



Insurance and reinsurance news

THE PROPOSED EUROPEAN REGIME FOR INSURANCE GUARANTEE SCHEMES

In July 2010 the European Commission proposed a framework that would require EU member states to establish or maintain insurance guarantee schemes (IGSs) to minimum standards. IGSs compensate the policyholders of insolvent insurers whose assets are not sufficient to meet claims in full.

This issue outlines how some aspects of the scheme may work and highlights some areas of uncertainty. Anyone wishing to respond to the proposal needs to do so by 30 November 2010.

Introduction

In July 2010 the European Commission published a white paper proposing a framework that would require EU member states to establish or maintain insurance guarantee schemes (IGSs) to minimum standards. This would also extend to Norway, Iceland and Liechtenstein under the European Economic Area Agreement. IGSs compensate the policyholders of insolvent insurers whose assets are not sufficient to meet claims in full. They may also sometimes give compensation to third party claimants against the policyholders.

The Commission seeks responses to its white paper by 30 November 2010. Its press release suggests that, if the project goes to plan, 'most improvements could already come into effect by end 2012', although this may be optimistic.

Background

Prudential requirements applying to EU insurers under the insurance framework directives are intended to minimise the risk of financial failure. The system is due to be improved under the Solvency II regime, now expected to come into force in January 2013. Even the updated prudential standards, however, will not give a full guarantee against insurer insolvency.

The Insurance Insolvency Directive has gone some way to ensuring that, when an insurance company fails, policyholders are protected on the same terms throughout the EU. The rules under this directive

prioritise the claims of insurance (not including reinsurance) creditors. The EU, however, has yet to address what happens if the assets of an insolvent insurer fall short of what is needed to meet policyholder claims in full (let alone the claims of other creditors). In this respect the insurance sector lags behind the investment and banking sectors.

In the UK, the Financial Services Compensation Scheme (FSCS) operates in effect as an IGS. However, only 12 of 30 EU-EEA member states operate insurance guarantee schemes of any kind. Of those that do, there are significant differences in how those schemes apply. Not all schemes apply to both life and non-life insurance. Many have territorial restrictions on which policyholders may benefit and financial limits are not harmonised.

These issues may interfere with the effectiveness of the Single European Market and the willingness of consumers to deal with insurers outside the state of their residence. They also cause problems in portfolio transfers, because supervisors in member states where policyholders are protected by IGSs may be reluctant to agree to a transfer of the business to a member state in which no such protection exists.

The white paper is accompanied by a full impact assessment. It follows a considerable period of research by the Commission and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) into the implications of developing IGSs across Europe.

The approach proposed by the Commission

The proposals put forward by the Commission are still at quite a high level and do not cover all the issues that will in due course arise. Further detail can be expected if and when the Commission initiates the legislative process with a formal proposal for a Community directive.

The Commission proposes that a directive should require member states to establish IGSSs as a last-resort mechanism for certain policyholders and beneficiaries under direct insurance contracts. All 'natural persons' would benefit, as would 'legal persons' (ie corporate bodies) satisfying criteria yet to be defined (no doubt in substance small or medium-sized enterprises).

IGSSs would operate on a 'home member state' basis. This would require, for instance, the UK IGSS to operate for the benefit of all qualifying policyholders of a UK insurer throughout the EEA. But the UK IGSS would not be required to cover the activities of any EEA insurers passporting into the UK, either on a services or on an establishment basis.

The white paper does not indicate to what proportion policyholders would be compensated in the event of an insolvency, although it 'strongly encourages portfolio transfer where reasonably practicable and justified in terms of costs and benefits'. So compensation is a last resort. Levels will doubtless be determined at a later stage. Under the UK FSCS, compensation on insurance claims is usually paid at 90 per cent, except for compulsory cover, for which 100 per cent is paid. With-profits policyholders are not compensated for the loss of bonuses unless they are declared and vested before the insolvency.

Minimum harmonisation

The proposed directive would apply a minimum harmonisation regime. The Commission comments that this 'means that Member States may, if they so desire, provide greater protection ("gold-plating") than is provided for in the relevant EU legislation'. So the UK, for instance, would be able under the FSCS to apply a higher level of compensation than that provided for under the directive to UK-authorized insurers. It would probably not, however, be able to require insurers passporting into the UK from other states to top up to that level, although

it may be allowed to give those firms the option of topping up in return for a contribution towards the cost.

It is possible that if a member state gold plates to a significant degree on the directive requirements, policyholders of firms authorised in that state may object (whether successfully is difficult to predict) to a portfolio transfer to a firm authorised in a state that has not gold plated.

Funding

The Commission recommends that IGSSs should be mainly pre-funded by insurers, possibly complemented by ex-post (ie retrospective) contributions in the event of lack of funds. The Commission's initial calculations arrived at a target level of 1.2 per cent of gross written premiums. These would be accumulated from the beginning of the scheme over a 10-year period. Pre-funding is also included in changes proposed by the Commission to European rules on deposit guarantee schemes.

The Association of British Insurers comments: 'we would still be very concerned if the Commission move towards pre-funding [for insurance], which would not be needed as insurers have a very different business model to banking'.

Currently, the FSCS is funded for insurance claims mainly by reference to expected outgoings over the following year.

Third parties

The white paper does not mention the rights of third party claimants under liability cover. Under the FSCS, third party claimants are generally eligible if the policyholder himself was eligible at the time the insurer became insolvent.

The Solvency II group support regime

It is worth noting that the absence of a European IGSS regime was one of the reasons the final version of the Solvency II Directive did not provide for the 'group support regime' initially proposed. The group support regime would have allowed insurance groups greater flexibility in capital management than is provided

for in the version of Solvency II finally adopted. It would, however, also have exempted solo insurers within insurance groups from complying with the higher solvency capital requirement provided that they complied with the lower minimum capital requirement and provided that the solvency capital requirement was covered at group level. There were concerns, among other things, that this would leave policyholders of the solo firms in question with insufficient protection.

The other main impediment to the group support regime was identified as 'the lack of a European framework covering crisis management and mediation of supervisory disputes'. This issue too may also soon be resolved if agreement can be reached on another directive currently under negotiation. This proposed directive is aimed, among other things, at transforming CEIOPS into an insurance regulatory authority in its own right and creating a European Systemic Risk Board. For further details see our briefing of June 2009 on The new regulatory architecture. A presidency compromise has recently been published, which it is hoped will lead to agreement on the directive in September 2010.

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