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Switzerland: Financial Sector Assessment Program— Factual Update—Insurance Sector Market and Regulatory Developments

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

SWITZERLAND

FACTUAL UPDATE: INSURANCE SECTOR MARKET AND REGULATORY DEVELOPMENTS

MAY 2007

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

Contents Page

ACRONYMS

ALM	Asset-liability-management
AML/CFT	Anti-money laundering, combating the financing of terrorism
BE	Best estimate
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CoC	Cost of capital
EU	European Union
FAOA	Federal Audit Oversight Authority
FINMA Act	Federal Act on Financial Market Supervision
FIU	Financial Intelligence Unit
FOPI	Federal Office of Private Insurance
FOPI-SO	FOPI Ordinance on the Supervision of Private Insurance Companies
FSAP	Financial Sector Assessment Program
IAIS	International Association of Insurance Supervisors
ICL	Insurance Contract Law
ICP	Insurance Core Principle
IRV	Interkantonaler Rückversicherungs-Verband
ISL	Insurance Supervision Law
MLCA	Money Laundering Control Authority
MoU	Memorandum of Understanding
MVM	Market value margin
SAM	Self-Assessment Modules
SFBC	Swiss Federal Banking Commission
SIA	Swiss Insurance Association
SO	Ordinance on the Supervision of Private Insurance Companies
SRO	Self-regulatory organization
SST	Swiss Solvency Test
ULP	Unit-linked policies

EXECUTIVE SUMMARY

Regulatory reforms since 2003 have updated Switzerland's regulatory and supervisory regime for the insurance industry to bring it in line with international best practices. The Insurance Supervision Law (ISL), which came into effect on January 1, 2006, has reoriented the regulatory focus and expanded the regulatory scope to include group/conglomerate supervision, corporate governance, risk management and market conduct of insurance intermediaries. The ISL also provides for a range of corrective and preventive regulatory measures and empowers the Federal Office of Private Insurance (FOPI) to exchange information with both domestic and foreign regulators.

The risk-based and principle-based approach to regulation and supervision is aligned with the structure of the Swiss Insurance Industry. The Swiss insurance market is highly concentrated, dominated by a few large players with a significant international presence. More than 75 percent of Switzerland's premium receipts are from foreign business. The Swiss Solvency Test (SST) is recognized, internationally, to be at the forefront of risk-based solvency regimes. The SST paves the way for risk-based and differentiated supervision of insurers. Active consultations with industry participants have contributed to the overriding policy objective of practical, proportionate and effective regulation.

While the updated regulatory framework has a very high level of observance with the Insurance Core Principles, implementation of the reforms is in transition. The broad legislative framework has been established. The FOPI has recently issued and is drafting a number of implementing decrees and guidelines. These include corporate governance guidelines tailored to the insurance industry, regulatory intervention levels, roles of external auditors and actuaries, intra-group transactions. Going forward, the key challenge is in balancing the objective of the ISL, i.e., to protect the insured from abuses and the insolvency risks of insurers, against the financial market policy of preserving the international competitiveness of Switzerland as a financial center as well as the cost of regulation/supervision.

For effective supervision of the large and internationally diversified Swiss insurance industry, it is critical that the FOPI is equipped with adequate regulatory resources. Retention of experienced key personnel and rapid development of regulatory capacity is key to maintaining the momentum in implementing the regulatory reforms under the ISL. The effective implementation of the SST requires the FOPI to have good insights into company-specific internal models. While self-governance and enhanced external audits are useful complements, there is scope for FOPI to further strengthen direct supervision of (re)insurers. This requires adequate resources for more effective and timely off-site surveillance as well as risk-focused on-site examinations. In addition, there are significant resource implications for the FOPI if it is appointed as the supervisor /lead supervisor for cross-border supervision of insurance groups/conglomerates, in recognition of its regulatory equivalence with the EU.

I. Background

1. **This Technical Note provides a factual update of the regulatory regime for the direct insurance industry in Switzerland.**[1] The Swiss insurance sector was formally assessed in 2001, as part of the Fund's initial Financial Sector Assessment Program (FSAP), against the Insurance Core Principles (ICP) issued by the International Association of Insurance Supervisors (IAIS) in October 2000.

2. **Switzerland undertook a complete revision of its insurance supervisory regime in 2003.** The Parliament adopted the ISL on December 17, 2004, establishing the legal foundation for the Ordinance on the Supervision of Private Insurance Companies (SO) and the FOPI Ordinance on the Supervision of Private Insurance Companies (FOPI-SO). As the ISL replaced preventive product supervision with risk-based supervision and a risk-sensitive solvency regime, consequential amendments were also made to the Insurance Contract Law (ICL) to strengthen disclosure requirements. Prior to this, the Swiss insurance legislative framework had been fragmented into five federal statutes, 11 Federal Council ordinances and decisions, and several unpublished directives.

3. **This update focuses on significant market and regulatory developments since the previous FSAP conducted in 2001.** Implementation of the regulatory reforms pursuant to the ISL and other developments are reviewed, and benchmarked against the revised ICP issued by the IAIS in October 2003.

II. Market Structure and Industry Performance

A. Market Structure

4. **Switzerland is an established insurance center, well served by large and sophisticated insurers.** As at August 31, 2006, there were 214 (re)insurers—23 Swiss life insurers, 4 foreign life insurers, 78 Swiss non-life insurers, 40 foreign non-life insurers, and 69 reinsurers. The majority of the insurers are joint stock companies, as insurance cooperatives have been declining due to difficulties in raising capital. Switzerland has the highest per capita expenditures for insurance in the world—about SwF 7,000 (excluding social security contributions).

5. **Swiss insurers are significant international players, with more than 70 percent of their global premiums sourced from abroad.** Of the total global premiums of SwF 187

[1] Prepared by Su Hoong Chang (Monetary and Capital Markets Department). A formal assessment of the Swiss reinsurance industry is reported in a separate Detailed Assessment Report.

billion recorded in 2004, SwF 133.5 billion was in respect of foreign business. While more than half of direct life premiums stems from Swiss business, about three quarters of non-life business were written abroad and more than 95 percent of reinsurance premiums came from foreign business. In 2005, Swiss insurers employed about 42,186 staff in Switzerland and 92,774 staff abroad.[2] With the acquisition of GE Insurance Solution, to be completed by end-2006, Swiss Re becomes the largest reinsurer in the world, with an estimated 25 percent of global life and 14 percent of global non-life reinsurance premiums.[3]

Table 1. Balance Sheet of Top Four Direct Insurance Groups by Region, 2005

In SwF Mn	**Baloise**	**Swiss Life**	**Winterthur**	**Zurich Fin'l Services**	**Total (%)**	
Switzerland	33,607	88,971	84,619	42,125	249,322	28.8
Europe	28,501	88,626	93,799	253,619	464,545	53.7
North America	0	0	5,753	89,884	95,637	11.1
Asia	0	0	5,897	N.A	5,897	0.7
Rest of world	0	0	-11,340	60,419	49,079	5.7
Total	**62,108**	**177,597**	**178,728**	**446,047**	**864,480**	**100.0**

Source: 2005 Annual Report of the Federal Office of Private Insurance.

6. **Even though the Swiss insurance market is highly concentrated, the market structure has remained stable.** In 2005, the five largest non-life insurers accounted for 72 percent of gross premiums written while the five largest life insurers accounted for 82 percent of the premiums earned. Swiss Re, European Re and Converium consistently maintain about 79 percent share of the Swiss reinsurance market. Exits from the market have been orderly and new niche players have been attracted to enter the market, in the absence of restrictive entry barriers.

7. **Some insurers have reviewed their business strategies to focus on their core businesses.** Traditionally, Swiss insurers operate life and non-life as well as reinsurance businesses as part of their diversification strategies. There is an emerging trend for insurers to specialize in their traditional core business.[4] Almost all direct insurers have withdrawn from active reinsurance operations. The number of insurers offering one-stop financial services via collaborative ventures with banks fell significantly.

[2] Data extracted from the Swiss Insurance Association, with its 80 members accounting for more than 95 percent of the premiums written in the Swiss market.

[3] Standard & Poor's Global Reinsurance Highlights 2006 Edition.

[4] As an example, Swiss Life has refocused on life insurance while Mobiliar specializes in non-life products.

8. **Insurance for buildings is mandatory in 19 cantons, provided by monopolistic cantonal insurers that are not regulated by the FOPI.** The total sum insured for buildings in 26 cantons amounted to more than SwF 2,000 billion and content cover is about SwF 700 billion. These cantonal insurers cover fire, lightning, explosion, aircraft and elemental perils only.[5] Potential economic losses from earthquakes are estimated at approximately SwF 80 billion in the region of Basle. Earthquake insurance is mandatory in Zurich while the other 18 cantons maintain a voluntary earthquake pool with the sum insured totaling SwF 1,200 billion. The Swiss Insurance Association (SIA) and the Interkantonaler Rückversicherungs-Verband (IRV), an inter cantonal pool of insurers, have launched a joint initiative to implement a mandatory earthquake insurance solution with appropriate reinsurance protection by January 1, 2008.[6]

B. Industry Performance

9. **The insurance industry has recovered from the stock market crash in 2001/2002.** Restructuring investment allocation strategies and more stable capital market performance led to improved earnings and capitalization of direct insurers. Investments in shares and mutual funds have been brought down to less than 8 percent (SwF 43 billion) of capital investment at end-2005. The direct insurance industry has been profitable, even after sustaining SwF 1.3 billion payouts caused by a severe storm in August 2005.

10. **Stabilized premium receipts and declining losses for direct Swiss business have strengthened capital and reserves of the direct insurers over the last three years.** Gross premiums of direct Swiss insurers totaled SwF 50.5 billion for 2005. For non-life insurance, motor insurance is the largest line of domestic business, accounting for 23 percent of market share, followed by fire and natural hazards insurance (15 percent). The latter suffered the highest loss ratio of 140 percent for 2005. A massive growth of 83 percent was registered in the unit-linked life insurance, boosted by good investment performance in 2005 and the introduction of new products that offer capital protection or a guaranteed minimum return at contract expiry. Occupational pension insurance declined 8.2 percent due mainly to the withdrawal of a number of insurers and guaranteed products. Health insurance has been hovering at the current level.

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[5] Elemental perils are defined by law and include flood, storm, hail, avalanche, snow pressure, snow slide, landslide, falling rock and rockslide.

[6] Source: Data quoted in this paragraph is from Guy Carpenter, *The World Catastrophe Reinsurance Market – Steep Peaks Overshadow Plateaus*, September 2006

11. **Total assets held by direct insurers amounted to SwF 450.3 billion as at end-2005, with significant shifts in asset allocations since 2002.** About 50 percent was invested in fixed income securities while investments in shares had been reduced significantly to only 8 percent of total assets at end-2005**.** Significantly, intra-group loans and investments in related companies amounted to SwF 55.7 billion or 12.4 percent of total assets. The current asset allocation strategy implies that insurers are unlikely to enjoy high, albeit volatile, investment returns as in the past. Future profitability will hinge on disciplined underwriting performance.

12. **The industry has been building up its equity base for the past three years, with combined life and non-life equity totaling SwF 26.5 billion at end-2005.** The surplus of the direct industry rose by SwF 1.7 billion in 2005 to reach SwF 4.1 billion while equity increased marginally by SwF 0.8 billion. Total reserves held by the direct insurance industry amounted to SwF 596.1 billion, of which life reserves accounted for SwF 513 billion.

III. Institutional Framework and Arrangements

13. **Pursuant to the ISL, the FOPI regulates and supervises all private (re)insurance entities, groups and conglomerates as well as intermediaries domiciled in Switzerland**. Exempt from the scope of the ISL are: (i) insurance companies with their registered office outside Switzerland if they only operate insurance in Switzerland; and (ii) insurance companies subject to special supervision pursuant to Swiss Federal Law, in respect of activities covered by such special supervision, including those registered in the register of occupational pension plans and insurance intermediaries dependent on an insurance policy holder, where they pursue exclusively the interests of the policy-holder and the companies the policy holder controls. Old age and survivors' insurance, Swiss National Accident Insurance Fund and military insurance are not subject to supervision by the FOPI.

14. **The health insurance sector is subject to dual supervision**. Basic health insurance is mandatory, mainly offered by health insurance associations regulated by the Federal Office of Public Health (FOPH). While private insurers are allowed to write basic health insurance, their level of interest is low as premium rates are fixed by the FOPH. The FOPI is responsible for supplementary private health insurance sold by private insurers and health insurance associations. The insolvencies of three health insurance associations (KBV; Accorda; and Zurzach) in recent years were attributable to their basic health insurance portfolios.

15. **The FOPI was restructured in mid-2004 to facilitate specialization according to the type of insurance operation.** Separate supervisory sections are responsible for non-life insurance, life insurance, intermediary, group and conglomerate and health insurance and reinsurance. With its current established headcount of 90 staff, the FOPI monitors over