Insurance Guarantee Schemes and Supervisory Philosophy

The Canadian Experience

Navigating the Way Forward for the Last-resort Protection to Policyholders

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4 Key Benefits of Insurance Guarantee Schemes

1. An IGS aligns perfectly with supervisory objectives
2. Supports efficiency and effectiveness in supervisory decision making
3. Applies the principles of insurance to the insurance industry itself
4. Reliability of claim payouts with IGS facilitates development of the insurance industry, which in turn provides financial and social benefits to consumers and contributes to economic growth in the jurisdiction

The Canadian experience illustrates these benefits.

The Canadian Supervisory Landscape Prior to 1980

- No general insurer has failed in over 50 years
- No life insurer has ever failed
- Supervisory framework is highly structured and routine:
    - on-site inspections duplicate work of independent auditor
    - no off-site inspection or financial analysis
    - rule-based, not risk-based
    - rudimentary capital requirement for general insurers, none for life insurers

Canada: Mini-Financial Crisis in the 1980s

- Turbulent economic conditions, increasing competition in financial services
- 12 general insurers and 3 life insurers fail, of which 1 was very large
- Unpaid claims for many consumers, businesses — tragic stories highlighted in the media
- Insurance industry suffers significant reputation damage
- Public pressure on government — “do something”
- Industry resists guarantee scheme but government ultimately says “you design an IGS — or we will design one”.

Key Points for IGS Design

- An IGS is a self-insurance policy for the insurance industry
- Protects insurers' reputations and their customers, so insurers pay the premium
- Avoids moral hazard by ensuring consumers still have skin in the game
- Does <u>not</u> benefit shareholders/management — only consumers
- Not a substitute for supervisory framework overseen by professional supervisors having adequate resources, following International Standards

The Canadian Plans

- **Compensation plans for life insurance and general insurance introduced in late 1980s**
- **Run by the respective industries with supervisor oversight and some independent directors on the board**
- **Canadian plans have successfully protected interests of consumers as well as benefiting industry members (no more reputation damage from failed institutions)**

Impact of Plans on Supervisory Effectiveness — No IGS

- **Closure of an insurer has major implications for claimants, employees/shareholders of the insurer and certainly for the supervisory agency**
- **Thus often see "innocent forbearance" (*i.e. wishful thinking*) as supervisor hopes closure won't be necessary**
- **In many countries forbearance continues indefinitely and the situation only gets worse: new customers continue to buy policies while asset base shrinks. Ship is clearly sinking, but additional passengers still getting on board.**
- **Ultimately, liquidation is the only option. Process takes years, with most of the insurer's remaining funds consumed by liquidation costs. Many tragic situations for claimants.**

Impact of Plans on Supervisory Effectiveness — With IGS

- **Plan facilitates smooth transition of insurer from supervisory regime to IGS, which works closely with resolution entity (or is the resolution entity), for the benefit of all claimants**
- **Tragic losses to claimants are avoided**
- **Instead of tying up supervisory resources for years, with liquidation costs eating up the failed insurer's asset base, claims are settled on time-line not appreciably different from what would be the case if no failure**
- **Industry does not suffer reputation damage, is able to strengthen its role in providing risk transfer services to consumers and in strengthening the country's economy**

Impact of Plans on Supervisory Effectiveness — With IGS, longer term

- Largely because of the Plans, in Canada early intervention has become the norm (no innocent forbearance)
- Most insolvencies have been resolved by the Life and General IGSs at a high "cents on the dollar" figure
- This means that the IGSs have ultimately received back most of the funds that were advanced to policyholders as a result of the failure
- The IGSs have in essence acted as financing vehicles, costing the industry little or nothing and yet protecting policyholders as well as the reputation of industry members

Impact of IGS on Supervisory Effectiveness

Overall, an IGS presents an opportunity to structure a triple "win - win" situation:

1. **Huge, direct benefit for claimants of failed insurers**
2. **Industry reputation is maintained, thus enabling insurers to fulfil their important role of providing risk mitigation services to the public and adding to the dynamism of the local economy**
3. **In case of a failure, supervisory agency is overseeing a well-defined, structured process with low media profile**

Thank you!

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