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**WHITE PAPER**

**On Insurance Guarantee Schemes**

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# WHITE PAPER

## On Insurance Guarantee Schemes

### 1. INTRODUCTION

Insurance Guarantee Schemes (IGSs) provide last-resort protection to consumers when insurance undertakings are unable to fulfil their contractual commitments. They thus protect people against the risk that claims will not be met if their insurance company becomes insolvent.

Guarantee schemes operate in other sectors of the financial services industry. In particular, deposit guarantee and investor compensation arrangements are in place in all EU Member States, and minimum protection standards have been harmonised at EU level with the implementation of the 1994 Deposit Guarantee Scheme (DGS) Directive and of the 1997 Investor Compensation Scheme (ICS) Directive<sup>1</sup>. However, there is no such common European framework in the insurance sector.

Of the 30 EU-EEA countries, only 12 operate one or more general insurance guarantee schemes. This means that, measured in terms of gross written premiums, one third of the entire EU-EEA insurance market is not covered by any IGS in the event of an insurance company going bankrupt. Some 26% of all life insurance policies and 56% of all non-life insurance policies are unprotected.

Where IGSs are in place, they differ frequently in coverage, which results in heterogeneous levels of policyholder protection between Member States. There are also significant differences in other aspects of IGS design that affect the scope of the protection provided, and in operational procedures and funding arrangements.

The lack of harmonised IGS arrangements in the EU hinders effective and equal consumer protection. This may lead to a loss of consumer confidence in the relevant markets and may ultimately put at risk market stability. It may also impede the functioning of the internal insurance market by distorting cross-border competition. In light of the lessons drawn from the recent crisis the development of harmonised insurance guarantee schemes could contribute to remedy the existing deficiencies.

This White Paper sets out a coherent framework for EU action on IGS protection for policyholders and beneficiaries, in order to guard against the need for taxpayer involvement. In particular, it proposes introducing a Directive to ensure that all Member States have an IGS that complies with a minimum set of design requirements. Evidence suggests that a coherent approach at EU level is the best way to provide an adequate remedy for the existing shortcomings and inequalities in policyholder protection. This White Paper does not intend to

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<sup>1</sup> Directive 1994/19/EC as amended by Directive 2009/14/EC of the European Parliament and of the Council of 30 May 1994 on Deposit Guarantee Schemes (OJ L135, 31.5.1994, pp. 5-14); and Directive 1997/9/EC of the European Parliament and of the Council of 3 March 1997 on Investor-Compensation Schemes (OJ L 84, 26.3.1997, pp. 22-38).

propose harmonising insurance products. Nor does it intend to disadvantage insurance products that are sold only on the domestic market.

The main options the Commission has identified as preferable are summarised and highlighted by text boxes at various points throughout Sections 3 and 4. All interested parties including the Member States are invited to submit comments and to provide further input on the identified options by 30 November 2010.

The White Paper is accompanied by an Impact Assessment which is supported by a comprehensive Methodological Report and other Annexes.

## **2. PURPOSE AND SCOPE OF THE WHITE PAPER**

### **2.1. Why is action needed on Insurance Guarantee Schemes?**

#### *2.1.1. Lessons from the crisis*

The recent financial turmoil has made people far more aware of the existence and limits of consumer protection/guarantee schemes in all financial sectors. Although not at the root of the crisis the insurance sector has proved far from being immune. Some important European insurers have reported particularly severe losses and have been forced to important injections of new capital<sup>2</sup>. In order to remedy the existing regulatory loopholes and inconsistencies caused by the fragmented IGS landscape in Europe, the Final Report (Recommendation 5) of the de Larosière Group recommended setting up harmonised IGSs throughout the EU<sup>3</sup>.

The same recommendation is included in the Preamble to the recently-adopted Solvency II Framework Directive<sup>4</sup>.

Furthermore, the Commission announced in its Communication of 4 March 2009 'Driving European recovery' that it would review the adequacy of existing guarantee schemes in the insurance sector by the end of 2009 and make appropriate legislative proposals<sup>5</sup>.

On 23 September 2009, the Commission adopted proposals for three Regulations establishing the European System of Financial Supervisors, including the creation of three European Supervisory Authorities. The Commission has been closely following the ongoing discussion between the co-legislators on the role of the new European Insurance and Occupational Pension Authority (EIOPA)<sup>6</sup>, which has also touched on the introduction of an IGS at national and/or EU level.

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<sup>2</sup> For further details see Impact Assessment Report Section 2.2.

<sup>3</sup> See [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf).

<sup>4</sup> Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (recast) (henceforward Solvency II) (OJ L 335, 17.12.2009, pp. 1-155); see particularly Recital 141 second subparagraph.

<sup>5</sup> Communication for the Spring European Council, 'Driving European Recovery' - COM(2009) 114, 4.3.2009.

<sup>6</sup> Proposal for a Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority (COM(2009)0502-C7-0168/2009-2009/0143(COD)).

### *2.1.2. Solvency II will not create a zero-failure environment*

Neither the current (Solvency I) nor the future (Solvency II) EU solvency regimes create, or can create, a zero-failure environment for insurance companies. The Solvency II Framework Directive, which will become applicable by 31 December 2012, provides for a risk-based, economic approach to solvency. It requires insurance and reinsurance companies to hold sufficient capital to cover their obligations for one year, subject to a 99.5% VaR confidence level<sup>7</sup>. This should ensure that no more than one insurer in 200 goes bankrupt in any one year. For the purposes of this White Paper, historical data and model estimations show that the probability of default of insurance companies generally ranges from 0.1% under normal economic conditions to 0.5% under exceptional conditions such as a financial crisis or where insurers face particular difficulties in a specific EU country<sup>8</sup>. Notwithstanding existing IGSs, this may result in losses being passed on to EU policyholders (or taxpayers). In extreme cases these losses may amount to as much as €46.5 billion for both life and non-life policies over a one-year time horizon. This is equivalent to around 4.4% of the total gross written premiums in the EU in one year. To illustrate this point, between 1996 and 2004 more than 130 insurers got insolvent in the EU and the 2009 failure of a Greek insurance group affected around 800,000 policyholders.

### *2.1.3. Cross-border insurance activity in the EU likely to increase*

Cross-border insurance activity — providing insurance services in other countries either directly or by setting up branches — represents, on average, 4.10% of total gross written premiums in the EU, amounting to a financial premium volume of €42.8 billion in 2007. The volume of activity is expected to grow further in the future. For instance, some major insurance groups are considering turning their subsidiaries into branches.

Even in Member States which have IGSs, these schemes do not always cover cross-border activity. Around 62% of cross-border life-insurance business and roughly 23% of cross-border non-life insurance activity in the European Union lacks any kind of IGS protection.

### *2.1.4. Policyholders and beneficiaries are insufficiently and/or unevenly protected*

The differences between national IGSs across the EU (including the total absence of any such schemes in some Member States) create insufficient and uneven levels of protection for insurance policyholders. Where national IGSs exist, they often differ significantly in their structure. Similarly, the lack of harmonised arrangements may raise particular consumer protection concerns when it comes to cross-border insurance business within the EU. If an insurance company with cross-border operations goes to the wall, some policyholders may find they are covered by an IGS, whereas other policyholders with an identical contract may not, or may have only a lower level of protection<sup>9</sup>.

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<sup>7</sup> In financial mathematics and risk management, Value at Risk (VaR) is the most commonly used quantitative measure of the risk of loss on a specific portfolio of assets.

<sup>8</sup> For more detailed analysis see section 2.2 of the impact assessment and in particular table 22.

<sup>9</sup> For a more in-depth analysis of the possible consequences for policyholders and taxpayers, see Section 3.1 of the Impact Assessment.

**Examples:**

A policyholder residing in a Member State without IGS protection may nevertheless be protected if his insurer is based in another EU country where the IGS offers protection on a 'home country' basis<sup>10</sup>.

A policyholder residing in a Member State with an IGS based on the 'home country' principle might not be covered if her insurer is based in another EU country where the IGS offers protection on a 'host-country' basis. She will, however, be protected if her policy was issued by a domestic insurance company.

If the Member State in which the policyholder resides has an IGS based on the host country principle, it does not matter whether the policy was issued by a domestic or a foreign ('incoming') insurer, as long as the IGSs in both countries offer equivalent protection. The level of protection may differ where one or both Member States concerned have limited the amount of compensation that will be paid.

*2.1.5. The current IGS landscape creates an uneven playing field for EU insurance undertakings*

The coexistence of different IGS systems (and the fact that some Member States have no IGS at all) also raises concerns about the lack of a level playing field between domestic and incoming insurance companies operating in the same market. These concerns may become particularly acute if some insurers operating in the same market are participating in an IGS and others are not, since the scope of geographical coverage of IGSs (where they exist) may differ between the home or host countries concerned.

**Examples:**

Distortions of competition may arise if consumers prefer to buy policies which are covered by an IGS (or similar products covered e.g. by deposit guarantee or investor compensation schemes), to the detriment of insurers which offer unprotected insurance products.

IGSs entail additional costs which might ultimately be borne by the policyholders. If consumers prefer lower-priced insurance products, competition might be distorted to the detriment of insurers which offer protected (and therefore probably more expensive) insurance products.

*2.1.6. The current IGS landscape affects market stability*

Insurance bankruptcies and resulting losses to policyholders and beneficiaries may affect the real economy by altering consumers' behaviour (e.g. they buy fewer insurance products) or by making the economy less able to manage the risk. Furthermore, despite the heavy penalties usually imposed on policyholders for early termination, policyholders may react to real or expected losses by surrendering their policies — thereby potentially aggravating a financial crisis situation.

*2.1.7. Are there viable alternatives to specific EU action on IGSs?*

The importance of introducing an IGS depends on the risk that insurance companies will go bankrupt, and the potential impact of such bankruptcies on consumers. This

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<sup>10</sup> For a more detailed analysis of the home-country principle and the host-country principle, see Section 4.2.

raises the question as to what alternative protection mechanisms are available at national or at European level to mitigate that risk or to reduce the losses for policyholders.

### **Prudential regulation and risk management**

Effective risk management and comprehensive governance structures are cornerstones of the future solvency system, in addition to capital requirements and appropriate supervisory powers. However, it is widely acknowledged that it would be too costly to set solvency requirements at a level sufficient to absorb all unexpected losses<sup>11</sup>.

### **Preferential treatment of policyholders in winding-up proceedings**

Should an insurance company become insolvent, current EU winding-up legislation offers Member States a choice between two alternatives in national law for giving policyholders priority over other creditors of the insurer in liquidation<sup>12</sup>. However, a cash-strapped policyholder may not find it practical to rely on the winding-up proceedings. These are often complex and time-consuming, and waiting for their completion may create serious liquidity shortages for policyholders with outstanding claims.

### **Case-by-case government intervention**

Case-by-case solutions such as *ex-post* government intervention, while flexible by nature, also have serious drawbacks. Unless they are even-handed they may raise concerns regarding fairness and transparency, as decisions are made on an *ad hoc* basis rather than according to a set of pre-designed rules. In addition, case-by-case intervention may be seen as conferring an unfair advantage on big companies, thereby creating ‘moral hazard’: allowing them to take risks with less fear of the consequences because others will pay to provide a safety net.

### **Additional information and enhanced transparency**

An alternative approach is to require that more information be given to policyholders so that they can choose the most appropriate insurance product for themselves. However, this assumes that policyholders will understand the information and be able to use it in their decision-making. In reality it is highly unlikely that policyholders will be able to understand and use all the information, particularly with regard to cross-border insurance business. Moreover, providing additional information does not address the issue of an uneven level playing field between insurance companies operating on the same markets.

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<sup>11</sup> See also Section 2.1.2 of this White Paper.

<sup>12</sup> See Article 10 of Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding-up of insurance undertakings (OJ L 110, 20.4.2001, pp. 28-39).

## 2.2. Scope, background and objectives of the White Paper

### 2.2.1. Scope and definition

This White Paper applies to all life and non-life insurance companies, including those which offer both types of product. It does not, however, extend to **pension funds** as defined by Directive 2003/41/EC<sup>13</sup> or to **reinsurance**.

For the purpose of this White Paper, **minimum harmonisation** means that Member States may, if they so desire, provide greater protection than is provided for in the relevant EU legislation.

### 2.2.2. Background

This White Paper has been drafted on the basis of work undertaken by the Commission since 2001 and following extensive consultation and debate with policyholders, industry practitioners and policymakers over the last two years. It also builds on a report on IGSs produced for the Commission by Oxera<sup>14</sup> (and finalised at the end of November 2007) and on a report produced for the Commission by insurance supervisors (CEIOPS)<sup>15</sup>. Furthermore, it responds to repeated concerns raised by the European Parliament<sup>16</sup>. The steps proposed in this White Paper have been analysed in detail in the impact assessment which accompanies it.

### 2.2.3. Objectives

In particular the White Paper recommends action to:

#### *Ensure comprehensive and even protection for policyholders and beneficiaries*

Ensuring adequate coverage for policyholders and beneficiaries if an insurance company collapses is a key objective of the future EU framework on IGSs. It is closely linked to the aim of guaranteeing equitable treatment of all policyholders and beneficiaries irrespective of the Member State in which they reside or whether they purchase policies from domestic or incoming EU insurers.

#### *Avoid distortions of competition*

A harmonised framework on IGS protection at EU level also aims to create a level playing field between insurance companies and to ensure that domestic companies and incoming EU insurers who operate under the freedom to provide services, or who provide insurance via branches, can compete on equal terms.

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<sup>13</sup> Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision (OJ L 235, 23.9.2003, pp. 10-21).

<sup>14</sup> For the report see [http://ec.europa.eu/internal\\_market/insurance/docs/guarantee\\_schemes\\_en.pdf](http://ec.europa.eu/internal_market/insurance/docs/guarantee_schemes_en.pdf).

<sup>15</sup> CEIOPS is the Committee of European Insurance and Occupational Pensions Supervisors. See [http://www.ceiops.eu/media/files/publications/submissionstotheec/CEIOPS-DOC-18-09%20Input\\_to\\_EC\\_work\\_on\\_IGS-approved\\_clean\\_.pdf](http://www.ceiops.eu/media/files/publications/submissionstotheec/CEIOPS-DOC-18-09%20Input_to_EC_work_on_IGS-approved_clean_.pdf).

<sup>16</sup> See Article 242 of the Solvency II Directive. See also European Parliament recommendation No 25 arising out of the Equitable Life Committee of Inquiry, calling on the Commission to rapidly proceed with legislation on IGSs: [http://www.europarl.europa.eu/comparl/tempcom/equi/default\\_en.htm](http://www.europarl.europa.eu/comparl/tempcom/equi/default_en.htm).



### *Reduce adverse incentives*

A harmonised framework on IGS should prevent tax-payers from ultimately bearing the costs of an insurance company's mismanagement. It would do so by introducing a legal framework which is financed by the undertakings themselves and that does not incentivise excessive risk-taking (moral hazard). This objective includes appropriate measures to ensure that the funds involved are used exclusively for the defined purposes of the IGS. In the context of IGS protection, there is little evidence that the introduction of protection schemes distorts market operations by providing the wrong incentive. Furthermore, moral hazard concerns are reduced through other protection mechanisms, such as a modern solvency regime and the action of prudential supervisors.

### *Ensure cost efficiency*

It is important that the IGS be cost-efficient. This means, in particular, that EU action on IGSs must strike the right balance between the benefits to policyholders and the costs of the protection offered. In the end, an IGS that is not cost-efficient will lead to higher costs for policyholders. In that context particular attention must be paid to Value Added Tax (VAT) aspects; it should be prevented that the cost efficiency of the IGS is adversely affected by a high amount of sticking VAT or by an obligatory management of administrative tax procedures which are disproportionate to the scope of activities of the IGS.

### *Enhance market confidence and stability*

EU action on IGSs also aims at enhancing market confidence and at furthering the stability of the EU internal insurance market.

## **3. ELEMENTS OF THE PROPOSED APPROACH**

### **3.1. Nature of possible EU action**

EU 'soft law' instruments such as recommendations, communications, guidelines or codes of conduct might influence the practice of Member States in the longer term. However, they are unlikely to fully correct the current shortcomings. Since such instruments are not legally binding, Member States would be asked to act on a voluntary basis only — and the shortcomings of the current fragmented IGS landscape in the EU are too significant to await the convergence of national approaches over time. Therefore, it will be necessary to adopt a legal measure with binding legal force.

The best legal instrument for introducing a binding requirement is a directive. Under Article 288 TFEU, a directive has individual application, meaning that it is binding upon those to whom it is addressed. It requires Member States to achieve a certain result but, unlike a regulation, leaves them free to choose their own forms and methods. This might prove useful given the complexity of the IGS issue, arising from the differences in the design and scope of the various national schemes.

The Commission proposes to establish at EU level a coherent and legally binding framework on IGS protection, applicable to all policyholders and beneficiaries, by means of a directive as defined in Article 288 TFEU.

### 3.2. Level of centralisation and role of the IGS

The creation of an IGS in each Member State is consistent with the existing national micro-prudential supervisory framework and would therefore help prevent regulatory moral hazard. A mutual borrowing facility could also be introduced as a means of mutual support between national IGSs. Such a system would require each national scheme to financially support an IGS in another Member State which lacks sufficient funds to meet its claims. To ensure that the potential costs for the contributing IGSs are transparent and predictable, there would have to be agreement on a fund-raising mechanism, clearly stating how much each IGS is required to contribute and under which circumstances. Finally, most of the problems stemming from the existence of different national legal frameworks could be resolved by setting up a single EU-wide IGS covering all life and non-life policies written and purchased within the European Union. At present, however, there does not seem to be sufficient political support for this idea. It may be considered at a later stage.

As a last-resort protection mechanism, an IGS can enhance confidence in the financial sector, and thus have a positive impact on the rest of the economy. An IGS with the wider role of preventing insurance insolvencies would be able to guide a troubled insurer through its financial difficulties, enabling it to stay in business. As set out under 2.1.7 there is a range of mechanisms in place to prevent insurance insolvencies and evidence suggests that these have, in general, been effective. It follows that IGS may step in when other protection mechanisms have failed in order to prevent or mitigate the impact of an insurer's collapse.

The Commission advocates the establishment of an IGS as a last-resort mechanism in each Member State.
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### 3.3. Geographical scope

Harmonising the geographical scope of IGS protection is crucial to ensure comprehensive and even policyholder protection in a cross-border context. IGSs based on the 'home country principle' cover not only policies issued by domestic insurers but those sold by branches of domestic insurers established in other EU Member States. By contrast, IGSs based on the 'host country principle' cover policies issued by branches of incoming insurers. In practice, some national IGS regimes combine elements of both principles.

The main advantage of the home country principle is its consistency with the 'home country *control* principle' which makes it easier to handle insurance default cases. Home country supervisors are responsible for prudential regulation, including solvency requirements, and for starting the winding-up process. Moreover, the home country principle is also in line with the deposit guarantee scheme in the banking sector and with the investor protection scheme in the securities sector.

A structure based upon the host country principle ensures that there is no uneven policyholder protection within Member States, thereby also preventing possible competitive distortions among insurers operating in the same Member State. However, adopting a host country structure has important drawbacks. First, it duplicates administrative costs as it requires insurers with cross-border business to participate in two or more IGSs. Second, action on IGSs might be difficult in practice, as the authorities that operate the scheme would not be the ones that conduct and supervise the winding-up proceedings. Third, if coverage is not harmonised, the host country structure can create uneven policyholder protection between different Member States.

The Commission advocates harmonising the geographical scope of IGSs on the basis of the 'home country' principle.

### 3.4. Policies covered

The collapse of a life insurer can result in considerable financial hardship for policyholders, especially for people who have bought life policies to provide for their retirement. Even if policyholders are able to recover part of their savings, they may not succeed in finding similar coverage because their personal situation, according to which premiums are calculated, has changed (e.g. in terms of age and health). Due to the long-term commitments inherent in life insurance products, policyholders are generally unable to predict how financially sound the insurance company will be when the policy reaches maturity.

For the purpose of this White Paper, life insurance policies include traditional risk-protection products together with savings and investment products (e.g. unit-linked insurance policies).

If a non-life insurer goes bankrupt, the average loss to policyholders is in general smaller and is usually limited to prepaid premiums. The contracts are short-term and most policyholders can easily buy replacement cover from another company. However, those policyholders and beneficiaries with outstanding claims at the time of insolvency may well incur more significant losses, which might exceed those of a typical life insurance product. There might be good arguments for limiting IGS protection to certain specific types of non-life insurance policy; however, for reasons of practicability and fairness, it might be difficult to split IGS coverage into too many sub-regimes.

The Commission advocates that IGSs should cover both life and non-life insurance policies.

### 3.5. Eligible claimants

Covering all natural and legal persons might be excessively costly. In order to reduce this financial burden, eligibility should perhaps be restricted to claimants who satisfy certain criteria, such as e.g. micro and small undertakings. Defining these criteria would require careful attention.

The Commission advocates that IGSs should cover natural persons and selected legal persons.

### 3.6. Funding

For an IGS to work effectively, appropriate fund-raising mechanisms are crucial. The structure of funding not only determines the level of protection but can also have important implications for the cost to the industry, bearing in mind that the levies imposed on insurers will probably translate into costs for policyholders. The following points therefore need careful consideration:

#### 3.6.1. *Timing of the funding*

**In an *ex-ante*-funded scheme**, the funds are raised in anticipation of possible bankruptcies, and the resources are transferred to, and managed by, the IGS via a system of levies on the industry. The main advantage, therefore, is the ready availability of funds to compensate

claimants should a crash occur. Moreover, *ex-ante*-funding is less subject to moral hazard problems, because insurers that become insolvent will already have contributed to the IGS. In addition, *ex-ante* funding is more likely to avoid the pro-cyclical effects associated with *ex-post* funded schemes. This positive feature can be reinforced by introducing *ex-ante* levies that are weighted according to the contributing company's risk of bankruptcy (see Section 4.6.3).

Clearly, set-up and operational costs tend to be higher than for *ex-post* funding, bearing in mind that an *ex-ante*-funded IGS has to employ investment professionals to manage the fund and to define and implement an investment strategy that strikes an appropriate balance between risk and return. In addition, there is always the possibility that the funds collected will prove insufficient in the event of a major insurance crash.

**In an *ex-post*-funded scheme** levies are not raised until an insurer fails and costs arise for the IGS. It follows that set-up and operational costs tend to be limited and funds can be tailored to actual default costs. Fairness and proportionality arguments may plead in favour of an *ex-post* system. *Ex-post* funding tends, however, to be more subject to moral hazard, as failed institutions never contribute to the IGS. Moreover, it may hinder prompt pay-out to policyholders. *Ex-post*-funded schemes may also increase pro-cyclicality, as insurers are more likely to fail when economic conditions are difficult.

### 3.6.2. Target level

Concerns about the potentially unlimited size of contributions to an IGS might be allayed by introducing caps or overriding limits on annual contributions to a scheme. In practice, these limits can be expressed as a percentage of the contributing member's premiums or reserves (the 'target level'), subject to an appropriate transition period.

To select an appropriate level of protection, Commission staff assessed various options, including the coverage level of existing IGSs. They arrived at a target level of 1.2% of gross written premiums, in the first instance. Applying this target level over, for instance, a 10-year horizon would translate into an annual contribution of 0.12% of gross written premiums from each contributing member of the scheme<sup>17</sup>.

To alleviate the risk of funding shortfalls should a large insurer fail, complementary *ex-post* funding arrangements or other sources of funding, such as external credit facilities or reinsurance, could be considered.

### 3.6.3. Contributions

To determine the total amount of funds to be raised from contributors to the IGS, there has to be an allocation mechanism. In practice, insurance companies contribute to existing IGSs in the EU in proportion to the size of their business. This avoids competitive distortions between small and large insurers and new market entrants. In general, three factors are used: (i) the size of the premium (gross or net), (ii) the size of technical provisions or reserves, and (iii) the number of policies. The different factors have different effects on the size of the contribution to be paid by individual companies.

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<sup>17</sup> See particularly table 51 of the Impact Assessment report. The figures obtained refer to levels identified for the PD=0.1%, 99% confidence scenario.

**Risk weighting** means calculating contributions according to the risks of the insurer, or its expected costs to the scheme. Risk-based contributions are calculated using several indicators reflecting the insurer's risk profile. The proposed indicators cover key risk classes used to evaluate the insurer's financial soundness, e.g. portfolio of insured risks, solvency, and asset quality. The data needed to compute these indicators are available under existing reporting obligations.

**Compensation limits and other reductions in benefits** might also be introduced. This means the IGS would require claimants to bear a share of any loss, so as to reduce funding needs for the scheme and avoid moral hazard on the part of policyholders. Methods include caps or limits on compensation, percentage reductions in claims or deductibles and minimum floors on the amount claimed. Any harmonisation at EU level would have to strike the right balance between ensuring equal minimum cover for all policyholders in all Member States and avoiding unnecessary intervention in national discretion on compensation limits and other reductions in benefits.

The Commission advocates that IGSs should be funded on the basis of *ex-ante* contributions by insurers, possibly complemented by *ex-post* funding arrangements in case of lack of funds, which should be calculated according to the individual risk profiles of the contributors. An appropriate target level for funding should be set, with a suitable transition period. The Commission is ready to consider harmonised compensation limits and other reductions in benefits, provided that appropriate coverage of policyholders and beneficiaries is guaranteed for all relevant classes of insurance and in all Member States.

### **3.7. Portfolio transfer and/or compensation of claims**

An IGS can act in two ways if an insurer becomes insolvent. It can secure continuity of insurance policies, by having them transferred to a solvent insurer or by taking them over directly (portfolio transfer). This may apply particularly to life insurance products, which, because they are long-term, are difficult to substitute under the same conditions. Alternatively, an IGS may only compensate policyholders or beneficiaries for their losses (compensation of claims).

The Commission strongly encourages portfolio transfer where reasonably practicable and justified in terms of costs and benefits. However, in the last resort, consumers must be protected in the event of an insurance failure. When all other means are exhausted, IGS should at least and within a pre-defined period of time, compensate policyholders and beneficiaries for their losses.

The Commission advocates that IGS should at least and within a pre-defined period of time compensate policyholders and beneficiaries for losses when an insurer becomes insolvent.

#### **4. NEXT STEPS**

This White Paper raises a number of issues in relation to the introduction of a legally binding EU solution for IGS. The Commission's preferred options are clearly set out in text boxes in Sections 3 and 4. The Commission calls upon all interested parties to provide their views on these options.

The Commission will carefully evaluate the feedback received and take it into account when coming forward with a legislative proposal.

Contributions to this consultation process should be sent to the Commission at the following address, [MARKT-H2@ec.europa.eu](mailto:MARKT-H2@ec.europa.eu), by 30 November 2010.