Analysis

Feasibility and affordability of an insurance guarantee scheme in the Netherlands

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1. Introduction

In January 2019, the Dutch Act on the Recovery and Resolution of Insurers came into effect, which seeks to improve policyholder protection in case an insurer runs into trouble. For instance, the Act ensures that certain pay-outs continue while an insurer is in resolution or bankruptcy proceedings, and it gives DNB powers to wind up insurers in an orderly manner while sparing policyholders as much as possible. Nevertheless, policyholders may still face pay-out curtailments. Unlike some neighbouring countries, the Netherlands does not have a guarantee system to prevent this from happening.[1] Schemes are in place in the Netherlands that protect deposits (deposit guarantee scheme – DGS) and investments (investor compensation scheme – ICS). An insurance guarantee scheme (IGS) can support the continuity and/or value of insurance policies. An IGS is sector-funded, and can be used to cap curtailments imposed on a failing insurer's policyholders.

The question of whether an IGS should be introduced in the Netherlands is a political one. The Minister of Finance has announced to start discussions with stakeholders on the desirability and feasibility of an IGS in the Netherlands.[2] What we have looked into is whether an IGS could be feasible and affordable in the Netherlands. We believe specific IGS designs are conceivable that offer policyholders affordable additional protection.

2. Different design options for an IGS

An IGS may be designed in a variety of ways. Key design variables are its functions, scope, level of guarantee provided and funding. The choices made for each variable largely determine an IGS's feasibility and affordability. Below, we discuss each variable in turn.

2.1 Functions of an IGS

An IGS can have three functions, corresponding to the different ways in which an insurer can be resolved or allowed to go bankrupt (see Figure 1).

- It can contribute to the funding of the insurer's sale or open firm-bail in (relaunch). In case of failure, the trustee in bankruptcy, or DNB as the resolution authority, will try to sell the failed insurer's portfolio to a solvent insurer. In addition, DNB has the option, in a resolution procedure, to restructure the failed insurer's balance sheet to allow an open-firm bail-in of the restructured insurer. Both strategies are relatively beneficial to policyholders, as their policies continue to exist. Unfortunately, sometimes the failed insurer's financial position precludes both strategies without curtailing insurance rights. In such a case, an IGS can be used to cap curtailments, while enabling the insurer's sale or open firm bail-in.

- It can annually supplement insurance pay-outs. If a sale is not possible on acceptable terms, a failed insurer can also be wound up in an orderly manner in what is known as run-off. In run-off, the failed insurer keeps its portfolio of insurance policies that subsequently expire over time and it does not sell

[1] The Netherlands does have guarantee funds for motor insurance liability and health insurance.
[2] Minister of Finance, Cover letter, report on introduction of an insurance guarantee scheme in the Netherlands, 5 April 2022, https://www.rijksoverheid.nl/documenten/kamerstukken/2022/04/05/aanbiedingsbrief-rapport-over-invoering-van-een-verzekeringsgarantiestelsel-in-nederland

new policies. While the insurer gets smaller, it continues to meet its obligations. However, an insurer’s funds may be insufficient to meet all of its obligations throughout the terms of its policies, given that it may face shortfalls due to its failure. In such a case an IGS can annually, over the duration of the portfolio, top up the insurer's pay-outs to policyholders to mitigate curtailments.[3]

- It can compensate policyholders in the event of an insurer’s liquidation. If the above two resolution strategies should prove infeasible, the insurance policies are terminated and the failed insurer’s assets liquidated. Policyholders and other creditors are paid out from the proceeds in accordance with their statutory order of priority. Policyholders may face losses as a result, as the liquidation pay-out is often insufficient to purchase an equivalent policy from another insurer. In such a case, an IGS can meet policyholders' losses by making a lump-sum payment.

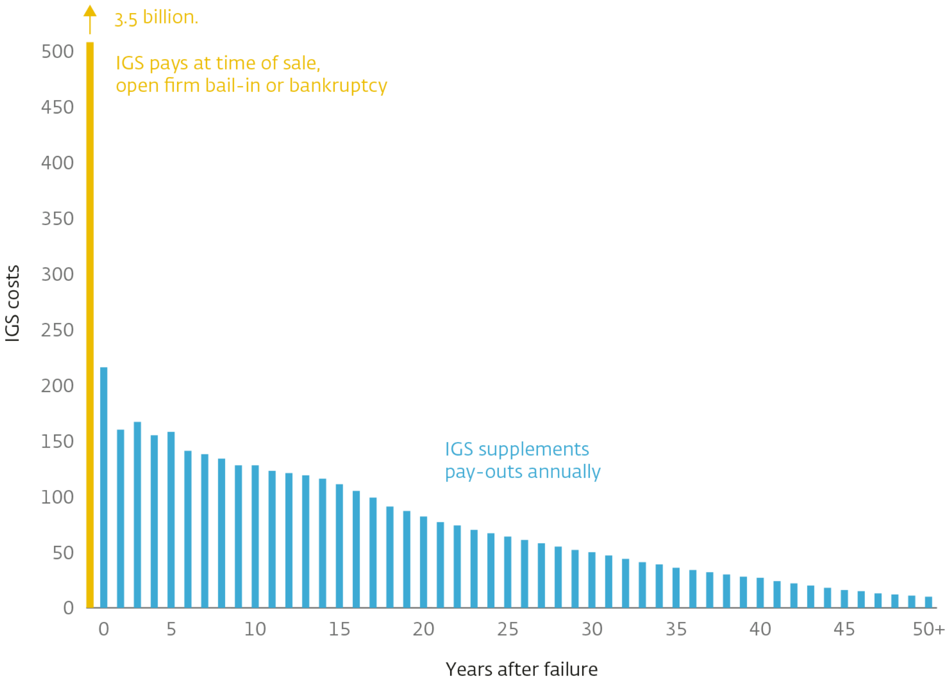
Note that in all three functions, the IGS is not required to pay out directly to policyholders. It can transfer its contribution towards a sale, its pay-out supplements or its compensation amount directly to the failed insurer. The trustee in bankruptcy, or DNB as the resolution authority, then ensures that this payment benefits policyholders.[4] This is a less complex set-up than making payments directly to policyholders, removing the need for data from the insurer's records. The IGS will not make the payment until the other creditors have taken their losses by applying resolution instruments or because insufficient funds remain for them following liquidation in bankruptcy.

An IGS that can perform all three of these functions will ensure maximum policyholder protection. Such an IGS maximises the options available to DNB in resolution or to the trustee in bankruptcy, making it most likely that insurance policies can be continued.

In addition, the function of making regular supplements to pay-outs during run-off makes it easier to fund an IGS. After all, the IGS pays out smaller amounts over the remaining terms of the policies, rather than a large amount up-front, as is the case in a sale, open firm bail-in or liquidation. This makes it easier to guarantee the policies of a large life insurer facing a considerable shortfall, as life insurance policies typically have terms spanning decades, meaning the IGS’s payment supplements are spread over those years (see Figure 1).[5,6]

[3] During run-off, another insurer may still acquire the portfolio or the insurer.
[4] This is different from a deposit guarantee scheme (DGS), under which the deposit guarantee fund does make direct payments to depositors.
[5] Capital requirements for such an insurer in run-off and the accounting treatment of payments from the IGS would have to be worked out in greater detail.
[6] IGS costs are based on the insurance liabilities (i.e. pay-outs and costs) of the five largest Dutch life insurers. The 10% shortfall remains after writing off the remaining creditors.

Figure 1: Cost (EUR million) of an IGS in case of failure of a large life insurer with a 10% shortfall if the IGS guarantees 95% of the policy value



Source: DNB.

2.2 Scope of an IGS

It must be determined which insurance policies an IGS should cover. Given the purpose of an IGS, which is to protect policyholders, it stands to reason that those policies should be covered under which policyholders face financial difficulties if their insurer should fail. These are policies that are important to policyholders in terms of wealth creation, or whose pay-outs are essential for their livelihood, such as individual life insurance, group pension insurance, income protection insurance, and funeral insurance. Such policies typically have long durations, sometimes spanning more than 30 years.

It would be less obvious for an IGS to cover non-life or health insurance, for the following reasons. Firstly, the value policyholders accrue under these policies is smaller due to the policies' short durations, which is typically one year. Secondly, Dutch law already provides additional protection in case of an insurer's failure – policyholders entitled to a pay-out of their non-life insurance if their insurer should fail are paid on a priority basis.[7] Because of this priority status, payments are likely to be made in full in most cases. For example, a policyholder whose house has burned down just before or just after a fire insurer's bankruptcy will most likely not be curtailed, and therefore does not need further protection under an IGS. For other policyholders, any

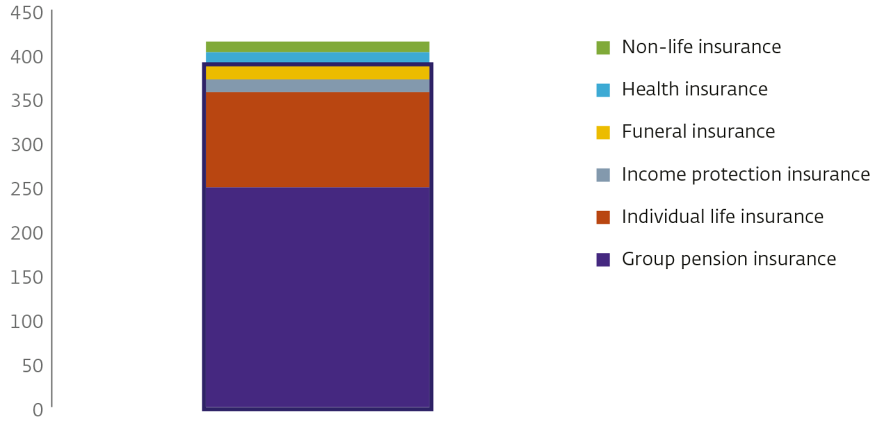
[7] Section 213m of the Dutch Bankruptcy Act

loss in case of bankruptcy is limited to having to take out new insurance and losing all or part of any premium they paid to the bankrupt insurer in advance.

Health insurance policyholders do not have a direct claim against the insurer (insurance in kind) or are already covered by a statutory guarantee scheme (non-contracted care policies).[8] In common with non-life insurance, any loss to health insurance policyholders only relates to prepaid premiums, not to their pay-outs. Curtailments of prepaid premiums will usually not have any serious financial ramifications.

If life, pension, income protection, and funeral insurance were included, the IGS would cover over 90% of the total value of claims on Dutch insurers (see Figure 2).

Figure 2: Technical provisions of Dutch insurers (2021, EUR billion)



Source: DNB.

In the Netherlands, occupational pension schemes can be provided by a pension fund, a premium pension institution or a life insurer. Pension funds provide the lion's share (see Table 1). Group pension insurance policies account for two-thirds of life insurers' insurance liabilities. Bringing group pension insurance policies under the scope of an IGS could have an impact on the pension market. After all, pension fund members would not be protected by a similar guarantee scheme, and the cost of group pension insurance would increase – albeit to a limited extent – due to an IGS levy.[9]

[8] Section 31 of the Dutch Health Insurance Act
[9] KPMG has calculated that premiums would go up by 0% to 30%, depending on the design chosen. Under a more affordable IGS as described in this analysis, the premium increase would be limited to 1%. KPMG, Study on costs and benefits of an Insurance Guarantee Scheme (IGS), 25 February 2022.

Table 1: Size of occupational pensions by providing entity (2020)

	Providing entity	Number	Value (percentage)			Number of members (millions)		
			Accrual phase	Pay-out phase	Total	Accrual phase	Pay-out phase	Total
Pillar 2 Occupational pensions	Pension funds	**171**	59.6%	30.0%	**89.6%**	15.7	3.6	**19.3**
	Life insurers	**12**	6.2%	3.6%	**9.7%**	4.2	1.8	**6.0**
	Premium pension institutions	**7**	0.7%		**0.7%**	0.7		**0.7**
	Total	**190**	66.4%	33.6%	**100%**	20.6	5.4	**26.0**

Source: AFM, Sectorbeeld Pensioenen 2022.

An IGS's impact on the pension market is unlikely to be decisive. Firstly, the rules governing pension providers already differ, such as supervisory requirements. Secondly, policyholders need not be fully protected under an IGS (see the next section on the level of the guarantee). Introducing an excess for policyholders under an IGS reduces the difference in protection between policyholders of group pension insurance and pension fund members. Thirdly, an employer's choice between a pension fund, a premium pension institution or a pension insurer depends on many factors, of which coverage by an IGS would be just one.

Another scope-related aspect is an IGS's geographical coverage, i.e. the choice between what is known as a home or a host approach. Under a home approach, an IGS covers policies sold by Dutch insurers subject to DNB supervision to both Dutch and foreign policyholders, but it excludes Dutch policyholders who have a policy with a foreign insurer. Under a host approach, all Dutch policyholders are protected regardless of whether they took out a policy with a Dutch or a foreign insurer, but policies sold by Dutch insurers to foreign policyholders are excluded.

Adopting a home approach would ensure alignment with the supervision and resolution frameworks, which also operate under the home approach. This ensures that responsibility for insurance supervision and resolution rests in the same jurisdiction as the responsibility for guaranteeing those insurers' policies. For this reason in particular, the European Insurance and Occupational Pensions Authority (EIOPA) recommends European harmonisation of national IGSs, with all IGSs adopting a home approach in principle.[10] In that case, any policyholder with a policy from an insurer in the European Union would be covered by an IGS, provided the type of insurance is covered. Adopting a home approach in the Netherlands would therefore also be in line with a possible harmonisation of IGSs in Europe. If harmonisation should fail, a host approach could also be adopted to provide protection to Dutch consumers with policies from foreign insurers as well.[11] This would, however, require the IGS to be in close contact with the authorities or the trustee in bankruptcy in the failing insurer's country.

[10] EIOPA, Opinion on the 2020 Review of Solvency II, 17 December 2020.
[11] In 2020, roughly 5% of life insurance premiums were paid by Dutch citizens to foreign insurers not covered under an IGS. The home approach would not cover such insurance policies, whereas the host approach would.

2.3 Level of the guarantee

The level of the guarantee provided determines the degree of protection and is therefore a key cost component. A full policy guarantee offers complete protection but is more expensive than a limited guarantee. To keep an IGS affordable, the amount of the guarantee can be capped.
Capping the guarantee can be done in a variety of ways. A fixed amount, i.e. an absolute ceiling, can be set. For example, the Dutch deposit guarantee scheme (DGS) guarantees savings up to €100,000. Alternatively, a percentage, i.e. a relative ceiling, can be set of, say, 95 or 90% of the policy value, leaving an excess to policyholders of 5 or 10% of the policy value, respectively. Opting for such a relative ceiling, or excess, would be preferable for various reasons.

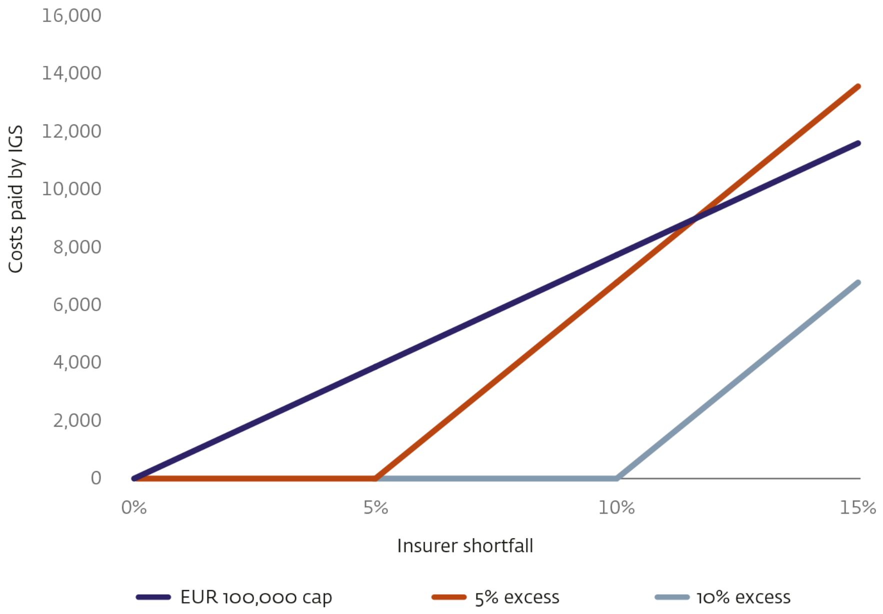
- The IGS can cover a wide range of insurance products, ranging from funeral insurance to pension insurance. These different products can have widely divergent values. Whereas a funeral insurance policy will usually have a value of no more than €10,000, a pension insurance policy of someone who is just retiring, or an incapacity for work insurance policy of someone who has just become incapacitated, may have a value of several hundred thousand euro. A single absolute ceiling would therefore provide generous protection to some, and less protection to others.

- An excess for policyholders reduces the risk of moral hazard that could be a potential drawback of an IGS. A common argument against an IGS, the risk of moral hazard occurs when policyholders are no longer incentivised to monitor the financial and operational soundness of insurers themselves. If they have an excess, policyholders retain this incentive at least partially, because in the event of an insurer failure, they may still face a loss – albeit more limited – despite the IGS. This is not the case with an absolute ceiling, as for the majority of policyholders the value of the policy will not exceed the ceiling.

- In many cases, a relative ceiling/excess for policyholders reduces IGS costs (see Figure 3).[12] After all, policyholders absorb the initial portion of a shortfall – how much depends on the level of the excess – and will be compensated for the portion over and above the excess only in case of a larger shortfall. The IGS then operates as a safety net in case of a large shortfall. An absolute ceiling can be more cost-effective for the IGS only in situations involving very large shortfalls, but such large shortfalls rarely occur when insurers fail.[13]

[12] Based on the baseline scenario in KPMG's study (see footnote 9). KPMG did not calculate the cost of an IGS that also performs the run-off function.
[13] In 15 of the 219 insurers that failed or nearly failed in Europe between 2000 and 2020, support from an IGS or government accounted for more than 20% of the assets of the insurer in question. EIOPA, Failures and near misses in insurance, October 2021.

Figure 3: Cost (EUR millions) of compensating policyholders in case of liquidation of a large life insurer with different shortfalls and different guarantee levels



Source: KPMG, Study on costs and benefits of an Insurance Guarantee Scheme (IGS), (pp. 144-145), DNB calculations.

2.4 Financing an IGS

An IGS operates a fund to which sector participants contribute. Two questions present themselves: how much should be built up ex-ante, i.e. before insurer failure has occurred, and how are levies raised from sector participants?

We will first consider the size of the fund. As a rule, an insurer – even if it is at risk of failure – is not likely to face liquidity shortfalls, but solvency shortfalls. In the event of imminent failure, insurers have a lower probability of an insurance run than the probability of a bank run in case of bank failure. Moreover, insurers generally have liquid assets. The immediate availability of substantial amounts of additional cash is therefore less of a necessity for an IGS.

Nevertheless, the IGS must be solidly funded for it to be able to credibly guarantee the policies of a major insurer without having to rely on temporary or permanent funding from the Dutch State.[14] As few Dutch insurers have failed in recent years, the actual deployment frequency of an IGS is difficult to estimate in advance. There is little

[14] We did not consider the impact which introducing an IGS would have on any contingent liabilities in the government budget.

statistical basis to predict the probability of failure or expected shortfalls.[15] The target size of the IGS fund is therefore better determined on the basis of desired capacity, in accordance with what is known as the deterministic approach.

Such a deterministic approach should involve all three functions of an IGS. An IGS that has enough funds to immediately absorb a significant shortfall of a major life insurer on an ex-ante basis would be unnecessarily costly. If such a situation should occur, the run-off instrument would also be available, which can reduce reliance on an IGS or at least spread it over the remaining terms of the insurer's policies. However, an IGS must have sufficient funds to enable the sale of a portfolio of a smaller failing insurer or compensate its policyholders in case of liquidation.

Besides raising ex-ante levies, there must be a solid statutory basis for ex-post levies, should the IGS fund itself face an unexpected shortfall. In addition, the IGS can cover temporary liquidity shortfalls with credit facilities taken out with private parties, similar to the DGS, which currently has a credit facility with a banking consortium worth €3 billion.

We will now turn to the distribution of the fund's accrual across the sector. An IGS requires a certain degree of solidarity, both between insurers and between policyholders. After all, insurers are required to foot the bill – or part thereof – should one among them fail. Likewise, if insurers pass on the cost of IGS levies, new policyholders will face higher premiums for the additional protection offered. By contrast, policyholders with policies already in force will not pay for their additional protection because their premium is fixed or is no longer due. While this solidarity will probably exist, it is not unlimited. Two elements could bolster solidarity.

Firstly, broad coverage of an IGS increases support for its funding. It is likely that insurers will try to pass on the levy to policyholders, depending on market conditions. The more policies the IGS covers, the more insurers and, possibly, policyholders can help foot the bill. For example, group pension insurance policies account for a large share of the market (see Figure 2) and are regularly renegotiated. This gives insurers the option of passing on the cost of building an IGS that covers these policies to their policyholders.[16]

Secondly, a risk-weighted levy, for example partly based on an insurer's solvency ratio, could improve incentives for insurers, and increase public support for an IGS. The DGS also features such a risk-weighted levy.

[15] The European Commission has attempted to use a statistical method to calculate the target size of IGSs in Europe, but acknowledges the limitations of such a model (Insurance guarantee schemes - Publications Office of the EU (europa.eu))
[16] KPMG's study suggests that in theory, if all life insurance policies were covered, around two-thirds of annual life insurance premiums collected would be eligible for increases to fund an IGS.

3. A feasible and affordable IGS

An IGS could be feasible and affordable in the Netherlands, depending on its design. Such an IGS could have the following design features:

(1) All three functions: contributing to the funding of a sale or open firm bail- entity, annual supplements to pay-outs during run-off and compensation in the event of liquidation
(2) Broad coverage: life insurance (including pension insurance), income protection insurance and funeral insurance, adopting a home approach
(3) A relative excess for policyholders, e.g. 5% of the policy value
(4) Both ex-ante and ex-post funding based on a risk-weighted sector levy

The IGS fund's target size can be determined according to its aspired capacity. For example, the aspiration might be for the IGS fund to have sufficient resources to contribute to the funding of sales of two medium-sized life insurers, or to supplement the pay-outs of one large life insurer during run-off, given a 10% curtailment of these insurers' insurance liabilities and a 5% policyholder excess.

In today's insurance market in the Netherlands, this would require a fund of around €500 million. This amount would be sufficient to cover the contribution to the sale of two medium-sized insurers in the curtailment scenario with the excess as discussed above. To supplement payments during run-off of a large life insurer with such a substantial curtailment, additional ex-post levies would need to be imposed from the 5th year onwards on average. Building up this fund over ten years would mean raising annual levies worth €50 million from the sector. If insurers were to pass on this levy in full to new policyholders and policyholders with regularly renegotiated contracts, this would push up premiums by a mere 1%. Although IGSs in Europe differ widely, such design and size of an IGS would not be fundamentally different from IGSs in Europe's largest countries (see Table 2).

Table 2: Design options for a Dutch IGS compared with the three largest IGSs in Europe

	Possible design, Netherlands	United Kingdom	Germany	France
Function	Sale/open firm bail-in, run-off, compensation	Sale, run-off, compensation	Sale, run-off	Sale, compensation
Scope	Life, funeral and income protection	Life and non-life	Life and income protection	Life
Home/Host	Home	Home and host	Home	Home
Level of guarantee	95%	100%	95%*	Absolute ceilings**
Ex-ante levy	0.015% of TV	0	0.02% of TV	0.017% of TV
Fund size	€ 500 million	0	€ 1,100 million	€ 835 million

*In case of sale another 5% may be cut.
**Pay-outs due at time of bankruptcy: no ceiling. Up to € 70,000 for future pay-outs and up to € 90,000 for disability, incapacity for work and term life insurance.

Source: EIOPA, Financial Services Compensation Scheme, Protektor AG, Fonds de garantie des assurances des personnes