Protection schemes in the insurance industry as a contribution to consumer protection

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That protection schemes, be they in the insurance industry or in other fields of private commerce, appear advantageous at first sight from the perspective of consumer protection seems obvious. Who would argue against that? Just consider if you had performed a service but the other party failed to reciprocate performance since your contractual partner was no longer able to meet its obligations. In such a situation it is always a good thing if we can trust a third party to intervene and provide security for the performed service which might frequently require finance in advance. But such a view only reveals one aspect of protection schemes for consumers.

If we take the common definition of consumer protection, this involves "all measures and decisions which are aimed at helping the consumer appropriately to assert its interests vis-à-vis the provider".[1] Consumer protection should therefore be guided by the interests of the consumer. Alongside the security that the contract entered into should be fulfilled, consumer interests also include doubtlessly the lowest possible cost for a desired service. Furthermore, the consumer's right of self-determination must be observed. We thus have to consider to what extent the restriction through an extensive regulatory framework of each consumer's option freely to decide for him or herself about the opportunities and risks of a contract can be justified. This has to start with the relevance of protection. So it might be justified, among other things, if a consumer is not in a position to make a proper assessment of the risk situation due to the long-term binding effect of their decision or the information available.

The attempt will be made below to illustrate some reference points identifying areas in the insurance industry in which the development of a protection scheme can be useful, taking account of aspects which are unavoidably connected with the construction or design of the corresponding systems in the insurance industry. Here experiences drawn from the protection scheme in the German life insurance industry will be used which was initiated in 2002 by German life insurance companies with Protektor Lebensversicherungs-AG and in 2004 was made mandatory by German legislators as a governmental guarantee fund called "Sicherungsfonds für die Lebensversicherer").

Goal of the protection scheme

The task of a protection scheme in the insurance industry is to safeguard the claims of the policyholders, insured persons, beneficiaries and other individuals vested with rights under the insurance contracts[2] (hereinafter "beneficiaries of an insurance policy" for short) if there is a risk to the insurance policies and other measures to protect the interests of policyholders are inadequate. Legislators in Germany presume a risk to the policies if an insurance company is no longer able to fulfil its obligations in the long term[3] or becomes insolvent.[4] In such an event a protection scheme can wholly or partly take on the fulfilment of the obligations through paying compensation or — as in the case of German life insurance — taking on the insurance policies and fundamentally continuing them as originally agreed.

The promise of a protection scheme is thus a warranty to third parties to guarantee contract fulfilment within a prescribed framework if the actual contractual partner defaults. Such guarantees are not cost-neutral in a capital-oriented economic system; in other words, they have a price. Since the guarantee is not normally given by the state within its budget, the question arises as to whether the price of a protection scheme justifies the benefit; that is to say, whether the policyholder is prepared to accept the additional costs arising with regard to the product as a result of the protection. In this context it is ultimately the subjective assessments of those involved in the decision-making process which play a key role. Some criteria will be set out below which could be of importance in this decision-making process.

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Costs of a protection scheme

It seems obvious that a general "all-round carefree" approach to protecting insurance policies cannot or can only be financed by the taxpayer community, as may be justified in many welfare benefits. Specifically, though, if protection is not guaranteed by the state, that is to say the taxpayer, but is borne by those who offer or acquire the product, the costs must be estimated in advance and taken into account against the background of the added benefit.

The costs of a protection scheme arise on the one hand from its organisation and on the other from its utilisation. Organisationally, setting up a protection scheme assumes an operational unit which takes care of its tasks. This gives rise to human resources and material costs — even if it is not utilised and with the greatest possible outsourcing of activities in the event of a failure. They arise, for example, through ensuring availability to answer requests from consumers and maintaining the readiness to act in an insurance case. In many cases, particularly with compensation systems, advance financing for the protection schemes is agreed so that they can rapidly pay out compensation in an insurance case. This regularly entails the collection of contributions at minimum on an annual basis, the orderly administration and investment of the advance finance moneys as well as an annual report.

The costs of making use of a protection scheme in the insurance industry are — alongside the likelihood of a failure occurring — significantly dependent on

- which beneficiaries of an insurance policy
- which policies
- and which scope

are to be protected.

Protection schemes are intended to serve consumer protection. Thus in determining the beneficiary to be protected in an insurance policy we have to start with the concept of the consumer. The Civil Code (BGB) in section 13 defines the consumer as any natural person who enters into a legal transaction for purposes that predominantly are outside his trade, business or profession. If thus the consumer can be separated from the tradesperson and freelancer, if necessary drawing on the rulings of the Federal Court of Justice, solely using the policyholder for guidance does not lead to a satisfactory result. Thus the policyholder frequently does not fall under the definition of consumer whereas the ultimate beneficiary does fulfil the definition. To this extent it is necessary in many cases to look in the individual insurance type at the beneficiary of the individual policy in order to interpret the concept of consumer appropriately against the background of the necessity of protection. A problem here is the need for protection of small business people which in many cases tends to correspond to the need for protection of consumers rather than entrepreneurs. Hence a clear definition is required here to differentiate between the beneficiaries of an insurance policy in need of protection, a definition which appropriately applies the concept of consumer and which may, as necessary, vary between insurance types.

Various criteria can be applied in determining the type of insurance policies which are worth protecting and trigger costs as part of their protection. Here the term of the policies and their social or indeed existential importance for the beneficiary play a special role.[5] Bindingly agreed long policy terms normally limit the portability of insurance cover. The policyholder is bound by a decision taken once and thus to an insurer for a long period of time. During this time the solvency situation of the insurer may change without the policyholder in actual fact being able to react to it since termination of the contractual relationship is associated with disadvantages. The policyholder's personal circumstances change over the term of the policy which — if they had to take out new insurance — would have an effect on the price of their insurance cover. Social policy considerations such as security in old age through retirement plans, disability or sickness cover also support the need for protection of the corresponding insurance policies. Thus it is understandable that in the debate about protection schemes in the insurance industry in Germany particular attention was paid to the protection of life insurance policies and private health insurance policies.

It is an advantage in these categories that in actual fact all the insurance policies have consumers as beneficiaries so that a differentiation between contracts in need of protection is not required. Beyond that, it is necessary to judge whether in other areas the default of an insurer would regularly be of similar social or existential importance for the beneficiaries of an insurance policy. Thus the settlement of fire / elemental claims can be existential, particularly in cases in which the building has been financed through borrowing, but also because private residential buildings are frequently a form of retirement planning. In this field of insurance demand there is the additional factor that the policyholder frequently does not have the opportunity — even if he or she so desire — of reducing the risk of an individual insurer defaulting by diversifying and spreading the risk to be insured over several insurance policies. This represents a difference to ordinary capital investment in which the investor can restrict as they wish the money they invest with a single institution.

The scope of protection is also of crucial importance with regard to the costs of a protection scheme. Compensation systems set up in the insurance industry outside Germany frequently have limitations in the form of an absolute or percentage excess as well as maximum compensation limits. In this context these criteria for the individual insurance types were partly laid down in different ways. Frequently the basis for the compensation limits in existing protection schemes in the insurance industry was analyses which said that in an insurance case the large majority of policyholders, e.g. 90 percent, would not suffer any losses through the limitation. In addition, the aim of individual designs was to guarantee a level playing field in the financial sphere so that product advantages would be avoided through consistent protection. But as already set out above, the latter can only succeed if there is the same flexibility for the policyholder — for example with regard to diversifying his or her risk positioning.

Alongside the policy-related limitation of protection, the costs of a protection scheme can also be restricted through time or volume-related maximum figures. Thus the financing of the German protection scheme in life insurance provides for the obligations towards policyholders to be reduced by up to five percent of the contractually guaranteed benefits if the funds of the

protection fund are not sufficient for a recapitalisation.[6] This is flanked by a limitation on the request for funds to avoid an excessive burden on the financing members.[7]

The policy-related scope of protection can, of course, also have an effect on the behaviour of policyholders when concluding a policy and thus — via the probability of a claim — indirectly on the costs of a protection scheme. Particularly in standardised insurance products, policyholders will tend to take their cue from the level of the premium or possible discounts rather than from the individual design of the insurance product. A possible corrective – that the policyholder also has to be convinced of the solidity of the insurer – would cease to apply if the policyholder were to receive their benefit at the same level from a protection scheme. Looked at in abstract terms, the existence of a protection scheme can furthermore amount to an incentive for more risky behaviour of insurers (moral hazard), even if there are no statistics on a causal relationship between the willingness to take risks of insurers and the existence of a protection scheme for customers. Here a crucial role is played by the regulatory solvency requirements. The required risk buffers under supervisory law are intended to prevent insolvency even if the costing assumptions of the insurers are not fulfilled. In the present time in particular, the change to Solvency II aims to enhance the risk awareness of insurers further and strengthen their equity base. Here the Solvency II model is guided by ensuring a maximum default probability of 0.5 percent, i.e. the model is intended to ensure that at maximum a single default can be expected within 200 years. This does not of course mean that one or several defaults will not in fact occur; after all, it is only a theoretical model. On the other hand the conclusion can nevertheless be drawn that the default probability in the future will tend to fall if companies have implemented the solvency requirements and the supervisory authorities rigorously apply Solvency II.

Cost-benefit analysis of appropriate consumer protection

The decision to set up and design a protection scheme which does justice to the interests of consumers is thus based on a (subjective) cost-benefit analysis. Higher level political interests that consumers must be protected against any risk of failure at all times without having to bear the costs for this will not be considered further in this respect. Such state “protection schemes” can, however, be eminently sensible in extreme situations as was shown by the banking crisis of 2008 and the “saver guarantee” announced by the German government on 5 October 2008. Whether it could ultimately be guaranteed by a national budget is another story.

As set out above, the benefits, or more precisely, the degree of the possible necessity to set up and the individual design of a protection scheme can be measured, among other things, against the following criteria:

- Social importance of the policy for the consumer
- Length of term of the insurance policy
- Existential threat on default of the insurer
- Inability to spread the risk over several insurance policies from different insurers.

Using individual insurance types / lines of business, criteria are investigated which may indicate an exceptional benefit for the beneficiaries of an insurance policy from a protection scheme and thus a special need for protection. Here only insurance types / lines of business are looked at in which the beneficiary of an insurance policy appears mainly as consumer.

With regard to social importance, this primarily includes insurance types / lines of business for the cover of life, health and retirement planning. Here policies must be considered which serve to cover the policyholder directly as well as policies which cover third parties, for example surviving dependents. This includes to begin with all types of life insurance which serve the goal of the long-term accrual of assets for retirement. Beyond that, risk protection policies should be taken into account among which occupational disability insurance is exceptionally important. Private health insurance policies are also of special importance. Beyond that, other insurance types / lines of business – particularly when they are in the benefits phase and are, for example, for the payment of a pension – can accrue a comparably high social importance for the beneficiaries of an insurance policy.

The specified insurance types / lines of business have in common that the policyholder frequently concludes the policy at a very early stage in his or her life in order then to maintain it until the end of their working life or even the end of their life. The costing of such policies is aimed at keeping the premiums for the insured risk stable over the term of the policies or to have only minor fluctuations, which means that the contributions at the start of the policies are partly used to create reserves for the later benefits phase. For this reason it is easy to understand that a later change of insurer will be associated with disadvantages for the policyholder and that the renewed conclusion of a policy at a later time is no longer possible under the same terms. This point in particular is of special importance with regard to the question as to how an appropriate protection scheme for these policies should be designed in order to do justice to the needs of consumers. Since the policies are designed for the long term, real protection of consumers can only be achieved through ensuring the continuation of the policies. This was the reason why in Germany run-off companies were set up in life and private health insurance as protection schemes which take care of the policies in the form in which they were entered into themselves or guarantee their continuation. One-off compensation would not have meet the needs of consumers. Protection schemes in other countries which were designed as compensation schemes are also increasingly trying to find solutions in which defaulted portfolios are transferred to other insurers in the market and in which the protection scheme financially supports the transfer. This is based on the understanding that ultimately only a continuation of the policies can do justice to the expectations of policyholders. In all the concepts this does not preclude giving consideration in a continuation of the insurance policies to whether or not a partial participation of the policyholders in recovering the defaulting portfolios is appropriate. This can be done both through a specific excess or reduced future surplus sharing. At the same time it should be avoided that the members who finance the protection scheme are overburdened by the portfolios to be rescued.

Alongside the insurance types / lines of business mentioned before, which

frequently are of existential importance for policyholders, there are other insurance types / lines of business the failure of which can pose an existential threat in the event of a default. These undoubtedly include among other things fire and elemental loss insurance and third-party liability insurance. Although in these insurance categories the policyholder is normally in a position to purchase new insurance cover under similar terms at short notice, they are in the case of loss in many cases dependent on the assured payment of the amount of the loss due to the high cost of the loss alone. It is clear that with these insurance types the focus is less on a continuation of the policies and more on protecting the benefits, so that compensation systems can provide appropriate solutions. Here in particular thought should be given to an excess for policyholders to ensure that the preferences of policyholders on concluding such policies, which can be changed at short notice, are not exclusively guided by the level of the premiums. Otherwise providers whose price calculation appears to be comparatively aggressive may be preferred at the cost of the remaining providers.

The extent to which a limitation in these insurance types / lines of business is appropriate depends significantly on whether policyholders are in a position to cover their risk with various insurers and thus to diversify. This will not be possible in many cases as can easily be seen from the examples of fire and elemental loss insurance or third-party liability insurance. Offsetting these risks is therefore also not done at the level of the policyholder but at the level of the insurer through the collective or, if in doubt, through reinsurance.

In this context, a special role is taken by compulsory insurances. Even if what has been said so far fundamentally applies, a number of European countries have seen a special need to protect the beneficiary of such insurance policies. But once the insurance monopolies have been removed, the importance of this point of view should lessen.

Summary

As set out, consumer protection through protection schemes is also always connected with the costs arising as a result. To the extent that these costs are not assumed by the state or the taxpayer, something which, after all, is to be increasingly prevented in future through the political measures introduced in Europe after the banking and debt crisis, the costs for protection schemes — apart from possible short-term subsidies — are reflected in the medium to long term directly or indirectly always in the costs of the product. In the insurance industry this comes to expression in higher premiums or reduced benefit expectations. To this extent the cases in which the benefit for the consumer justifies the costs of a protection scheme should be investigated in detail. The starting point for any such considerations should always be the degree to which a consumer is affected. An additional expenditure can only be justified to prevent significant risks, i.e. in particular if the default of an insurer represents an existential threat to the consumer or the insurance is of exceptional social importance.

Here the costs accruing are ultimately crucially dependent on the utilisation of the protection scheme. In this context it is important, on the one hand, which beneficiaries of an insurance policy or which insurance policies are to be protected, and on the other hand, whether excesses and limitations are justifiable and can be implemented.

But the most significant factor with regard to costs is the degree of probability that a protection scheme will be utilised at all; that is ultimately the question of the probability that an insurer will get into difficulties. This question is in turn connected with the own funds of the companies as well as the quality of the supervisory system. Here the expectation is that the tendency will be for Solvency II to reduce the probability of the default of an insurer. But neither can a default be excluded as a result since we are talking about a theoretical model. The fact that in Germany only a very small number of companies have in the past been known to get into trouble, affecting consumers, gives grounds for a certain amount of hope that the probability of companies in Germany getting into trouble in the future will be low, but of course no one can give a guarantee that it will never happen. To this extent appropriately designed protection schemes can be in the interest of consumers in certain insurance types and contribute to consumer protection.

Notes

1 Gabler Wirtschaftslexikon.

2 Cf. section 126 subsection 2 sentence 1 of the Supervision of Insurance Companies Act (Insurance Supervision Act — VAG).

3 Section 89 subsection 1 sentence 1 VAG.

4 Section 88 subsection 2 VAG.

5 Cf. among others also OECD Working Papers on Finance, Insurance and Private pensions, No. 31, Policyholder Protection Scheme, 2013, p. 251.

6 Section 125 subsection 5 sentence 1 VAG.

7 Section 129 subsection 5 VAG.