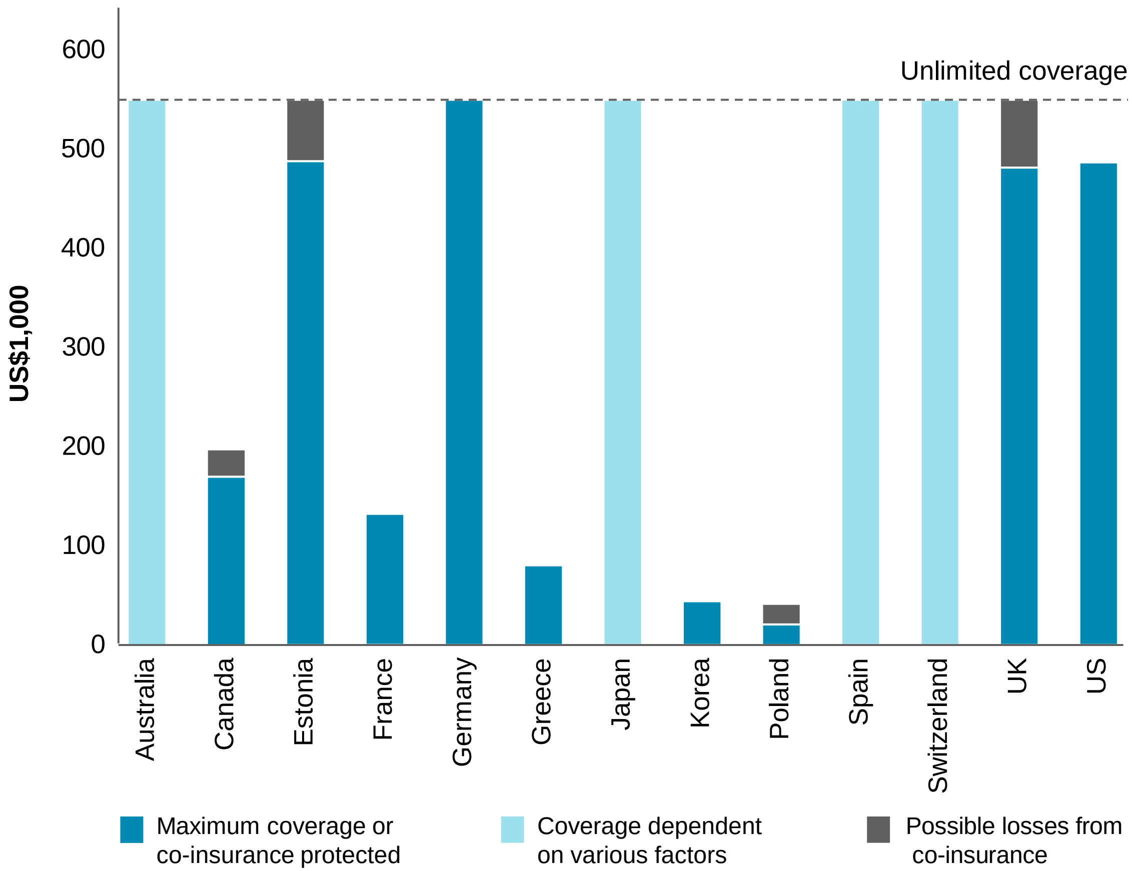
**Funding**

- Ex-ante or ex-post
- Separate for life and non-life
- Pooling between insurance classes
- Industry contributions (including risk-weighting)
- Provisioning

1. Co-insurance is an arrangement in which the policyholder shares the burden of an insurer's failure. This measure is widely used in the insurance sector when there is a defined, maximum coverage level (e.g. Canada, Estonia, France, Ireland, Japan, Norway, Poland, United Kingdom)

# High and unlimited coverage is typically only provided by countries with more developed financial systems

## Coverage levels for life schemes in selected countries



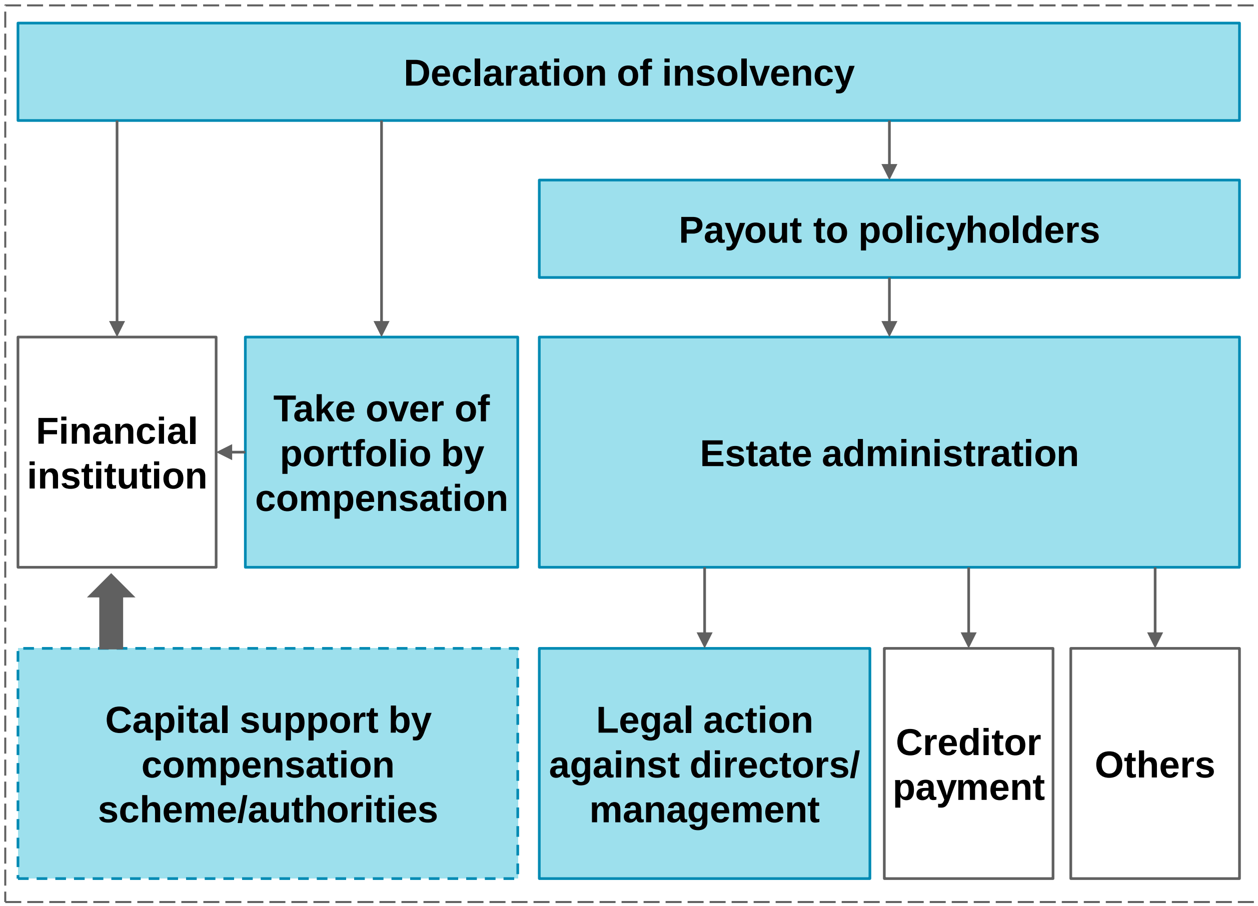

Note: The diagram has been simplified using the maximum available coverage in the country, irrespective of the line protected
Source: OECD, Oliver Wyman analysis

## Comments

- Coverage for life insurance policies varies from country to country depending on the local regulation. It may be unlimited (e.g. Germany) or depend on co-insurance or some other factors (Estonia, UK)
- US has a cap of US 0.5 MN for life lines, other countries have smaller limits
- For non-life policies with short tail risks unlimited guarantee is also common (e.g. Australia, Belgium, Denmark, Finland, France)
- Ireland and Switzerland have maximum guarantee of US 1.1 for non-life contracts

# The resulting resolution framework ensures quick pay-out, policy continuation and high degree of certainty for policy holders and beneficiaries

## Resolution framework




## Comments

- Intervention of the policyholder is triggered by a declaration of the insolvency or regulatory action
- Policyholder typically receives quick settlement and treatment advantage versus normal wind-up of a failed insurance company (which can take years)
- Even if the legal wind-up process takes longer, pay-outs are prefunded and the process provides a high degree of certainty to the policyholder and beneficiaries

# Germany has a private IGS for life insurance and an IGS for health insurance
## Both are governed by the market with some participation from the Regulator

| IGS for life insurance (Protektor AG) | IGS for private health insurance (Medicator AG) |
| --- | --- |
| • Set up as a private company<br>• Shareholders: German life insurers which are members of the Industry Association<br>• Supervised by: BaFin<br>• Scope of mandate: All types of life insurance, retirement benefits<br>– Take over business of a failed insurer, **fulfilment of running off contracts**<br>– Rescue company role: handle run off business of a failed insurer<br>• Portfolio: ~EUR 775 MN portfolio (12/11)<br>• Largest take over: Mannheimer L.V. AG, 2003, (~350,000 policies)<br>• Financed via annual contributions paid by members, max of 0.2% of technical reserves on ex-ante basis<br>• Can borrow funds but cannot lend | • The scheme is not operational<br>• Shareholders: Private health insurance companies<br>• Supervisor: BaFin<br>• Scope of mandate: provide guarantee in the area of private health insurance, ensure continuation of private health policies (payment of policies is not envisioned)<br>• The scheme is funded on ex-ante basis |

# Structure of presentation

# How strong is the strategic rationale for setting up a life IGS in Russia?

**Customer protection**

- Prevalence of cash flow underwriting and relative financial weakness of many insurers makes customer protection an important agenda
- Motion for tax incentives and subsidies are unlikely to be successful without establishing a high degree of protection

**Industry growth**

- Life insurance is still a very underdeveloped sector with no more than 0.1% GDP penetration
- Introduction of an IGS will can significantly improve consumer trust and accelerate growth

**Industry and economic stability**

- Condition soundness of regulation and market infrastructure are established, IGS will likely stabilise the fledgling life insurance sector
- Life insurers create long term money for the economy and funding of infrastructure – a key government policy objective

**State exposure**

- State exposure to life insurance is small given small size of the segment
- However, if growth targets are achieved, there will be insurers who’s failure would likely trigger government intervention – and implicit guarantees paid for from the budget

Degree of relevance

# How sound is the regulatory basis for an IGS to build on

**Sufficiency of existing regulation**

- Significant progress on individual aspects of life insurance regulation
- But still a longer path towards a comprehensive framework that:
  - Supports more advanced product structure
  - Embeds risk based prudential supervision
- Much of the required market infrastructure (e.g. actuaries) still to be established
- Many of the required insurer risk management capabilities still to be established
- Industry self governance still to be developed/expanded

**Alternative mechanisms**

- Special depository structure still under consideration?

Degree of relevance

# How material are the risks associated with introducing an IGS in Russia?

**Moral hazard**

- High risk with customers:
  - Low financial literacy and understanding of insurer financial stability in product choice
  - Preference for low price “as long as someone pays”
- High risk with insurers
  - Despite higher capital requirements for life insurers, players lack financial strength and are producing products with questionable economics
  - Life saving products need upfront funding before book becomes profitable (only few insurers can afford taking a long term view)

**Competitive distortion**

- High risk that weak players operate on the cost of strong players
  - Relatively high premiums create attractive cash flows
  - Weaker players can promote products “backed by IGS protection”

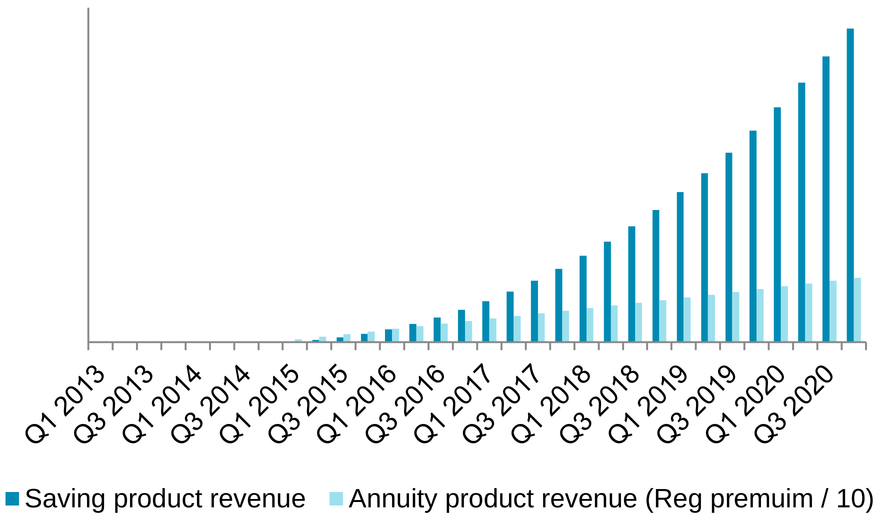
**Cost and practicability**

- Given small size of industry, fixed cost of scheme may turn out to be more material than in large life markets
- Given risks of failure to pay-up, will likely require pre-funding from insurers (with the larger companies taking the burden)
- Some sort of State involvement likely required until insurance association become fully self-governed

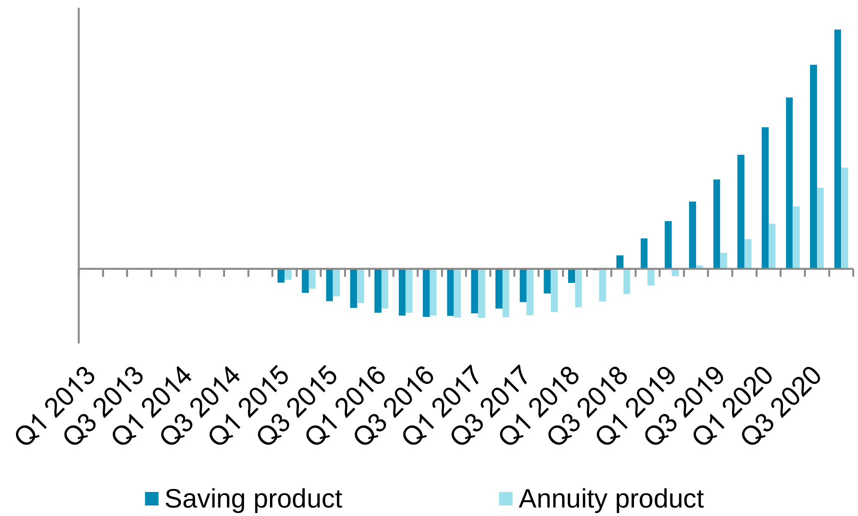
Degree of relevance

# Economic projection for Life/Savings business based on five year contracts
## Client example

### Life/savings revenue development




### Life/savings profit development




- The savings product and the annuity product involve an initial funding strain
  - The reserving basis for an annuity fund is typically more conservative than the profit margin leading to a funding strain
  - The savings product includes a guarantee of the sum invested – initial expenses need to be clawed back by future investment return
- A 5 year Life/Saving product payback period would typically exceed five years if growth is very fast

# So what may be a prudent way forward?

### Synthesis of observations:

- There is a very strong strategic rationale for introducing an IGS for life insurance in Russia
- However:
  - The associated risks of moral hazard, competitive distortion and associated cost are material and cannot be ignored
  - Mitigating these risks requires progress on developing prudential regulation and strengthening life insurance industry infrastructure

### Potential way forward:

- Integrate creation of an IGS into the design of the target regulatory framework for life Ins.
- Articulate key design elements as a policy objective, for example:
  - Coverage limits and introduction of deductible to encourage prudent choice of insurer
  - Operated by industry association with insurers being the majority shareholders
  - Mandatory membership for all members of the life insurance association
  - Prefunded by members
  - Supervised by the regulator along stringent criteria
- Accelerate establishment of market infrastructure as a joined objective for all life insurers associated in the life insurance industry association

# Structure of presentation

# Back up slide: Selected examples of IGS in European countries

## We have reviewed major building blocks behind European Life insurance IGS (1/3)

### Outline of the major IGS features in France

**Scheme name**
Guarantee Fund for Life insurance (FGAP)

**Participation requirements**
All life assurance companies established under French law (code des assurances)

**Supervisory authority**
Authorite de controle des assurances at des mutuelles (ACAM)

**Number of participants**
~130 life insurers

**Ownership and management**
The FGAP is a legal entity managed by the Board that constitutes 12 industry representatives

**Maximum coverage**
EUR 90,000 on policies in the event of death or invalidity; otherwise EUR 70000

**Funding mechanism**
Ex-ante. Fund size is 0.05% of mathematical provisions. Contribution of each participant reflects its relative net reserves

**Borrowing power**
Yes up to certain limit, from non-life insurers only

**Comments:**

- France has two insurance guarantee schemes: one for life insurance and another one for compulsory non-life insurance
- FGAP was established subsequent to the failure of Europavie, life insurance company, in December 1997
- Scheme intervention is triggered by ACAM and determined by an assigned liquidator rather then the scheme itself
- In the late 1990-s and early 2000-s there have been a number of failures in the French market that required intervention:
  - International Claims Services SA (1999)
  - European Insurance group (2000)
  - Independent Insurance (2000)
  - Caisse Generale d'Assurances (2003)
- The Fund does not accept any State funding

Source: OXERA

# Back up slide: Selected examples of IGS in European countries
## We have reviewed major building blocks behind European Life insurance IGS (2/3)

### Outline of the major IGS features in Germany

**Scheme name**
Guarantee Fund for Life insurance

**Participation requirements**
All licensed insurers (with some exceptions); voluntary participation of Pensionskassen

**Supervisory authority**
German Minfin (BaFin)

**Number of participants**
~130 companies (~95% of the market)

**Ownership and management**
The guarantee scheme is operated by Protektor AG, a private company

**Maximum coverage**
No monetary compensation – guarantee that policies will continue till expiration

**Funding mechanism**
Ex-ante. Target capital is 0.1% of life assurance net reserves

**Borrowing power**
Yes

**Comments:**

- Germany has two statutory guarantee schemes: for Life insurance, managed by Protector AG and for private health insurance, managed by Medicator AG (the latter is currently inactive)
- Similar to France, setting up Guarantee Fund for Life insurance was triggered by the failure of a large life insurer (Mannheimer Lenesversicherung AG) and the necessity to deal with ~350,000 life insurance policyholders
- The scheme ensures continuation (run off) of policies of insolvent insurers (no monetary payments)
- Protektor AG reinsures part of life assets it has taken over from Mannheimer and may apply for additional guarantees up to EUR 6 BN for the assets taken over before the scheme had been set up
- The Fund does not accept any State funding

Source: OXERA

# Back up slide: Selected examples of IGS in European countries
## We have reviewed major building blocks behind European Life insurance IGS (3/3)

### Outline of the major IGS features in Poland

**Scheme name**
Insurance Guarantee Fund (IGF)

**Participation requirements**
All life assurers on ex post basis in the event of a failure of another life assurer

**Supervisory authority**
Financial Supervisory Authorities, Ministry of Finance

**Number of participants**
~35 life insurers operating in Poland

**Ownership and management**
A council that comprises representatives from Minfin, Regulator and insurers' representatives

**Maximum coverage**
EUR 30,000 or up to 50% of the policy amount

**Funding mechanism**
Ex-post

**Borrowing power**
No, due to the nature of funding

**Comments:**

- The Insurance Guarantee Fund in Poland protects Life insurance and four types of compulsory non-life insurance: OMTPL, farmers' TPL, farm buildings and professional TPL
- The scheme's objectives are twofold:
  - Provide compensation to policyholder, claimants and beneficiaries following declaration of bankruptcy (similar to France and several other EU countries (applies to both life and non-life lines of insurance)
  - Secure continuation of policies (applies to non-life lines of insurance only)
- Unlike many EU countries, the IGF is financed ex-post (insurers are not required to pay contributions until particular event happens). Thus, the scheme cannot borrow funds or provide additional guarantees
- The scheme was involved in liquidation of a number of insurers in late 1990-s, 2000-s with claims exceeding EUR 50 MN

Source: OXERA

# QUALIFICATIONS, ASSUMPTIONS AND LIMITING CONDITIONS

This report is for the exclusive use of the Oliver Wyman client named herein. This report is not intended for general circulation or publication, nor is it to be reproduced, quoted or distributed for any purpose without the prior written permission of Oliver Wyman. There are no third party beneficiaries with respect to this report, and Oliver Wyman does not accept any liability to any third party.

Information furnished by others, upon which all or portions of this report are based, is believed to be reliable but has not been independently verified, unless otherwise expressly indicated. Public information and industry and statistical data are from sources we deem to be reliable; however, we make no representation as to the accuracy or completeness of such information. The findings contained in this report may contain predictions based on current data and historical trends. Any such predictions are subject to inherent risks and uncertainties. Oliver Wyman accepts no responsibility for actual results or future events.

The opinions expressed in this report are valid only for the purpose stated herein and as of the date of this report. No obligation is assumed to revise this report to reflect changes, events or conditions, which occur subsequent to the date hereof.

All decisions in connection with the implementation or use of advice or recommendations contained in this report are the sole responsibility of the client. This report does not represent investment advice nor does it provide an opinion regarding the fairness of any transaction to any and all parties.