ADVESTRA INSIGHTS

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Insurance restructurings under the revised Swiss Insurance Supervisory Act and the draft EU Insurance Recovery and Resolution Directive: Some observations

The Swiss federal parliament has approved, on 18 March 2022, a partial revision to the Insurance Supervisory Act (expected to enter into force in July 2023), which introduces a dedicated restructuring regime for insurance companies. At the same time, a draft Insurance Recovery and Resolution Directive is under consideration in the European Union.

This edition of Advestra Insights looks at the way in which either legislation addresses certain key topics in restructuring an insurance company.

1 OVERVIEW

1.1 Status of Swiss and EU legislation

On 18 March 2022, the Swiss federal parliament approved the final bill for a partial revision of the Insurance Supervisory Act[1] ("rev-ISA"). The Federal Department of Finance and the Swiss Financial Market Supervisory Authority FINMA have already published[2] and/or are expected in due course to publish consultation drafts and then final versions of changes to implementing ordinances and regulatory guidance, and the new rules are expected to enter into force as of 1 July 2023.

In parallel, the European Commission published its draft of an Insurance Recovery and Resolution Directive ("D-IRRD") in September 2021, together with reform proposals for the Solvency II regime.[3] Previously, the European Insurance and Occupational Pensions Authority (EIOPA) had provided advice to the Commission to adopt a harmonised resolution regime. The draft directive was subject to a consultation

[1] SR 961.01.

[2] Federal Department of Finance, Media release of 17 May 2022 '*Privatversicherungen: EFD eröffnet Vernehmlassung zur Änderung der Aufsichtsverordnung*'.

[3] European Commission, Media release of 22 September 2021 '*Reviewing EU insurance rules: encouraging insurers to invest in Europe's future*'.

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procedure until January 2022.[4] It will next be debated in the European Parliament and the Council.

1.2 The new Swiss restructuring regime

The current law disapplies the general insolvency law regime in the case of insurance companies, and grants FINMA insolvency jurisdiction over them (instead of the courts and authorities tasked with insolvency measures over other companies). The FINMA only has the powers, however, to order "*protective measures*" (art. 51 ISA) or to initiate bankruptcy proceedings (art. 53 ff. ISA). No explicit restructuring powers currently exist for Swiss insurance companies.

The adopted 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,[5] but departs from them in certain respects to take account of the characteristics of an insurance business. It is applicable for Swiss licensed insurance companies and Swiss branches of foreign insurance companies, Swiss-domiciled ultimate parent companies of an insurance group or conglomerate, and Swiss-domiciled entities within an insurance group or conglomerate that undertake significant functions for regulated activities.

The insurance restructuring regime, similarly to that for banks, authorizes 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, FINMA will be authorized to adjust existing insurance contracts, in particular by restricting or cancelling rights of the insured party. This last right has led to some political debate, but was confirmed in the parliamentary hearings.

1.3 The EU's draft directive

The proposed new directive would apply to EU (re)insurers as well as to EU-based holding companies of insurance groups and conglomerates, and thereby create an EU-wide harmonized recovery and resolution framework for such undertakings. It would require each Member State to designate an insurance resolution authority (which may or may not also be the insurance supervisory authority), and to enact laws giving that authority a minimum harmonised set of powers. Resolution proceedings pursuant to the directive are conceived as an alternative to general corporate insolvency procedures under each Members State's domestic law, which will remain available for insurance companies.

The resolution powers to be afforded to national resolution authorities include the placing of a company in run-off (i.e. prohibiting the writing of new business), a transfer of shares or assets and liabilities to a purchaser, to a bridge institution or to a publicly-controlled asset management vehicle, and bail-in (by way of write-down or conversion to equity). Authorities will also be empowered to cancel or modify the terms of contracts, to cancel, reduce or restructure insurance claims, and to require group entities to provide operational services or facilities to support the entity in resolution.

2 COMPARATIVE TOPICS

2.1 Supervisory vs. resolution authorities

Under the special insolvency regimes that Swiss law provides for financial market participants (banks, securities firms, insurers, financial market infrastructures etc.), the role of the resolution authority is universally bestowed on their supervisory authority, FINMA, without any specific arrangements

[4] See e.g. for a critical assessment by the trade federation of European insurers: Insurance Europe, Views on EC proposals on establishment of an Insurance Recovery and Resolution Directive (19 January 2022).
[5] SR 952.0.

being required by law for the separation of the two roles.

The draft IRRD, in contrast, requires each EU Member State to designate a "*resolution authority*", but leaves it to each Member State to decide whether or not these should be the same authorities that also exercise prudential supervision over insurers. This creates the need for multiple provisions in the IRRD regarding consultation and joint decision-making between such authorities, where they are distinct. Conversely, where the same authority assumes both supervisory and resolution functions, it is specified that "*adequate structural arrangements should be put in place to separate those functions [...] and to ensure operational independence*" (Recitals para. (15) D-IRRD), "*to avoid conflicts of interest*" (art. 3 (3) D-IRRD).

2.2 The trigger point for resolution action

Art. 51a rev-ISA provides that FINMA may take resolution action if there is "*founded concern that an insurance company is overindebted or has serious liquidity problems*". The trigger point is deliberately not linked to a company's Swiss Solvency Test (SST) ratio, to keep it separate from the intervention threshold system of the SST regime.[6] The threshold is, however, significantly lower in the case of mere protective measures under the current art. 51 ISA, which can be taken if an insurance company "*does not comply with the provisions of this Act, an ordinance or directions of FINMA, or the interests of insured parties otherwise appear jeopardized*". This clearly includes the case where an insurer's SST ratio falls below the prescribed level.

Art. 19 D-IRRD authorizes resolution action if an insurance or reinsurance undertaking is "*failing or likely to fail*" and there is no reasonable prospect of other actions preventing failure within a reasonable time. While this, in itself, sounds quite similar to the Swiss approach, Art. 19 (3) D-IRRD lists a number of situations where an undertaking is deemed to be "*failing or likely to fail*", one of which is an established or likely breach of the minimum capital requirement of Solvency II, if there is "*no reasonable prospect of compliance being restored*". EU law will thus link the trigger for resolution action, in part, to the solvency regime.

2.3 Ranking of liabilities in bankruptcy and bail-in waterfall

For reasons of consistency and also to facilitate compliance with the no-creditor-worse-off (NCWO) rule, the sequence in which eligible liabilities are submitted to bail-in (the "bail-in waterfall") should mirror the ranking that they would have in bankruptcy.

The revised Insurance Supervisory Act achieves this by establishing the following hierarchy of unsecured claims, both for purposes of the bail-in tool in restructuring proceedings (art. 52d (4) rev-ISA) and of bankruptcy (art. 54a and 54a^{ter} rev-ISA):

1. first-class privileged claims (i.e. chiefly certain claims of employees);
2. general second-class privileged claims (e.g. certain social security contributions);
3. insurance claims for which tied assets are prescribed, but prove insufficient for their discharge;
4. insurance claims for which no tied assets are prescribed;
5. third-class (i.e. non-privileged and non-subordinated) claims;
6. subordinated claims (other than regulatory capital instruments);
7. regulatory capital instruments recognized as such by FINMA.

Two aspects of this ranking are novel: the privileged treatment of insurance claims (even apart from their priority claim on tied assets, where applicable), and the mandatory "deep

[6] Botschaft zur Änderung des Versicherungsaufsichtsgesetzes (VAG) vom 21. Oktober 2020, BBl 2020 9015.

subordination" of regulatory capital instruments compared to other subordinated debt.

The ranking departs from the initial proposal in the draft rev-ISA published in October 2020,[7] which proposed to rank insurance claims for which tied assets are prescribed (but prove insufficient for their discharge) highest in the hierarchy of unsecured claims - ahead even of first and second-class privileged claims. The parliament, however, decided to reverse this sequence and establish the ranking as described above, thereby making it more similar to that in respect of privileged deposits in bank insolvency under the Banking Act.[8]

The EU's draft Insurance Recovery and Resolution Directive achieves a similar result by directing that the write-down or conversion tool must be applied to eligible liabilities in the sequence conforming to their hierarchy in normal insolvency proceedings, but that in any case regulatory capital instruments of tiers 1, 2 and 3 must be bailed-in before other eligible liabilities (art. 37 (1) D-IRRD).[9] Reference is made to art. 275 (1) of the Solvency II Directive,[10] which requires that Member States afford insurance claims a precedence over other claims against the insurance undertaking, either in the form of an absolute precedence in respect of "*assets representing the technical provisions*" (i.e., in Swiss terminology, tied assets), or of a relative precedence in respect of the whole of the insurance undertaking's assets, subject to certain higher-privileged types of liability. Contrary to Swiss law, however, art. 26 (2)(2) D-IRRD excludes the mandatory conversion of insurance claims to equity.

2.4 Protection of netting, set-off and security

An important consideration for the structuring of various types of transactions with regulated entities is the extent to which set-off rights, and pre-agreed netting or security arrangements, would be protected in the case of insolvency proceedings.

Following the example of Swiss bank insolvency law, art. 51b rev-ISA stipulates that pre-existing agreements on the netting of claims, on the private realization of certain collateral, and on the transfer of claims, liabilities and collateral remain unaffected by the exercise of any of the insolvency powers provided by the Insurance Supervisory Act (i.e. protective measures, restructuring and bankruptcy). Only FINMA's power to suspend termination rights is reserved. It is to be expected that, on the model of FINMA's Bank Insolvency Ordinance ("BIO-FINMA") (art. 49 (b) and art. 51 (1)(h) BIO-FINMA), the implementing provisions will specify that secured liabilities and those capable of set-off are excluded from bail-in, and that where assets and liabilities are transferred under a restructuring plan, claims and liabilities capable of being set off against each other, as well as secured liabilities and the assets over which they are secured, may only be transferred together.

In a similar manner, art. 57 (1) D-IRRD requires Member States to "*ensure that there is appropriate protection for title transfer financial collateral arrangements, set-off and netting arrangements, and reinsurance arrangements*" against partial transfers, modification or termination. Paragraph 2 of the same provision, however, permits resolution authorities to disregard this

[7] BBl 2020 9061 ff.
[8] The approach taken in the rev-ISA is more consistent than that of the Banking Act in its revised form adopted by parliament on 17 December 2021 (but not yet in force) ("rev-BankA"), which grants all deposits preferential treatment over ordinary claims in a bail-in scenario (art. 30b para. 7 rev-BankA), but limits privileged treatment to "privileged deposits" (i.e. to a maximum of CHF 100,000 per depositor) in bank insolvency proceedings (art. 37a BankA).
[9] See, however, for a detailed discussion pointing out certain ambiguities: Insurance Europe, Views on EC proposals on establishment of an Insurance Recovery and Resolution Directive (19 January 2022), 11.
[10] Directive 2009/139/EC.

protection "*where necessary to better achieve the resolution objectives* ...", thereby considerably compromising legal certainty.

2.5 Requirements to include recognition clauses in contracts

Similarly to the Bank Recovery and Resolution Directive ("BRRD")[11] (art. 55 and art. 71a BRRD), the draft Insurance Recovery and Resolution Directive requires insurers to include, in contracts governed by the law of a non-EEA country, contractual bail-in recognition clauses (art. 45 (2) D-IRRD), and in *financial* contracts governed by such third-country laws, contractual clauses recognizing the effect of resolution stay powers (art. 50 D-IRRD).

The revised Swiss Insurance Supervisory Act does not stipulate any requirement for recognition clauses in contracts governed by non-Swiss laws. However, in the case of banking law, such silence of the primary legislation (in that case, the Banking Act) has not prevented the Federal Council from imposing, in the implementing ordinance, a requirement to include clauses, in certain financial contracts, recognizing the power of FINMA to stay termination rights in connection with a restructuring procedure (art. 12 (2bis) of the Banking Ordinance[12]). It is therefore entirely possible that similar requirements will be stipulated for insurers in the provisions implementing the revised Insurance Supervisory Act.

2.6 Requirements of recovery and resolution planning are becoming the norm

The supervisory requirement of planning for recovery and resolution originated in special regimes for systemically important financial institutions (in Switzerland: provisions for systemically important banks introduced in 2011/12). The new legislation for insurers both in Switzerland and in the EU, however, now makes these requirements the norm for insurance groups.

Although no Swiss insurance company is currently classified as a global systemically important financial institution (G-SIFI), the revised Insurance Supervisory Act will forthwith require (all) FINMA-supervised insurance groups and conglomerates, and will further authorize FINMA to require individual "*economically significant insurance companies*" (if they are not already covered by a group plan), to prepare a stabilization plan, explaining "*by which means it intends to sustainably stabilize itself in the case of a crisis, in such manner that it can continue its business activity independently or with private debt financing*" (art. 22a para. 1, art. 67 para. 4 rev-ISA). The wording slightly deviates from the draft published in October 2020,[13] which referred to the continuance of business activity "*without any governmental support*", although this change seems to us to be of a technical nature only. FINMA can further require insurance groups or conglomerates to assist with its preparation of a resolution plan (art. 22a, 67 (5) and 75 (5) rev-ISA).

In the draft Insurance Recovery and Resolution Directive, the provisions on recovery and resolution planning take up a significant part of the legislative text. Here as well, the requirement to prepare such plans is set to become the norm for the insurance industry. While low-risk-profile insurers can be exempted, the available plans must cover at least 80% (recovery plans) and 70% (resolution plans) of each jurisdiction's insurance market. In the case of insurance groups, the plans are to be prepared primarily on a group level (art. 5 (2)(2) and art. 9 (2)(2) D-IRRD). Resolution authorities explicitly shall have the power to require an insurance undertaking to take measures to address or remove any "*substantive impediments to the resolvability of the insurance or reinsurance undertaking*" (art. 15 f. D-IRRD). The Commission's explanatory memorandum

[11] Directive 2014/49/EU, as amended.
[12] SR 952.02.
[13] See footnote 7 above.

speaks, in this respect, of "*what is necessary in order to simplify the structure and operations of the insurance or reinsurance undertaking solely to improve its resolvability*". This proposed power has been criticized in consultation.[14]

3 OUTLOOK

As mentioned above, the revisions to the Swiss Insurance Supervisory Act have been finally approved, but implementing provisions remain to be finalized and the changes are expected to enter into force as of 1 July 2023. The EU's draft Insurance Recovery and Resolution Directive is expected to be debated in the European Parliament in 2023, and may yet undergo significant change.

Meanwhile, other jurisdictions are also looking to align their insolvency rules applicable to insurers to the requirements of the 'Key Attributes of Effective Resolution Regimes' published in 2014 by the Financial Stability Board (FSB).[15] In the United Kingdom, for example, HM Treasury held a consultation in 2021 on a limited number of amendments to insolvency rules in the Financial Services and Markets Act 2000 (FSMA); at the same time, it announced that it was working with the Bank of England to develop a specific resolution regime for insurers, and would publish a respective proposal in due course.[16]

In view of the formal requirements of recovery and resolution planning to be introduced both in Switzerland and in the EU, Swiss insurance companies and Swiss-based international insurance groups are well advised to have this topic on their radar screen, and to consider whether any recovery planning they may have done in the past will need to be revisited and enhanced in light of the expected regulatory requirements.

[14] Insurance Europe, Views on EC proposals on establishment of an Insurance Recovery and Resolution Directive (19 January 2022), 5 f.

[15] For a global overview of existing and proposed specific legislation on the resolution of insurers, see: International Association of Insurance Supervisors (IAIS), Application Paper on Resolution Powers and Planning (23 June 2021), Annex.

[16] HM Treasury, Amendments to the Insolvency Arrangements for Insurers: Consultation (May 2021), no. 1.15.

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