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DETAILED ASSESSMENT OF OBSERVANCE—INSURANCE CORE PRINCIPLES

This Detailed Assessment of Observance on the Insurance Core Principles on Switzerland was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on August 20, 2014.

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Prepared By
Monetary and Capital Markets Department

This Detailed Assessment Report was prepared in the context of an IMF Financial Sector Assessment Program (FSAP) mission in Switzerland during September 2013, led by Charles Enoch, IMF and overseen by the Monetary and Capital Markets Department, IMF. Further information on the FSAP program can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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Glossary

ALM	Asset Liability Management
AML	Anti-money laundering
AMLA	Anti-Money Laundering Act
AMLO	Anti-Money Laundering and Terrorism Financing Ordinance
APLIEM	Anti- persistent low interest rate environment measures
BOD	Board of Directors
CCG	Swiss Code of Best Practice for Corporate Governance
CEO	Chief Executive Officer
CFT	Combating Financing of Terrorism
CG	Corporate governance
CO	Code of Obligations
ERM	Enterprise Risk Management
FAOA	Federal Audit Oversight Authority
FDF	Federal Department of Finance
FFSA	Federal Financial Services Act
FINMA	Swiss Financial Market Supervisory Authority
FINMASA	Financial Market Supervision Act of 22 June 2007
FOPH	Federal Office of Public Health
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
IAIS	International Association of Insurance Supervisors
IBO	Insurance Bankruptcy Ordinance
ICA	Insurance Contract Act
ICP	Insurance Core Principle
ICS	Internal Control Systems
IMF	International Monetary Fund
ISA	Insurance Supervision Act of 17 December 2004
ISO	Insurance Supervision Ordinance
MOU	Memorandum of Understanding
MROS	Money Laundering Reporting Office of Switzerland
PA	Personal Accident
RM	Risk Management
SESTA	Collective Investment Schemes Act
SIA	Swiss Insurers Association
SIBA	Swiss Insurance Brokers Association
SNB	Swiss National Bank
SRO	Self-regulatory Organization
SQA	Swiss Qualitative Assessment
SST	Swiss Solvency Test
SUVA	Swiss Accident Insurance Office

EXECUTIVE SUMMARY

The insurance industry in Switzerland is well developed having among the highest insurance penetration and expenditure per capita in the world. Insurance penetration is the fourth highest in the world with 14.1 gross premium as percentage of GDP, well above the EU average penetration of 7.8 percent. Expenditure per capita on insurance leads worldwide with over CHF 10 thousand. Total premium in 2012 amounted to CHF 83 billion, of which 40 percent corresponds to life insurance, and 30 percent each to non-life and to comprehensive health insurance. Total assets of the sector are CHF 460 billion or around 15 percent of the financial sector assets, of which two thirds correspond to life insurance. Over half of the investments on own account are in fixed income instruments, 17 percent in real estate and mortgages, and only 2 percent in equities.

The sector is dominated by a few players writing significant international business. The life sector is dominated by two players, responsible for 54 percent of the business and the top ten life insurers account for 97 percent of the market. The non-life sector is also concentrated but less than the life sector; here the top ten insurers account for 65 percent of the business. Without taking Swiss Re and Zurich Insurance Group into account, the Swiss insurance groups write on average around 35 percent of the premium outside Switzerland and over 45 percent of their assets are related to foreign business. For Swiss Re and Zurich Insurance Group the domestic premium is only 1.7 percent and 9.8 percent, respectively, of their total premium income.

The industry has weathered the 2008 crisis well; however the current low interest rate environment is affecting the sector. The negative impact on the share prices of Swiss insurers during the crisis has basically been reversed. However, the ensuing challenging economic environment is adversely affecting the industry, which has not been growing, except for the mandatory occupation pension business, which grew 6 percent in 2011. Low interest yields have reduced the government-mandated guarantees that insurers are required to offer, making their products less attractive, and has probably created negative spreads in a few portfolios. Measures being introduced include the reduction in 2012 of the statutorily guaranteed return for the occupational pensions to 1.5 percent.

The lack of availability of Swiss government bonds to match long term liabilities of life insurers and pension funds could be a source of vulnerability. The long term nature of the liabilities of life insurers and pension funds could in principle be matched by investment in Swiss government securities. However, the CHF one trillion of assets managed by life insurers and pension funds is disproportionate to the CHF 80 billion outstanding bonds by the federal government. Before taking diversification benefits into account, the cost of capital under the Swiss Solvency Test (SST) to hold equity investments can require high returns; thus leaving real estate as the main domestic alternative for investments; this in turn runs the risk of contributing to the creation of a real estate bubble, and possibly raise liquidity issues.

Important mandatory insurance and pension providers are not supervised in line with FINMA standards. Pension funds providing for the mandatory Swiss occupational pensions are supervised

under softer solvency requirements compared to insurers active in the same business segment. Thus participants' pensions have different level of protection. Mandatory insurance is present in several lines of business, for instance in health, accident, motor, fire and property. It is recommended that mechanisms be devised to ensure consistent effective supervision for all insurance and pension providers.

Significant regulatory reforms and increased supervision since 2003 have updated Switzerland's regulatory and supervisory regime for the insurance industry to levels consistent with international best practices. The Financial Market Supervisory Authority Act of June 22, 2007 (FINMASA), together with two related Ordinances, serves as an umbrella law for sector-specific laws governing financial market regulation and supervision and also establishes the integrated financial services supervisor FINMA. The new insurance law effective on January 2006 and the introduction of the SST have reoriented the regulatory focus towards a risk based supervision supported by a strong risk sensitive solvency regime.

The Swiss authorities succeeded in passing and implementing a state-of-the-art solvency regime. This Swiss solvency test should serve to properly asses the risks run by the insurers; however, its risk sensitive provisions showing at an early stage the negative effects of the low interest rate environment on the solvency ratio has led the authorities to introduce temporary measures to offset the stress to the sector, partly to avoid that Swiss companies become disadvantaged vis-à-vis those from areas without an advanced regime. The temporary measures have been taken with care and maintaining as much transparency as possible; however the measures have implicitly reduced policyholders' protection and it is recommended to remove them as scheduled in 2016.

Supervision focuses on ensuring sufficiency of liquid assets to meet policy liabilities. There are statutory accounting methods to determine technical provisions and value of assets on a prudent basis for "tied asset" purposes. Insurers (excluding reinsurers) are required to earmark and ring-fence assets designated as tied assets subject to a liquidity test to back the technical provisions plus a risk margin. Policyholders have priority claims over the tied assets. In addition, robust solvency requirements ensure there is sufficient capital to safeguard the insurers' financial soundness under adverse conditions. The triple focus on the adequacy of technical provisions, liquidity and safety of tied assets, and the adequacy of capital forms the basis of FINMA's supervision.

FINMA supervision is particularly strong in quantitative analysis and group supervision, while risk management, internal control and governance requirements are relatively new. FINMA has highly qualified staff. A large group of actuaries and mathematicians support the offsite reviews, internal model approval and other SST quantitative work. All but two domestic insurance groups have active colleges in place that engage in group wide supervision. The granular and aggregated approaches towards solvency of a group are also commendable. Qualitative assessment of insurers' operating environment is newer. The Swiss Qualitative Assessment (SQA) was first carried out in 2008, covering all insurers. The second SQA was carried out in 2012 and was risk-prioritized to cover groups and insurers in the high-risk categories. For SQA various means are used to gather information and carry out the analyses, including a questionnaire answered separately by key

functions of the insurer, followed up with onsite visits to discuss findings and set out remedial steps if needed.

Increasing the intensity of onsite supervision will complement FINMA's strong supervisory framework. Increasing the intensity of onsite supervision will complement FINMA's strong supervisory framework. In addition to onsite inspections, FINMA uses a variety of other ways to gather information and make assessments. As a result, FINMA's onsite inspections tend to be focused in scope and, compared to some jurisdictions, less frequent. The main purpose of a FINMA inspection is either to verify a specific concern identified during offsite analysis, to gain understanding of an observed emerging trend, or determine if the insurer has a weakness or is not complying in a specific area. There is a danger that FINMA may not be able to identify weaknesses in the insurer's operation without direct observation and verification through onsite inspections. FINMA should therefore increase the frequency and scope of inspections. More in-depth onsite inspections will enhance FINMA's understanding of insurers' operations and facilitate more accurate risk ratings. FINMA is encouraged to maintain its direct supervision of insurers, limiting the use of external auditors to checking compliance with clearly defined guidelines that require minimal or no supervisory judgment.

The position of Switzerland as global insurance center and a reinsurance hub sets additional demands on the regulatory framework.

- In 2012 FINMA started a review of the possibility of expanding public disclosure requirements, taking into account international standards and practices. It is recommended that FINMA completes its review and Swiss authorities institute the necessary regulatory changes to be more in line with international standards.

- While laws clearly stipulate the intention to protect policyholders and entrust FINMA to intervene on behalf of the policyholders and their beneficiaries, FINMA has yet to articulate specific rules on business conduct. Supervision of tied agents is indirectly through insurers. Supervision of brokers is minimal There are no on-going reporting requirements for intermediaries. It is recommended that Swiss authorities press on with the legislative effort to improve policyholder protection and enhances brokers' supervision.

- The requirements on the investments of reinsurers need to be strengthening. Notwithstanding the specific characteristics of the reinsurance business, the lack of the requirement to have tied assets backing up reinsurance liabilities could weaken the asset quality of reinsurers as well as the ability of FINMA to liquidate them. Ultimately this could impact on policyholder's protection given that cedents can use reinsurance recoverable as part of their tied assets. FINMA's legal reach to the assets in case of liquidation is particularly relevant in its role as home supervisor given the ability of reinsures to operate in foreign jurisdictions without local capital requirements.

- All reinsurers established in Switzerland are supervised by FINMA, although branches of companies headquartered outside Switzerland and conducting only reinsurance business are