TC Notes

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Policyholder Protection Plans

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Overview[1]

The fundamental objective of a policyholder protection plan (PPP) is to reduce the adverse effects on policyholders and third-party claimants of the inability of an insurer to fully meet its policy obligations. PPPs most commonly provide protection against the financial failure of an insurer, although they sometimes provide protection to third-party claimants if coverage mandated by law has nevertheless not been obtained.

This objective is closely aligned with a key objective of insurance regulation and supervision—protecting the interests of insurance consumers. However, the existence of a PPP alters the market environment, which can have both benefits and costs, and might increase some risks while reducing others.

This note explains why a PPP might be needed to protect insurance consumers. It discusses factors that might affect a decision to establish a policyholder protection plan from the perspectives of various stakeholders, along with steps that can be taken to deal with potential concerns. Significant issues related to the coverage, operations, and funding of a policyholder protection plan are identified, and the key elements of an action plan to establish a PPP are suggested.

The Need for a PPP

This section explains what a PPP is and why consumers might need the protection it can provide.

The Risks Are Real

PPPs reduce the adverse effects on policyholders and third-party claimants of the inability of an insurer to make payment, so it is worth considering whether consumers actually need such protection.

PPPs most commonly provide protection against the financial failure of an insurer, but perhaps the risk of failure is so low that a PPP is not needed. This argument lost considerable credibility during the 2008-09 global financial crisis. Many highly-rated financial institutions, even in jurisdictions with well-developed regulatory and supervisory systems, have shown that they are not immune to the risk of failure.

In any event, most jurisdictions do not include “prevention of all insurance company failures” as an objective of their supervisory regime. Companies that are inefficient or for other reasons uncompetitive in the marketplace should be allowed to fail. Otherwise, the financial system will be burdened by their operations and the cost of insurance coverage for consumers will be higher than it should be. Healthy markets will normally experience *some* failures.

Some PPPs provide protection to policyholders and other policy claimants in all cases where an insurer is unable to fully fund its outstanding claims. Other PPPs cover only third-party claimants if coverage mandated by law, such as motor vehicle third-party liability or workers’ compensation, has nevertheless not been obtained. The fact that coverage has been mandated means that lawmakers considered it essential that all those subject to the risk be protected. Unless mechanisms exist to ensure that everyone who is supposed to purchase the mandated coverage has actually done so, the possibility exists that coverage will not be in place and others will suffer the consequences.

The risks against which PPPs might provide protection are real—even if the likelihood that they are realized might be low.

[1] This note was prepared by Michael Hafeman on behalf of Toronto Centre.

The Financial Hardship Can Be Significant

The failure of an insurer can expose many consumers, both individuals and organizations, to the risk of significant financial loss. A failed insurer will probably be unable to fully meet its current financial obligations and will certainly be unable to meet its future obligations under existing insurance policies, some of which may be very long-term in nature.

These obligations are varied and include the following:

- Past claims that have not yet been paid
- Cash values under long-term life insurance and savings products
- Future periodic payments under annuities, accident and health insurance, and structured settlements
- Insurance coverage for the remainder of the period in respect of which premiums have already been received
- The commitment to provide insurance coverage in future periods under longer-term policies—including a guarantee of insurability and often a guaranteed price.

Accordingly, there are many ways in which consumers might suffer loss if an insurer fails. The magnitude of such losses can be very large, far exceeding the premiums paid and often exceeding the ability of the consumer to absorb the loss. This can be contrasted with the potential loss of a depositor if a bank fails, which can also be significant but is limited to the account balance.

Indeed, insurance is often purchased to protect consumers against risks they cannot afford to take because they are large in relation to savings and income. Such losses can cause significant financial hardship to individuals, their families, and businesses, which might even have wider effects on social welfare and business activity. Accordingly, it can be argued that consumers should be protected from significant financial loss if an insurer fails.

In most cases, even a failed insurer will have assets to meet at least a portion of its existing obligations. This would reduce the loss suffered by some of the consumers. But in addition to any shortfalls in the amounts of payments, consumers might have to wait a long time before receiving their payments. This is because it can take a long time to liquidate assets and to document all amounts owed to policyholders and other claimants.

The Ability to Deal with the Risks Is Limited

Consumers have limited ability to protect against the risk of failure. In a competitive market, it is reasonable to expect consumers to take some responsibility for selecting providers who are capable of satisfactorily delivering the desired goods and services. However, insurance consumers face several challenges in this regard.

It is difficult even for insurance supervisors to assess the financial strength of an insurer at a point in time, and most insurance consumers are much less capable of doing so before they purchase insurance. Consumers can be helped in this process, for example, by the disclosure of insurers' financial statements, risks, and risk management practices, the publication of risk-based solvency margins and ratios, and the advice of brokers—who can assist in the selection of both the coverage needed and the insurers who will provide it. Even with such information, however, the challenge is significant and consumers may have difficulty in distinguishing between strong and weak insurers when they purchase coverage.

In some cases, consumers are constrained in their choice of insurer. For example, motor vehicle third-party liability coverage might be provided by an insurer with a legislated monopoly position.

Alternatively, there might be very few insurers offering a particular coverage, or the consumer might be under strong pressure, perhaps implicit in nature (for example, as a condition of borrowing), to purchase coverage from a particular insurer.

One method of reducing risk might be to spread the coverage among multiple insurers, much as an individual might make deposits with several banks. However, for many types of insurance coverage, such as property insurance on a residence, this is impossible.

Some consumers who might be affected by the failure of an insurer play no role at all in the selection of the insurer. Examples include third-party claimants under liability coverage and individual employees covered under group insurance programs established by their employer. Similarly, there is little if anything a third party can do to protect against the failure of someone else to purchase mandated coverage from a reputable and financially-strong insurance company.

An insurer that was in good financial condition when a policy was purchased might later deteriorate for a variety of reasons, such as mismanagement or systemic disruptions. It can be difficult or even impossible for policyholders to respond by taking their business elsewhere. Some policies can be cancelled only with significant financial penalties, while other products, such as annuities in payment, cannot be cancelled at all. Policyholders under long-term life insurance policies might have developed health conditions that make them uninsurable or insurable only at a much higher cost—or might simply be too old to qualify for a new policy with another insurer.

Advantages of a PPP

This section explains the advantages to both consumers and other stakeholders of having a PPP.

Protects Consumers

The most concrete advantage of a PPP to consumers is that it limits the potential financial hardship they might otherwise have suffered when an insurer is unable to make payment. This is of direct benefit to the policyholders and claimants involved, and it indirectly helps those such as their dependents and creditors.

Insurance is a valuable tool that can be used by consumers to protect against the financial effects of a wide range of risks. However, some consumers might avoid purchasing insurance because of concerns about the financial strength of a particular insurer or insurers in general. The existence of a PPP, which would reduce their potential loss in the event of a failure, should provide some peace of mind and reduce their reluctance to purchase insurance. They would thus be better protected against insurable risks.

Considering the difficulties consumers have in protecting against the failure of an insurer, it might be viewed as unfair that the potentially significant costs of a failure fall entirely on those consumers directly affected by the failure. A PPP can spread the costs of a failure more widely among insurance consumers, not just those who are policyholders of the failed insurer.

Supports Government Objectives

The existence of a PPP can support a variety of government objectives. The consumer-protection benefits that have already been discussed contribute to overall social welfare. Increased use of insurance can also reduce the need for costly government social assistance and disaster relief programs. Higher insurance penetration is generally recognized as a contributor to economic growth and development.

Governments often seek to provide a level playing field in the financial sector. In many jurisdictions, depositors are protected against the failure of their bank. Providing similar protection to insurance consumers would not only be fair but also help to level the playing field on which life insurers compete with banks for savings business. It should also help to enhance the overall reputation of the government, which would be seen as supportive of a mechanism designed to help protect consumers.

A PPP would contribute to the strength and stability of the financial sector. The comfort provided by a PPP would reduce the risk of a "run" on a troubled insurer, thus providing more opportunity for intervention and improvement measures to take effect and improving the insurer's chances of recovery. It would also reduce the risk that the failure of one insurer would have contagion effects, such as the panicked withdrawal of funds from savings products, which could weaken other insurers, the financial sector, and the economy as a whole.

The existence of a PPP should also decrease the likelihood that government will be called on to rescue failing insurers or, after the fact, to cover the losses suffered by policyholders of failed insurers. Such ad hoc bailouts can be costly, disruptive, and contribute to moral hazard.

Reinforces Supervision

Insurance regulation and supervision and PPPs share a key objective—protecting the interests of insurance consumers. Effective regulation and supervision can certainly help to reduce the risk of failure and to reduce the costs of failures that do occur, which will reduce the cost of the protection provided by a PPP. But a PPP can also reinforce the efforts of the supervisory authority.

PPPs have a direct financial interest in maintaining a financially-strong industry and in minimizing the losses incurred if an insurer does fail. They often seek to achieve these objectives by analyzing the financial condition of insurers, requiring—or encouraging the supervisory authority to require—prompt corrective action, and contributing to the prompt and orderly resolution of failed insurers. Some PPPs assess costs against participating insurers in a risk-based manner, for example, based on the required risk-based solvency margin or the supervisory authority's risk rating. Such initiatives can enhance the effectiveness of insurance supervision.

As already mentioned, the comfort provided by a PPP would reduce the risk of a "run" on a troubled insurer and the risk of contagion effects that could weaken other insurers. This might provide more opportunity for intervention and improvement measures to take effect and improve an insurer's chances of recovery. It could also facilitate earlier and stronger supervisory intervention by reducing the temptation to exercise forbearance (on the basis that giving an insurer more time to recover might avoid the need for policyholders to suffer losses).

A PPP can also help by providing a wider range of resolution alternatives than simply liquidating a failed insurer. This not only reduces the costs that would be borne by other insurers and their policyholders but can also improve the recovery by those whose claims are not fully covered by the PPP and others, such as general creditors.

Helps the Insurance Sector

A PPP can help the insurance sector in several ways. It will lessen the concerns of consumers about their potential loss in the event of a failure of an insurer and better enable life insurers to compete with banks for savings business. Both industry support for a PPP and the minimization of hardship if an insurer does fail would serve to strengthen the reputation of the industry. All of these factors should make it easier to sell insurance. The overall market should expand and insurance penetration should grow, contributing to the incomes of both insurers and intermediaries.

The existence of a PPP might also support more competition within the industry. New and small insurers should be better able to compete against larger and longer-established insurers, because of the assurance provided by a PPP. Consumers might benefit through a wider choice of products, more attractive prices and product features, and better service. In turn, this should also contribute to the overall growth of the insurance sector.

Potential Stakeholder Concerns

This section identifies and explains various concerns that are often raised by stakeholders when the establishment of a PPP is being considered.

Creates Moral Hazard

The concern most commonly raised about having a PPP is that it would create moral hazard. By insulating persons from the consequences of the failure of an insurer they may behave differently than if fully exposed to the risk, and such behavior could adversely affect others. A PPP could create moral hazard for several types of stakeholders: consumers; intermediaries; insurers; and the supervisory authority.

A PPP might encourage irresponsible behavior by insurance consumers. In a free market, consumers should exercise good judgment and select providers of goods and services who are likely to meet their obligations. The protection provided by a PPP would lessen the magnitude of the loss that an insurance consumer might suffer if the insurer selected ultimately fails. This might, for example, result in a consumer deciding to purchase an underpriced product from a weak insurer rather than a fairly-priced product from a strong insurer, when the latter decision might have been made in the absence of a PPP. (Of course, the behavior can only be considered irresponsible if consumers are actually able to differentiate between strong and weak insurers. As argued above, most consumers may be unable to do so.)

Similarly, the existence of a PPP might cause intermediaries to exercise less diligence when selecting the insurer (or insurers) they are willing to represent and the products they propose to consumers. Also, either because of a lack of knowledge or eagerness to make a sale, they might promote unrealistic expectations among consumers by overstating the protection provided by the PPP.

The existence of a PPP might also encourage some insurers to take excessive business risks, because the potential adverse effects on their policyholders of risks gone wrong would be limited. Their risk appetite should in theory not be affected by the existence of a PPP because a PPP is of no direct benefit to shareholders, general creditors, and employees of a failed insurer—it only provides a degree of protection to insurance consumers. In any event, the experience of the 2008-2009 financial crisis has called into question the extent to which managers may be inclined to limit their risk-taking to protect the interests of these stakeholders.

A comment sometimes advanced by those who are not familiar with the way PPPs operate is that a PPP will merely serve to "bail out" poorly-run insurers and benefit their shareholders. However, PPPs only provide compensation to policyholders, never to shareholders or managers of insurance companies.

A PPP might lead to weaker insurance supervision. The premise underlying this statement is that a supervisory authority would be less concerned about the failure of an insurer because a PPP would limit the losses of policyholders, and hence might supervise less diligently. (In practice, the opposite seems to be the case. As noted in the previous section, the comfort provided by the PPP—along with the insistence of the PPP on minimizing potential costs—can encourage the supervisory authority to intervene more aggressively in dealing with problem insurers, rather than being tempted to exercise forbearance in the hope that they will recover.)

Disproportionately Benefits Weak Insurers

As noted above, a PPP can contribute to the overall growth of the insurance sector. However, the consumer behavior described above could disproportionately benefit weak insurers, helping them to gain market share at the expense of stronger insurers. Weak insurers with aggressive managers—particularly if their compensation is tied to growth rather than profitability—might actively exploit this opportunity by marketing products that are attractive to consumers or intermediaries, but risky from the standpoint of profitability.

In addition to losing market share, responsible insurers might also have been forced to reduce their profit margins to compete with such insurers. Although lower profit margins might have benefited policyholders, they might also have made the insurer financially weaker than it would otherwise have been or reduced the returns realized by its shareholders. If responsible insurers exit segments of the market because of unfair competition, the resulting reduction in choice and competition might ultimately prove detrimental to consumers.

Imposes Unfair Costs

A PPP could be considered to impose unfair costs on responsible consumers and insurers. When a PPP helps to cover the obligations of a failed insurer, it is often impossible for the PPP to recover all of the funds it has advanced from the assets of the failed insurer. The net cost must be borne by insurers and policyholders more broadly, including insurers that have been operating prudently and policyholders who took care to do business with such insurers (perhaps, at higher premium rates than those they could have obtained from the failed insurer).

It might not be possible to charge the net cost in a manner that is fully equitable in relation to the protection received. For example, some policies might be fully paid-up at the time the cost arises and the premiums of others might be fixed, so that the cost could not be recovered by increasing premiums. Likewise, if costs are being funded entirely by post-failure assessments, the policyholders of the failed insurer would not bear any of these costs. Other policyholders, or shareholders, would need to be charged more to cover the costs related to such policies.

Some consumers might not need the protection of a PPP. Wealthy individuals and large businesses might be better able both to assess the risk of failure and to withstand its financial consequences than other insurance consumers. They might be willing to forgo the protection of a PPP, particularly if this means that they will not share in the cost of failures. Also, covering large policies to the same extent as smaller policies might significantly increase the cost of a PPP.

Might Generate Unaffordable Costs

The costs of providing protection might be unaffordable and seriously weaken otherwise-healthy insurers. The failure of a large insurer or of several smaller insurers in close succession might impose such significant costs on the remaining insurers that their own solvency is threatened. This concern is particularly acute if the industry is fairly concentrated, with one or more large insurers having significant shares of the market. It can also present a significant barrier to the establishment of a PPP, for example, if some insurers are already considered by others in the industry to be very weak. Government might also be concerned that, should costs become unaffordable, it would face pressure to provide financial support.

All PPPs will incur expenses, including both ongoing operational costs and the additional costs related to dealing with the failure of an insurer. If the insurance sector is very small, even reasonable operational expenses might be considered unaffordable.

Some PPPs, especially those that use a pre-funding approach, can accumulate significant assets. These assets can be invested by the PPP and the income used to help defray its expenses. However, if the PPP did not exist, those assets would be at the disposal of insurers—to support growth of their business, distribute as dividends to shareholders, or enhance the attractiveness of products. Insurers might, therefore, consider the lost opportunity to use these assets as an additional cost.

This existence of a large pool of investments can also create moral hazard for those managing the PPP. They might spend more on operational expenses or select a more costly approach to resolving the failure of an insurer than they would in the absence of such a fund. Either of these outcomes would add to the overall cost of the PPP.

Dealing with Concerns

This section discusses steps that can be taken to help deal with these concerns. Some steps relate to the PPP itself—decisions about its coverage, operations, and funding. Sections below cover each of these three areas more extensively. Other steps involve communication and supervisory action.

Design Coverage Carefully

The most important step that can be taken to deal with concerns about moral hazard among consumers is to build risk sharing into the design of the PPP coverage—so that consumers are less-than-fully protected from the risk of failure. Risk-sharing mechanisms could include deductibles, co-payments, and maximum benefit limits. The coverage provided by the PPP might also be reduced in respect of uneconomic products, such as those that promise to credit interest at rates unsupportable in the investment market.

To deal with concerns about the PPP providing coverage to those who do not need it, certain classes of insurance could be excluded from coverage (such as aviation or nuclear liability), coverage limits could be established that would be sufficient to cover most policies but would not fully cover the largest policies, or a means test could be applied to the coverage (dealing more generously with those policyholders having lower income or assets).

Concerns about potentially high costs and moral hazard among insurers might be dealt with by excluding some high-risk classes of business (such as surety or credit protection) from coverage.

Communicate Risks and Limitations

Simply building risk-sharing into the coverage provided by a PPP will do little to reduce moral hazard among consumers unless they are informed of the limitations before making decisions. A variety of communication techniques can be used to provide this information. They might include information provided on the website of the PPP, advertising campaigns, and brochures.

A proactive approach might require intermediaries to explain the coverage and its limitations before concluding a sale, give the consumer a brochure that contains this information, and obtain the signature of the consumer acknowledging its receipt. Such an approach would also help to deal with concerns about consumers holding unreasonable expectations about the coverage—and intermediaries encouraging such expectations.

Communication can also help consumers and intermediaries to assess the financial strength of insurers, so that they might avoid those at higher risk of failure. Insurers might be required to make their financial statements available to the public, and financially-strong insurers should not be prohibited from advertising their strength. The supervisory authority might contribute to the communication effort by publishing comparative financial information in its annual report or on its website. This information might even include capital adequacy and solvency ratios and an explanation of how they have been calculated and can be interpreted.

Establish Effective Governance

The establishment of effective governance structures and practices for a PPP can help to deal with concerns about potentially high operational costs. The role of the PPP should be clearly defined, and it should be directed by a board that is independent of senior management.

The insurance industry, which has a keen interest in controlling the costs of the PPP, should participate in its governance. Industry involvement can also help to ensure that effective and efficient approaches are employed to deal with failed insurers.

Use Funding Incentives and Limitations

The funding of a PPP can be multifaceted, and incorporate incentives and limitations to deal with a variety of concerns. To deal with concerns about the potential effects of a PPP on the behavior of insurers, the rates at which costs are assessed might vary in accordance with risk (for example, in proportion to the capital required of insurers under a risk-based capital adequacy regime).

The use of at least some *pre-funding* of the expected cost of coverage can help to deal with concerns about the unfair distribution of costs, by ensuring that policyholders of a failed insurer will have contributed toward the cost. It can also help to smooth costs over time, reducing the abrupt increase in costs that might otherwise occur when an insurer fails. As well, an element of pre-funding will help to ensure that the PPP has funds available to begin paying time-critical claims (such as medical and disability) immediately rather than having to delay while funds are made available to the PPP.

At the same time, limiting the extent of pre-funding can reduce concerns about the opportunity cost of having assets tied up in a PPP, rather than being at the disposal of insurers. It can also help to discourage excessive spending on administration and inefficient approaches to resolution. With a small fund there is also less potential loss because of fraud or mismanagement of the assets.

Under a *post-funding* approach, assessments for the funding of the PPP are made after an insolvency has occurred, when actual funding requirements are known. This avoids incurring costs in anticipation of potential failures. The annual post-assessment rate can be capped (carrying over any excess costs to future years), which can help to deal with concerns about the costs being unaffordable. (Unfortunately, post-funding also tends to increase the amount of time required to begin making payments to claimants, which can give rise to consumer dissatisfaction.)

Government support might also be used as a means to limit the exposure of industry to potentially high costs because of the failure of a large insurer or of several insurers in close succession. However, to avoid the moral hazard risk that could accompany such support, it should probably be temporary in nature and subject to clearly-defined conditions.

Regulate and Supervise Effectively

Effective regulation and supervision can help to reduce both the risk of failure and the costs of failures that do occur. Conversely, with weak regulation and supervision, the costs of failures might be so high as to make a PPP unaffordable. Thus the existence of adequate regulation and supervision is a precondition for the operation of a viable PPP.

In practical terms, this includes dealing with the weakest insurers before establishing a PPP. Supervisory intervention to return them to strength, merge them with stronger insurers, or wind them up will remove a significant barrier to the establishment of a PPP.

On an ongoing basis, strong supervisory oversight can reduce concerns that moral hazard might cause insurers to take on excessive risk. Such oversight could include attention to the governance and risk management practices of insurers and assessment of the viability of their products. Steps should be taken to deal promptly with emerging problems.

A strong legal framework can also help to deal with concerns about the potential costs of a PPP. The framework should include a range of supervisory intervention powers, alternative methods for resolving a failed insurer, and clear insolvency provisions that are suitable to the nature of the insurance business.

It is clear from practical experience with PPPs that when supervisory intervention is timely, the actual compensation payments from a PPP can be reduced to very low levels. In fact, the actual out-of-pocket cost may be only a few percent of the failed insurer's assets. For example, if the supervisor stops an insurer from doing business when it has assets sufficient to pay off 95 percent of its liabilities, and it takes five years to liquidate all of the insurer's assets, then the PPP will ultimately be reimbursed for most of its payments to policyholders and its real cost will effectively be only the time value of money plus the portion that cannot be recovered from the insurer (the portion might be more than 5 percent because of the expenses of liquidation or less than 5 percent if assets appreciate in value during the liquidation process).

Coverage

From the point of view of consumers, the most important aspect of a PPP is the coverage that it provides. This section discusses various aspects of coverage, including its scope, the nature of the benefits provided, and limitations that might be applied. It is essential that all aspects of coverage be carefully considered, clearly defined, and appropriately communicated.

Scope

A significant aspect of the scope of coverage of a PPP is the classes of business for which protection will be provided. Usually, a PPP will cover either life insurance business or nonlife insurance business, but not both; in other words, there are usually separate PPPs for life and nonlife business. In part, this is because in most jurisdictions these businesses are conducted by different insurers. However, the separation also reflects differences in the nature of the obligations and how the obligations of a failed insurer might best be dealt with.

Typically, most of the obligations of a nonlife insurer are short-term in nature, while many of the obligations of a life insurer are long-term in nature. If a nonlife insurer fails, consumers might be adequately protected if outstanding claims are settled, existing policies are continued long enough to enable policyholders to seek replacement coverage, and premiums that have not yet been earned by the termination date are refunded. Such an approach would inadequately protect policyholders and beneficiaries under long-term life insurance and annuity policies, who are at risk of losing cash values or future periodic benefit payments, and who might no longer qualify for replacement coverage. Therefore, in addition to settling outstanding claims, a PPP will seek to transfer policies to another insurer so that they can remain in force as originally intended.

However, even within life insurance or nonlife insurance a PPP might not cover all classes of business. Some classes of business might be excluded because the policyholders are typically large organizations that are better able to assess the riskiness of an insurer and to bear the financial consequences of a failure. Others might be excluded because they are considered particularly risky and sharing the cost of a failure to which they might contribute would be unfair.

It can be argued that coverage by a PPP is particularly appropriate for products whose purchase is mandatory. In such cases, the government has given its explicit endorsement of the need for the coverage and consumers are not allowed to self-insure the risks. They are forced to select an insurer, even if they do not trust any of those offering the mandatory coverage.

One class of business that often requires special consideration is accident and sickness insurance. In many jurisdictions, both life insurers and nonlife insurers are permitted to write this class of business. Care must be taken that the same policies are not covered by two PPPs or, conversely, unintentionally excluded from coverage.

Generally speaking, all insurers that write a class of business covered by a PPP are required to participate in it. Such a requirement is needed to avoid adverse selection by insurers, whereby weak insurers might decide to participate in order to help attract business while strong insurers might decide not to participate in order to avoid sharing in the cost of failures.

However, exceptions to the participation requirement are sometimes made. Reinsurers are excluded because the insurers who are their customers are considered to be capable of assessing the risk of failure. Government-owned insurers might be excluded because of an explicit or implicit guarantee by the government that they would not be allowed to fail. Fraternal or cooperative insurers might be excluded on the basis that they are managed by their members, who will presumably look out for each other's interests—even in the event of failure. The validity of the assumptions underlying such exceptions should be carefully considered in relation to the circumstances in your jurisdiction. The possible effects on competitive equity within the marketplace should also be considered.

Sometimes it is proposed that coverage should be extended only to individual consumers, not to businesses. The thinking here is that businesses would have greater financial resources than most individual consumers and would also likely have obtained professional advice in selecting their insurance services. However, in most countries there are large numbers of small enterprises, whose financial resources and ability to access professional insurance advisors would not be much different than for individuals. Thus, a blanket exclusion for businesses would probably not be an equitable approach. Other types of limitations on the scope of coverage mentioned above will generally have the effect of ensuring that most PPP benefits go to claimants that are not large corporations (which *would* have professional insurance advisors), thus better meeting the overall objectives of the PPP.

Another aspect of the scope of coverage is its geographic reach. Although many insurers operate in more than one jurisdiction, PPPs often limit their coverage to consumers in a particular jurisdiction. However, even if the focus of a PPP is on a single jurisdiction, defining the scope of coverage is not as simple as it might seem. The following are just a few examples of the situations that need to be dealt with by the coverage rules:

- A person bought a life insurance policy while living in the jurisdiction, but has since moved abroad

- A local resident has incurred a claim under an accident and sickness policy while travelling abroad
- A resident of a foreign country has insured a property located in the jurisdiction with a local insurer
- A local business has purchased coverage on all of its properties, including those located outside the jurisdiction, under a single policy issued by a local insurer
- The local branch of a foreign company is insured under a policy purchased by its parent, which covers all of its properties worldwide.

Nature of Benefits

As discussed in the first section, there are many ways that the inability of an insurer to make payment can create financial hardship for consumers. Accordingly, there are various types of benefits that a PPP might provide to protect consumers.

One type of benefit common to all PPPs (including those that protect third parties against someone's failure to purchase mandated coverage) is the payment of all or a portion (depending on the plan details), of lump-sum claims that have already been incurred, for example, undisputed property damage and other nonlife claims, as well as death claims under life insurance policies.

A similar type of benefit relates to payment of the remaining obligation for claims or benefits that are being settled through periodic payments. Examples of this type of obligation include retirement annuities, monthly benefits under disability insurance policies, and structured settlements under liability insurance policies. In such cases, a PPP might make a lump sum payment to settle the obligation or seek to transfer the obligation to continue the periodic payments to another insurer (along with assets that would enable it to do so).

Life insurance, annuity, and other savings products often involve the accumulation of values over a period of years. Sometimes these values arise as a byproduct of charging level premiums for a risk that increases with age. In other products, the amounts are being accumulated in order to make lump-sum or periodic payments in the future. Under the terms of some products the policyholder has the right to borrow against the policy value or to surrender the policy for a cash payment. However, with some other products the policyholder is not entitled under the contract to early access to the accumulated value. For policies with cash surrender values, a PPP might pay such values to policyholders who elect to surrender their policies. Alternatively, and for policies that do not provide for cash surrender, transfer of the policies to another insurer would be sought.

A related issue, which can affect all types of products, is the treatment of premiums that have been paid for coverage periods extending beyond the date of failure. If policies are being transferred to another insurer, the corresponding unearned premiums would also be transferred. However, if the policies are being terminated, the PPP might refund to policyholders all or a part of the premiums that are unearned at the date of termination.

In the case of life insurance or accident and sickness insurance, policyholders might suffer by having to replace policies at higher premiums because of advanced age, or being unable to purchase replacement coverage at any price because they no longer qualify. Such hardship can only be avoided if the PPP is able to transfer the policies to another insurer.

Reference has been made above to the transfer of policies to another insurer. Sometimes, however, no other insurer may be willing to accept the transfer. To deal with such situations, some PPPs have created insurers, of which they are the sole owner, whose purpose is to accept transfers of such policies and administer them on an ongoing basis. In other cases, particularly if the obligations are relatively short-term in nature, they might be left with the failed insurer and settled on a run-off basis during the winding-up process.

Limitations on Benefits

Even with respect to covered classes of business, a PPP might not fully protect all consumers from loss. Limitations are often imposed, both to deal with moral hazard and to target the benefits of a PPP toward those who might otherwise suffer the greatest financial hardship.

The most common type of limitation is the establishment of maximum amounts of benefits covered by the PPP in respect of each consumer. The maximums often differ to reflect differences in the nature of benefits. For example, in the case of life insurance business, different maximums might be established for death benefits, cash surrender values, monthly annuity or disability payments, accident and sickness benefits, and unearned premiums. The establishment of maximums is a matter of judgment, but factors that might be considered include the following:

- The maximum could fully cover the obligations to most but not all policyholders (for example, 90 percent of them)
- The maximum covered by deposit insurance could be a benchmark for the maximum coverage of cash surrender values
- The maximum amount payable for third-party motor vehicle liability coverage might be equal to the minimum compulsory coverage required by the government
- The discounted present value of the maximum periodic payments covered could be consistent with the maximum lump-sum benefit payments covered.

Other types of limitations might also be applied, perhaps in combination with one another. Some examples, along with their effects, include the following:

- Deductibles ensure that each consumer suffers some loss, so that none are fully protected against risk; this can reduce moral hazard, but might be considered unduly harsh to small policyholders
- Co-payments, where policyholders are entitled to a percentage of their claim amounts, also ensure that each consumer suffers some loss, but the loss is proportional to the amount of the claim and thus less punitive to small policyholders
- For policies that are transferred to another insurer, the benefits might be reduced if there are insufficient assets available to support the liabilities or if the products were sold on an uneconomic basis (in such a case, there should be some independent third-party review, such as by the liquidator, the court, or the supervisor, to ensure that the transferred policies are not being unfairly discounted); this can reduce moral hazard in the selection of products
- For nonlife insurance products, the unearned premium amount might not be covered by the PPP; this acts as a type of deductible, with small policies being the least affected, but can create potential inequities because those who have just paid their premiums are most exposed to loss
- Benefits might be reduced or eliminated for claimants who have high income or net worth; this can help to target benefits toward those with greatest need, but might be considered unfair to policyholders who had to pay higher premiums to cover the cost of the PPP but received less protection against loss; it can also be difficult to administer such a limitation.

When designing limitations on benefits, it is necessary to consider the fact that some policyholders might be covered under more than one policy with the same insurer—and some of these policies might be in different classes of insurance. For example, a person might be covered under group life and health insurance policies purchased by his employer, have a joint (with his spouse) individual life insurance policy, and be accumulating retirement savings under a deferred annuity. In dealing with this and other issues related to limitations, judgment will be required to achieve an acceptable balance between fairness and complexity.

The following information relates to Assuris, the life insurance PPP in Canada, and provides an example of how benefit limitations have been designed and interrelate.[2]

Transfer of Policies to a Solvent Company

Rather than cancelling the policy and paying cash compensation, Assuris protects policyholders by facilitating the transfer of the policy to a solvent company and ensures the continuity of covered benefits under the original terms of the policy. This avoids any interruption in the provision of benefits and guarantees that policyholders, who may find it difficult to obtain a new policy due to changed circumstances, retain their benefits.

Policyholder Protection

When policies are transferred to a solvent company, Assuris guarantees that policyholders will retain at least 85% of their promised benefits under a variety of products issued by life insurance companies in Canada. However, Assuris also provides 100% protection when benefits are below certain dollar values:

- Death Benefits of $200,000
- Monthly Income of $2,000
- Health Expense of $60,000
- Cash Values of $60,000

Accumulated Values

For deposit type products, Assuris guarantees that policyholders will retain 100% of the Accumulated Value up to $100,000. This applies to the values of:

- Accumulation annuities
- Universal life overflow accounts
- Dividend deposit accounts

The 85% protection does not apply to accumulated values.

Assuris provides separate protection for individual, group, registered and non-registered benefits. Assuris also provides separate protection for individual Tax Free Savings Accounts and group Tax Free Savings Accounts invested in accumulation annuities.

Operations

This section discusses various issues related to the operations of PPPs, such as their possible roles, legal form, governance, and the powers needed to carry out their responsibilities.

[2] The information has been extracted from a brochure for consumers, which is available on the website of Assuris at www.assuris.ca.

Roles

A fundamental choice that will affect the operation of a PPP is the roles that it will play. The objective of any PPP is to protect consumers against losses that they might suffer if an insurer fails (or if mandatory coverage has not been purchased by a third party). However, the roles that a PPP might play in seeking to meet this objective can vary considerably.

All PPPs make payments to consumers to help cover deficiencies in the amounts payable by insurers, and many arrange transfers of the business of failed insurers to healthy insurers. This role consists of providing protection after the fact, once an insurer has already failed.

However, waiting for an insurer to fail and then picking up the pieces might not be the most efficient and least costly way to deal with a troubled insurer. For example, a portfolio of insurance business will often have more value to another insurer if it is transferred before the problems of the insurer are widely known—and policyholders and intermediaries begin moving business elsewhere. Accordingly, some PPPs are able to offer temporary financial support to troubled insurers, if this seems likely to result in a less-costly resolution. This would provide more time, during which the PPP could work with the insurer to arrange the sale and transfer of all or parts of its business to other insurers.

Some PPPs take an even more proactive approach. In order to reduce the risk of failures and their potential cost, they monitor the financial condition of insurers and work with the supervisory authority to seek corrective action.

To carry out any of these roles—and particularly the latter—a PPP needs some of the same information about insurers as does the supervisory authority. The potential for duplication of effort (and cost) and conflict between the PPP and the supervisory authority also exists. Accordingly, it is essential that the respective roles of both parties be clearly defined and understood by one another—and the industry. Normally it should be clear that the supervisory agency remains as the unambiguous oversight authority, but possibly with input and advice from the PPP. An active two-way exchange of information, subject to confidentiality requirements, can be very useful.

Legal Form

Not all PPPs take the same legal form. Some are government agencies while others are non-governmental entities created by the insurance industry. Factors that might affect the choice of legal form are discussed below.

A PPP that takes the form of a government agency will probably be established and governed by a law enacted specifically for that purpose. The law and subsidiary regulations will cover key issues related to the governance, funding, operation, and coverage of the PPP.

Establishing a PPP as a government agency might be particularly appropriate if the insurance industry is small, weak, or unable to organize the creation of a PPP itself. For the sake of efficiency, it might even be operated in conjunction with the supervisory authority or the deposit insurer. If the PPP will need financial support from the government, the government might be unwilling to provide such support to a non-governmental entity.

However, even if the PPP is to be funded entirely through industry assessments, its status as a government agency might well imply that government would support it if necessary. Government might not want to take on such a commitment, even if it is only by implication. Also, in some jurisdictions, industry and the general public might not trust a government agency to prudently operate a PPP—particularly if large sums of money will be accumulated through a pre-funding approach. Finally, drafting and obtaining approval of the necessary legislation might be difficult and subject to considerable delay.

A PPP established by the insurance industry will probably take the form of a not-for-profit corporation (or something similar, depending on local requirements). The law would need to include some basic provisions to facilitate its operation, such as the following:

- A requirement that insurers participate in a designated PPP
- A requirement that a PPP be able to levy assessments on insurers
- Authorization for the supervisory authority to share information with a PPP
- Authorization for a liquidator to enter into an agreement with a PPP to facilitate the payment of claims and the preservation of the assets of a failed insurer
- A provision that repayment to the PPP of the amounts advanced would have a high priority claim against the assets of the failed insurer.

Key issues related to the ownership, governance, funding, operation, and coverage of the PPP would be set out in documents such as its corporate charter, bylaws, and memorandum of operation, rather than in the legislation. Legal documents would also be needed to set out the agreements between the PPP and the government, for example, to specify that an insurer will not be licensed unless it participates in the PPP, and between the PPP and insurers, evidencing their participation and committing them to abide by its rules.

Establishing a PPP as a non-governmental entity might be particularly appropriate if the insurance industry is strong overall and well-organized. Having industry take the lead in the creation and governance of a PPP could increase the confidence of participants that it is being structured and operated prudently and efficiently.

Governance

As an entity with responsibilities for the financial well-being of consumers, a PPP should have a sound governance structure and strong practices. This includes a board comprised predominately of individuals who are not involved in the day-to-day management of the PPP. In the case of a PPP that is a government agency, it is likely that some of the directors will be designated by their position, for example, deputy minister of finance, head of the supervisory authority, and head of the deposit insurer.

The directors should be knowledgeable about the industry and financial matters. At least some of them should have experience working in the industry at a senior level. Some PPPs include directors who are currently working in the industry, while others require that directors be retired from executive positions in the industry. An advantage of the former approach is that it ensures up-to-date input on the problems faced by the industry and might help in the identification of alternatives for dealing with a failed insurer. However, it might also create conflicts of interest for the directors and make the supervisory authority unwilling to share confidential information about insurers with the PPP. One way to deal with these objectives and concerns would be to prohibit current industry executives from serving as directors, but to establish a separate industry advisory committee that could provide input to both the board and senior management of the PPP (without having access to confidential information).

Some decisions, such as the selection of directors and changes to the bylaws, might require the approval of the insurers that participate in the PPP. Such decisions might be taken at an annual membership meeting, at special meetings, or through written ballot. The voting rights of the member insurers might be proportional to their share of the costs of the PPP.

The role of the supervisory authority in the governance of the PPP should be clearly defined. For example, the supervisory authority might have the right to participate in meetings of the board and the members, and be required to give prior approval to proposed changes to the corporate charter or bylaws.

An individual should be appointed to lead the day-to-day operations of the PPP. The management team and staff should be sufficient in number and capabilities to enable the PPP to perform its intended roles. A PPP that intends to carry out monitoring and preventive financing will need more resources than a PPP that simply intends to settle claims after an insurer has failed. However, unless failures are a regular occurrence in a jurisdiction, it is unlikely to be cost-effective for a PPP to maintain sufficient staff to deal with failures that have yet to occur. Instead, temporary staff or consulting assistance might be retained to supplement permanent staff as the need arises.

Required Powers

A PPP will need various powers to operate effectively. These powers might be specified either in legislation or in the bylaws of the PPP.

One such power is the right to obtain information from insurers. At a minimum, a PPP must have the information needed to calculate its coverage exposure in respect of each insurer and each insurer's share of the costs of the PPP. If a PPP will be performing risk assessments of the insurers, it will need access to more extensive information, for example, copies of the financial statements and returns submitted to the supervisory authority.

A PPP must also have the power to raise funds to meet both operational expenses and the costs of coverage. Funding needs and sources will be discussed in the next section. Regardless of the funding approach, the obligation of an insurer to make required contributions must be legally enforceable.

In order for a PPP to be able to provide financial support, either to avoid the failure of an insurer or facilitate a more effective resolution, it must have the power to do so. For example, the bylaws might impose conditions that must be met before the board can approve such support and authorize the necessary funding.

A PPP must have the power to deal with the liquidator handling the winding-up of an insurer. It must also have the legal right to repayment, as a high priority claim against the assets of the failed insurer, of the amounts advanced to consumers. The fact that in law the PPP will become a preferred creditor of the failed institution, being repaid over time for the amounts paid out to policyholders as the estate of the insurer is liquidated, is an important feature of most PPPs.

Finally, a PPP needs operational powers such as the ability to obtain independent expert advice, for example, legal, actuarial, and corporate finance, and to retain temporary staff to handle consumer inquiries and other work arising from the failure of an insurer.

Dealing with a Failure

A PPP will need to work with and through other parties to deal with an insurer that is at risk of failing or has already failed. A PPP might encourage the supervisory authority to require an insurer to make operational changes to strengthen its financial condition. Such changes might include altering its business strategy, reducing costs, increasing premium rates, and outsourcing certain functions.

If the condition of an insurer is more serious, more drastic measures might be sought. They could include reducing liabilities through reinsurance or the sale of blocks of business, and improving the asset position by selling subsidiaries, problem assets, or assets on which gains can be realized. Capital might be strengthened by issuing new shares, converting debt into share capital, or taking on new subordinated debt. The PPP itself might play a role in providing financial support or helping to facilitate other measures. It might need independent expert assistance to evaluate alternatives and structure the financial support arrangements.

If the failure of an insurer is imminent, it will often be necessary to take many steps within a short period of time. For example, the supervisory authority might take control of the insurer and apply to a court for a winding-up order and the appointment of a liquidator. Liquidators are willing to work with PPPs in exchange for their financial support in respect of covered benefits. Without this support a liquidator would need to reduce or stop payments to policyholders in order to determine how much the assets of the insurer would enable it to pay. This interruption in payments would damage the business and impair the recovery for policyholders and other creditors.

The PPP might cooperate with the supervisory authority to identify an appropriate liquidator that could be proposed to the court. Contractual arrangements between the PPP and the proposed liquidator might be executed prior to applying to the court for a winding-up order.

Procedures should be in place for operating the business during the periods in which the supervisory authority has control of the insurer and immediately after the winding-up order has been issued. The PPP, the supervisory authority, and the proposed liquidator might collaborate to ensure that the procedures are adequate and clearly understood. The PPP should also have a communication plan to inform consumers about the coverage and respond to questions that they might have once the failure of the insurer has been announced.

In light of the time pressures inherent in dealing with a failure, a PPP should have comprehensive plans for doing so. The plans might describe the main steps involved, identify key legal requirements, discuss staffing needs, identify potential advisors and liquidators, contain draft agreements between the PPP and a liquidator, describe the procedures for dealing with claims, detail communication activities, and discuss funding alternatives.

Funding

The previous sections have discussed various purposes for which a PPP might need funds. This section examines those needs more closely, identifies possible sources of funds, and considers the issue of timing.

Needs

A PPP will need funds to cover its operational expenses. Some operational expenses are routine and ongoing, and will be incurred regardless of whether or not any insurer has failed. These expenses include maintaining an office and paying permanent staff to perform tasks such as monitoring insurers, responding to consumer inquiries, and communicating with the supervisory authority. Routine operational expenses should be fairly predictable.

Additional, non-routine operational expenses might be incurred in respect of a troubled insurer. For example, an actuary might be retained to help assess its financial condition, and a lawyer and an investment banker might be retained to help structure a financial support package. If an insurer actually fails, expenses will be incurred in dealing with the liquidator and communicating with consumers. These types of expenses might be difficult to predict, particularly if the industry is small or significant problems are infrequent. However, if they do occur, such expenses might be large in relation to the routine operational expenses.

If a PPP decides to provide financial support to a troubled insurer, it will need funds to enable it to do so. Such needs might be very large, and are likely to be unpredictable and urgent in nature. However, if the financial support proves successful, the funds should eventually be recoverable from the insurer. If unsuccessful, the funds might be either lost or partially recovered when the insurer is liquidated.

If an insurer fails, the PPP will need funds with which to pay covered claims. As the liquidation progresses, the funds advanced by the PPP will be recoverable—at least in part and perhaps in full if supervisory intervention has been on a timely basis —from the assets of the insurer.

Some PPPs have established an insurer into which undesirable blocks of business of failed insurers can be transferred and subsequently run off. If so, funds will be needed for the initial capital of the insurer and to support the business it is administering. The ownership interest in this insurer is likely to be a permanent investment of the PPP, although dividends might be received if the run-off business generates profits.

Sources

Various sources of funds are potentially available to PPPs, and some of these sources are more suitable to some needs than to others. Accordingly, it is not unusual for a PPP to rely on a combination of several sources of funds.

In some jurisdictions, premium tax is a source of funds for the PPP. Premium tax has the advantages of being easy to calculate and collect, and fairly predictable in amount. The rates of premium tax might differ by class of business to reflect differences in their riskiness, but no differentiation is possible with respect to the riskiness of the various insurers. It is difficult to adjust premium tax rates to accommodate changing needs.

Many PPPs rely heavily on the assessment of costs against participating insurers as a source of funds. The basis of assessment can be simple or complex. For example, the routine operating expenses of the PPP might be shared equally among all insurers. Assessments might also be based on the size of the insurer, perhaps as a percentage of premiums, assets, or liabilities.

To help control moral hazard and distribute costs more fairly, some PPPs vary the level of assessment to take account of the level of risk. There are various ways that this might be done, including the following:

- Vary premium-based assessment rates by class of business;
- Assess in proportion to the required capital of each insurer (for covered classes of business) under a risk-based capital adequacy regime; and
- Assess at higher rates for insurers that are rated as more risky by the supervisory authority or on the basis of a risk-rating formula.

The advantage of an assessment approach is that assessment rates can usually be adjusted annually to meet changing needs. Assessment rates might be capped, with excess expenses being carried over to future years and assessed then.

As mentioned above, although some needs might be both large and urgent, they might also be temporary in nature. It takes time to raise funds through either premium taxes or assessments, so other sources of funds are needed. PPPs often maintain a pool of liquid assets sufficient to cover reasonable fluctuations in their needs, for example, the need to retain experts to help deal with a troubled insurer. They might also maintain a short-term line of credit with a bank that could be drawn upon to meet urgent needs, although the experience in some jurisdictions has been that such lines of credit cannot necessarily be drawn down as quickly as expected.

A PPP might also need larger sums of money, for example, to provide financial support to an insurer or settle claims of a failed insurer. Sometimes, it might only be possible to recover these funds over a period of years. There are various ways a PPP might meet such needs, including:

- Borrowing from a commercial bank;
- Borrowing from one or more participating insurers;
- Issuing debt securities, either privately or in the market; and
- Borrowing from government.

Timing

The coverage provided by a PPP could be viewed as an insurance policy against the risk that insurers might fail. In some jurisdictions, the anticipated needs of a PPP are pre-funded through premium taxes or assessments, much like the premiums of an insurance policy.

Pre-funding can spread costs evenly over time. It helps to ensure that all policyholders contribute toward the cost of protection and enables insurers to budget for the expense and reflect it in their pricing. The pool of assets that accumulates provides liquidity to meet unanticipated operational expenses and can generate investment income to help cover the expenses.

However, pre-funding also has potential disadvantages. Perhaps the most significant is that the amount of the fund could prove insufficient to meet the needs of the PPP. It is difficult to predict the magnitude and timing of funding needs. For example, it might have been many years since the most recent failure of an insurer, when several fail in close succession. An insurer might fail soon after the PPP is established, before the fund has had an opportunity to grow.

The fund also ties up assets that insurers might better use in their business. If the fund grows excessively large, tax rules might make it impossible to return the excess to insurers. A large fund might also encourage excessive operational spending by the PPP or make it less diligent in seeking cost-effective approaches to resolving failed insurers.

An alternative that avoids the disadvantages of pre-funding is post-funding, which involves assessing actual costs against the insurers. Post-funding has the advantage that should no insurer fail no one will have paid for coverage that proved to be unnecessary. However, a disadvantage is that some consumers who benefit from the PPP when their insurer fails might have entirely escaped paying for the coverage.

The unpredictability of costs also means that the assessments might be subject to large fluctuations. To deal with the risk that the assessments in any one year might place an unreasonable burden on healthy insurers, many PPPs cap the assessment rate and carry over excess costs to future years.

To achieve the benefits of both pre-funding and post-funding, while minimizing the drawbacks, some PPPs use elements of each. For example, assessments might pre-fund anticipated operational costs, including non-routine expenses, and contribute to the development of a liquidity pool that can cover the initial expenses related to a failure. The actual costs of coverage might be assessed against insurers in proportion to their required capital, with costs in excess of an annual cap carried over to future years. A line of credit from a bank and voluntary loans from insurers might be used to bridge any timing gaps.

Regardless of the intended approach to funding, modeling should be done to estimate funding needs and the capacity of various sources of funds to meet those needs. A range of assumptions should be used, to ensure that premium tax or assessment rates are set at appropriate levels and that plans can be made to obtain the additional funds that might be needed under adverse circumstances.

Establishing a PPP

This section discusses the development of an action plan to establish a PPP. It focuses on a few key issues specifically related to PPPs.

Action Planning

The action planning process begins with an assessment of the problem—in this case, the exposure of consumers to potential financial hardship if an insurer is unable to make payment. This assessment involves analyzing the situation, identifying the causes of the problem, evaluating the benefits of solving it and the risks that may come from not doing so, and stating the challenge precisely in a problem statement. The knowledge you have gained from this note should help you to make this assessment. Armed with a clear understanding of the challenge, you will be in an excellent position to develop a solution.

To arrive at a solution, you must define the preferred outcome. For example, the preferred outcome might be to establish a PPP that will protect consumers against the failure of a life insurer, with limits consistent with those of deposit insurance in your jurisdiction, within the next three years. With that target in mind, you can outline the main steps of a plan to get there. As you develop your plan, it is important to analyze the needs and interests of key stakeholders—those who have power to influence the plan—and assess its effects on them.

The plan should evolve to include details on the activities to be undertaken within each of the main steps, the resources needed for each activity, the timing, duration, and preconditions for each action, and the critical path for the activities (the shortest time in which the project can be completed). Before finalizing the plan, you should evaluate whether it will get you to where you want to go, in time, with the available resources. The implementation risks should be considered and a contingency plan prepared, in case things do not go as planned.

Political Will and Readiness

Despite the likely need of consumers for a PPP, many jurisdictions do not have them. In some jurisdictions, the precondition of adequate regulation and supervision has not yet been achieved. In others, the arguments against having a PPP have either been considered more persuasive than the arguments in favor of having a PPP or steps remain to be taken to deal with identified concerns. Still others have simply not gotten around to seriously considering the establishment of a PPP.

Knowledge of the decisions taken by other countries can be useful when considering the arguments for and against the establishment of a PPP and the manner in which a PPP might be designed to deal with the various concerns that commonly arise. However, in the end, decisions should focus on the needs of consumers and the ability of a PPP to meet those needs in the context of the situation in your jurisdiction. To a large extent, these decisions will hinge on the issues of political will and readiness.

There are many issues that could affect the decision about whether the establishment of a PPP would be an appropriate step to take. Some issues involve the fairness of tradeoffs, for example, between the benefits of protecting some consumers from potentially significant loss and the costs that such protection imposes on other policyholders. Another important point to consider, especially considering the experience of the 2008-2009 global financial crisis, is the extent to which the existence of a PPP might contribute to the perceived soundness of the financial system and hence to the development of business and the overall economy. Other issues relate to how the behaviors of various individuals and organizations might change in response to the existence of a PPP. Judgment enters into the evaluation of such issues and the results of the evaluations might differ significantly depending on the nature of a stakeholder's values and relationship to the insurance market.

As you assess the situation in your jurisdiction, some questions that might be considered include the following:

- Are there any aspects of the situation that might pose barriers to the establishment of a PPP?
- If so, what can be done to remove the barriers—and when?
- Do stakeholders have any specific objectives or concerns that might affect the design of a PPP?
- If so, how can a PPP be designed—and the design communicated—to achieve the objectives and alleviate the concerns as effectively as possible?

Main Steps

If your analysis leads you to conclude that the political will to establish a PPP exists and any potential barriers are probably surmountable, you might decide to develop an action plan to establish a PPP. The main steps in your action plan might include those discussed below.

The first step in the action plan might well be to deal with any barriers to the establishment of a PPP, or develop plans for doing so that can be completed before the PPP begins operating. Such barriers might include:

- Significant weaknesses in the regulatory framework and supervisory practices
- Insurers that are likely to fail
- Legal provisions on winding-up that are inappropriate for insurers.

Another early step might be to seek the views and participation of stakeholders. Meetings might be held with key stakeholders, such as industry and consumer associations, to provide them with basic information about PPPs and identify specific objectives and concerns they might have. Surveys and focus groups might be used to gather information from a broader range of stakeholders, such as consumers. A project team should be formed to work on the design and implementation of the PPP; it might include representatives of key stakeholders, such as the supervisory authority, the finance ministry, industry associations, and the deposit insurer.

The next main step might be to develop policy proposals that deal with key aspects of the PPP. The issues addressed should include:

- The classes of business to be covered
- Initial views on coverage limits and other risk-sharing mechanisms
- Whether the PPP would be a government agency or formed by the industry
- The funding approach.

The policy proposals should be communicated to key stakeholders. The proposals might be revised in response to their feedback. Any approvals required to proceed with the project should be obtained.

With agreement on key aspects of the PPP in place, the steps required to detail the design of the PPP and to bring it into existence could be taken. The initial action plan should include at least an approximation of what these steps might be and the time and resources it might take to accomplish them. However, as the policy proposals take shape, it should be possible to refine the plan. The steps might include:

- Defining the coverage in detail
- Agreeing on the specific roles the PPP will play and how it will interact with the supervisory authority
- Developing the details of the funding approach and calculating the initial funding requirements
- Amending laws to authorize the formation of the PPP and to require the participation of insurers
- Preparing the legal documentation establishing the PPP and governing its operation
- Selecting the directors of the PPP, recruiting managers and staff, and setting up an office
- Developing a campaign to inform stakeholders of the existence, roles, and coverage of the PPP.