

Some comments to the *Proposal for changing the regulations of insurance associations, paper for public debate*, of the Hungarian Financial Supervisory Authority, of 10 August 2010 (86955-3/2010)

The paper focuses on two issues:

- The issue of final guarantor
- The issue of the legal form

The two issues are not necessarily the same although they are linked. The comments hereafter focus on each of these two issues, and concludes with comments on the HFSA's conclusions.

The case of final guarantor

1. The first debate on the final guarantor, other than the state, is certainly a timely one: not only have many taxpayers paid for several large financial institutions, including insurers – almost 10 billion euro¹ - but also have many policymakers and advisers pointed to the need of introducing also for the insurance sector guarantee schemes. The de Larosière report², the subsequent EU Commission communication³ and recently the EIOPA regulation⁴ have called for an insurance guarantee scheme. Hungary did not participate in the public consultation of 2008 but the paper when referred to the "*spreading the responsibility*" scheme suggests that independent of the solutions for the mutual sector (=the Hungarian insurance associations), there is no great support for an additional guarantee of this nature.
2. In case Hungary were to decide to introduce an overall insurance guarantee scheme⁵, such scheme would have to cover all insurers, whatever their legal form. Mutual insurers will claim that it is unfair as they do not venture in foreign/unknown markets (in general) and they

¹ See The Geneva Association, '*Systemic Risk in Insurance: An analysis of insurance and financial stability*', March 2010.

² See de Larosière Report, February 2009, which states "*Recommendation 5: The Group considers that the Solvency 2 directive must be adopted and include a balanced group support regime, coupled with sufficient safeguards for host Member States, a binding mediation process between supervisors and the setting-up of harmonised insurance guarantee schemes.*"

³ See EU Commission Communication, 4 March 2009, "*Driving European recovery*" which states "*The Commission underlines the need to reinforce the protection of consumers, investors and small companies. The Commission stresses that additional measures are needed to reinforce depositor, investor and policyholder protection.*"

⁴ European Parliament legislative resolution of 22 September 2010 on the proposal for a regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority, Art. 12e.

⁵ Beyond the mandatory vehicle insurance compensation fund, established by decree in January 2010

(=their members) will have to pay for the whims of the competition. Joint-stock insurers on the other hand will claim that they do not want to have such scheme as – to use the paper’s own words – they have a final guarantor, called shareholder. Needless to say, no insurer is immune for bankruptcy as shareholder’s pockets are not unlimitedly deep and also mutual insurers can go belly up, with the exception of the mutual “which cannot go bankrupt” (see box 1). What an insurance guarantee scheme finally does is adding a layer before the state (=taxpayers) eventually intervenes. Such layer should be there for all policyholders/beneficiaries despite the moral hazard issue.

Box 1: the mutual which can’t go bankrupt

EMANI, European Mutual Association for the Nuclear Industry, was founded in 1978 by the nuclear (electricity) sector.

- Membership is reserved to a company or authority in the public or private sector owning, controlling or operating a nuclear installation which include names such as Vatenfalls, British Energy Plc, the European Commission.
- All policyholders are members. It is fair to presume that all members have deep pockets.
- The mutual covers for a wide range of insurance risks relating to nuclear power stations and other companies in the nuclear industry. At present , EMANI covers in excess of 100 nuclear sites for its members in Belgium, Canada, Czech Republic, Finland, France, Germany, Hungary, Italy, Rumania, The Netherlands, The Slovak Republic, South Africa, Sweden, Switzerland, United Kingdom and the USA. The capacity provided by EMANI is independent of that provided by the various nuclear pools.
- The mutual is a variable premium mutual.
- EMANI’s own funds under Solvency I are largely above the required minimum. Article 26 of the Articles of Association provides for additional contributions from members if required to meet claims. These calls are foreseen to be a maximum of 6 calls per year. Should more funds be necessary to pay out for a claim, claims proportionality kicks in. At present, the maximum loss is lower than the own funds and technical provisions and 6 calls. (source: Articles of association and Annual report EMANI 2009)

3. The paper argues that insurance associations in Hungary do not have owners, equivalent to owners of joint-stock companies or cooperative companies where there are identifiable ownership titles called shares. The ‘owner’ concept is hereby reduced to an individual owner concept, although joint and indivisible ownership or co-ownership is a very common concept of ownership too. In such case, should a co-owner want to exercise the full use of his rights (e.g. potential to sell) this is translated in selling the joint and indivisible property so as to be able to exit the co-ownership. In case of a mutual, this is equivalent to demutualization (which is why carpetbaggers in the UK have been so successful) or voluntary liquidation. With other words, it is not because the ownership rights are atypical that they are not ownership rights: joint ownership is ownership too.

4. The paper further explains that because of this lack of (individual) ownership after a while nobody will want to save the mutual. A case in point was MÁV-ÁBE where the 'owners' decided to let go; the members voted against additional payments in great majority. Clearly the 'owners' jointly felt that the company had outlived its purpose. Also in joint-stock companies owners decide to withdraw funds, close subsidiaries and branches if growth is not in line with ROE. The non-willingness of owners to cough up additional capital does not seem a sufficient condition to prohibit mutual insurers altogether. Additionally it should remain possible under Hungarian law to create and dissolve mutuals in an orderly fashion.
5. The "*profit-oriented*" scheme as described, presumes that 'capitalistic' owners have a larger incentive to be the final guarantor 'because they do not want to lose their previous investments'. It concludes that because of these incentives the owners are the final guarantors.
 - Does this argument not suppose that all shareholders are long term shareholders? This cannot be the case.
 - It may well be true that the propensity to invest additional capital in joint-stock insurers by shareholders is larger than the propensity to invest via supplementary calls in mutual insurers by members, but we have not been able to find a study which would corroborate with facts this ingoing hypothesis.
 - Lastly, many banks, of which the large majority were joint-stock owned were in need the past years of state aid, despite the public company institutional form⁶. The depth and width of the crisis at this point in time is inducing policymakers to contemplate bailing-in options of bondholders as an extra layer of 'final guarantor' before the state appears. It may well be that shareholders alone 'won't do the trick', so maybe they are not so 'final' after all?
6. The "*swallowing the loss*" scheme is the scheme where the owner is systematically the customer, and where profit orientation is not the purpose of the existence of the company. Per definition the company's reason for existence is not-for-profit but for-service while making profit to keep the company solvent.
 - However, the paper argues that in case all customers are owners, not for profit operation is the logical option. A *contrario* this would mean that if not all customers are owners there is more profit orientation. The argument is debatable. Would it not be more correct to argue that such not-for-profit operation is the result of a statutory decision upon creation?
 - Loss spreading mechanisms: indeed, there are two logical methods to mutualize the risk (spread the risk): reduced service (such as proportional claims pay-out) and/or additional

⁶ The fact that banks in the EU are joint-stock or cooperative only in legal form is linked to the fact that the second banking directive laid down 5 million euro as minimum capital to start a bank, composed exclusively of capital and reserves. This de facto excludes other legal forms.

payments (such as supplementary calls). Both schemes are being used across Europe and may result in different types of mutuals⁷. They can even be combined (see box 1).

- In the reduced service scheme such as proportional claims pay-out, it may indeed be argued that when third parties are involved this is not the ideal situation. However, when examining the situation in 5 EU countries (see table 1), we note that all 5 countries allow both variable and fixed premium mutuals and that third party motor liability is not reserved by legislation for a particular type of mutual.
- Alternatively there is the additional payment scheme, also called the variable premium mutual, which is a scheme used both in third party liability lines as well as other lines as shown in table 1.

Table 1: Type of mutual insurers in selected countries and allowed lines of business⁸

Country	Type of mutuals	Allowed lines of business
Belgium	Fixed or variable	All classes
France	Fixed or variable	Life or capitalization business can only be written by fixed premium mutuals
Italy	Fixed or variable	All classes
The Netherlands	Fixed or variable	All classes
Spain	Fixed or variable	Reinsurance, credit and suretyship, life and liability in excess of insured capital in case of fire and natural forces can only be written by fixed premium mutuals

Here the paper argues that in case of larger mutuals, only a formal obligation works. However, would it not be more transparent and clear for all concerned parties to have the obligation for additional payments formalized either by law, or in the articles of association, or even better both, for large as well as small mutuals, independent of their size. In some countries the supplementary calls are regulated with minima and/or maxima, and compulsion plays a role (see box 2). Also CEIOPS recognized this in its report of 2007 *"The responses indicate that the contractual*

⁷ For example in the Netherlands there are 3 types of mutuals: firstly the mutual with full legal liability (W.A.), secondly the mutual with limited liability (B.A.) and thirdly the mutual with excluded liability (U.A.). Each type of mutual has a different degree of liability when confronted with liquidation. Additionally any of these regimes needs to be chosen for the eventual yearly deficits. Only in the case of W.A. mutuals and if the statutes provide so, supplementary calls are possible.

⁸ See *Mutual Insurance Companies, The regulatory, financial and fiscal arrangements*, AISAM 2007 – this studies examines only the above mentioned 5 countries.

*obligation of members to honour supplementary contributions plays a significant role in undertakings' default risk assessment when making calls."*⁹

Box 2: Supplementary calls – examples of some statutory and/or regulatory regimes ¹⁰

France: Regulatory and statutory supplementary call regime.

- Maximum amount is difference between maximum premium envisaged and premium already requested for the year; needs to be at least 150% of normal premium
- Effective call decided by the Board of Directors for each subcategory or for one single subcategory of insurance written; call addressed to all members of that year including to former members
- May be decided until all claims for the year concerned have been settled
- Must be explicitly foreseen in the bylaws
- Call for one category and rebate for another category of members is possible in same period
- Members who do not pay the supplementary calls, so do not fulfill the conditions for membership are considered as not having paid their premium and may have their insurance policies cancelled by the mutual insurance company besides the legal recovery

The Netherlands: Statutory supplementary call regime

- The maximum amount is one year's premium
- Effective call decided by the Board of directors
- Deadline for calling is until the final closure of the accounting period during which decision was made; can be required from a former member
- May not be decided for one particular class or sub-class of insurance
- Call for one category and rebate for another category of members is NOT possible

Spain: Statutory supplementary call regime

- Annual premium (accounting period) is the maximum in a fixed premium mutual, in a variable premium mutual there is no maximum
- Must be decided by the ordinary General Assembly
- Cannot be decided for a particular class or sub class of insurance
- Call for one category and rebate for another category of members is NOT possible
- Deadline for calling is until the final closure of the accounting period during which decision was made; can be required from a former member

7. The "protecting the reputation of the sector" scheme would be possible if the EU would be considered as the relevant market and not Hungary only. Although it may be true that the mutual insurance sector in Hungary is not strong, the same cannot be said about the mutual

⁹ CEIOPS, *Report on the implementation of the current insurance directives with regard to the eligible elements to meet the solvency margin*, 2007

¹⁰ See note 8

insurance sector in Europe. However, for such EU scheme to work some preconditions are necessary, of which some even may be in place (partially):

- The potential to create (cross-border) mutual groups: in a mutual group, the creation of the group is based on contractual links, not the exchange of capital, and each mutual keeps its insurance license and continues to fulfill the prudential requirements. The statutes of the group define the financial solidarity, which is a mandatory part at the moment of formation of the mutual group. Each member-mutual signs an affiliation convention, and adapts its statutes in line with the affiliation. The group 'company' has no insurance licence.¹¹ This legal tool not only makes it possible to mutualise horizontal functions in order to implement optimum and integrated risk piloting but above all it enables financial solidarity to be set up between affiliates and therefore recreates the bases for justifying diversification gains. Such structure has for example been introduced in France. As a result, based on recent research for example of the top 2004 and 2008 European insurers, several French mutual groups have been catapulted into the top European players¹². It should also be noted that the current French mutual group or SGAM legislation allows other EU mutual insurers to become part of such mutual groups, effectively bringing these mutuals under group supervision.
- The introduction of the concept of a "subsidizing" member: in some countries it is possible to have a subsidizing member. Such subsidizing member can be an institution or an individual and may but does not have to be a policyholder. The articles of association of the mutual describe the boundaries such as the voting rights of such members, the "profit participation" rights, a seat in the board etc. In any case, such subsidizing members can never be the majority of members¹³. The introduction of a subsidizing member structure could allow for EU sector solidarity.
- It should be noted however that in some countries mutuals can be set up as "stock mutuals": this is the case when there are only a few members, or not enough solidarity or when the risk is extremely difficult to place. Such stock mutual can become a regular mutual if the mutual becomes richer or if the market matures, and the founding sponsoring shareholders/members who contributed to the share capital can be paid off.

¹¹ For more information on such mutual groups see for example: "SGAM : Société de groupe d'assurance mutuelle", (in English), Amaury Roland-Gosselin, Groupe MACSF, published in ROAM/AMI, special edition, 2009

¹² See "De grootste Europese verzekeringsgroepen" (The largest European insurance groups), Lieve Lowet, BFW 2010-6, www.larcier.be

¹³ For example in Italy such concept exist, called 'socio sovventore': such member has max. 5 votes; mutual insurance legislation in Italy uses as source of law the law applicable to cooperative companies and this concept is used in cooperative societies since 1992; for more information on the *socio sovventore*, see note 8; see also "Financial development and the growth of cooperative firms", Francesca Gagliardi, The Business School, University of Hertfordshire (UK), Published in Small Business Economics: An Entrepreneurship Journal, 2009, 32 (4), pp.439-464

This is for example the case in the Netherlands but also the Polish regulation offers here an interesting inspiration (see box 3)

Box 3 – How mutuals can be created in Poland

Polish regulations allows for 3 categories of founders:

1. founders
2. capital investors
3. policyholders which is the most important group

The founders take part in the registration and licencing process. They may be capital investors or policyholders although this is not compulsory.

Capital investors have member's rights – they may be member of the insurance management body or supervisory body (art. 46.5). The statutes of mutual insurers may provide for the repayment of the basic capital but only out of surplus and within the period of the establishment of the reserves capital.

In extremely rare situations the capital investors may have the only voting rights, the policyholders only gaining a right to vote once the initial capital is repaid to the capital investors.

As a consequence of this regulation there are mutual insurers with shares and mutual insurers without shares.

The case of the legal form

8. What is called commonly a Hungarian mutual insurer is actually an (insurance) association. *Strictu sensu* the legal form of mutual insurance society does not exist in Hungary but neither does the insurance association.
9. Such situation is not unusual in Europe; in several other countries the legal form of association inspires the 'mutual'. In the Netherlands for example "*a mutual insurance company is an association with a special purpose and must be established by notarial act. The articles of association must mention that the purpose of the mutual is to conclude insurance contracts for its members and to insure members and/or non-members (in case of U.A. mutuals)*". This means that an association which states in its articles of association that its purpose is insurance automatically becomes a mutual insurance company. The life of the insurance association, thus mutual is regulated by the insurance prudential legislation. In case of death, the proceeds are to go to the members or not, depending on the articles of association¹⁴. As the Dutch mutual insurance sector is quite vibrant and healthy, the reference to the association form in itself seems not sufficient to conclude that it is unfit. But it would be incorrect to state that the Hungarian Act of associations is equivalent to the Dutch one as no such study could be found.

¹⁴ See note 8

10. But there are other situations too. For example¹⁵:
- in Italy, the sources of law for the mutual insurers are besides 3 articles in the Civil Code the law applicable to cooperative companies if compatible with mutuality and only thereafter the law applicable to joint stock companies. No reference is made to the law on the associations.
 - in Portugal, the mutual insurers are called mutual associations, but have the legal characteristics of a cooperative insurer, such as a cooperative share capital.
 - in France the mutual insurers are governed by at the Insurance Code which contains specific articles, several decrees, and a specific mutual code for some specialized mutuals.
 - in Finland, there are two legal forms: the mutual insurance company, used for larger mutuals and the mutual association, used for small mutuals.
 - in the UK, mutuals take many forms and operate in a wide range of business and social environments. Most people recognise mutuals through one or more of the long established building societies, co-operatives, friendly societies and mutual insurers. But the sector encompasses many more types of organisations – some large and well established like housing associations, clubs and employee owned businesses to smaller, specialist bodies such as credit unions, football supporter trusts and community mutuals.¹⁶
11. The paper argues also that in case the insurance associations are variable premium associations (i.e. associations with a compulsory “swallow the loss” scheme), they can be called mutual. Does this mean that *a contrario* a fixed premium association is no mutual but remains an association? This is potentially confusing.
12. Because the mutual insurers (read : associations) have no ownership this can sometimes form a higher risk, “*practically an invitation to steal or ‘privatize’ this capital*”. Although this cannot be excluded, such is human nature, this would mean that the amount of fraud in the mutual insurance sector would be disproportionate. Is this the case? Does the legal form really have an impact on the amount of fraud?
13. Further, because the company is not managed by the owners, mutual insurers would attract larger risk takers. Besides the This would mean that bankruptcies would be larger in the mutual insurance sector than in the joint-stock or cooperative sector. The paper concludes ‘*thus (the mutual) is not a truly risk-free institution under any circumstances*’. This conclusion is certainly true for mutual insurers as for any other insurer, even for any company. No insurer is risk-free.

¹⁵ See note 8, see also AISAM, “*Mutual insurance in figures*”, 2007.

¹⁶ See www.mutuo.co.uk

14. Where one can agree¹⁷, is that there can be cases where there are conflicting objectives. A first case can be when "a mutual insurer's management may have social and other objectives besides prudent management of the insurance business. In one case study this led to use the insurer's balance sheet to invest in other activities for the benefit of their members. This led to a concentration of investments in group companies, real estate and, as it turned out, large credits to those companies, with significant bank debts. The solution was a programme of disposals and better asset diversification agreed with the firm." A second case concerned another conflict "between the need for prudence and the wish to keep rates low for members. Mutuels who can make supplementary calls on their members may rely too much on that and relax their vigilance on risk selection and monitoring of claims development, which may in turn lead to buying too little reinsurance cover...".
15. Given all the above, are mutual insurers then structurally a higher systemic risk? Recent analysis of bankruptcy data for EU insurers based on an analysis of the list of EU insurers that went into liquidation in the last 5 years leads to a preliminary figure of 26 insurers, of which 5 were mutuals¹⁸. This means that the mutual insurers constitute 19% of the total liquidations, while they represent more than 50% of the EU insurance market in terms of numbers.¹⁹ From the 5 mutuals in the list of liquidations, there were 2 Dutch mutuals that were part of the non-directive regime. *Strictu sensu* the European directives were not even applicable to them and there was even no obligation to report them. Nevertheless, these 2 mutuals on a total of more than 113 Dutch non-directive insurers or those 5 on a total of more than 5000 constitute a significant higher confidence level than the anticipated 1 in 200 year event or the 99.5% confidence level that will apply as consumer protection threshold in Solvency II. There is no structural problem in the mutual insurance sector (whether based on association law, cooperative law or sui generis law), the soundness of it more than fulfills the consumer protection objectives that are imposed on the insurers under Solvency II.
16. If one adds the "near bankrupts" to the abovementioned figures, such as the several insurers in the Netherlands and Europe which received state support, the case is even more clear. In total, almost 10 billion euro of direct state support was granted during the crisis to insurers world wide (excluding the ones with major banking activities)²⁰. Of this amount, for example around 3 billion euro went to AEGON, a major Dutch joint-stock insurer with many owners.

¹⁷ See the Sharma report "Prudential Supervision of Insurance Undertakings", December 2002: "mutual insurers face conflicting objectives"

¹⁸ See http://ec.europa.eu/internal_market/insurance/windingup_en.htm, analysis based on data between 2006-mid 2010

¹⁹ Figures based on the AISAM study 'Mutual insurance in figures', 2007.

²⁰ The Geneva Association, 'Systemic Risk in Insurance: An analysis of insurance and financial stability', March 2010.

17. Given the current crisis environment, several circles are even wondering to which extent mutuals cannot aid economic stability in the financial system. The Oxford University on 17 September 2010 published a report titled '*Promoting corporate diversity in the financial services sector*'. The report produces a raft of recommendations to help the government to support its Coalition Agreement commitment to foster diversity in financial services and promote mutuals. Key recommendations from the report include among others, in the area of Financial Regulation:
- Making a binding requirement for the new Regulator to promote diversity of ownership
 - Appointing a new Head of Mutuals Policy, to co-ordinate the Regulator's work with mutuals²¹
18. The HFSA is concerned that for associations which slide downhill negative feedback mechanisms will kick in. Capital injections are not possible/considered as not linked to governance rights or (identifiable individual) ownership rights.
- Governance rights: In a mutual, members make up the general assembly (direct or indirect, different forms exist) and have in many mutuals around Europe additional 'say' in panels²². Also board members of mutuals are member-policyholders.
 - Ownership rights: Dividends? No. Members are not entitled to dividends. But the general assembly can vote for rebates and/or profit participations. Capital gains? No. Mutual members have no right to a share in the underlying value of the business, unless in case of demutualization or winding up and provided the legislation and/or articles of association allow for the distribution of the proceeds. In a joint-stock company, capital gains are on paper only as long as the share is not sold. Unfortunately, based on paper gains, real money sometimes leaves the company (bonus?)
 - Capital injections: it depends - institutional capital injections are not possible as such but the above paragraphs suggest possibilities; the same is true for retail capital injections which depend on several factors.

Possible ways to resolve the problems

19. All financial institutions have to be placed under the effect of a final guarantor scheme: yes, if supervised as financial institution (not applicable to the non-directive insurers)
20. Conclusions have to be drawn regarding the absence of owner: yes, if there is a real absence of owner. However, it is not because there are no individual owners that there are no owners. Co-ownership is also ownership, even if joint and indivisible.
21. It is expedient to remove all financial institutions from under the effect of the Act on associations: Is the decree 4070 of 1940 better? Can this decree be used as a basis with improvements to avoid some perceived shortcomings?

²¹ <http://www.kellogg.ox.ac.uk/researchcentres/documents/Mutuals%20oxford%20brochure.pdf>

²² Several mutual insurers in the EU have member' representative panels, regional members panels, customer's examining committees etc. see e.g. Tapiola, Liverpool Victoria, Reale Mutua and many others.

22. It would be expedient to introduce the mutual insurance company form but only for small ones, and only variable premium? Yes for the introduction, no for the size and form. There are other better and proven solutions in the EU including a combination of the best available solutions.
23. It is advisable to set up an upper limit for membership and revenues: No, there are other ways. Why would Hungary systematically allow its mutuals when becoming larger to become part of foreign groups?
24. There would be no capital requirement: no, not *strictu sensu*, but there should be an initial fund or equivalent requirement (still to be worked out)
25. Mutual insurance companies cannot be active in all sectors: this sounds like the easy solution but there are other ways to avoid such radical decision as is the case in several other EU member states.
26. Existing large associations should become cooperatives: this should at all times remain an option, namely that mutuals can become cooperatives. It should not be reserved to large associations only.
27. The actual owners would be the present members: are the present members not at all owners??

Disclaimer

This note has been written on a pro bono basis and with the aim to nurture and stimulate the current debate on the mutual insurance legislation in Hungary. The arguments are sourced from available knowledge and do not seek to be exhaustive, comprehensive or scientifically robust. There is a risk that they represent facts incorrectly or incompletely although such incorrectness or incompleteness is never intentional.