

[Draft] Issues Paper on roles and functioning of Policyholder Protection Schemes (PPSs)

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Acronyms

ComFrame	Common Framework for the Supervision of Internationally Active Insurance Groups
EU	European Union. For the sake of simplicity, “European Union” and “EU” are used in this paper to refer to the broader European Economic Area (EEA) ¹
IAIS	International Association of Insurance Supervisors
IAIG	Internationally Active Insurance Group
ICP	Insurance Core Principle
IGS	Insurance Guarantee Scheme (a synonym for PPS, used in some jurisdictions)
LoB	Line of Business
MoU	Memorandum of Understanding
NCWOL	No creditor worse off than in liquidation
PPS	Policyholder Protection Scheme

¹ At the time of writing of this Issues Paper, the EEA encompasses the 27 EU member countries, plus Iceland, Liechtenstein and Norway. EU rules related to insurance supervision also apply to these three countries which are not members of the EU but belong to the EEA.

1 Introduction

1.1 Objectives and background

1. This Issues Paper (Paper) on the roles of Policyholder Protection Schemes (PPSs) provides an updated overview of global practices around PPSs and their roles in insurance resolution and a variety of related activities. This Paper describes current practices for PPSs and is intended to serve as a guide for jurisdictions considering establishing a PPS or modifying an existing PPS. It is not the intention of this Paper to discuss resolution regimes as a whole, including roles and responsibilities of resolution authorities.² This Paper is not meant to set new standards or expectations with respect to supervisory practices around PPSs.

2. In October 2013, the IAIS developed the Issues Paper on policyholder protection schemes (hereafter “the 2013 Issues Paper”) in order to provide an overview of the features of PPSs and the functions they can perform.³ This Paper has been developed as a follow-up to the 2013 Issues Paper, building on subsequent developments such as the adoption of the revised set of Insurance Core Principles (ICPs) and Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) in November 2019, as well as the outcome of the IAIS Members survey on PPSs conducted in early 2022.

3. The contents of the 2013 Issues Paper are still relevant in many aspects and provide useful guidance to jurisdictions that are interested in this topic. As such, this Paper does not intend to replace the 2013 Issues Paper, but rather to supplement it through providing updated information on selected PPS topics. This Paper and the 2013 Issues Paper together provide supporting material on PPSs. Where relevant, this Paper refers to the contents of the 2013 Issues Paper and aims to avoid repetition as far as possible.

4. PPSs are often established as a “last-resort” mechanism to provide protections to policyholders in the event of an insurer’s failure. While effective supervision can reduce the probability and impact of an insurer failure and promote policyholder protection, it cannot eliminate the possibility of an insurer failure. When an insurer is failing and has inadequate capacity to fulfil its obligations to its policyholders, a PPS can provide a certain level of protection for the policyholders through mobilising its fund, which may be set up on either an ex-ante or ex-post basis. PPSs may also provide a mechanism to ensure that resolution costs are borne by industry participants rather than by the society as a whole. Furthermore, depending on their mandates, PPSs may serve the supervisory objective of maintaining financial stability by facilitating effective resolution of distressed

² For supporting material on supervisory practices related to resolution, refer to the IAIS [Application Paper on Resolution Powers and Planning](#) (June 2021).

³ The 2013 Issues Paper is available at:
https://www.iaisweb.org/uploads/2022/01/Issues_paper_on_policyholder_protection_schemes.pdf.pdf

insurers.⁴ Some jurisdictions set up other types of policyholder protection mechanisms such as preferred claims, tied assets and segregated assets, which are covered in Section 7 of this Paper.

5. The ICPs and ComFrame do not require jurisdictions to have policyholder protection mechanisms in place. Rather, paragraph 61 of the ICP Introduction and Assessment Methodology indicates that “In general, deciding on the appropriate level of policyholder protection is a policy question to be addressed by each jurisdiction”, and that “Protection mechanisms could include, for example, (...) a policyholder protection scheme”.

6. In line with the ICP Introduction and Assessment Methodology, this Paper therefore does not set any requirements related to PPSs, but instead aims to provide background, describe current practices, and identify related regulatory and supervisory issues and challenges.

1.2 Terminology

7. Some jurisdictions use other terms, such as “Insurance Guarantee Schemes (IGS)”, “Guaranty Associations” or “Guaranty Funds”, instead of PPSs. Where appropriate, this Paper uses the relevant term as a synonym for “PPS” (eg when describing those jurisdictions’ best practices).

8. In this Paper, other terms have the same meaning as set out in the IAIS Glossary, with the exceptions described in the following paragraphs. To facilitate the understanding of the Paper, definitions of terms that are used frequently in the Paper are shown in the table below.

9. Insurance groups as a whole are rarely (if ever) covered by a PPS. Even though the IAIS Glossary and the ICP Introduction define the term “insurer” as meaning insurance legal entities and insurance groups (including insurance-led financial conglomerates), in this Paper, unless otherwise specified, the term “insurer” would normally not refer to insurance groups but only to insurance legal entities.

10. Reinsurers and/or reinsurance business are rarely (if ever) covered by a PPS (see also Section 3). Even though, pursuant to the ICP Introduction, the term “insurer” or the phrase “insurance legal entity” normally include “reinsurer” and the term “insurance” includes reinsurance, in this Paper, unless otherwise specified, the terms “insurer” and “insurance” would normally not include “reinsurer” and “reinsurance”.

11. “Recovery” is not a defined term in the IAIS Glossary, but is implicit in the relevant IAIS materials that the term is generally understood to mean actions taken to preserve the financial position and viability of an insurer that comes under severe stress. More specifically, to more clearly differentiate between “recovery” and “resolution” applications, this Paper refers to a recovery phase that is generally characterised by a few elements: the insurer is still in a going-concern situation,

⁴ See ICP 1.2, which states: “Primary legislation clearly determines the objectives of insurance supervision and these include at least to:

- protect policyholders;
- promote the maintenance of a fair, safe and stable insurance market; and
- contribute to financial stability.”

In addition, with respect to objectives of a resolution framework, ICP 12.2 states: “Legislation provides a framework for resolving insurers which:

- protects policyholders; and
- provides for the absorption of losses in a manner that respects the liquidation claims hierarchy.”

Building on this Standard, CF 12.2.a.1 provides: “In addition to the resolution objectives in Standard 12.2, the framework for resolving IAIGs should also include as an objective the contribution to financial stability, where applicable.”

does not meet the conditions to enter into resolution, but is subject to severe financial distress to an extent that an intervention is needed. Measures applied in the recovery phase can cover both those taken before (more specifically known as preventive measures) and after the breach of pre-defined levels of capital and/or liquidity requirements. The insurer remains managed by its owners, even though some recovery measures may be triggered by the authorities.

Table: List of resolution-related terms (in IAIS Glossary and ICP Guidance material)

Term	Definition and/or additional guidance
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 in some jurisdictions, separately from the insurance legal entity they belong to.
Portfolio transfer	Transfer of one or more policies together with, when relevant, the assets backing those liabilities.
Resolution	Actions taken by a resolution authority towards 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	<p>A person that is authorised by law to exercise resolution powers over insurers.</p> <p>This term is used when it involves resolution powers and/or processes after resolution has been instituted: this includes supervisors acting under their resolution powers.</p> <p>Depending on the jurisdiction, this term may include supervisors, other governmental entities or private persons (including administrators, receivers, trustees, conservators, liquidators, or other officers) or courts authorised by law to exercise resolution powers.</p>
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.
Supervisor	This term is used when it involves responsibilities and/or roles of the day-to-day supervision of an insurer.
Supervisor and/or resolution authority	This term is used when it involves responsibilities for planning and/or initiation of resolution and encompasses supervisors acting in their pre-resolution roles (eg before a supervisor or resolution authority institutes resolution and/or obtains any necessary administrative and/or judicial approvals to do so).

1.3 Inputs

12. This Paper relies on public documentation on resolution for insurers, including material from the IAIS and IAIS Members, notably the European Insurance and Occupational Pensions Authority

(EIOPA)'s Opinion on the 2020 review of Solvency II (hereafter "the 2020 EIOPA opinion"),⁵ which provided recommendations for harmonisation of national PPSs at EU level. It also benefits from the inputs provided by 30 IAIS Members who participated in a Member survey in early 2022. In addition, this Paper considers the International Forum of Insurance Guarantee Schemes (IFIGS)' Framework Guidance (hereafter "the FIGS Framework Guidance") and feedback provided from the FIGS, which was consulted during the development of this paper in light of the organisations' relevance and expertise in this area.⁶

1.4 Structure

13. The reminder of the Paper is structured as follows. Section 2 discusses powers and functions that could be exercised by a PPS in the event of an insurer failure, including how such powers and functions could be used in different phases (ie resolution, liquidation and in a few cases recovery). Section 3 discusses issues of coverage, including considerations relevant to the determination of the scope, limits and other design of a PPS, as well as issues of cross-border cooperation relating to coverage. Section 4 discusses practices for PPS funding, such as different sources and methods of PPS funding and methods to determine levy on insurers. Section 5 covers issues relevant to disclosure and communication of information about PPSs to policyholders and to the public. Section 6 addresses issues of cooperation and coordination between multiple PPSs and between a PPS and the supervisor and/or resolution authority. Section 7 provides an overview of other policyholder protection mechanisms adopted by jurisdictions, both in and outside the context of resolution.

14. Some of the topics addressed in the 2013 Issues Paper, such as issues relevant to governance and organisational arrangements of PPSs, are generally considered to be out of scope of this Paper. Readers may refer to the 2013 Issues Paper for guidance on such topics.

2 Roles of PPSs in recovery and resolution

2.1 Overview

15. Generally, a PPS is established in a jurisdiction by legislation that authorises the PPS, specifies how it is organised and governed, to whom it is accountable, and how it is funded (industry, policyholders, government or some combination of these).⁷ The legislation may detail operating rules and procedures for the functioning of the PPS and establish its powers. A PPS may have a role in both recovery and resolution (including liquidation), with a focus on minimising disruption of coverage and payments to policyholders and maximising the performance of the insurer's obligations to them. There is also a need to manage the insurer's losses and preserve its assets (especially during run-off and/or liquidation). The primary functions of a PPS may include the payment of policyholder claims, provision of liquidity, managing a run-off, effecting a portfolio transfer, and establishing a bridge institution or serving in that capacity. Functions and powers vary widely by jurisdiction.

16. Similarly, events that trigger the engagement of a PPS may vary depending on its roles and functions. Where a PPS has a role to play in recovery scenarios, its engagement may be earlier,

⁵ https://www.eiopa.europa.eu/document-library/opinion/opinion-2020-review-of-solvency-ii_en

⁶ See the box under Section 6.1 (Cooperation and coordination between PPSs) of this Paper for an overview of the FIGS. Further information about the FIGS such as its activities and membership can be found on the FIGS website (<http://www.ifigs.org/>). The FIGS Framework Guidance is available at: http://www.ifigs.org/wp-content/uploads/210120-IFIGS-Framework-Guidance-typo-edited_vF.pdf

⁷ See Section 4.1 for considerations relevant to sources of PPS funding.

while in most jurisdictions, the PPS is not engaged until the initiation of insolvency proceedings. There have been suggestions that involvement in resolution planning could be one role of a PPS, especially in the case of systemically important insurers. Determining when and how to engage a PPS may involve an assessment of the impacts of an insurer's failure on financial stability and/or public interest. Additionally, the institutional nature of the PPS, eg public or private, may limit the point of engagement or roles the PPS may play.

17. In recovery scenarios, events that trigger the engagement of a PPS may include the supervisor's assessment of an insurer's financial condition, eg asset adequacy, cash flow testing, and/or capitalisation; certain supervisory measures and/or court-ordered actions taken to address an insurer's financial condition.

18. Within resolution or insolvency, the involvement of a PPS may be triggered by events that include a declaration that an insurer is no longer viable or likely to cease to be viable, supervisory or court-ordered merger of an insurer; formal entry of the insurer into resolution or an insolvency order; appointment of an administrator or liquidator of an insurer; de-registration of an insurer; forced portfolio transfer; and/or certain events of default by the insurer.

19. The basic functions of a PPS, and the powers needed to implement them, are clearly discussed in the 2013 Issues Paper.⁸ The remainder of this section will outline and discuss those powers and tools necessary for the PPS to meet its objectives.

2.2 Functions of PPSs

20. Depending on national frameworks, PPSs could fulfil various functions in different stages of recovery and resolution. In the event of an insurer resolution, a PPS not only pays claims to policyholders of the resolved insurer, but could also fulfil other functions to facilitate continuation of policies through run-off, such as providing a cash injection, establishing a bridge institution or assuming that role. Furthermore, in some jurisdictions, a PPS could be triggered to make interventions at an even earlier stage, in order to facilitate the recovery of a troubled insurer for the purpose of protecting financial stability. In such a case, it is particularly important to give due consideration to potential moral hazard that could arise in the industry from such an intervention.

Payment of claims

21. One of the main functions of a PPS is to minimise policyholder losses. Subject to any applicable limits on payment, the PPS will compensate policyholders or beneficiaries of an insurer in resolution or in liquidation for some or all of their claims under contracts that are covered by the scheme. Some PPSs make direct payments to policyholders, others make payments indirectly through the insolvent insurer or the liquidator. Some jurisdictions see the possibility of both direct and indirect payments. This also depends on the situation. In a situation where the insolvent insurer is purchased, the purchaser will handle the claims. With regard to timing of payment, some jurisdictions explicitly provide the possibility to make advance or interim payments. Depending on the jurisdictions' choices, some PPSs include the refunding of unearned premiums in their coverage. In a regular insolvency procedure, the liquidator and the PPS work together to appropriately handle claims. In addition, some PPSs can provide loans to policyholders of the failing insurer. Such loans will be repaid when the policyholders later receive payments from the failing insurer. In some jurisdictions relevant authorities need to file an official court request in order to be authorised to use the PPS.

⁸ See the 2013 Issues Paper at pages 20-23.

Take-over of claims

22. Most PPSs, after they have (totally or partially) compensated policyholders, are “subrogated to the rights of the policyholders”, up to the amounts they have compensated.⁹ This means that they take over the entire rights of the policyholder to recover the compensated amount. The PPS pays the claim of the policyholder and recovers the funds from the failing insurer. Particularly for non-life policies, this enables the policyholders to receive a relatively rapid payment, which allows them to purchase a new insurance policy elsewhere. In addition, the preferential ranking of insurance claims over most other creditors in a liquidation means that the subrogated PPS has a better chance of recovering claims payments (since “subrogation” in this context means that the PPS has fully acquired the preferential ranking of the compensated policyholder), thus reducing the cost to the industry through levies needed to recover the shortfall (ie, the difference between the amount the PPS has compensated to policyholders, and the amount the PPS can recover from the insurer’s assets). Reasonable expectation of recovery against the estate of the failed insurer for funds advanced to protect policyholders is important in order to maintain the confidence in the PPS’ financial capacity. Certain jurisdictions also provide for the PPS to recover administrative expenses, and in some cases those expenses have even higher priority in the hierarchy of claims than insurance policies, although this might not be fully compatible with ICP 12.9 and associated guidance (as higher priority to PPS will mean lower payments to uncovered policyholders).

Bridge institution and run-off

23. When there is no purchaser available for a failing insurer, the insurance portfolios may be transferred to a bridge institution. This means that the portfolios are under interim management until a purchaser is found. A bridge institution is a temporary institution aimed at receiving a transfer of assets and insurance liabilities from an insurer in resolution, with the intention to transfer the received assets and liabilities to a private sector purchaser at a later stage. A bridge institution may involve the establishment of a separate insurer or the bridge role could be undertaken by the PPS itself. The bridge institution allows the payments to be continued and the PPS can supplement those payments to compensate for all or part of any reduction in benefits. In some jurisdictions, the PPS can only fund the transfer to the bridge institution but cannot be involved in the administration of benefits. If no purchaser is found in the short term, the portfolio (or part of it) can also be placed in run-off. In practice, this means part of the portfolio runs off until the claim is fully met and another part will eventually be purchased as the portfolio gradually shrinks. Some PPSs make use of a claims management firm to administer the claims in run-off, due to the long-term nature of this particular PPS application. In practice, for run-off the PPS can make use of the existing administrative arrangements and IT systems already available within the failing firm, in order to ensure an effective pay-out. In some cases, PPSs take over the claims in the time between the licence withdrawal and the appointment of a liquidator.

Examples:

Canada

In Canada, there have been four life insurance failures since 1990. In each case Assuris, the PPS for Canadian life insurers, paid no claims directly to policyholders to compensate them for benefits lost because policyholder liabilities were transferred to one or more solvent life insurer and the policy benefits continued by the assuming insurer(s). Assuris provided funding, based on its protection levels, to support the transfer in each case. In one example, Assuris entered into an indemnity

⁹ See also the IFIGS Framework Guidance at page 13, which proposes that the PPS should have, by law, the right to recover its funds provided in accordance with the statutory creditor hierarchy.

reinsurance agreement with the purchasing insurer to transfer the economic risk associated with a particular block of annuity policies to Assuris. In another case, Assuris purchased government bonds to replace a real estate asset supporting policyholder liabilities and assumed the risk of the sale of that real estate asset. In all cases, Assuris worked closely and collaboratively with the supervisor and the liquidator to achieve a resolution that best protected policyholders.

Germany

In 2002, Protektor AG, the German PPS for life-insurance policies, was founded by a private initiative. Mandatory participation for that sector was introduced after the failure of the life insurer Mannheimer Leben in 2003. Protektor AG was aimed at the continuation of policies and therefore only facilitates the transfer of portfolios, a bridge institution, and a run-off. In the case of Mannheimer Leben, the portfolios were placed in the bridge institution in order to make a sale happen. However, parts of the portfolio remained in the bridge institution until 2017, when a transfer was made.

Japan

Depending on the transfer scheme of the insurance policy, the Policyholder Protection Corporations (PPCs) are able to assist the payment of the claims of policyholders by (i) providing financial support to facilitate transfer of insurance portfolios of the failed insurer to another insurer, (ii) establishing as a subsidiary a bridge institution that takes over insurance portfolios of the failed insurer, and (iii) directly taking over the insurance portfolios of the failed insurer. In addition, the PPC can (iv) provide financial support through the failing insurer to assist the payment of insurance claims, and (v) provide loans to policyholders of the failing insurer.

Cash-injection to support sale-of-business or restart

24. In some cases, a purchase of the failing insurer might be possible only with a cash injection; this option should be used only as a measure of last resort to ensure the continuation of critical insurance coverage, eg where no comparable coverage is available in the market through another insurer. A sale-of-business can be the most practical and cost-effective way of ensuring the continuation of policies. A PPS can support the sale of business by providing funding. In some jurisdictions, a failing insurer may be allowed to restart its operations (open firm bail-in). This is done when a sale of business has not been possible and a continuation of policies is required, eg niche insurers that dominate a specific market. Some PPSs can provide funding only for the administration of a failing insurer to facilitate transfer of business or run-off. In addition, in some jurisdictions the PPS can be used to facilitate specific resolution actions.

2.3 Intervention by PPSs

2.3.1 Recovery phase

25. Only a few members responded to the survey that PPSs can be used for recovery in their jurisdiction. The primary objective of a PPS centres on the protection of policyholders against losses in the event of an insurer's failure. However, in some jurisdictions and/or cases, a PPS may also help to reduce the risk of insolvency and to improve the chance of recovery of an insurer. In this way, a PPS may contribute to the mitigation of contagion risks and to safeguarding public interests and eventually financial stability as a whole. It is usual for a PPS to come into play at the later stage of an insurer's failure when the insurer has no reasonable prospect of returning to viability, ie in times of resolution and/or insolvency proceedings. A PPS may also serve its functions at an earlier stage on a going concern basis; beyond its primary role of paying claims to policyholders on an ex-post crisis basis. A PPS may intervene early to restore the financial condition and viability of an insurer under severe stress. In some jurisdictions, a PPS is vested with powers to take a more proactive

approach in collaboration with the supervisor. For example, a PPS may seek preventive or corrective actions on insurers before recovery actions are taken, in order to minimise the risk of claims compensation payments.

26. As demonstrated in the following examples, the PPS may assume various roles in the recovery phase, when permitted.

Examples:

Chinese Taipei

There are two main tools during the recovery phase. When an insurer's finance or business deteriorates, but the supervisor still does not consider its capital to be seriously inadequate, the Financial Supervisory Commission (FSC) may mandate the Taiwan Insurance Guaranty Fund (TIGF) to take it under conservatorship if the situation is not improved in a certain period. Meanwhile, distressed insurers can apply for loans to the TIGF. However, this has not yet been applied in practice.

United Kingdom

Currently, the UK has no statutory resolution regime for insurers. The following tools are available to a firm in recovery:

- Secure or facilitate the transfer of insurance business to another firm;
- Assist the firm to enable it to continue to effect contracts of insurance; and
- Secure the issue of policies by another firm in substitution for their existing policies.

In addition, proposed legislation currently in Parliament would provide the option for write-down with a top-up by the Financial Services Compensation Scheme (FSCS).

27. The form of any PPS intervention at the recovery phase should be carefully considered in order to minimise the risk of potential moral hazard that could arise from such an intervention. If a PPS intervenes (i) before the insurer reaches the point of resolution, and (ii) for the purpose of the recovery of the insurer rather than the rehabilitation or transfer of its insurance portfolio, such funding could lead to insurers' or markets' expectation that a troubled insurer can be saved (or "bailed out") with the industry's money. For example, where the PPS provides funding to recapitalise an insurer, safeguards should include that such funds are provided in the form of a loan with appropriate terms and conditions in order to assure that the funds will subsequently be recouped from the insurer.

28. However, it is worth noting that the extent to which a PPS would be involved and how the PPS could effectively facilitate the recovery of an insurer depends on many factors, including clear allocation of roles between the PPS and the supervisor under different stages of crisis management, and further considering the risk of potential moral hazard. In jurisdictions where PPSs are governed by insurers, their involvement in the recovery phase also implicates competitive considerations in the insurance market.

2.3.2 Resolution phase

29. A failing insurer could be subjected either to liquidation or to other resolution powers. A PPS could intervene in all situations, albeit in different ways. Moreover, a PPS intervention would also differ depending on the products offered by the insurer.

30. At least in non-life, liquidation usually results in the termination of the policies. Claims are paid in whole or significant part to policyholders, and insurance coverage ends. In case the administrator could not honour the entire claim due to the deficit in the estate that caused the

insurer's failure, the PPS could pay the remaining amount of the claim up to any applicable limit on PPS coverage. To minimise delays in the process, the PPS may also step in and take over the claims from the insurer, pay off the policyholders and recover the funds from the failed insurer's estate. Furthermore, instead of terminating the policies, an administrator could place the portfolio (or part of it) into run-off, whereby the PPS might supplement payments to compensate for all or part of any reduction in benefits on the regular periodic pay-outs.

31. In case an insurer is subjected to resolution powers other than liquidation, the insurer's insurance contracts would typically be either transferred or put into run-off. Alternatively, under open firm bail-in (see Paragraph 24), the insurance contracts will be continued with the same insurer which has been allowed to restart its operations. Where continuation of policies is sought, a PPS could perform different tasks besides paying claims, such as establishing or assuming the role of a bridge institution or performing a cash injection to support a sale of business. When insurance contracts are run off, the insurer ceases to write new business and administers existing contractual obligations, thereby continuing to provide insurance coverage to existing policyholders.

32. The nature of a PPS intervention would also differ depending on the products being offered by the insurer, these can be either products with long term protections (typically life policies) or products with short term protection (typically non-life policies). For life products, claims payments likely need to be continuing over longer periods. For non-life products, payments might be necessary for only a short period (eg 30 or 60 days) so that the policyholder has sufficient time to find another insurer.¹⁰

33. When the resolution authority needs to write-down insurance portfolios, a PPS can compensate. The most important reason for avoiding liquidation of a failing insurer is to ensure the continuation of the policies. The most common way to do this is to facilitate a sale of the business. To prepare for this and make a sale more feasible, the insurer's balance sheet needs to be restructured. This often entails the so-called "bail-in tool", which allows the resolution authority to convert, restructure and/or write down the claims of shareholders and creditors. In addition, this might include the power to write down some part of the insurance policies' value.¹¹ When this happens, a PPS can compensate some or all of the lost policy value, by an ex-ante lump-sum payment, by supplementing the payment of claims or by subsidising a portion of the premium. When a sale of business is not feasible, some resolution authorities can opt for a so-called "open firm bail-in", which allows a restart of the insurance business through writing down liabilities or converting them to equity to recapitalise the insurer. This also generally involves a write-down of policy value. In this case too, a PPS can mitigate the diminution in value.

34. However, it is worth noting that the extent to which a PPS could be involved in the resolution phase, could effectively facilitate the resolution of an insurer. When a PPS is involved, it is expected that there is a clear allocation of roles between the PPS and resolution authorities, at least under the resolution phase. In the process of an insurer's failure, after the decision that the insurer is no longer viable, or is likely to be no longer viable, and has no reasonable prospect of returning to viability, the supervisory authority hands over the decision-making authority to the resolution authority or the

¹⁰ Considerations relevant to whether continuation of policies should be sought will be addressed in more detail in Section 3.5.

¹¹ In order to facilitate the write-down, temporary restriction or suspension could be imposed on the policyholders' rights of withdrawing from their insurance contracts. According to the [IAIS Application Paper on Resolution Powers and Planning](#) (Page 24), the legislation should provide for the scope of the moratorium to be as broad as necessary, so that all policyholders, whether protected or unprotected by a PPS, could be in scope when appropriate; though, when exercising the power, the resolution authority should then have the flexibility to determine which policyholders would fall into scope of the moratorium on a case-by-case basis.

liquidator. The PPS, when one is involved, should be able to engage directly with all these related entities. It should be noted that not all jurisdictions have resolution frameworks that fully comply with ICP 12, and comprehensive PPSs in place.

3 Coverage

35. This 2013 Issues Paper provides that a jurisdiction needs to strike a balance, in determining the coverage provided by a PPS, between what can be expected by policyholders and what a PPS can be expected to cover.¹² Factors to consider in this respect will include seeking to ensure that the PPS provides sufficient protection to policyholders, without resulting in excessive costs, nor in overreliance on the PPS (and the moral hazards that might entail).¹³

36. The high-level consideration provided in the 2013 Issues Paper is applicable as an overarching concept in determining various aspects of PPS coverage such as classes of policies and types of policyholders to cover and levels of protection limits and other mechanisms such as absolute or proportional (percentage) deductibles, which will be discussed under the following subsections. Jurisdictions may also consider factors such as implications for financial stability and the need to protect (the most) vulnerable policyholders.

37. The level and scope of coverage of PPSs should be clearly determined by policymakers in a manner consistent with the PPSs' public policy objectives and related design features.¹⁴ It is also important that the level and scope of protection are reviewed periodically to ensure that they continue to meet the public policy objectives of the PPS.¹⁵

3.1 Scope of coverage

38. Classes of policies —or lines of business (LoBs)— protected by PPSs vary by jurisdiction. Possible arrangements include: a single PPS that protects both life and non-life LoBs; a single PPS that only protects life LoBs or only protects non-life LoBs; or separate PPSs for life and non-life business. Several jurisdictions have more than two PPSs. In some cases, PPSs are designed to cover a broad range of policies with specific exceptions, while in other cases, PPSs may be established to provide protection only to specific classes of policies such as certain mandatory policies.

39. As mentioned in the 2013 Issues Paper, coverage may be considered more important for certain classes of policies than for others.¹⁶ Coverage, including limits and exclusions, could be determined in a manner that reflects the importance of coverage for the classes of policies under consideration. Jurisdictions may apply higher coverage limits, or even provide unlimited cover, to classes of policies for which the importance of coverage is considered to be high. Conversely, classes of policies for which the importance of coverage is considered to be low may be awarded lower limits or excluded from coverage. In determining the optimal scope of coverage, jurisdictions will need to balance the importance of coverage against other factors such as cost to provide protection, and potential risks of moral hazard.

¹² See the 2013 Issues Paper at page 17.

¹³ *Id.* at page 17.

¹⁴ See also the IFIGS Framework Guidance at page 8.

¹⁵ *Id.* at page 8.

¹⁶ See the 2013 Issues Paper at page 17.

40. Examples of policy features that may increase the need for protection by a PPS, or that are likely to be covered by PPSs, include:

- the policy is mandatory (so that the public purpose supporting the requirement for mandatory insurance is not undermined by the failure of the insurer);
- the policy insures third-party beneficiaries (ie “innocent victims”);¹⁷
- the policy insures against personal injury (as opposed to property damage);¹⁸
- the policy is provided under social insurance (eg industrial accident compensation);
- the policy is considered to provide protection against hardship or to be of relatively high importance to the financial health of individuals (eg provision for old age security); and
- the policy is not readily replaceable (eg a whole life insurance policy purchased by a young and healthy individual who is now decades older and has suffered health issues that might disqualify the policyholder from securing replacement cover) (see also Paragraph 41)

41. On the other hand, large commercial policies such as marine, aviation, credit insurance and reinsurance are usually excluded from protection by a PPS. As mentioned in the 2013 Issues Paper, these types of policies are generally considered not to fit a PPS’s typical purpose to protect the interest of individuals and small business policyholders (see also Section 3.4 for issues about scope of policyholders and claimants to be protected by a PPS).¹⁹ The 2013 Issues Paper also noted that funding the coverage of these types of policies by a PPS could be too costly.²⁰ Policies whose ultimate risks are not born by policyholders — eg policies issued in connection with public benefit schemes for which a government or public guaranty is provided — may often be excluded from protection of PPSs as well.

42. When considering the scope of coverage, attention should also be paid to the specific design of the coverage for each class of policies that could fall within the coverage of the PPS. Considerations mentioned in this subsection often play an important role in determining such issues as limits and methods of coverage, which will be discussed under the following subsections.

Examples:

EIOPA

As a part of the 2020 EIOPA opinion, EIOPA advised that national IGSs (ie PPSs) within the EU should cover specific life and non-life policies. EIOPA proposed minimum harmonisation which should cover the following:

¹⁷ It should be noted that moral hazard considerations do not apply to third-party claims or to group insurance offered by employers as an employee benefit, because the claimants who are protected by the PPS had no role in selecting the underlying insurance cover.

Furthermore, it is questionable whether these considerations even apply to those (ordinary) policyholders who will directly benefit from the insurance cover. While it is generally accepted that the purchase of insurance cover can have moral hazard effect (it can encourage imprudent behaviour), it seems doubtful that the “insurance of insurance”, ie the additional guarantee of a PPS, can have any tangible additional effects. See also Paragraph 44 below.

¹⁸ In some jurisdictions, claims related to personal injury have more generous limits than those related to property damage.

¹⁹ See the 2013 Issues Paper at page 19.

²⁰ *Id.* at page 19.

i) claims-related protection where the failure of an insurer could lead to considerable financial or social hardship for policyholders and beneficiaries (such as, for instance, fire insurance and other damages to property, accident insurance, sickness, liability, suretyship products if the beneficiary is a natural person); and

ii) contract-related protection (such as, for instance, health, savings, and life including occupational pensions by life insurers falling under Solvency II).²¹

France

The Fonds de Garantie des Assurances Obligatoires (Guarantee Fund for Mandatory Insurance) (FGAO) provides protection against failures of insurers in certain non-life mandatory insurance LoBs.

Before 2000, its scope of coverage was limited to motor liability insurance. It was then extended to include all other mandatory non-life insurance provided by insurers headquartered in France, in the context of the failure of an insurer (ICD Caution) which provided mandatory suretyship insurance.

The FGAO did not cover the insolvency of insurers headquartered in other EU countries, while these latter did not either contribute to the FGAO's financing.

In 2015, the European Commission (EC) asked France to change the rules of the FGAO, taking the view that the IGS was discriminating against insurers based in other EU countries as it only covered insurers headquartered in France.

In response to the EC's "reasoned opinion", the French authorities amended their legislation by extending the coverage of the FGAO to incoming EU providers (ie to the host-country principle).

Simultaneously, they restricted the scope of the IGS to the following LoBs: third party motor liability, 'dommage ouvrage' (an LoB within construction insurance which protects the buyers of a new building against construction defects) and mandatory medical liability insurance. This restriction was triggered by the concern that French industry, and in the end French policyholders, might have to pay for the failure of foreign insurers which are not supervised by the French supervisor (ie Autorité de contrôle prudentiel et de résolution (ACPR)). A former bill had even limited the scope to the French IGS to third party motor liability.

As a result of this amendment, French policyholders are no longer covered for mandatory insurance after July 2018, other than third party motor liability, "dommage ouvrage" and medical civil liability. The protection offered by the IGS has been reduced to three mandatory LoBs.

United States

Each state has a Life and Health Insurance Guaranty Association, which covers life insurance, health insurance (including medical, disability income, and long-term care, and health maintenance organization contracts), and annuities, including cash surrender values for life insurance and annuities. There are limited exclusions, including reinsurance and stop-loss insurance, certain unallocated annuity contracts and insurance issued in connection with governmental health benefit programmes where the government is the ultimate guarantor of payment.

In addition to excluding life and health business, the Property and Casualty Insurance Guaranty Associations exclude reinsurance, mortgage guaranty, financial guaranty, fidelity or surety bonds, credit insurance, vendors' single interest insurance, collateral protection insurance, warranties or

²¹ See the 2020 EIOPA opinion at page 94.

service contracts, title insurance, ocean marine insurance, and transactions that transfer investment or credit risk without the transfer of insurance risk.

Neither guaranty association covers extracontractual obligations, non-insurance obligations, or self-insured risks retained by the policyholder.

Some insurers' business mix makes them members of both guaranty associations in some or all of the states where they do business. In that case, the scope of coverage in the event of insolvency is determined on a policy-by-policy basis, and assessments are calculated on the basis of premium volume in covered lines of insurance.

3.2 Limits on compensation

43. A PPS does not have unlimited resources at its disposal, so it cannot be expected to provide unlimited protection for all claimants in order to leave them in exactly the same position as though the insurer were still solvent. Therefore, some limitations on compensation are often established. Limitations on PPS protection could also serve, in some circumstances, to reduce the element of moral hazard, noting that, in practice, moral hazard only exists with respect to those consumers who can assess, at the time they purchase insurance, financial strength or potential weaknesses of insurers. So far, there does not appear to have been any actual evidence in any jurisdiction that existing PPSs have induced moral hazard.

44. Limits generally take the form of caps on payment, fixed deductibles, or proportional deductibles. Deductibles, in practice, allow increased compensation for larger claims. Caps and deductibles could be applied on a per-claimant, per-policy, or per-claim basis. A separate limit for each claim is easier to administer, but might provide, at least in some LoBs, incentives to evade the limits on compensation by purchasing multiple policies which can be combined to provide a benefit that exceeds the PPS cap.

45. Some PPSs also have aggregate limits on compensation per insolvency or for their market as a whole. It may also happen (eg in Canada) that a PPS has some form of "circuit breaker" where the level of protection may depend on the level of difficulty the provided protection would cause to the other industry players. While this could make compensation uncertain, resulting in treating similarly situated claimants differently (based on the magnitude of insolvency of the failed insurer), these devices are sometimes seen as important to prevent contagion effects.

46. Limits often vary by line of business. Unlimited protection might be provided in LoBs such as workers' compensation where the insurance finances a governmental benefit programme, or in mandatory LoBs where the mandatory insurance is itself unlimited (see below).

47. Limits on compensation are expected to reflect the PPS's objectives; they should be set using relevant data (eg features of insurance products, concentration of players in the market). Factors to consider in establishing limits on compensation can include:

- the importance of risk coverage to the policyholder and the potential impact of reduced payment on vulnerable populations (eg hospital and long-term care insurance). Products with a social element (eg provision for old age security) or an investment guarantee may be viewed as having a greater need for protection than more commercially-based products;
- whether the level of compensation provided will enhance confidence in the insurance market;
- whether the insurance protects third parties (eg liability insurance); and for mandatory insurance (eg motor insurance), whether the compensation provided is sufficient to meet the minimum coverage requirements;

- whether policyholders are “locked in” to their policies, because it is either impossible or too costly for them to move the policy to a new insurer when the deteriorating financial position of their initial insurer becomes known;
- the impact on the industry of the levies necessary to support the level of compensation;
- the ability to adjust the compensation framework as needed;
- how operating costs can best be contained;
- consistency with the protection offered by other protection schemes for comparable products, be it in different sectors (eg annuities as compared with deposits and investments), or within the insurance sector itself (where disparities can be found when products compete across different PPS classifications); and
- whether premiums continue to be paid.

48. Limits should be fair, objective, and clearly delineated. A PPS’s compensation framework should be easily understandable by the public. It may also happen (eg in Canada) that the PPS is allowed to provide higher compensation than the pre-set limit, in cases where it appreciates that observing the pre-set limit would constitute a hardship case.

49. As mentioned in Paragraph 37, the level and scope of protection should be reviewed periodically. Review is particularly important when the inflation rate is high, when new products are launched, or where there is a change in the PPS’s objectives. Some PPS have limits that incorporate automatic indexed adjustments.

50. Limitations in concentrated markets may also help avoiding spill over effects in case a large insurer fails.

3.3 Method of compensation

51. In some cases, the PPS can achieve its objectives simply by paying claims in cash. Non-life policies can often be terminated soon after liquidation or other resolution proceedings are commenced, giving policyholders a short period of time in which to secure replacement cover. Nevertheless, even when the obligations of the PPS are limited to the payment of losses that were incurred before the policy termination date, the payment process could still take time to complete, and the magnitude of the PPS exposure might not be clear at the time the PPS is first triggered. There are some LoBs where claims arising from personal injuries could result in periodic payments extending for many years; there are also a number of LoBs where claims may materialise years after the termination of the contract, eg medical liability or construction insurance.

52. As already briefly mentioned in Paragraph 40, for some LoBs such as life, disability, and long-term care insurance, the insurance policy is structured on a lifetime or very long-term basis. This long-term continuation of cover is one of the central features of the policy. Policyholders pay substantial amounts in the early years of the policy, when losses are unlikely, for the right to guaranteed policy continuation in later years when the probability of loss is high. Policyholders, especially those who have reached advanced ages or have deteriorating health, are dependent on the ability to keep their existing policies because buying a new policy would be cost-prohibitive, or not available at all. If the policyholder’s accumulated premium reserve is sufficient and can be transferred to a new insurer, the policy could be continued. Otherwise, the PPS should be expected to ensure the continuation of cover.

53. One way continuation can be achieved is for the PPS to take over the policy, collecting premiums and paying claims in the same manner—in particular following the same calendar—as

the insolvent insurer would have done. The PPS could be granted the power to seek premium increases if a solvent insurer in a similar situation would be entitled to an increase. Another way to provide for continuation is for the PPS to enter into an agreement with a solvent insurer to take over a block of policies, with the PPS paying the insurer an amount sufficient to defray the difference between future premiums and future benefits, reflecting the unearned premium provision the insolvent insurer previously funded, or should have funded (because insolvencies often involve a history of premiums that were insufficient to finance the technical reserves that would ultimately pay claims).

54. When the PPS takes over a policy, jurisdictional law might provide that the policy to be taken over should be left unchanged; or, on the contrary, it might provide for specified modifications such as a proportional deductible (eg 5%, 10%... of the original policy value), or for eliminating or modifying certain specified benefits.

Example:

United States

In the United States, a PPS is not responsible for guaranteed interest rates in life policies and annuities in excess of a formula based on published market benchmarks.

55. Where policies (eg life, or annuities) have cash surrender provisions, PPSs will generally provide compensation when a covered policyholder requests a surrender. Surrenders could be covered by PPSs on the same terms as benefit claims, on the rationale that they are based on accumulated value which would otherwise be applied towards expected future claims. However, some jurisdictions set a lower limit for surrender value in some LoBs. In specific circumstances, it could also be appropriate, even in the absence of a formal surrender mechanism in the policy, that the PPS commute the policy by paying the policyholder a lump sum that reflects the accumulated value within the policy.

3.4 Eligible policyholders and claimants

56. Individuals, and perhaps small business policyholders, are typically the intended beneficiaries of the PPS. They typically have the most need for protection, and the least ability to absorb the loss of cover and to make arrangements in advance to mitigate the potential impact of an insurer's insolvency. On the contrary, large commercial risks, beyond being more difficult to assess, could be too costly for a PPS to cover. Accordingly, some PPSs make protection available only to individuals. Others have size thresholds for commercial enterprises that limit the eligibility for protection.

Example:

United States

In connection with the issue indicated in the preceding paragraph, the United States takes a related, but different approach under which most non-life PPSs have "high net worth" exclusions. These exclude a small number of wealthy individuals who are deemed to be sophisticated purchasers, but operate primarily to exclude larger commercial policyholders. A common threshold is \$50 million, but some states draw the line as low as \$10 million.

57. Another common exclusion is for "insiders", eg the managers, Board members, auditors and "large shareholders" of a failing insurer.

Example:

France

In France, shareholders holding more than 5% of the shares of the failing insurers, directly or indirectly, are excluded from any benefit from both life and non-life PPSs.

58. Even where the policyholder is ineligible, PPSs may include third-party claimants. For instance, jurisdictions often recognise that liability insurance and workers' compensation insurance exist for protection of accident victims as well as policyholders. Seriously affected claimants may be devastated if they must depend on compensation from a defendant who was insured with an insolvent insurer. Accordingly, PPSs often provide coverage for third-party claims against ineligible policyholders, but are granted a subrogation right to recover from the policyholder on behalf of the claimant.

59. Where group insurance policies are sold to employers or associations, PPSs base eligibility and limits on compensation on the beneficiary, eg the employee or association member, not on the commercial enterprise or trust that holds the master policy.

3.5 Treatment of unearned premiums

60. Because the return of unearned premiums is an insurer's obligation to a policyholder and arises directly out of the policy, some PPSs cover returns of premium as well as benefit claims. On the other hand, in most non-life LoBs, a default in refunding a premium is not likely to affect policyholders as heavily as a default in paying a benefit claim.

Examples:

EIOPA

The 2020 EIOPA opinion recommends that unearned premiums should not be covered.²² This is consistent with the decision of many (though not all) countries to assign a lower place in the liquidation hierarchy to unearned premiums, ranking above the claims of general creditors but below claims for policy benefits. Some jurisdictions follow a middle course, allowing some degree of PPS compensation for unearned premiums but only after satisfying a deductible that does not apply to benefit claims.

Korea

The Korea Deposit Insurance Cooperation (KDIC) covers 100% of claims for unearned premiums against a failed insurer, subject to the same KRW 50 million aggregate cap that applies to benefit claims.

United Kingdom

The FSCS covers 100% of claims for unearned premiums for life insurance, and 90% of claims for unearned premiums for non-life insurance.

United States

Under the National Association of Insurance Commissioners (NAIC) Property and Casualty Insurance Guaranty Association Model Act, claims for unearned premium are covered by the PPS,

²² See the 2020 EIOPA opinion at page 94.

but at a significantly lower limit: \$10,000, as opposed to \$500,000 for benefit claims. However, this provision has not been adopted by the States in a uniform manner, so the extent of coverage varies by jurisdiction (as does the priority of unearned premium claims within the liquidation hierarchy).

61. All other things equal, reduced funding (or no funding) for unearned premium claims allows the PPS to target more funding to compensate benefit claims. Consider the following example:

- Failing Insurer had a portfolio of 100,000 policyholders;
- annual premium paid by each policyholder was CUs (currency unit) 1,000;
- claim frequency is 1%;
- average claim amount is CUs 80,000 (representing a claim ratio of 80%); and
- average unearned premium is 6 months.

In this case, unearned premiums amount to million CUs 50; outstanding claims amount to million CUs 80; 100,000 policyholders have an (average) unearned premium credit of CUs 500 against Failing Insurer, and (approximately) 1,000 policyholders have an outstanding claim credit against Failing Insurer with an average value of CUs 80,000. It is debatable whether it is the best use of available funds to compensate a mass of policyholders for the low-severity default in unearned premium when the same funds could be spent on compensating those few policyholders who have suffered high-severity benefit claims.

3.6 Cross-border issues of coverage: home- and host-jurisdiction principles

62. PPS issues related to cross-border insurance business are discussed in the 2013 Issues Paper.²³ In such situations where cross-border insurance exists, PPSs may be established based on:

- the “home-jurisdiction” principle, where the PPS of the jurisdiction where the insurer is headquartered and supervised will compensate policies written in other jurisdictions, or
- the “host-jurisdiction” principle, where the PPS of the jurisdiction where the insurer is authorised to do business will compensate losses arising from defaulting insurers headquartered and supervised in other jurisdictions. An example of this is when the residence of the policyholder, the location of the insured property, or the place where the insurance policy was underwritten, are located in the host jurisdiction.

63. Jurisdictions should consider the advantages and weaknesses of each approach when deciding which to follow. A significant advantage to the home-jurisdiction principle is that it encourages prudent supervision by internalising the cost of failure. Jurisdictions are not required to fund events beyond their control, when a supervisor in another jurisdiction fails to prevent one of its domestic insurers that has cross-border activities, from becoming insolvent. However, a significant insolvency could strain the capacity of the home-jurisdiction PPS, particularly in the cases where foreign business is significant relative to domestic business.

64. It is expected that a PPS organised on the host-jurisdiction principle can assess insurers in proportion to their operations²⁴. It is also often sustained that the host-jurisdiction principle ensures that all policyholders living in the jurisdiction have the same protection when they buy the same type

²³ See the 2013 Issues Paper at pages 24-26.

²⁴ This is also true of PPSs organised on the home-jurisdiction principle.

of coverage, regardless of where their insurer is headquartered²⁵. Recent examples of failures in the EU suggest, however, that even with a host-jurisdiction principle, the treatment of policyholders of a failed insurer may still be highly dependent on the jurisdiction where the failed insured was headquartered (the “home” jurisdiction), notably because the liquidation laws that will apply are those of the home jurisdiction, and liquidation laws sometimes very markedly diverge across jurisdictions. For instance, there may be sizeable differences in the right to lodge insurance claims, in particular with regards to time-limits to be observed, which may be much shorter in some jurisdictions than in others. On the other hand, the weakness in supervisory incentives in the host-jurisdiction principle appears less stringent in markets where there is a high degree of supervisory convergence.

Examples:

EIOPA

While both options described in the preceding paragraph can work for the protection for policyholders, EIOPA advises that the geographical coverage of PPSs should be harmonised based on the home-jurisdiction principle.²⁶ Under the host-jurisdiction principle, the jurisdiction responsible for compensating the cross-border policyholders is not the jurisdiction responsible for the prudential supervision of the failed insurer. EIOPA considered this a drawback of the host-jurisdiction principle because shifting the cost of a failure to the industry or the policyholders of a different jurisdiction is deemed not to incentivise efficient prudential supervision.

United States

The first PPS in the USA was established in 1941 by the state of New York, for domestic life insurers, and operated on the home-jurisdiction principle. Others were subsequently established on a state-by-state basis, and in 1970, the NAIC facilitated the creation of a multi-state system by adopting two model laws. One provided for each state to establish a non-life PPS following the host-jurisdiction principle, and the other, which was less widely adopted at the time, provided for each state to establish a life and health PPS following the home-jurisdiction principle. In 1985, the USA transitioned fully to a version of the host-jurisdiction principle, amending the life and health model act to provide protection based on the insured’s state of residence, and all states now provide PPS coverage on that basis. There is a gap-filling provision (see box after Paragraph 71) under which the home-state PPS responds if the failed insurer never did business in the insured’s state of residence. The structure of the US market is different from the EU single market, with each host US state retaining the authority to deny, suspend or revoke a licence. In the US context, one advantage to the host-jurisdiction approach is that it enables the PPS funding to be shared by the states on a wider basis. Each state’s PPS is funded by all insurers licensed within the state, in proportion to their market share, rather than requiring a small state to bear the entire burden of a nationwide insolvency if one of its domestic insurers fails with a substantial portfolio of interstate business. A further rationale for the host-jurisdiction approach is that each state’s paramount interest is protecting its own residents, and each state has organised its PPSs around the belief that similarly situated policyholders within the state should be treated consistently, regardless of where their insurer is headquartered. Concerns about insulating home-state supervisors from the consequences of failure are addressed through other means, including the host states’ concurrent prudential supervision

²⁵ See the EIOPA [Opinion on the 2020 review of Solvency II, Background analysis](#) (December 2020) at page 696.

²⁶ See the 2020 EIOPA opinion at page 94.

powers and the NAIC's review of member jurisdictions' effectiveness through its accreditation process.

65. Another factor to consider when deciding between approaches is compatibility with other jurisdictions with significant cross-border activity, to avoid or mitigate the problems with gaps or duplications discussed in the paragraphs that follow.

66. In the situation of such "single" markets, it has been underlined that differences in PPS coverage stemming from the location of the insurer could leave some policyholders unprotected and affect confidence in the insurance market.²⁷ For example, consider Jurisdictions A and B, where cross-border sales of direct insurance are allowed between these jurisdictions. A policyholder is domiciled in Jurisdiction B and a failed insurer is liquidated (or resolved in some manner that triggers PPS protection). If the PPS in Jurisdiction B follows the home-jurisdiction principle, then it compensates the policyholder if the failed insurer is headquartered in Jurisdiction B, but not if the failed insurer is headquartered in Jurisdiction A. Unless Jurisdiction A also has a "home jurisdiction" PPS that has been triggered by the resolution action, the policyholder will be left without any protection.

67. An opposite case to be considered is as follows; the failed insurer is headquartered in Jurisdiction A, the policyholder is domiciled in Jurisdiction B, the PPS in Jurisdiction A follows the home-jurisdiction principle, and the PPS in Jurisdiction B follows the host-jurisdiction principle. Then the failed insurer would have contributed to two PPSs (making the cross-border policy more costly). It is to be expected, though, that such double coverage would not result in double compensation of the policyholder, as in all likelihood, both PPSs would seek to reach an agreement to share the compensation costs. Ex-ante arrangements could also be found to avoid double levying.

68. Gaps (or potential overlaps) in protection may be avoided if Jurisdictions A and B both follow the same approach. If both PPSs follow the home-jurisdiction principle, all policyholders will be covered by the PPS where the failed insurer was headquartered, regardless of where the policyholder is domiciled. If both follow the host-jurisdiction principle, all policyholders will be covered by the PPS where the policyholder is domiciled, regardless of where the failed insurer was headquartered.

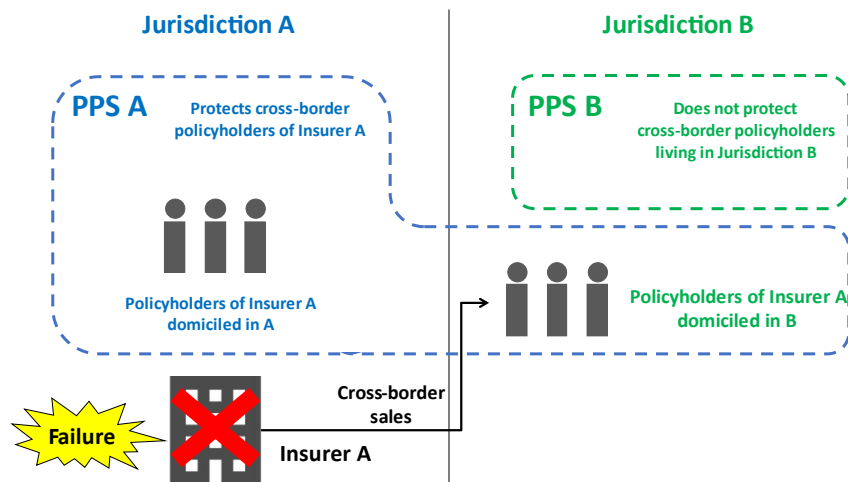
69. The following charts illustrate how different schemes combine, in the case of a defaulting insurer headquartered in Jurisdiction A with cross-border policyholders in Jurisdiction B (please refer to definitions provided under Paragraph 62).

²⁷ See the EIOPA's [Consultation Paper on Proposals for Solvency II 2020 Review Harmonisation of National Insurance Guarantee Schemes](#) (July 2019) in particular at pages 8, 10-11 and 31.

Illustrations of different schemes of protection – with potential impact on scope of covered policyholders

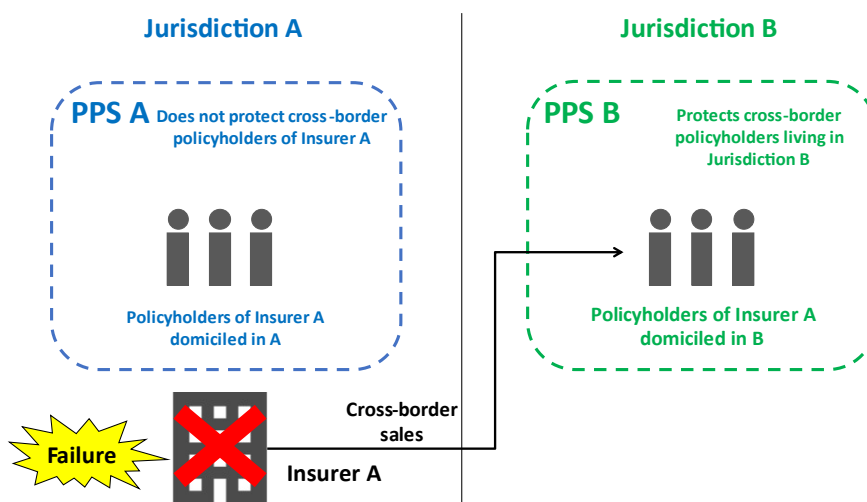
Case 1: Both jurisdictions A and B follow the “home-jurisdiction principle” — if insurer headquartered in A fails, policyholders living in jurisdiction B

- are **protected** by the PPS headquartered in **A**, and
- are **not protected** by the PPS headquartered in **B**

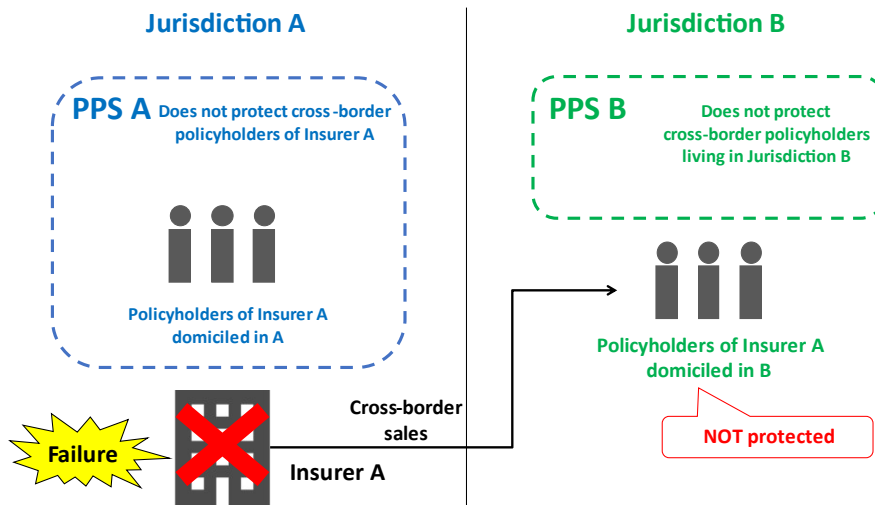


Case 2: Both jurisdictions A and B follow the “host-jurisdiction principle” — if insurer headquartered in A fails, policyholders living in B

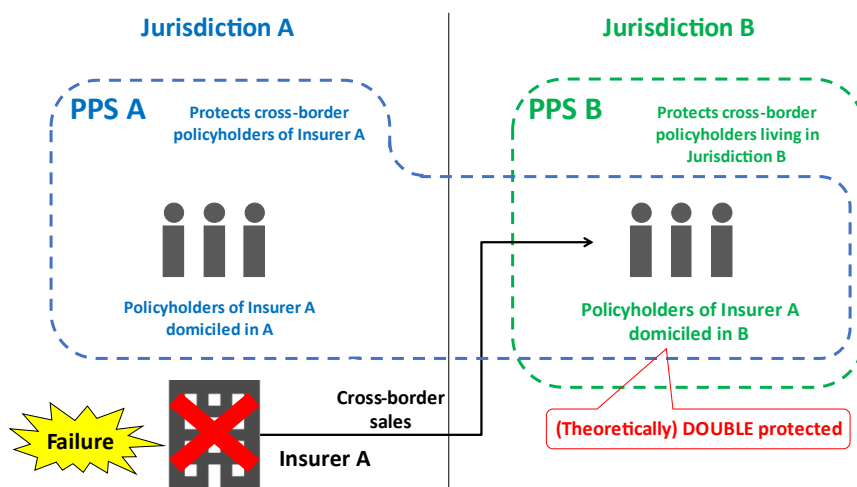
- are **not protected** by the PPS headquartered in **A**, and
- are **protected** by the PPS headquartered in **B**



Case 3: Jurisdiction A follows the “host-jurisdiction principle”, and Jurisdiction B follows the “home-jurisdiction principle” — if insurer headquartered in A fails, policyholders living in B are protected **neither** by the PPS headquartered in A, **nor** by the PPS headquartered in B



Case 4: Jurisdiction A follows the “home-jurisdiction principle”, and Jurisdiction B follows the “host-jurisdiction principle” — if insurer headquartered in A fails, policyholders living in B are protected **both** by the PPS headquartered in A **and** by the PPS headquartered in B



70. Jurisdictions may also prepare to take measures to overcome the operational issues presented when multiple PPSs are involved. For instance, the PPS located in the jurisdiction of the policyholders of the failed cross-border insurer (the “host” PPS), may more easily deal with policyholders than the PPS located in the jurisdiction of the failed insurer (the “home” PPS). The host PPS would then act as a point of contact, or front office (see Paragraph 109), for policyholders, and obtain recovery from the home PPS after paying claims on its behalf. This modification of the “home-

country principle” is particularly useful when there are language differences, and has been recently implemented in the EU with respect to motor liability insurance.²⁸

71. If the failed insurer has an effective PPS organised on the home-jurisdiction principle, then all eligible policyholders will be protected, subject to that jurisdiction’s limitations and exclusions on compensation. However, complications arise when one or more host-jurisdiction PPSs is involved. It is not always clear which “host” has the closest nexus to the transaction. The jurisdiction where the claimant resides is not necessarily the jurisdiction where the contract was issued.

Example:

United States

In the United States, the laws governing property and casualty association PPSs provide that if a claim is eligible for coverage by more than one PPS, primary responsibility for compensation rests with the PPS where the insured resides, except for workers’ compensation claims and first-party property insurance claims, where the residence of the claimant or the location of the property takes precedence. For life and health insurance, it is possible for the policyholder to move from the state where they bought the policy to another state where the insurer has never been licensed. These are referred to as “orphan policyholders”, and the United States PPS laws provide that in those limited situations, they will be protected by the insurer’s home-state PPS.

4 Funding

72. In order for a PPS to effectively fulfil its role in a resolution of a failing insurer, it is essential for the jurisdiction to establish funding arrangements for the PPS that are both efficient and adequate. The 2013 Issues Paper noted that funding was critical for maintaining public confidence in the insurance market, while funding which proved inadequate could delay or jeopardise the protection of policyholders.²⁹ The PPS needs to have sufficient, quickly available and adequate funds and funding mechanisms necessary to facilitate prompt funding of obligations or any assumption of contracts.³⁰ It is also important that funding arrangements are clearly defined and established in law or regulation or other legal instrument.³¹

4.1 Sources for PPS funding

73. There are several approaches that are typically used to fund a PPS, such as collecting assessments from insurers, providing support by the government or applying a surcharge to policyholders. Furthermore, these approaches may also be used in combination.

Contributions from insurers

74. The payments for funding a PPS can be collected as contributions from insurers whose claims are covered by the PPS (ie insurers participating in the PPS framework). The survey of IAIS Members indicates that this is the most common approach for PPS funding. Under this approach, a

²⁸ See [Directive \(EU\) 2021/2118 of the European Parliament and of the Council of 24 November 2021 amending Directive 2009/103/EC relating to insurance against civil liability in respect of the use of motor vehicles, and the enforcement of the obligation to insure against such liability](#).

²⁹ See the 2013 Issues Paper at page 12.

³⁰ See the IFIGS Framework Guidance at page 9.

³¹ *Id.* at page 9.

levy or assessment to cover the funding is applied to insurers either before (ex-ante) or after (ex-post) the resolution of an insurer.

75. This method not only enables the coverage of loss made by a failure event within the insurance sector without using public funding, but can also help to mitigate moral hazard of insurers by requiring all relevant insurers to contribute to the funding. On the other hand, there may be a risk of weakening the insurance sector, particularly in the event of a systemic-wide crisis. As stated in Section 4.2, such risks are greater with “ex-post” funding approaches, rather than “ex-ante”.

Surcharge on policyholders

76. The funding of a PPS may be collected directly from policyholders, usually in the form of a levy or a tax on the premium paid by the policyholder. A public understanding may be required when taking such measures, as the policyholder directly bears the burden of funding policyholder protection in the event of an insurer's failure. This approach can also be combined with, for example, government funding whereby the government provides a loan to the PPS in the event of a failure which is subsequently repaid by collecting levies on premiums.

Government funding

77. In some jurisdictions, the government may provide funding to the PPS in such forms as loans. The cost of such funding can be recovered as a claim against the entity or can be recouped from the insurance sector. Under this approach, the government often monitors the use of the fund during resolution. Compared to contributions from insurers, it is even more important to avoid moral hazard of insurers when taking this approach, especially if the cost of funding is to be recovered from the broader insurance sector rather than from the entity. This approach is typically used in combination with insurer contributions or surcharge on policyholders in order to cover any potential shortfalls that might arise from these sources alone.

78. As noted in the earlier paragraph, PPSs are most often funded with contributions from insurers who are the members of the PPSs. As such, the rest of this section will discuss relevant issues from the perspective of PPS funding from insurer contributions.

4.2 Ex-ante, ex-post and hybrid funding

79. The payment for a PPS fund can be made before (ex-ante) or after (ex-post) an insurer failure that triggers use of the PPS. With ex-post funding arrangements, solvent insurers pay assessments after the insolvency has occurred. With ex-ante funding arrangements, solvent insurers pay assessments before the insolvency has occurred. The pros and cons of ex-ante funding and ex-post funding, which are primarily based on the 2013 Issues Paper, are listed as follows.³²

Ex-ante funding
<p><u>Pros</u></p> <ul style="list-style-type: none"> - Funds can be built up slowly, and will be available immediately in the event of a failure; - Helps to mitigate moral hazard as all relevant insurers (including the insolvent insurer) contribute to the funding and levies can be risk-based; - Reduces potential adverse knock-on effects of levying funds on the industry after the event (ie their impact on capital); and

³² See the 2013 Issues Paper at pages 12-13.

- Provides opportunities to smooth the assessments paid by insurers over the course of a business cycle.

Cons

- Difficult to predict exactly how much funding will be needed to cover future insurer insolvencies, and thus may need access to emergency liquidity to meet urgent costs (eg annuity payments) or unexpected costs;
- Collecting funds in advance result in (i) an opportunity cost of tying up funds that could be used for other purposes and (ii) increased administrative and governance costs associated with maintaining a permanent fund; and
- The presence of a substantial public or quasi-public fund could spark demand to divert it for additional purposes.

Ex-post funding

Pros

- Solvent insurers have access to the funds until levies are required, thus, until required, they form part of the insurers' assets and are able to be used for purposes other than funding the PPS (eg to earn interest or pay other liabilities), and do not incur costs to maintain a permanent fund; and
- As there is no permanent fund, this negates the risk of funds potentially being used for other purposes and thus of not being available to the PPS when needed.

Cons

- The insolvent insurer does not contribute into the ex-post fund that compensates its own policyholders;
- If an insolvency is a result of a systemic problem (such as an underperforming stock market), then some insurers may also be in a weakened condition and may not have the funds needed to pay some or all of the assessment upon them; and
- The size of the assessment on insurers post-event may become large as they are not accumulated beforehand, and can also be less predictable since they are not based on a pre-determined formula.

Hybrid approach

80. In the event of a system-wide crisis, an ex-ante fund alone may not provide sufficient funding. Some jurisdictions combine ex-ante and ex-post approaches. Mostly in such cases, the ex-ante approach will be the primary method for funding and the ex-post approach may work as a backup resource which will additionally be used in the event that the ex-ante fund is insufficient to cover the cost of the failure. The ex-post funding in such circumstances is covered by the insurance sector. Such combinations may help to ensure adequate funding and to mitigate the weaknesses of each approach.

4.3 Determining the levy level for insurers

81. Whether assessments are collected from insurers on ex-ante or ex-post basis, the amount/rate of the levy on insurers needs to be determined in a manner consistent with the target (or maximum) size of the PPS fund. In the case of ex-post funding arrangements, the amount of PPS funding needed may be assessed at a level that is specific to the needs of a given failure event. In

the case of ex-ante funding arrangements, a jurisdiction may need to decide the target size of the PPS fund based on factors such as an expected amount of funds needed to address potential future insurer failures and costs to maintain such funds.³³ Some jurisdictions use statistical processes such as the Value at Risk (VaR) or the probability of default and loss given default (PD and LGD) approach to inform such a decision.

82. A levy for an insurer is typically decided based on aspects such as the size of each insurer or using a risk-based contribution approach. Examples of indicators that are used as a basis of calculation or considered as a factor to determine a levy amount include the gross written premiums (GWPs) and the amount of relevant liabilities of the insurer. In addition, in order to mitigate a potentially excessive burden on the industry, some jurisdictions set a ceiling to the levy level for each individual insurer.

83. When determining the levy rate for insurers, it is important to ensure proportionality and fairness of the levy level, in light of the fact that when the PPS funding is dependent on insurers' contribution, the cost of a failing insurer will consequently be borne by the other solvent insurers.

84. As price is one of the most important factors in choosing an insurer, competition creates incentives for insurers to price their products aggressively, assuming risks that threaten the firm's financial soundness. If customers know that any losses will be borne by the PPS if the insurer fails, they will have no incentive to discourage such behaviour by paying higher prices for the safety offered by financially responsible insurers.

85. If the risk of an insurer is untied from its levy level for the PPS, it can give rise to moral hazard arising from the incentive it creates for insurers to take higher risks in their business model. Risk-based contributions may be incorporated in a PPS to discourage imprudent behaviour by insurers. The aim is to ensure that the insurers that pose a greater risk for the PPS pay higher contributions for the cost of protecting policyholders against their failure. It could reduce the incentives for imprudent risk-taking since insurers would have to internalise the costs of those risks through higher levies. However, risk-based contributions are not straightforward to design and calibrate in a way that policymakers can be confident accurately reflects differences in the risks that insurers represent to the PPS. Options include different assessment rates for different types of business; setting contributions as a proportion of the risk-based capital that each insurer is required to maintain for covered classes of business; additional contributions where an insurer fails to meet specified reserve ratios; and requiring higher rates of contribution from insurers that are rated as riskier by the supervisor. The implementation of differential contributions also requires the PPS to have access to firm-specific financial information, which may not be appropriate for industry-operated PPSs.

Examples:

Australia

The calculation is not risk-based. The amount of levy is calculated on the basis of gross premiums received by general insurer. The levy rate has a statutory ceiling of 5% of the gross premiums for each general insurer under Section 5 of the Financial Claims Scheme (General Insurers) Levy Act 2008.

China

³³ See also the 2013 Issues Paper at page 14-15 (Paragraphs 49-51) for considerations of funding needs by LoBs.

The rate of fund contribution by insurers is decided based on a combination of factors such as the speed of development and scale of the insurance sector, the risk profile of the insurance sector and the affordability of the sector.

Italy

The determination of the contribution considers the results recorded in the previous year's annual report of the Fund and depends on expenses relating to the management of the Fund in the previous year. Not later than 31 January of each year insurers must make a provisional contribution for the current year, determined by applying the rate established for that year to the premiums earned resulting from the last approved balance sheet, net of operating costs determined by the Istituto per la Vigilanza sulle Assicurazioni (IVASS). The reconciliation between the amount due by the insurer and the provisional amount paid must be made by 30 September following the date of approval of the balance sheet.

Malaysia

Under the Differential Levy Systems (DLS) and Differential Levy Systems for Takaful (DLST),³⁴ insurer members are differentiated in accordance with their risk profiles. This is to introduce fairness into the levy system process by charging higher levies for members assessed to be of higher risk. In determining the levy applicable, insurer members will be assessed and classified into different categories in an assessment year based on a combined quantitative (eg capital and operational/sustainability measures) and qualitative (eg supervisory rating) criteria approach.

Singapore

Singapore also uses a risk-based methodology whereby insurers of a higher risk profile will be levied at a higher rate. The risk profile is assessed and determined via the Comprehensive Risk Assessment Framework & Techniques (CRAFT) framework of the Monetary Authority of Singapore (MAS).

UK

A firm's share of the Financial Services Compensation Scheme (FSCS) levy is determined by (1) the base costs levy, which is calculated by reference to the regulatory costs paid by the firm, and (2) the specific costs levy and the compensation costs levy, which are calculated by reference to the amount of business conducted by the firm. 75% of these levies are calculated by reference to relevant net premium income; the remaining 25% is based on eligible liabilities.

4.4 Differences between resolution funds and PPSs

86. Outcomes from the IAIS Members survey indicate that resolution funds are not currently widespread for the insurance sector. The resolution funding arrangements that are in place are generally reserved for institutions or situations where the failure is expected to have a material impact on financial stability. In all but one case, those arrangements are not designed specifically for the

³⁴ "Takaful" refers to a risk-sharing arrangement structured to comply with Islamic prohibitions against traditional insurance. In [its Glossary](#) (updated in January 2018), the Islamic Financial Services Board (IFSB) defines Takaful as "A mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants' risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks."

insurance sector but are available for resolution of systemic financial institutions generally (see Box below).

Examples:Australia

In addition to the Financial Claims scheme (which protects deposits and general insurance policies), the Financial System Stability Special Account (FSSSA) can be used to support a government-backed recapitalisation of banks and insurers. The FSSSA is a broad special appropriation that can be used for resolution actions provided the specified statutory conditions are met. In the case of an insurer, the account may be used for making contracts and arrangements of up to AUD 10 billion by the Australian government for two purposes: (i) protecting the interests of policyholders in ways that are consistent with the continued development of a viable, competitive and innovative insurance industry; or (ii) protecting financial system stability in Australia.

Chinese Taipei

In addition to the Insurance Guaranty Fund, a special reserve fund is set aside to deal with matters regarding the resolution of financial institutions (including the banks, insurers and securities firms) and reducing financial systemic risk. It is funded by part of the business taxes paid by financial institutions during 2011-2024. Use of the reserve fund for the resolution of individual financial institutions requires advance government approval.

Japan

Aside from the policyholder protection scheme involving the Policyholder Protection Corporations for life- and non-life insurance, the Deposit Insurance Corporation of Japan (DICJ) may provide funding to financial institutions (including banks, broker dealers, financial holding companies and insurance companies), when the prime minister confirms that severe disruption would be caused in Japan's financial market and any other financial systems if such funding was not provided, according to the Article 126-2 of the Deposit Insurance Act. The funds needed for the measures are charged to the DICJ's Crisis Management Account, which is separated from its General Account and is financed by "ex-post" contributions paid by financial institutions.

Netherlands

A resolution fund, funded ex-post by levies on the insurance sector, was established by the Dutch resolution regime for insurers, which came into effect in 2019. It can be used to cover operational costs of resolution, such as the use of a bridge institution; to compensate creditors, including policyholders, under the "no creditor worse off than in liquidation (NCWOL)" safeguard; and to reimburse the liquidation estate of the failed insurer where pay-outs made to policyholders during a resolution (for example, under pensions and annuities) are subsequently determined to have been too high, to the detriment of other creditors. Rather than recover excess payments from the policyholders, parity can be restored by compensating other creditors through the resolution fund. Thereby, the resolution fund supports continuity of payments during resolution or insolvency procedures to those policyholders that rely on these payments. The resolution fund cannot be used to guarantee policies, absorb losses or capitalise a failing insurer.

Singapore

PPS funds can be used to facilitate either the transfer of the whole or part of a Scheme member's insurance business to another insurer; or the run-off of its insurance business, which are common resolution actions. In addition, when resolution actions are taken on an insurer which is systemically

important or critical, a standalone resolution fund may be tapped to fund the resolution measures. The standalone resolution fund is financed ex-post. When the resolution fund is activated, MAS will provide a temporary loan to the resolution fund. This will subsequently be recovered from the industry via ex-post levies.

To facilitate the resolution of a Scheme member, PPS funds will be used first, as an ex-ante financing component, before MAS triggers the use of the resolution fund.

United States

If a non-bank financial company is designated as a systemically important financial institution (SIFI) by the Financial Stability Oversight Council, it may be resolved, if it fails, by the Federal Deposit Insurance Corporation (FDIC) under its Orderly Liquidation Authority conferred by Title II of the Dodd-Frank Act. Funding is available for the FDIC under this framework for purposes such as loans to the financial institution, transfers of assets and liabilities or payments to certain creditors. However, if the failed SIFI is an insurer, or has subsidiaries or affiliates that are insurers, the insurer(s) will be liquidated or rehabilitated under state law if the appropriate state judicial filing is made within 60 days after the commencement of the federal resolution process.

87. The purposes for which a PPS and a resolution fund may be used, and the conditions for their use, will depend on the applicable legal framework and their individual mandates and governing rules. For example, many PPSs may fulfil their mandate to protect policyholders by funding measures such as portfolio transfer, which may take place under a resolution framework. To this extent, PPS resources may support resolution measures in a manner similar to a resolution fund. The differences discussed in this subsection are not universal. While they describe a conceptual distinction, in practice funding arrangements and mandates will be tailored to individual frameworks.

88. At a conceptual level, the difference between a PPS and a resolution fund resides in the purposes for which they may be used. The primary purpose of a PPS is to protect the policyholders and beneficiaries of the classes of policies that fall within its coverage. The measures that it funds will generally be aimed at this purpose. Put simply, where the PPS mandate is aimed at protecting specified classes of insurance policies, it would not be a legitimate use of a PPS to fund the continuity of liabilities or activities that are not covered claims, or not essential themselves for the protection of covered claims. By comparison, resolution funds may have different purposes, which can aim at preserving financial stability, at avoiding systemic impact, or at funding compensation under the NCWOL safeguard. The former purpose may be determined by the conditions for entry into a specialised resolution framework, for example, a threshold for that framework that requires the institution to be systemic or critical in failure. In such cases, the resolution fund might be available for use for any institution within the resolution scheme but, by definition, that institution must have met the applicable threshold. Alternatively, use of resolution funding arrangements may require a case-by-case determination that a particular institution gives rise to systemic risks in failure. However, in either type of case, once the conditions have been met, the resolution fund can generally be used for different purposes than a pure PPS. This could entail providing support for a wider set of liabilities where necessary to contain the systemic impact of the failure.

89. Where a jurisdiction has both a PPS and a resolution fund that may be used in relation to a failing insurer, the legal framework should be clear about the scope, limits and purposes of each type of fund, the specific circumstances in which they can be used, and any hierarchy between them (eg which fund should be used first, and any limits to the amounts that may be paid). This is important to provide clarity for authorities and for the industry stakeholders that are required to contribute to either fund. Overlap between the two types of fund risks could create ambiguity, and this may be suboptimal where different bodies or authorities are responsible for managing the funds and making decisions about their use.

5 Disclosure and communication

90. Public disclosure and communication confirming the existence of a PPS is an integral component of a well-functioning PPS. Disclosure and communication of the benefits, prescriptions and limitations of a PPS can contribute significantly to the efficacy of the PPS. Effective and clear disclosure and communication regarding the PPS can promote financial stability by supporting confidence in the market. Subject to legal prohibitions, it is essential that the PPS inform the public about the benefits and limitations of the PPS on an ongoing basis.³⁵

5.1 ICPs and PPS disclosure

91. ICP 19.7 specifies: “The supervisor requires insurers and intermediaries to provide timely, clear and adequate pre-contractual and contractual information to customers.”³⁶ Guidance material associated with ICP 19.7, addressing disclosure of information about a product to customers, provides guidance for the timing of the provision of information to customers, clear delivery and adequacy of information to customers, product features and disclosures through digital channels.³⁷ This guidance on disclosure also applies to the provision of information about the PPS in the context of product sales. ICP 19.7.17 specifies further: “Where applicable, the customer may also be provided with information on any policyholder protection scheme or compensation scheme in the case of an insurer not being able to meet its liabilities and any limitations on such a scheme.”³⁸

92. ICP 19.13 specifies: “The supervisor publicly discloses information that supports the fair treatment of customers.”³⁹ In particular, ICP 19.13.1 specifies: “The supervisor should publish the policyholder protection arrangements that are in place for insurance contracts sold within its jurisdiction and insurers subject to its supervision and confirm the position of policyholders dealing with insurers and intermediaries not subject to oversight or supervision within its jurisdiction.”⁴⁰

5.2 Disclosure considerations relevant to PPS

93. The objectives of the public disclosure programme should be adequately and clearly defined and consistent with the public policy objectives and mandate of the PPS. The public disclosure programme should be implemented in accordance with principles of proportionality.

94. The PPS in conjunction with supervisors, insurers and intermediaries share responsibility for promoting public awareness of the PPS and may use multiple communication tools as part of a comprehensive communication programme embracing frequency and efficiency of communication.

95. The public awareness of the PPS should not be utilised as a marketing tool in furtherance of commercial objectives. Some jurisdictions restrict public disclosure of information by insurers about PPSs for secrecy reasons or prohibit use in product advertisements. On the other hand, some jurisdictions require disclosure of specific information such as limits on PPS coverage at particular stages, such as at the point of sale.

³⁵ See the IFIGS Framework Guidance at page 10.

³⁶ See ICP 19.7

³⁷ See ICP 19.7.1 to ICP 19.7.23

³⁸ See ICP 19.7.17

³⁹ See ICP 19.13

⁴⁰ See ICP 13.13.1

96. Some jurisdictions implement programmes aimed at promoting public awareness of the PPS coverage. The public disclosure programme could convey information about the following:

- the scope of coverage of the PPS (ie which types of insurance policies or LoBs are covered by the PPS, and which are not);
- a list of which insurers are subscribed to the PPS and how they can be identified;
- PPS coverage limits; and
- other information, such as the mandate of the PPS.

97. Coverage limits of the PPS should easily be understood by the public. Fostering a sound public understanding of a PPS's coverage limits will mitigate the potential for policyholder moral hazard. The existence of a PPS should not be a substitute for consumers taking appropriate steps to make well-informed decisions when selecting a policy or for insurers to have robust risk management frameworks in place.

98. The PPS public disclosure programme should refer to coverage limits including whether they apply by contract or by policyholder. Coverage limits should be distinguished where applicable along product categorisation, eg life and non-life products. When multiple PPSs exist, the scope of each PPS should be described clearly; consumers should be informed of the products and amounts that are covered by each specific PPS.

99. The PPS should, through its public disclosure programme, build credibility with policyholders and stakeholders through an active communication process that is effective at different levels of stakeholder, eg insurers, consumers and intermediaries. The public disclosure programme may consider a tailored approach for the various classes of stakeholder.

100. The PPS should consider using external public relations, advertisements and branding expertise to supplement internal capacity in these disciplines in order to maximise the effectiveness of the public awareness programme. Jurisdictions may use a variety of means to increase public awareness such as public websites, advertisements, campaigns on PPS coverage and eligibility, annual public survey and social media.

Examples of PPS communications that account for policyholder preferences and challenges:

When communicating to policyholders, some IAIS members account for policyholders' preferences in communication methods or their challenges in receiving communications. Members use different generations of technology to meet generational preferences and overcome geographical barriers that may hinder policyholder accessibility to PPS information. For example, in Spain, while most policyholders use the PPS webpage, traditional media like publications in official journals and direct contact by phone are still used. Chinese Taipei uses a principle of inclusion to raise public awareness. This IAIS member uses a broader range of communication methods, from in-person events to interactive social media, to reach policyholders. Malaysia also uses multiple channels of communication, including leveraging digital and social media channels, and has begun reducing use of traditional media. Australia plans to use policyholder circumstances and needs, such as generational considerations and accessibility to technology, to determine appropriate communication methods when administering the PPS.

101. The PPS should engage insurers and other safety-net participants to ensure the consistency and accuracy of the information provided to policyholders and to promote awareness on an ongoing basis.⁴¹

102. The PPS should monitor its public awareness activities and arrangements periodically, with independent evaluations of the effectiveness of its public awareness programme or activities.⁴² In the event of an insurer failure the PPS or an empowered authority, liquidator or court appointee should notify policyholders as expeditiously and appropriately as possible of the role of the PPS and how protection will be provided, via media such as press releases, print advertising, websites and other media outlets.⁴³

6 Cooperation and coordination

103. As stressed in the IAIS *Application Paper on Resolution Powers and Planning*, “Cooperation and coordination have proven to be essential for effective crisis management. Lack of cooperation and coordination, where all involved parties seek their own interest without considering the effectiveness of the overall resolution process, could lead to a suboptimal resolution outcome, particularly in cross-border cases.”⁴⁴

104. The need for cooperation and coordination amongst PPSs, and between PPSs and supervisors, is discussed in the 2013 Issues Paper, which remains fully relevant on these issues.

6.1 Cooperation and coordination between PPSs

105. Insurance is a business with a significant cross-border activity, notably by local branches or on a service basis. Where this activity is material, cooperation and coordination between national PPSs are essential, with the aim of; a) providing an efficient and effective response in case of insurance failures; and b) ensuring the fair treatment of all policyholders, including a swift pay-out of benefits, regardless of where they subscribed to the policies.

106. The cross-border cooperation and coordination agreements with other PPSs should lay down the scope of such cooperation and information sharing. This could take the form of a signed Memorandum of Understanding (MoU) committing to information exchange, which may include the creation of specific cooperation platforms. The 2013 Issues Paper provides a list of aspects that should be part of such agreements to define the roles and responsibilities of the different parties involved.

107. Cooperation and coordination between PPSs should take place in both normal times (ie business-as-usual) and in crisis times (ie when the PPS needs to be triggered). In normal times, for example, PPSs may want to exchange information that would allow them to better understand the different roles and powers that each PPS has in the resolution process or the size of the exposure in which they may be incurring.

108. Cooperation and coordination are particularly important in times of crisis, especially in those jurisdictions that follow a home-jurisdiction approach, ie where the domestic PPS covers policies issued by domestic insurers both at national level and abroad via local branches or on a service

⁴¹ See the IFIGS Framework Guidance at Page 10.

⁴² *Id.* at page 10.

⁴³ *Id.* at page 10.

⁴⁴ See the IAIS [Application Paper on Resolution Powers and Planning](#) (June 2021) at page 44.

basis. In case of failures with cross-border impact, the arrangements could contribute to removing obstacles to the effective and efficient process of providing protection to policyholders.

109. For instance, if there are claims that are covered by the PPS in another country, the PPS of the host country could act as a “front office”, assembling the claims and providing a means to pay them out, thereby mitigating potential issues related to language or banking transfer costs.⁴⁵ The scope of cooperation could even be broader, and include settlement of claims by the host PPS on behalf of the home PPS, which would then pay back the funds for the settlement of the claims and any operational costs incurred by the host PPS (see also Section 3.6 for cross-border issues of coverage).

110. As noted in the 2013 Issues Paper, coordination and cooperation should be particularly intense in cases where the PPSs of both the home and host jurisdictions are responsible for covering policies sold on a cross-border basis. This scenario poses several challenges in terms of membership of the two schemes, distribution of compensation costs, level of compensation, etc., which should - to the extent possible - be clarified in a business-as-usual environment, ie before a crisis materialises. For this situation, the work of international or regional institutions can be of great help.

Examples:

International Forum of Insurance Guarantee Schemes (IFIGS)

The FIGS was formed in May 2013 by a group of IGSs from around the world interested in sharing their experiences in providing policyholder protection in the event of an insurance company failure. FIGS facilitates and promotes international cooperation amongst PPSs and other stakeholder organisations with an interest in policyholder protection.⁴⁶ Among the work done, FIGS has published Framework Guidance in December 2020, which identifies core principles, common attributes and best practices for PPSs.

European Union

In the European Union, EIOPA, an independent advisory body to the European Commission, the European Parliament and the Council of the European Union, was set up in 2011 with the aim of fostering financial stability and confidence in the insurance and pensions markets. Article 26 of Regulation (EU) No 1094/2010⁴⁷ (the EIOPA Regulation) states that “the Authority may contribute to the assessment of the need for a European network of national insurance guarantee schemes which is adequately funded and sufficiently harmonised.” EIOPA has carried out a significant amount of work in the field of IGSs, which led to a comprehensive technical advice to the European Commission on the topic in the context of the 2020 Review of Solvency II. The advice proposed the introduction of a European network of national IGSs or alternative mechanisms that should meet a minimum set of harmonised features for the benefit of policyholders and financial stability.⁴⁸

⁴⁵ See the EIOPA [Opinion on the 2020 review of Solvency II, Background analysis](#) (December 2020) at page 696.

⁴⁶ <http://www.ifigs.org/>

⁴⁷ See Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC, OJ L 331, 15.12.2010, page. 48.

⁴⁸ See the 2020 EIOPA opinion. Chapter 13 of the Opinion and accompanying documents includes a comprehensive proposal for the introduction of a European network of national insurance guarantee schemes

United States

In the United States, the enabling laws specifically authorise each state PPS to participate in an organisation of “associations of similar purposes” to facilitate interstate cooperation to further the purposes of the member PPSs. The National Conference of Insurance Guaranty Funds (NCIGF) is the national coordinating body for nonlife PPSs, and the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) plays that role for life and health. In addition, some PPSs in the United States also participate in jointly-owned management companies.

6.2 Cooperation and coordination between a PPS and a supervisor/resolution authority

111. As noted in the 2013 Issues Paper, it is important that PPSs and relevant authorities cooperate fully and effectively. Effective cooperation should ensure that their respective actions mutually promote the achievement of each other’s objectives.

112. The objectives and roles of the resolution authority and the PPS, when these exist, are complementary. Consistent with ICP 12, the resolution authority may need to act beyond the powers available in the normal insurance insolvency process, or those available to the supervisor in the ordinary course of business. PPS’s actions will support the resolution authority’s objective of protecting policyholders⁴⁹; PPSs may provide resources available to assist in the resolution of the insurer.

113. Like cooperation between PPSs, cooperation with the supervisor and/or resolution authority can take place both in “business-as-usual” and during times of crisis. Subject to proportionality, routine business-as-usual cooperation will help the parties to gain familiarity with each other’s objectives, governance structures and operational arrangements and potentially to discuss emerging risks on a sector-wide or firm specific basis. Cooperation, if an insurer has failed or is nearing failure, will enable the supervisor and/or resolution authority and the PPS to coordinate their actions, with the aim of maximising the effectiveness of these actions and their ability to support the achievement of their objectives.

114. Despite the clear mutual benefits of cooperation between PPSs and supervisors and/or resolution authorities, constraints may be present that impede the development or operation of effective arrangements.

115. As noted in the 2013 Issues Paper, “*Clear roles and responsibilities for those involved in the case of a distressed insurer are important*”.⁵⁰ Any lack of clarity or mutual understanding on these points between the supervisor and/or resolution authority and the PPS risks undermining the ability of these parties to develop plans to manage the failure of an insurer, or to implement such plans where needed, in a way that that optimises the support for each other’s objectives. Effective cooperation will typically require confidential and potentially sensitive firm-specific information to be shared between the relevant parties. It is important that any restrictions on such information sharing do not present a challenge to effective cooperation.

116. There is an argument that PPSs can play an important role in developing or assessing resolution strategies, and therefore, they could be part of or otherwise support resolution planning,

or alternative mechanisms that should meet a minimum set of harmonised features for the benefit of policyholders and financial stability.

⁴⁹ See ICP 12.2.1

⁵⁰ See the 2013 Issues Paper at page 27.

crisis management groups (CMGs), supervisory colleges and other coordination efforts, with appropriate confidentiality protections in place. On the other hand, it should also be considered that some jurisdictions do not have a PPS and in others, existing PPSs only cover a small part of the business written by the insurer (eg mandatory insurance).

117. There are a number of possible arrangements the parties could consider developing, which may mitigate these potential barriers to effective cooperation. Given the diversity of the potential challenges to be overcome, it may be beneficial for the relevant authorities to consider implementing more than one, and potentially several, of these arrangements.

118. As noted above, arrangements must be in place to enable and support the sharing of confidential information between the parties. Such arrangements typically include MoUs between the parties. It is expected that the applicable legal regimes support the operation of such MoUs for sharing confidential information between parties. Beyond these contractual arrangements, the applicable legal regimes may also facilitate the sharing of confidential information through statutory arrangements, such as specific provisions allowing or mandating such sharing of information, or more general arrangements that apply a legal duty of professional secrecy on information shared between the parties.

119. The parties should consider what operational and administrative arrangements might facilitate active cooperation between the parties. Subject to proportionality, regular business-as-usual meetings can promote clarity and common understanding of the objectives, arrangements and potential constraints each party faces. Operational arrangements should ensure that the parties have comprehensive and current contact details for each other's key staff, including for time outside of normal business hours. Should the transfer of large quantities of confidential data between the parties be potentially required in a crisis situation, the parties, in advance of any failure, may wish to arrange the operational details of such transfer, in order to ensure the security and efficiency of the process.

120. The parties may also wish to consider sharing details of their contingency planning for crisis situations, either on a generic or firm-specific basis. Subject to proportionality and confidentiality safeguards, the sharing of watchlist, risk ratings or risk dashboards maintained by the parties may also facilitate their ability to prepare for potential actions that may be required in a crisis. Finally, the parties may wish to consider holding crisis simulation exercises or "walkthroughs" to ensure that their contingency plans are compatible and to promote mutual understanding of each other's role, responsibilities and desired outcomes in crisis situations.

121. Plans for a forthcoming resolution action are perhaps the most sensitive information a supervisor or resolution authority possesses. Therefore, it is imperative that this information be given the strongest level of protection, both legally and operationally.

122. Supervisors and resolution authorities need to share confidential information with PPSs for any of them to fulfil their responsibilities effectively, and the governing laws must clearly delineate when and how confidential information can be shared, and what obligations must be assumed by the recipient of the information.

123. In particular, there must be legal authority for the supervisor and/or resolution authority to have the discretion to share confidential information about insolvent and impaired insurers with a PPS, but only on the condition that the PPS is bound by the same obligations of professional secrecy that apply to the supervisor and/or resolution authority. Confidentiality protocols may also be embedded in the internal operating documents of the PPS.

124. It is useful to have MoUs in place between the PPS and the supervisor, and separately between the PPS and the resolution authority, to spell out the terms under which confidential information is shared and the duties and expectations of the parties. This applies even for

relationships where sensitive information is primarily shared informally without the actual exchange of documents. Provisions for sharing and protecting confidential information are also common in coordination agreements between different PPSs.

Examples:Canada

The Insurance Companies Act of Canada provides a wide range of discretionary intervention powers that allow the Office of the Superintendent of Financial Institution (OSFI) to intervene to address any concerns that should arise with a company. OSFI has primary responsibility for regulating and supervising companies. Canada has two PPSs that protect eligible policyholders from undue financial loss if a member insurer becomes insolvent - Property and Casualty Insurance Compensation Corporation (PACICC) (non-life insurance) and Assuris (life insurance). Both PPSs are private non-profit corporations.

OSFI has published Guides to Interventions to promote awareness and enhance transparency of how it will interact if/when intervention with a distressed company becomes necessary. The Guide outlines the types of involvement that a company can normally expect from OSFI and summarises the circumstances under which certain intervention measures may be expected at progressive “stages” of distress. It also describes the co-ordination mechanisms in place between OSFI, PACICC, Assuris and other pertinent parties at each “stage”.

The intervention process is not a rigid regime under which every situation is necessarily addressed with a predetermined set of actions. Circumstances may vary significantly from case to case and the Guide should not be interpreted as limiting the scope of action that may be taken by OSFI and PPSs in dealing with specific problems or companies. The Guide aims to communicate at which stage an action/intervention would typically occur. However, interventions described at one stage may also be used at later stages and, in some situations, certain interventions may also take place at an earlier stage than set out in the Guide. Additionally, OSFI and the PPSs may choose to implement their powers at different times and/or stages, depending on the specific circumstances.

United States

In the US, the importance of early coordination between supervisors or resolution authorities and the PPS is reflected in a 2004 National Association of Insurance Commissioners Whitepaper (“Communication and Coordination Among Regulators, Receivers, and Guaranty Associations: An Approach to a National State Based System”). As noted in the NAIC Whitepaper, the need for coordination among regulators, receivers and the PPS should begin as soon as it appears there is a significant possibility of liquidation and may occur even before the insurer is placed into resolution.

7 Other policyholder protection mechanisms

7.1 Other mechanisms aimed at protecting policyholders in the event of an insurer failure

125. Annex I to the 2013 Issues Paper introduces the notions of “other policyholder protection mechanisms”, categorised as “preferred claims”, “tied assets” and “segregated assets” based on their generally observed features. Further, ICP 12.9.1 and ICP 12.9.2 provide guidance about preferred claims and tied assets. Distinctions between these mechanisms are not always straightforward since their definitions and specific features vary across jurisdictions. However, all

these schemes aim at ensuring precedence of insurance claims over other claims. This precedence is established by law, and is sometimes reinforced by additional features, such as different forms of asset separation or segregation. These policyholder protection mechanisms and PPSs could complement each other. These mechanisms ensure that policyholders have some precedence in accessing assets of a failed insurer, while PPSs could compensate policyholders in case the insurer's assets are not sufficient.

126. Unlike the ordinary PPS which sits outside of the supervisory framework, these other mechanisms fall within the supervisory framework.

7.1.1 Preferred claims

127. Preferred claims are claims that are accorded priority of payment from the insurer's assets under the jurisdictions' applicable law. ICP 12.9.1 mentions that: "Policyholders should receive high legal priority in the liquidation of an insurance legal entity (or of a branch) so that policyholders rank above ordinary unsecured creditors".⁵¹ Under this mechanism, the assets of a failed insurer are used to satisfy claims arising from insurance contracts before they are available to general creditors. There might be other limited classes of creditors (ie "preferential creditors"), whose claims would be satisfied before the policyholders' claims. These might include claims by liquidators, such as claims corresponding to expenses arising from the liquidation procedure, claims by employees, claims by tax or fiscal authorities, claims by social security systems and claims on assets subject to rights in rem (eg through collateral, lien, mortgage).⁵²

Examples:

Bermuda

Under Bermuda's Insurance Amendment (No.2) Act 2018, in a liquidation of an insurer the claims of unsecured policyholder creditors of the insurer (including persons reinsured by the insurer in respect of claims under such contracts of reinsurance), should be paid before the claims of all other non-preferential creditors.

European Union

Article 275 of the Solvency II Directive deals with the precedence of insurance claims over other claims and prescribes two alternatives for the Member States to secure claims from insurance contracts. Under one of the alternatives (article 275.1.b), regarding the whole of the assets of the insurer, insurance claims take precedence over any other claim on the insurer, with the only possible exceptions of employees claims, tax claims, social security claims, claims on assets subject to rights in rem and expenses arising from the liquidation procedure.

Portugal

Under Law 147/2015, if those "special assets" on which insurance claims have absolute preference (see Box under 7.1.2) are insufficient for full compensation of insurance claims, policyholders also have priority over the other corporate assets required for such full compensation. This second preference however is not absolute, because it is overtaken by the insurer's workers credits, by liquidation expenses and, regarding "Non-Life" business, also by the rights *in rem* of third parties.

⁵¹ See ICP 12.9.1.

⁵² See ICP 12.9.1.

7.1.2 Tied assets

128. Under this mechanism, insurers are required to hold assets to cover all technical reserves plus a potential surcharge. ICP 12.9.2 mentions that: “In some jurisdictions, policyholders receive higher priority but only on a determined part of the insurance legal entity’s assets (eg the assets covering technical provisions). In such jurisdictions, with respect to this portion of the insurer’s assets, policyholders’ claims are generally subordinate only to liquidation expenses”.⁵³ These assets must usually be flagged, and may usually only be invested in certain investment categories. Tied assets serve to compensate policyholders on a priority basis.

129. The institution of tied assets also facilitates a portfolio transfer in cases where the termination of the contract would be associated with further financial disadvantages (eg in life or health insurance).

Examples:

China, Hong Kong

All long-term insurers must maintain a separate fund for each class of insurance business and ensure that in the event of insolvency the assets representing the fund be available only for meeting the liabilities of the insurer attributable to that part of that business to which the fund relates. Also, Section 25A of the Insurance Ordinance requires an insurer carrying on general business, other than a professional reinsurer or a captive insurer, to maintain assets in Hong Kong of an amount which is not less than the aggregate of 80% of its net liabilities and the solvency margin applicable to its Hong Kong general business, so that in the event of insolvency of an insurer, assets will be available in Hong Kong to meet the claims of Hong Kong policyholders.

Additionally, policyholders of non-life insurers enjoy the status of preferential creditors. They have a preferential claim against the remaining assets of a non-life insurer (direct insurance claims have a higher level of preference than reinsurance claims). These preferences apply to claims, but do not apply to premium refunds.

European Union

Article 275.1 of the Solvency II Directive deals with the precedence of insurance claims over other claims and prescribes two alternatives for the Member States. Under one of the alternatives (article 275.1.a), regarding assets representing technical provisions, insurance claims take absolute precedence over any other claim on the insurer (with the only possible exception of expenses arising from the liquidation procedure), and insurers must establish and keep up to date a special register of the assets used to cover the technical provisions.

For example, in Germany, according to section 315 of the German Insurance Supervision Act (VAG), policyholders, including those with outstanding claims, are protected by “guarantee assets” which rank prior to the claims of the remaining insolvency creditors.

In the case of a portfolio transfer to a bridge institution as the protection funds for life or substitute health insurance, these guarantee assets will be transferred together with the portfolio.

Portugal

⁵³ ICP 12.9.2

Under Law 147/2015, insurance claims are preferential claims, and have special protection throughout the liquidation proceedings. Thus, all amounts due to a policyholder, an insured or a beneficiary are considered to be an “insurance credit”. This definition is critical because insurance claims have absolute preference (with the only exception of liquidation expenses credits) over all other claims against the insurance company, regarding the assets representing the technical provisions.

Switzerland

Tied assets are compulsory for insurance (except for reinsurance). They must cover technical provisions plus a surcharge. These assets must be flagged, and can only be invested in specific investment categories, under consideration of diversification requirements. In an insolvency case, they provide for a liability substrate which ensures that policyholders are compensated on a priority basis. The Swiss Insurance Supervisory Act has just been amended, with entry into force expected by mid-2023. With regards to tied assets, the revised act foresees that FINMA can exempt insurance companies that serve only professional policyholders from the tied assets requirements. It is also expected that the prudent person principle will play a more significant role in the requirements with regards to the investments in tied assets.

7.1.3 Segregated assets

130. Insurers may be requested to hold segregated funds for specific types of insurance business or for specific policies. Whereas tied assets are usually solely flagged, segregated assets are ring-fenced and held by the insurance company in separate accounts. These funds cannot be accessed to support other liabilities of the insurer.

131. A benefit of a segregated fund is its efficiency, as it provides for policyholders' protection for little or no additional organisational or financial cost. The fact that the funds are segregated may add more security for the policyholders.

132. A disadvantage is the fact that the insurance company sets up these segregated funds itself. If technical provisions have not been calculated correctly, the assets will not be sufficient to cover the claims.

Example:

Malaysia

Insurers are required to establish and maintain separate insurance funds for their Malaysian policies on the one hand and for their foreign policies on the other hand. Life insurers are further required to segregate their insurance assets according to the categories of policies.

Licensed takaful operators must establish general takaful funds or family takaful funds (which are similar to insurance funds) which can only be used to meet the liabilities and expenses incurred by the respective funds.

These funds cover at least 100 % of the liabilities at all times. In the liquidation of an insurance company or a takaful operator payments to meet liabilities to an insurance policy or takaful certificate have priority.

7.2 Other protection mechanisms outside of insurers' failure

133. Some jurisdictions have put in place mechanisms that protect persons who are harmed by some sort of (uninsured) event, outside of any insurer's failure. These schemes therefore are not PPSs in the scope of this Issues Paper, but they could be used as "springboards" to establish PPSs.

7.2.1 *Mechanisms that indemnify the victim when the responsible person is unknown or uninsured*

134. Those mechanisms are not uncommon in third party liability insurance, in particular in motor third party liability and workers' compensation. If the party responsible for an accident is unidentified or uninsured, the scheme will compensate the victims of the accident (and will generally claim reimbursement against the responsible person when they are identified).

135. Not infrequently (eg France, Italy, Switzerland), the bodies compensating the victims when there is no identified insurer, are the same as those compensating policyholders when an insurer is insolvent—which can make sense since, in both cases, it is about compensating victims in the absence of an insurer capable of doing so.

7.2.2 *Mechanisms covering catastrophe risks*

136. Jurisdictions often have specialised schemes in place to provide protection against certain catastrophic events such as natural catastrophe perils, cyber risks, pandemic and terrorism, which are typically considered to be difficult for an individual firm to insure. Those mechanisms could also be used as springboards for establishing PPSs. They are discussed in the document "The role of insurance supervisors in multi-stakeholder approaches to address pandemic protection gaps",⁵⁴ which was prepared jointly by staff members of the IAIS and the Access to Insurance Initiative (A2ii) and published in September 2022.

⁵⁴ <https://www.iaisweb.org/uploads/2022/09/220929-The-role-of-insurance-supervisors-in-multi-stakeholder-approaches-to-address-pandemic-protection-gaps.pdf>

Annex: Consideration of how and whether the existence of PPSs could affect behaviour

1. Moral hazard

The 2013 Issues Paper discussed whether the existence of a PPS could have an impact on the behaviour of insurers, policyholders and supervisors.⁵⁵ This section revisits those potential impacts and considers some measures designed to mitigate any negative impact, or moral hazard, that could arise in connection with a PPS.

Moral hazard refers to an increased tendency for a party to take risks in the belief that the negative consequences of those risks will be borne, in whole or in part, by others. The problem of moral hazard, particularly for larger and more systemic institutions, was illustrated by behaviour of some market participants in the years preceding the great financial crisis of 2007–09. Indeed, the implicit assumption that some financial institutions, being “too big to fail”, would be bailed out with losses falling to public finances, seems to have increased risk-taking and reduced due diligence and market discipline by (some) market players. This experience has made clear that a key element for mitigating moral hazard is an effective resolution regime that allows for an orderly failure for all institutions (and in particular for large institutions) while allocating losses to their shareholders, their creditors and, when appropriate, to the industry.

The Research and Guidance Committee of the International Association of Deposit Insurers (IADI) (among others) has considered moral hazard risks associated with deposit guarantee or protection schemes within the banking sector. The IADI issued a Guidance Paper addressing this issue in 2013, entitled “Enhanced Guidance for Effective Deposit Insurance Systems: Mitigating Moral Hazard”.⁵⁶ Although these protection schemes are often referred to as deposit “insurance”, they only protect depositors, not the bank itself, and they are only triggered when the bank is insolvent, so they do not diminish the consequences of imprudent behaviour to the bank or its shareholders. If the bank fails, all is lost from their own perspective whether or not a deposit protection schemes⁵⁷ steps in to mitigate the consequences to depositors. Thus, any risk of moral hazard is indirect: if depositors are unprotected, they have an incentive to seek out strong banks and to pull their funds out if they learn that their bank is in deteriorating condition or is taking imprudent risks with their money. Hypothetically, then, a protection scheme could reduce customer vigilance and in turn allow more imprudent behaviour by the bank.

In practice, however, the IADI explains that only “a very small number of large-scale depositors” could exert such vigilance, and even for those depositors, “that discipline is likely to be insufficient to adequately control moral hazard.”⁵⁸ The IADI found that generally, retail depositors have neither the skill, the time nor the information to exert efficient market discipline,⁵⁹ and that market discipline

⁵⁵ See the 2013 Issues Paper at page 7.

⁵⁶ The IADI Guidance Paper is available at:

https://www.iadi.org/en/assets/File/Papers/Approved%20Guidance%20Papers/IADI_Mitigating_Moral_Hazard_Enhanced_Guidance_2013-05.pdf

⁵⁷ Called “deposit insurance” in the IADI Guidance Paper.

⁵⁸ See IADI Guidance Paper at page 14.

⁵⁹ *Id.* at pages 13–14.

is most likely to be effective on banks that “raise significant funds from the capital markets”.⁶⁰ This focus on debt and equity investments as the most effective source of market discipline suggests that the role of large depositors is less important, and in any case, the large bulk of their deposits will usually exceed caps on protection that have been imposed for other reasons. In addition to the role of markets in helping to mitigate moral hazard, effective supervision and regulation of banks, the presence of effective early warning and intervention regimes, and deposit insurance design features such as limited coverage and the use of differential (or risk-adjusted) premium systems also play critical roles in moral hazard mitigation.

All in all, the (limited) potential risk of moral hazard and the existence of a variety of mechanisms to help mitigate it has not impeded the establishment of deposit protection schemes, recommended by international standards and present in more than 150 jurisdictions. The IADI Guidance Paper also noted that incentives directed towards retail depositors “have been shown to be less effective for mitigating moral hazard, especially during periods of financial distress or crisis”, and in particular, identified proportional deductibles⁶¹ as a tool that was “was once touted as an effective way to impose depositor discipline”, but experience has shown that it “is not an effective tool ... as it can inflict losses without instilling discipline and may trigger bank runs.”⁶² The analysis of the safeguards adopted within the banking sector may help in designing insurance PPSs, keeping in mind that sizeable differences exist.

Like deposit protection schemes in banking, insurance PPSs change the market environment by protecting certain classes of persons from some or all the consequences of the failure of an insurer. It can be examined whether this can have a sizeable impact on the risk behaviour of various factors in that market: insurers, policyholders and supervisors.

Insurers

It has not been documented, and it does not appear credible, that insurers could engage in increased risk-taking in the knowledge that the impact of their insolvency on protected policyholders would be mitigated by the PPS in the event of their insolvency. Indeed, (like deposit protection schemes), PPSs generally benefit from a full right of recovery against the estate of the failed insurer, for all amounts paid to policyholders. Accordingly, PPS do not protect imprudent insurers against the consequences of their insolvency and would not consequently encourage insurers into increased risk-taking.

On the contrary, and with regards to collective market discipline, when PPSs are funded by the industry, their existence has the effect of shifting part or all of the cost of a failure from the policyholders of the failed insurer to the industry as a whole. This appears to be a strong incentive to market discipline.

Policyholders and intermediaries

It has sometimes been sustained that the existence of PPSs could induce policyholders and intermediaries to be less vigilant in choosing insurance products and in monitoring the financial health of the insurers they choose. For example, policyholders could be tempted to purchase an under priced product from a weak insurer rather than a fairly priced product from a strong insurer if

⁶⁰ *Id.* at page 14.

⁶¹ Called “coinsurance” in the IADI Guidance Paper.

⁶² *Id.* at page 13.

they are not at risk of loss; intermediaries, likewise, could be less diligent when selecting insurers or products to propose to their clients. This however seems questionable. The moral hazard in this case relies on policyholders (and intermediaries) being able to distinguish between weak and strong insurers.

But very likely, the majority of policyholders who would benefit from PPS protection do not have such specialised knowledge or skills.⁶³ On the contrary, under the standards that every active insurer must be licensed (ICP 4), and effectively supervised (ICP 9 and 10) in the interest of policyholders (ICP 1), the lay policyholder can reasonably expect that any licensed insurer is safe, sound and effectively supervised. This is all the more true in multi-jurisdictional single markets such as the EU or the USA, where a policyholder based eg in Portugal or in California is not expected to exert vigilance on the soundness of an insurer headquartered in eg Finland or Maine.

Supervisors

The existence of a PPS may result in reduced vigilance and rigour by supervisors or policymakers. A supervisor may be less concerned by the failure of an insurer if losses to policyholders, and therefore their own risks of reputational damage, are limited. This could be even more the case in some multi-jurisdictional single markets where the cost of the failure is borne by the (insurance industry of the) jurisdictions where the failed insurer sold products, if those differ from the jurisdiction where the failed insurer was headquartered (see above the discussion of home- vs host-jurisdiction principle).

2. Safeguards to mitigate moral hazard

The considerations described above show that the extent to which an insurance PPS could increase risk-taking is limited for a series of stakeholders, and probably non-existent for others. However, this should not prevent policymakers from taking a range of measures that could mitigate any potential moral hazard and encourage prudent behaviour. The safeguards typically adopted fall into three main categories: limits on coverage (caps, deductibles, exclusions), risk-based contributions and the wider framework safeguards of prudential regulation, supervision and resolution or insolvency. These are broadly similar to those that have been adopted, either singly or in combination, to address any moral hazard arising from deposit protection schemes, although there may be sector-specific differences in the way they apply.

Limits on PPS coverage

As discussed in Section 3, PPS coverage may be limited by setting maximum coverage levels and deductibles for protected policies. It could be expected that those (probably few) policyholders who know they will bear a part of the claim even though the PPS exist, will be as vigilant as they would have been in the absence of any PPS.

(Large) commercial policyholders, arguably more capable of assessing the strength and weakness of individual insurers, are generally excluded from PPS protection. On the other hand, just as in third-party liability insurance, any limitation aimed at preventing moral hazard should not be enforceable against victims who have no responsibility in the choice of the insurer.

⁶³ Just as is the case for depositors in the context of banking: see the IADI Guidance Paper at page 14.

It should be noted, however, that mitigating moral hazard is not the only reason why policymakers may decide to adopt limitations on PPS coverage. Other reasons come into play, eg some categories of policyholders are less in need of protection for social policy reasons, and / or the costs to the PPS and thereby to the sector should be limited.

It can be noted that a form of “proportional deductible” has been tried by some jurisdictions in the banking sector to mitigate the moral hazard risks on depositors associated with the existence of deposit protection scheme.⁶⁴ In the banking context however, the measure was found to be ineffective in its ability to promote market discipline.⁶⁵

Risk-based contributions

Risk-based contributions could be incorporated in a PPS to encourage prudent behaviour by insurers. However, and as noted in Section 4, there could be some challenges in the implementation of this approach. Risk-based contributions are not straightforward to design and calibrate in a way that faithfully reflects the risk of the insurer. In some “multi-jurisdictional single markets”, it has been illustrated that the frequency of failure could vary from (less than) 1 to 100, depending on the jurisdiction where the insurer was supervised; this, practically, makes it impossible to design contributions that proportionally reflects the risk.

Experience in the banking sector suggest that an effective approach to mitigating moral hazard associated with protection schemes may be best achieved by a combination of safeguards. In any event, broader framework conditions, including effective regulation and supervision, and a resolution or insolvency regime that can impose losses on creditors, shareholders and industry, are also key for imposing regulatory discipline and controlling moral hazard. PPS design safeguards should not be seen as a substitute for a general framework that promotes sound risk management and robust supervision.

⁶⁴ Proportional deductible is called “coinsurance” in the IADI paper: see page13. Meaning that the depositor assumes the loss of a percentage of the covered deposit.

⁶⁵ Mainly for those reasons mentioned above: only a very small number of large-scale depositors can impose market discipline. Besides, deposit deductibles were considered to potentially increase the risk of bank runs. This latter drawback, however, would not apply (or not apply with the same magnitude) to the insurance sector.