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Pending revisions of the Insurance Supervisory Act and the Banking Act: Regulatory trends and effects for customers

The Swiss federal parliament is currently debating partial revisions to both the Insurance Supervisory Act and the Banking Act. One common key topic of both revision projects is insolvency: while the Banking Act's seasoned rules on restructuring proceedings are further amended and depositor insurance protection is (somewhat) strengthened, the Insurance Supervisory Act will for the first time contain explicit restructuring powers of the FINMA. The latter revision also comprises other important aspects, such as client categorization as a basis of levels of protection, and a new regime for insurance intermediaries.

This edition of Advestra Insights looks at the proposed revisions primarily from the perspective of insurers' and banks' customers and counterparties - highlighting opportunities and threats - and further points to some broader regulatory trends exemplified by the proposals.

1 STATUS OF THE REVISIONS

Both revision projects were launched by public consultation procedures in 2018 and 2019, followed by the publication of drafts by the Federal Council that are currently under consideration by the Federal Assembly.

The Federal Council's draft for the partial revision of the Insurance Supervisory Act[1] ("rev-ISA") was published in October 2020,[2] after a consultation procedure running from November 2018 to February 2019. In March 2021, the bill had its first reading in the National Council, which made some significant amendments.

In the case of the Banking Act,[3] the Federal Council's draft for a partial revision ("rev-BankA") was published in June 2020,[4] after a consultation procedure running from March to June 2019. As with the Insurance

[1] SR 961.01.

[2] The Federal Council, Media release of 21 October 2020 '*Federal Council adopts dispatch on partial revision of Insurance Oversight Act*'; Botschaft zur Änderung des Versicherungsaufsichtsgesetzes (VAG) vom 21. Oktober 2020, BBl 2020 8967 ff.

[3] SR 952.0.

[4] The Federal Council, Media release of 19 June 2020 '*Federal Council adopts dispatch on partial revision of Banking Act*'; Botschaft zur Änderung des Bankengesetzes (BankG) (Insolvenz, Einlagensicherung, Segregierung) vom 19. Juni 2020, BBl 2020 6359.

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Supervision Act, the bill had its first reading in the National Council in March 2021; the Council of States debated on the bill on 16 September 2021. In both chambers, only few and fairly insignificant amendments were made to the Federal Council's proposal. In particular, the National Council rejected a minority motion to increase the total cover sum of depositor insurance from 1.6 to 2.5 per cent. of the total sum of all insured deposits.

2 REGULATORY TRENDS ON DISPLAY

2.1 Tiered regulatory regimes

The revision project for the Insurance Supervision Act proposes that insurance companies who only insure professional clients (defined by reference to the Insurance Contract Act[5] in its version effective as from 1 January 2022[6]) can be exempted from certain significant regulatory requirements (they may not be required to maintain tied assets, nor an "organizational fund", and may not have to adhere to an ombudsman scheme). Insurance companies who have both professional and other clients can benefit from the exemptions with respect to their business with professional clients. Captive insurance companies are also exempted from a range of requirements (art. 30 ff. rev-ISA).

Insurance companies meeting certain criteria of "insignificance" (to be elaborated in implementing regulation by the Federal Council) are proposed to be exempted entirely from supervision (art. 2 (5)(b) rev-ISA). The current law already gives the FINMA the competence to exempt insurers whose activity is economically insignificant or affects only a small population of insured parties from supervision, if "*special circumstances*" so warrant (art. 2 (3) ISA). Going forward, the Federal Council will be empowered to define criteria for automatic exemption. Pursuant to the government's proposal this possibility would have been limited to "small" insurers, but the National Council deleted the word "small" from the provision.

These new instances of a differentiation or 'tiering' of regulatory regimes follow a trend that is also visible in banking regulation, with the lighter-touch "Fintech licence" (art. 1*b* BankA, in force since 2019) and the small banks regime[7] on the lower end, and the particularly demanding regime for systemically important banks (art. 7 ff. BankA, in force since 2012) on the upper end.

2.2 Everyone must "*enjoy a good reputation*" and „*guarantee proper business conduct*"

The regulatory requirement of "*enjoying a good reputation*" and "*guaranteeing proper business conduct*" (*Gewähr für einwandfreie Geschäftstätigkeit bieten*) was initially conceived for members of the board of directors and top management of banks, in the sense of a 'fit and proper' test for these individuals (art. 3 (2)(c) BankA). The erstwhile Federal Banking Commission and later the FINMA then also applied the requirement to banks as such, using "*proper business conduct*" as a general standard of propriety under which supervisory demands could be made of banks that had no specific basis in law. More recently, the FINMA has also increasingly extended the requirement to key executives in risk or compliance functions, even if they are not members of the bank's executive committee.

The concept also applies in insurance regulation by virtue of art. 14 ISA, which was revised in 2018 - together with the enactment of the Financial Institutions Act[8] - to make it explicit that the requirement of "*guaranteeing proper business conduct*" applied not only to the directors and executives of an insurance company, but also to the company itself (thereby codifying the past practice of the FINMA). In the Financial Institutions Act itself, the concept was extended to the asset

[5] SR 221.229.1.
[6] AS 2020 4969.
[7] FINMA, Press release of 27 November 2019 '*FINMA implementing small banks regime*'.
[8] SR 954.1.

managers and trustees who were newly submitted to prudential supervision.

A further regulatory trend now seems to consist in extending the above-described requirements even to legal entities (and to their directors and managers) who are not subject to fully-fledged prudential supervision. Art. 14 (3) ISA already applies the requirement of "*guaranteeing proper business conduct*" to service providers who perform significant functions of an insurance company, based on an outsourcing arrangement. The revised Insurance Supervisory Act will newly stipulate a requirement of "*enjoying a good reputation and guaranteeing compliance with the duties under this Act*" for non-tied insurance intermediaries (art. 41 (2)(b) and art. 46 (1)(b) rev-ISA).

This proliferation of a requirement originally stipulated for banks' directors and executives, with its wide potential reach and blurred edges, brings ever more people under the threat of a thumbs-down by the FINMA.

2.3 Tighter regulatory grip on "unregulated" group companies

As a complement to the supervision of individual regulated legal entities (banks, securities firms, insurance companies, etc.), Swiss financial market regulation calls for the consolidated supervision of the corporate groups to which they belong. The supervised group as a whole must fulfil certain requirements (e.g. have sufficient regulatory capital, control its risks, etc. on a consolidated basis), which may indirectly also impact on the individual group companies. Nevertheless, companies that do not themselves conduct a regulated business remain, on a stand-alone basis, "unregulated".

This principle has come under pressure in recent legislation and practice. The instances multiply where regulatory requirements are extended directly to "unregulated" entities of supervised groups.

One of the first steps was an extension of the FINMA's insolvency jurisdiction: since 2016, the Banking Act has provided that within a FINMA-supervised banking group, an individually unregulated Swiss parent company, as well as Swiss group companies that perform significant functions for the regulated businesses, are subject to the same special insolvency law regime as licensed banks, including the jurisdiction of the FINMA (instead of the ordinary insolvency courts and authorities).

The draft revised Banking Act now also permits the Federal Council to define requirements for the capitalization and organization of such companies if they perform significant functions for systemically important banks (SIBs) (art. 3*g* (3) and (4) rev-BankA).

The revised Insurance Supervision Act will require the prior approval of the FINMA for any appointments to the board of directors and executive management of an (individually unregulated) parent company of an insurance group or conglomerate and, if the FINMA so directs, of other Swiss group companies who perform significant functions for regulated entities (art. 71^{bis} and 79^{bis} rev-ISA). Unlike the revised Banking Act, it will, however, not permit the imposition of capitalization and organization requirements for such companies.

2.4 Preparing for recovery and resolution, under the FINMA's auspices

The supervisory requirement of planning for recovery and resolution originated in the special regime for SIBs which was introduced in 2011 and entered in force in 2012 (art. 9 (2)(d) BankA). It was then also included in the Financial Market Infrastructures Act (FMIA)[9] of

[9] SR 958.0.

2015, for "*systemically important financial market infrastructures*" (art. 24 FMIA).

Although none of the Swiss insurance companies are currently classified as global systemically important financial institutions (G-SIFIs), the revised Insurance Supervisory Act will forthwith require (all) FINMA-supervised insurance groups and conglomerates, and will further authorize the FINMA to require "*economically significant insurance companies*", to prepare a stabilization plan, explaining "*by which means it indends to sustainably stabilize itself in the case of a crisis, in such manner that it can continue its business activity without state support*".[10] The FINMA may further require insurance groups or conglomerates to assist with the preparation of a resolution plan (art. 22*a*, 67 (4) and 75 (4) rev-ISA). The revised Insurance Supervisory Act thus largely assimilates insurance groups and conglomerates to domestic systemically important banks (D-SIBs).

2.5 From penal to administrative sanctions

The Federal Council's proposal scales back the penal provisions of the Insurance Supervisory Act, both by reducing the catalogue of punishable offences and by lowering the maximum amounts of monetary penalties threatened for less grave contraventions (art. 86 f. rev-ISA). The Federal Council explains that this is proposed "*taking account of the principle followed by parliament in the case of the Financial Services Act, namely, that in the field of financial market regulation lawful conduct shall essentially and to the extent possible be assured by instruments of supervisory law rather than by penal provisions*".[11] When debating the Financial Services Act (FinSA)[12] of 2018, the Federal Assembly had limited the application of the Act's penal provisions to persons other than financial institutions supervised by the FINMA and persons working for them (art. 92 FinSA).

The Federal Council's approach - which did not fail to draw opposition in the parliamentary debate, but survived the National Council hearing – is remarkable and welcome. Perhaps reflecting an increasing confidence of the legislator that supervisory sanctions are working and do not need the backing of penal provisions in all cases, it could help to halt and reverse the long-standing trend of a multiplication of criminal penalties in federal legislation more generally.

3 KEY TOPICS FOR CUSTOMERS (INSURANCE SUPERVISORY ACT)

3.1 New restructuring regime

The current law gives the FINMA insolvency jurisdiction over insurance companies (instead of the courts and authorities tasked with insolvency measures over other companies), but only permits it to order "*protective measures*" (art. 51 ISA) or to initiate bankruptcy proceedings (art. 53 ff. ISA). No explicit restructuring powers currently exist for insurance companies.

The proposed revision of the Insurance Supervisory Act remedies this situation by introducing a dedicated restructuring regime, which is generally modelled on the respective provisions of the Banking Act, but departs from them in certain respect to take account of the characteristics of an insurance business.

The insurance restructuring regime, similarly to that for banks, will authorize a transfer of assets and liabilities to a third party and a bail-in of debt (by way of write-down or conversion to equity); in addition, the FINMA will be authorized to *adjust existing insurance contracts,* in particular by restricting or cancelling rights of the insured party. This

[10] Cited from the Federal Council's proposal; the National Council slightly changed this wording to "*...continue its business activity independently or with private debt financing*" (AB 2021 N 752)

[11] Cf. Botschaft (cited in fn. 1), BBl 2020 9049 (our translation from the German original).
[12] SR 950.1.

right has led to some political debate, but was confirmed in the National Council hearing.

In the sequence in which claims shall be submitted to a bail-in (the "bail-in waterfall"), claims under insurance contracts are afforded privileged treatment: those insurance claims for which no tied assets are prescribed (see 3.2 below) rank with preference to common "class 3" claims (i.e. they will only be affected if a bail-in of such common class 3 claims is insufficient). Insurance claims for which tied assets are prescribed but prove insufficient for their satisfaction in the specific case, rank with a still higher preference (pursuant to the Federal Council's proposal, senior to *all* other unsecured claims, including those with a class 1 or 2 bankruptcy privilege; the National Council has, however, reversed this order).

By basing the restructuring provisions on the model of the (revised) Banking Act, the project also adopts the latter's emphasis on flexibility at the expense of legal safeguards (cf. below 4.1), and its scant regard for legal process. For example, because it is stipulated that a successful judicial appeal against the FINMA's approval of a restructuring plan may only result in the award of compensation (art. 54*d* (1) rev-ISA), restructurings will be unappealable in principle.

While the introduction of a restructuring regime is undoubtedly welcome from the perspective of policyholders and other counterparties of an insurance company, the legislator's tendency to give the FINMA free rein in such proceedings and clear away substantive and procedural checks can be viewed critically.

3.2 Waiver of requirement of tied assets for business with professional clients

Licensed Swiss insurance companies - with the exception of reinsurers – are obliged to set aside designated assets ("*tied assets*") to secure their obligations under insurance contracts. The investment and custody of tied assets are closely regulated. In the event of the insurer's insolvency, they are used with priority to satisfy the claims of the insured.

As the most significant of the proposed alleviations for insurers of professional clients (see above 2.1), it is envisaged that they may petition the FINMA to exempt them from the requirement of maintaining tied assets in respect of such clients' contracts. This should give insurance companies more flexibility in investing their assets (which of course are still required in sufficient amounts to cover technical provisions for insurance claims and minimum capital requirements). It will, howeverin turn decrease the specific legal protection of those policyholders who fall within the category of professional clients.

3.3 Overhaul of the insurance intermediaries regime

While 'tied' insurance intermediaries, who depend on one or more insurance companies, are only indirectly supervised in Switzerland through the supervision of such insurers, the "non-tied" insurance intermediaries have long been the subject of a special, relatively light (non-prudential) supervisory regime: They need to be recorded in a public register maintained by the FINMA; ensure adequate training of their staff; maintain professional liability insurance; and provide certain information to clients when first contacting them (art. 40 ff. ISA).

This regime is now overhauled and extended in the rev-ISA. Non-tied insurance intermediaries are newly subjected to a 'fit and proper' requirement (see above 2.2) and may have to adhere to an ombudsman scheme (see below 3.5).

In the spirit of the new Financial Services Act which entered into force on 1 January 2020, the rev-ISA further provides for new rules for non-tied insurance intermediaries with respect to conflicts of interest and, in particular, the permissibility and disclosure of third party compensation (art. 45*a* and 45*b* rev-ISA).[13]

3.4 Qualified life insurance regulated as investment products

"*Qualified life insurance contracts*", defined as life insurance where the policyholder bears a risk of loss in the savings process (as well as capitalization operations and tontines), are subjected to a number of rules in the revised Insurance Supervision Act which are similar to those for financial instruments under the Financial Services Act (FinSA) (art. 39a ff. rev-ISA): the offeror needs to prepare a key information document (KID); there are supervisory rules on advertising; and the insurance company or insurance intermediary has to perform an assessment of appropriateness before recommending the product to a client and to document the process.

The similarity between the new rules for "*qualified life insurance contracts*" and the rules applicable to financial instruments under the Financial Services Act is not surprising, as it follows the principle "*same business, same rules*". Indeed, the Federal Department of Finance had already suggested to apply the latter rules to such products based on the model set by the European PRIIPS-Regulation. However, it withdrew its proposal, after it was criticized in the consultation proceedings. The revised Insurance Supervisory Act closes the gap with a solution that is tailored to insurance products while based on the template of the Financial Services Act.

Similarly to the FinSA regime, the new provisions on qualified life insurance should make it easier for clients to hold financial institutions (in this case, insurance companies and intermediaries) to account for mis-sold products.

3.5 Edition of documents and mandatory ombudsman affiliation (or not?)

Policyholders will be given the right at any time to obtain a copy of the file of information which an insurance company or insurance intermediary maintains in their respect (art. 80 f. rev-ISA). These rights, again, are inspired by similar provisions that apply to clients of financial service providers under the Financial Services Act.

In addition, the project of the Federal Council proposes to require each insurance company or non-tied insurance intermediary to adhere to an ombudsman scheme, and to participate in its proceedings if a policyholder initiates them (art. 82*c* f. rev-ISA). An ombudsman scheme of the Swiss insurance industry already exists, but adherence to it has been voluntary and it has currently no basis in statutory law.

Under the proposed new regime, ombudsman schemes would need to obtain "*recognition*" (in effect, a licence) by the Federal Department of Finance (art. 83 rev-ISA). The ombudsman proceedings must be "*inexpensive or free of charge*" for the policyholder (art. 82*a* (1) rev-ISA). Also, interestingly, insurance companies and intermediaries would have a duty to comply with any information requests by the ombudsman; their counterparty would, however, have no right to access the information provided (art. 82*d* (2) and art. 82*a* (3) rev-ISA).

When debating the proposed bill, a majority in the National Council decided to strike out the provisions on ombudsman schemes, arguing that the existing voluntary scheme was sufficient. It remains to be seen whether the second chamber of the Federal Assembly will take the same view.

[13] Cf. Botschaft (cited in fn. 1), BBl 2020 9012. For details, see the upcoming Advestra Insights (September 2021): 'The Remuneration of Insurance Intermediaries under the revised Insurance Supervisory Act'.

4 KEY TOPICS FOR CUSTOMERS (BANKING ACT)

4.1 Tweaks to the restructuring regime

Unlike the Insurance Supervision Act, the Banking Act has provided for a restructuring procedure since 2004. Some important instruments available within that procedure – such as bail-in orders – are, however, now barely mentioned in the Act itself and only comprehensively regulated in the FINMA's Banking Insolvency Ordinance (BIO-FINMA). In the proposed revision of the Banking Act, the Federal Council wants to enshrine more rules in the Act itself.

In this process, various existing rules are tweaked in favour of yet more flexibility for the FINMA as the resolution authority in charge (which of course spells uncertainty for third parties dealing with a bank). For example, it will be specified that the FINMA may refrain from publicising protective measures decreed for a bank (e.g. restrictions on its operations, a prohibition to make payments, or a moratorium) if publicity threatens to frustrate their purpose – even where the protection of third parties would require publication (art. 26 (2) rev-BankA; similarly, art. 51 (3) rev-ISA). Also, while a bail-in must in principle be applied equally to all outstanding debts of the same class that are not exempted by law, the new rules permit the FINMA also to exempt, in a specific instance, any claims stemming from the provision of goods or services, if this is deemed necessary for the continuation of the bank's operations (art. 30*b* (4) rev-BankA). It is difficult to imagine situations where this condition is fulfilled, since existing claims normally relate to goods or services already provided. In the case of a transfer of assets and liabilities of the bank to a third party or a bridge bank, both an independent valuation and a re-balancing (compensation) between the legal entities – which today are mandated by law – will be made voluntary (art. 31*b* rev-BankA: "*the FINMA may* …").

Finally, the "*no creditor worse off*" (NCWO) requirement for a restructuring is weakened in the case of SIBs: the FINMA may approve a restructuring plan although the creditors fare worse than in a liquidation, provided that they are "*adequately compensated*" (art. 31 (3) rev-BankA). This only makes sense if, by "*adequately*", one understands something less than "*fully*", as otherwise the NCWO test would by definition be met.

4.2 Revised funding system for the deposit insurance scheme

The Swiss deposit insurance scheme, which aims to protect cash deposits with Swiss banks up to a maximum of CHF 100'000 per client, is currently an unfunded scheme. Only upon a bank's insolvency are other banks required to provide contributions to fund the pay-out of insured deposits to clients. For this purpose, they are required to hold additional liquidity (within the more general minimum liquidity regime); the liquid funds so held are, however, not specially protected (e.g. by a right of lien) in favour of the deposit insurance scheme.

While more pervasive proposed changes to this funding model were abandoned in the past, the Federal Council now proposes that banks should hold high-quality liquid securities or cash, in the amount of half their respective potential contribution obligations to the deposit insurance system, with a third-party custodian to secure such obligations (or alternatively extend cash loans to the deposit insurance system in the same amount).

For the process of paying out deposit insurance funds, time limits are set: seven business days for the funds to reach the bankruptcy liquidator, after the FINMA triggers the mechanism; and another seven business days for the funds to reach the client, after the liquidator received the client's payment instructions. This may, overall, result in more or less than the twenty business days currently prescribed for the entire process.

Finally, the total upper limit of depositor insurance, which currently stands at CHF 6 billion, shall be raised to the higher of this number and 1.6 per cent. of the total sum of insured deposits (at all Swiss banks). This percentage is said currently to correspond to around CHF 7.3 billion.[14] While that amount would be sufficient to secure all privileged deposits of a smaller bank, it would cover only a fraction of affected deposits in the case of the insolvency of one of the largest banks. Clients of smaller Swiss banks are, therefore, clearly at an advantage as regards deposit insurance protection.

4.3 Mandatory segregation of client and nostro securities positions

Under current law, the direct participants of a Swiss central counterparty (CCP; i.e. of SIX x-clear AG) or central securities depositary (CSD; i.e. of SIX SIS AG) have the duty to segregate their holdings with such infrastructures into client positions and proprietary (*nostro*) positions (art. 59 and 73 FMIA). It is not entirely clear whether an analogous duty exists for indirect participants (i.e. clients of direct participants who are themselves intermediaries). The duty of separation is intended to protect client positions and facilitate their separation in the event of an insolvency of the participant; it applies to all classes of assets, but only if they are held through a Swiss CCP or CSD.

By way of an amendment to the Federal Intermediated Securities Act (FISA),[15] it is now proposed to require all custodians of intermediated securities (*Bucheffekten*) to segregate their holdings of such securities with sub-custodians into client and proprietary positions, to be held in separate securities accounts. If segregration is not possible in the case of non-Swiss sub-custodians, the Swiss custodian must (subject to certain exceptions) take other precautions that ensure a comparable level of protection for accountholders.

By this legislative change, the duty to segregate will be extended, as far as intermediated securities are concerned, to all Swiss custodians (banks and securities firms), whether or not they hold such securities as direct participants of a Swiss CSD. This is expected to strengthen the (already extensive) legal protection of custody account holders against insolvency risks.

5 OUTLOOK

Whereas the Council of States recently debated the bill for the revision of the Banking Act on 16 September 2021 (as the second chamber after the National Council), the Insurance Supervision Act is expected to have its Council of States reading later this year. Further readings of the proposals in both chambers will then be necessary before final bills are passed, and the Federal Council will need to prepare consequential changes to its implementing Ordinances. The changes to the Insurance Supervision Act and to the Banking Act are currently expected to enter into force in 2023.

[14] AB 2021 N 423.

[15] SR 957.1.

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