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RVP Bulletin

Swiss Insurance Law Update 2011/1

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Supervision Law

Cross-border insurance business

In recent years insurers have increased their transactional business with cross-border elements. At the same time, the legal and reputational risks associated with cross-border business have increased significantly. FINMA has issued a new position paper in October 2010 addressing the increased risks in cross-border financial services. The paper is intended (among others) for insurance companies.

Cross-border insurance services are frequently regulated activities outside Switzerland. The system of insurance supervision in many countries requires companies to obtain a licence in order to operate within their territory (e.g. Germany, France, Italy, UK, USA). Only in very rare cases are companies permitted to offer or provide services across borders without maintaining a physical presence in the country and without a licence. For example, insurance companies selling products incorporating collective investment

schemes to U.S. investors are required to verify whether the funds have to be registered with the SEC. Insurance companies must check funds on a case-by-case basis because not all funds need to be approved by the SEC. In particular, there are a number of life insurance products that must be authorised. In addition to carrying out these controls, insurance companies must also comply with existing disclosure requirements. Prospectuses for securities offered must clearly disclose any applicable warnings and risks for U.S. clients.

The Insurance Supervision Act imposes various obligations on insurance companies in respect of business transacted outside Switzerland. The business activities outside Switzerland are reviewed in the course of obtaining the licence. The Insurance Supervision Act provides that the granting of a licence by FINMA to conduct insurance business requires any applicant intending to operate outside Switzerland to supply its services to target markets in compliance with foreign supervisory legislation. At the time when the business plan is submitted, the licence(s) granted by the relevant foreign supervisor(s), or an equivalent certificate, must be appended (Art. 4 para. 2 lit. c ISA). Any subsequent amendments to the business plan must be presented to FINMA (Art. 5 para. 2 ISA). Violating foreign rules may breach the requirement that business be conducted in a proper manner.

Furthermore, supervision law includes various organisational rules that also apply to the cross-border business: Art 22 ISA provides that insurance companies must be structured in such a way as to enable them to identify, mitigate and monitor all material risks. In addition, all insurance companies are responsible for setting up an effective system of internal control (Art. 27 para. 1 ISA). These requirements are further defined in the Insurance Supervision Ordinance and are also dealt with in the Circular 2008/32 “Corporate governance insurers”.

The breach of foreign supervision law may also cause negative private law consequences for insurers: In some countries, insurance policies taken out in breach of local supervisory rules will either be voidable or void (e.g. France, Italy).

Finally, the revised Lugano Convention took effect on 1 January 2011. According to the revised convention, clients may take legal actions in their home country where the bank has directed its services to that country or member state. As a result, financial institutions in all Lugano Convention member states can expect increasing numbers of lawsuits subject to mandatory local law in their clients’ countries of habitual residence. Also a Swiss judge could conceivably rule that mandatory foreign rules take precedence over Swiss provisions by virtue of Art. 19 IPLA.

Insurance wrappers

A current example of immanent legal and reputational risks in the cross-border insurance business is the insurance wrapper. Insurance wrappers are often not distributed from Switzerland, but rather through licenced subsidiaries of Swiss insurers abroad (for example in Ireland, Liechtenstein and Luxembourg). The products generally comply with private, supervisory and tax law requirements of the client’s country of domicile and thereby provide legitimate tax privileges (see FINMA position paper on risks in cross-border financial services of October 2010).

Insurers with business models involving insurance wrappers have an on-going supervisory responsibility to discharge their identification obligations, even if the insurance application was submitted through another financial intermediary. They are responsible for duly verifying the identity of the client, establishing the identity of the beneficial owner if required and discharging all other obligations relevant to the business.

As regards the banking area, in the event a securities account being part of an insurance wrapper the insurance company replaces the former owner of the account as beneficial owner pursuant to CDB 08, although the former owner actually pays the premium. However, FINMA considers certain set-ups as abusive and requires banks to treat the actual payer of the premium as the beneficial owner. The banks and securities dealers must know the identity of the owners of the accounts held by the insurer if the insured person may directly influence the investment decisions. The new rules apply to all insurance wrapper products that were opened with the financial intermediary after 1 January 2011 (see FINMA notification 9/2010 that was replaced by FINMA notification 18/2010 of December 2010).

Rating agencies in the insurance area

It is intended to amend the Circular on rating agencies. The modifications aim to extend the requirements for rating agencies to all entities supervised by FINMA including the insurance companies and to create standardised conditions for their recognition. The consultation period ended on 13 May 2011.

The circular governs the recognition of external credit assessment institutions (rating agencies). The assessments of creditworthiness (ratings) made by rating agencies are utilised within the context of financial market regulation by institutions which are subject to supervision by FINMA. The insurance companies may use ratings from the recognised rating agencies for determining capital in accordance with the Swiss Solvency Test and determining tied assets. FINMA may recognise a rating agency for ratings (among others) of the market segment "Commercial Entities", including banks and insurance providers and their credit instruments.

The Circular shall enter into force on 1 January 2012, however, includes the following transitional provisions: With respect to the use of ratings for the purpose of determining tied assets, the provisions of the Circular shall enter into force only as of 1 January 2015. By this date, rating agencies which are not yet recognised by FINMA and whose ratings are used by insurance companies for supervisory purposes must have applied to FINMA for recognition. Up until this date, insurance companies may continue to use ratings by rating agencies which currently qualify as "recognised" under FINMA Circular 08/18 "Investment Guidelines for Insurers".

FINMA distribution rules

Based on its strategic goals and the findings of the investigations into the Madoff and Lehman affairs, FINMA launched a cross-sector "Distribution rules" project analysing financial products and services for retail clients and examining the value chain and legal environment. FINMA has identified in its report of 2010 a considerable information gap and a power imbalance between financial services providers and retail clients which are not adequately levelled out by the laws in force. FINMA is therefore promoting discussion on the subject of enhancing client protection by:

- Expanding duties to produce a prospectus and notification duties at product level;
- Strengthening and harmonising rules of business conducted at the point of sale;
- Improving transparency at the point of sale;
- Bringing in stricter and more consistent regulation of cross-border distribution of foreign financial products in Switzerland;
- Adopting client segmentation into qualified and standard clients;
- Bringing in rules of business conduct and a registration requirement for financial services providers that are not subject to prudential supervision;
- Bringing in an ombudsman's office with the power to render rulings for all financial services providers.

Implementation of these proposals will require supervisory measures by FINMA as well as a new Financial Services Act and potentially an interim Ordinance on Rules of Business in order to enhance client protection and Switzerland's attractiveness as a financial centre. The consultation period ended on 2 May 2011.

The project concerns also the supervision of the insurance intermediaries. There would be need for coordination when introducing a new Financial Services Act in view of the on-going revision of the Insurance Contract Act: The consultation paper of the new Insurance Contract Act of 2008 includes (among others) an extension of the information duties of the insurers, new rules for the insurance intermediaries and their compensation as well as statutory rules for an ombudsman's office currently existing only on a private level. The results of the consultation were published in 2010. The report on the new act ("Botschaft") is intended to be published mid of 2011.

The FINMA distribution report includes in particular the following additional considerations for the insurance area:

- Any unified prospectus requirement may generally not be extended to insurance products. However, standardized information on the essential character of combined financial products (product

description) would also apply to combined insurance products, e.g. fund-based life insurance products.

- The general waiver of preventive supervision of premium rates and general insurance conditions is intended to remain.
- One would need to indicate (as planned on a civil law level) whether one acts as tied agent or broker and (as under existing supervision law) what connections exist. As part of the pre-contractual information requirements, potential and actual conflicts of interests would need to be disclosed.
- The existing termination rights would not need to be extended.

Technical provisions in reinsurance

Currently, there are no special regulations on determining technical provisions for the reinsurance business. Therefore, FINMA plans to issue a new Circular on "Technical provisions in reinsurance". The Circular aims at setting down the provisions in the laws and ordinances and prescribes minimum requirements to ensure that insurance companies have sufficient level of technical provisions from an actuarial viewpoint. The requirements defined in the Circular relate to the reinsurance business and are directed at all insurance companies active in this business. The consultation ended on 15 September 2010.

Implementation of SST

At the end of the five-year transition period and the binding introduction of SST from 1 January 2011, the financial soundness for insurance companies will be identified in parallel according to Solvency I and SST principles. If the insurance company is unable to comply with the SST requirements, it must either reduce its risk exposure or ensure that it has more risk-bearing capital. The insurance companies and insurance groups subject to SST had to file the SST report by 30 April 2011. FINMA had published guidance for the drafting of the relevant report.

The solvency requirements of FINMA have been criticized since their implementation at the beginning of 2011. Various improvements have been requested for 2012 (see report in NZZ of 29 January 2011, p. 35).

Implementation of remuneration schemes

The transition period for financial institutions subject to FINMA Circular 2010/01 (Remuneration Schemes) to implement its provisions ended on 31 December 2010. The financial institutions concerned had to submit an implementation report to FINMA by the end of April 2011. According to FINMA, the financial institutions concerned reviewed their remuneration practices in light of the Circular's principles and the demands of the marketplace.

Systemic risks in the insurance sector?

In the insurance sector if an emergency situation occurs an ordinary wind-up in the private industry or possibly enforced by the government or the relevant authorities may take place. The failed insurance company or the problematic portfolio may be taken over by a healthy insurance company or a designated rescue company. Supporting public means may be considered for the protection of the insured persons, however, not for the insurance company itself. As a result, there is no actual constraint to rescue supervised insurance companies in Switzerland. The problem of "too big to fail" is not the same in the insurance sector as it is in the banking sector.

Accordingly, both the final report of the expert commission for the limitation of economic risks through big corporations of September 2010 and the FINMA working paper of June 2010 state that no systemic risks could be identified in the insurance sector in Switzerland. However, a number of shortcomings have been recognised in traditional insurance activities and non-insurance and capital market activities: limited attention to liquidity; vulnerability of the reserving process; concentration risks in general and, in particular, with respect to reinsurance recoverables; regulation and supervision of non-insurance activities and capital market activities; and regulation and supervision of insurance groups. As a result, rather than conducting a major overhaul, the existing supervisory regime should be enhanced to mitigate the identified shortcomings. Appropriate proposals are outlined in the full report.

Technical provisions and unauthorized business (decision)

FINMA had to decide in a case where an insurance company performed the business of supplementary health insurance without holding the required licence. In addition, the insurance company did not provide for sufficient technical provisions.

FINMA states the following in its decision: As the insurance company is subject to the Insurance Supervision Act due to its unauthorized insurance products, it should have secured the claims from the insurance contracts by means of tied assets pursuant to Art. 17 ISA. FINMA is competent in the area of supplementary insurance also if the relevant products are distributed without necessary licence, as an activity subject to supervision is exercised. As a result, FINMA is allowed to instruct an insurer to provide for technical provisions for the purpose of covering unexpectedly occurring late losses. In the case at hand, FINMA ordered the insurer to transfer a cash amount to a savings account with a bank supervised by FINMA (FINMA Bulletin 1/2010, p. 122-133).

Definition of insurance (decision)

The Federal Administrative Court had to decide on contracts of a company which undertook against consideration to guarantee as bailer rent payments of the tenant to the landlord under rental agreements up to a maximum amount. In return, the landlord did not request any cash deposit as security.

The Federal Administrative Court qualified these contracts as insurance contracts and considered the company to be subject to the Insurance Supervision Act (Decision of the Federal Administrative Court B-2808/2009 of 25 March 2010).

Non-public fund distribution (decision)

The public distribution of collective investment schemes requires an authorisation (Art. 19 CISA) or an approval (Art. 120 CISA) by FINMA. FINMA used to interpret Art. 3 CISA very restrictively and considered promotion as public whenever it was directed to non-qualified investors. This restrictive interpretation was not covered by the Supreme Court in a recent decision. According to the Supreme Court, promotion does also not qualify as public if it is addressed to a narrowly described circle of persons which requires a decision on a case-by-case basis (Decision of the Supreme Court 2C_89/2010 of 10 February 2011).

New rules for simplified prospectus

The Federal Council has taken into consideration the international development in the area of collective investment schemes (in particular the European UCITS IV Guidelines) and introduced a formalized simplified prospectus for securities funds and other funds for traditional investments. The amended Collective Investment Schemes Ordinance enters into effect on 15 July 2011.

FINMA Anti-Money Laundering Ordinance

FINMA has harmonised its three former anti-money laundering ordinances and combined them into one single ordinance. This new ordinance also applies to insurance companies which perform direct life assurance business or offer or distribute shares in investment funds (Art. 2 para. 2 lit. c MLA). The standardised ordinance is primarily a technical combination and includes only few notable changes (waiver of the duty to perform due diligence for low-value assets, delegation and appointment of third parties).

Financial reporting for listed insurance companies

FINMA and SIX Exchange Regulation reinforce the supervision of financial reporting as regards listed insurance companies. The financial statements of Swiss insurance companies listed on SIX Swiss Exchange are in the future to be monitored by either FINMA or SIX Exchange Regulation. This means that SIX Exchange Regulation will be responsible for the IFRS, US GAAP and Swiss GAAP FER accounting standards. For its part, FINMA will focus on the rules on accounting standards provided for under banking and insurance legislation (Media Release of SIX Exchange Regulation of 10 December 2010).

Stamp duty on insurance premiums

The Federal Tax Authority has published the Circular No. 33 regarding stamp duty on insurance premiums on 4 February 2011. Such Circular specifies Art. 21-26 of the Federal Stamp Duty Act and Art. 26-28 of the Federal Stamp Duty Ordinance and replaces the

guidance of the Federal Tax Authority for the stamp duty on insurance premiums of 1974 (last update on 1 May 2001).

Transport insurance and embargo law

Swiss embargo law includes a master act (Embargo Act) and various ordinances for specific embargo cases. The Embargo Act provides in Art. 1 para. 1 that the Federation may issue compulsory measures in order to implement sanctions that have been issued by the United Nations, the Organisation for Security and Cooperation in Europe or by one of the most important trade partners of Switzerland. The ordinances do not only include obligations and restrictions for the exporters, but also for companies that provide related services, for example insurance services (compare for example Art. 1 para. 3 of the Iran-Ordinance).

Based on the above, it is advisable for insurance companies in Switzerland to provide for appropriate exclusions in the general insurance conditions of transport insurance in order to avoid any breach of Swiss embargo law.

Contract Law

Providing grace period (Decision)

Pursuant to Art. 20 para. 1 ICA the insurer must remind the debtor and request payment in writing on pain of default consequences.

According to the legal practice of the Swiss Supreme Court, all default consequences must explicitly be indicated. The mere delivery of an extract of the Insurance Contract Act is not sufficient (Decision of the Supreme Court 4A_397/2010 of 28 September 2010; SCD 128 III 186).

Breach of reporting duty (decision)

According to the Swiss Supreme Court, it is possible to agree that legal prejudice shall also occur if the breach of obligation ("Obliegenheitsverletzung") does not negatively affect the insurer. The legal consequences of a breach of obligation require only fault but not causality pursuant to Art. 45 ICA (Decision of the Supreme Court 4A_349/2010 of 29 September 2010).

Breach of notification duty (Decision)

The Swiss Supreme Court had to decide a case in 2010 where the policyholder negatively answered the question whether he consumes or consumed narcotics or drugs, although he had smoked occasionally cannabis during his professional education. A loss event occurred and the insurer terminated the contract and refused to pay due a breach of the notification duty.

According to the Swiss Supreme Court, the policyholder had without doubt breached the notification duty. The question remained whether the concealed risk was material which is required for the consequences of a breach of the notification duty to apply. The materiality of an enquired risk is legally presumed (Art. 4 para. 3 ICA). The policyholder may reverse the presumption through counter-evidence. In the case at hand, the policyholder was successful by referring to a research paper of the Federal Office of Statistic according to which every third 25 year old had consumed cannabis already once (SCD 136 III 334).

It should be noted in this context that the consultation paper to the new Insurance Contract Act (Art. 15) does not any longer maintain the legal presumption of materiality.

Observation by private detective (Decision)

A liability insurer mandated a private detective to observe an injured person making a claim. As a consequence, the injured person sued for injunctive relief, editing all documents as well as payment of compensation for personal suffering. The Swiss Supreme Court had (among others) to examine the question whether the observation was an unlawful breach of personal rights (Art. 28 CC).

First, the Swiss Supreme Court had to ask the question whether the right of personality or the right on one's own image had been breached. If applicable, the Swiss Supreme Court had to further ask the question for possible legal justification. Consent of the injured person or overriding private or public interests may serve as legal justification.

In the case at hand, the Swiss Supreme Court affirmed the breach of the right of personality, however, considered it as justified based on the overriding interests of the insurer and the insurance community behind the insurer to not be under an obligation to wrongly make payments. The interest of the insurer in an efficient combat of abuse was considered to be more important than the interest of the observed person in the integrity of his personality (SCD 136 III 410).

International

Solvency II (EU)

EIOPA has published the report on QIS5 on 14 March 2011. QIS5 is the fifth and last quantitative impact study before the planned introduction of Solvency II in the EU Member States on 1 January 2013. However, the latest alterations of Solvency II in the course of the QIS5 study have been heavily criticized. These alterations are alleged to not correspond to the long-term character of the (life) insurance business and to even reinforce pro-cyclical variation. Furthermore, it is argued that the alterations are excessively restrictive as regards the stress scenarios.

Finally, it is worth mentioning in the context of Solvency II that the FMA Finance Supervision Authority of Liechtenstein has presented a revised insurance supervision act for the purpose of implementing Solvency II. It follows that Liechtenstein is the first EEA/EU Member State that has produced a specific implementation proposal for Solvency II.

Unisex rates for insurances (EU)

According to a decision of the EU Court of 1 March 2011, the taking into consideration of the sex of insured persons as risk factor in insurance contracts qualifies as an inadmissible discrimination. As a consequence of this decision, the rule of gender-neutral premium and benefits must be applied in the EU after 21 December 2012 (see NZZ of 2 March 2011).

Product intervention (UK)

FSA has published a discussion paper on product intervention in January 2011. It is intended in the UK to make a shift towards a more interventionist approach with tighter supervision of the governance of product development. Future interventions might include banning products or prohibiting the sale of certain products to specific groups of customers. The consultation period ended in April 2011.

Mixed insurance companies in third countries (Germany)

Mixed insurance companies from third countries no longer require BaFin approval after April 2011 if they exclusively perform the reinsurance business from their office in Germany and are authorized to perform the reinsurance business in their state of head office where their administrative centre is located. Furthermore, they must be supervised in their state of head office according to internationally recognized principles. Also there must be a satisfactory cooperation between BaFin and the competent authorities in the state of head office (BaFin Journal 04/11, p. 3).

Investment guidelines (Germany)

In April 2011 BaFin published its new Circular 4/2011 (VA) with considerations regarding the investment of tied assets of insurance companies. The previous administrative practice regarding the investment of tight assets has been supplemented. Alterations concern in particular the area of asset-liability-management, shareholders and fund investments (BaFin Journal 4/2011, p. 3; BaFin Journal 5/2011, p. 6).

Group internal insurance distribution (France)

In May 2011 ACP published recommendations regarding the distribution of “contracts d’assurance vie en unites de compte”, composed of debt claim securities issued by a company that is financially associated with the insurance company. The document discusses how one should correctly deal with conflicts of interests for the protection of the insured persons in situations where one and the same group of companies enters into the insurance contract, issues the debt claim securities (bonds and other debt claims), sells the contract and pays the security. The recom-

mendations focus (among others) on the duty to inform, the duty to provide advice and the independent evaluation (2011-R-03 of 6 May 2011).

Abbreviations

ACP:	Autorité de Contrôle Prudentiel
CC:	Swiss Code Civil of 1907
BaFin:	Bundesamt für Finanzdienstleistungen
CDB 08:	Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence
CISA:	Swiss Collective Investment Schemes Act of 2006
EEA:	European Economic Area
EIOPA:	European Insurance and Occupational Pensions Authority
EU	European Union
FINMA:	Swiss Financial Market Supervisory Authority
IPLA:	Swiss Federal International Private Law Act of 1987
ICA:	Insurance Contract Act of 1908
ISA	Insurance Supervision Act of 2004
MLA:	Swiss Anti-Money Laundering Act of 1997
NZZ:	Neue Zürcher Zeitung
SCD:	Supreme Court Decision
SEC:	U.S. Securities and Exchange Commission
SST:	Swiss Solvency Test

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