Fact sheet on unit-linked life insurance

Updated: 1 May 2008

1. Background

With the introduction of the new supervision law[1] effective 1 January 2006, the provisions governing unit-linked life insurance were changed fundamentally. In a few areas, interpretation of the new rules has been uncertain and unclear.

2. Objective of the fact sheet

The objective of this fact sheet is to explain FOPI practice with respect to unit-linked life insurance. The following questions will be answered:

- What requirements must life insurances meet to be classified as unit-linked?
- How are the insurance classes for unit-linked life insurance licensed?
- How is the target amount of tied assets for unit-linked life insurance determined, and what assets must the tied assets contain?
- How is unit-linked life insurance considered within the framework of Solvency I?

This fact sheet does not discuss the question of required minimum capital, since article 7 SO conclusively and unambiguously answers this question. This fact sheet also does not aim to determine the treatment of unit-linked life insurance within the framework of the Swiss Solvency Test (SST) or to fix the settlement amounts of unit-linked life insurance policies.

3. Legal foundations

The following articles of the SO contain the specific relevant provisions on unit-linked life insurance for purposes of this fact sheet:

- article 25 (Solvency I)
- articles 77, 81 (tied assets)
- Annex 1 (classes of insurance)

Additionally, article 117 SO is also relevant.

[1] Federal Law on the Supervision of Insurance Undertakings of 17 December 2004 (Insurance Supervision Act, ISA, SR 961.01), Ordinance on the Supervision of Private Insurance Undertakings of 9 November 2005 (Supervision Ordinance, SO, SR 961.011), and FOPI Ordinance on the Supervision of Private Insurance Undertakings (FOPI Supervision Ordinance, FOPI-SO, SR 961.011.1)

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4. Characterisation of unit-linked life insurance

4.1 Definition

Unit-linked life insurances are life insurance policies in which the survival benefits and settlement amounts depend on the price development of securities, other assets, or indices. The securities, other assets, and indices are known to the client.

4.2 Comments on the definition

In addition to the survival benefits dependent on the underlying assets, other policy components are possible or even mandatory. These include benefits in the event of death and additional guarantees in the event of survival.

Often, the policyholder can choose the assets underlying the policy – freely or by selecting from several predetermined options.

Unit-linked life insurance is to be distinguished from classic endowment insurance with predetermined profit participation dependent on fixed benchmarks. Even if, depending on the design of the products, the amount of the survival and death benefit may be identical, the products differ in that classic endowment policies are based on fixed-interest capitalization, not underlying investments. The difference is apparent especially in the calculation of the surrender amounts.

This fact sheet uses the terms "underlying assets" and "securing assets". "Underlying assets" are assets on which the insurance policy relies and which determine the benefits arising from the policy. "Securing assets" are the assets held by the insurer to constitute the tied assets.

4.3 Categories

Depending on the type of assets underlying the policy, unit-linked life insurance is divided into two categories:

- fund-unit-linked life insurance, in which the underlying assets consist solely of units of open collective capital investments[2], and
- life insurance linked to internal investment holdings or other benchmarks.

The first category encompasses life insurance in classes A2.1 to A2.3 as set out in Annex 1 of the SO, while the second category encompasses classes A2.4 to A2.6.

5. Licence for insurance class A2

The licence is granted for the entire class A2 and not for the individual subclasses A2.1 to A2.6.

If on 31 December 2005, i.e. immediately prior to the enforcement of the new insurance supervision legislation on 1 January 2006, an insurance company held a licence for insurance class 3 (unit-linked life insurance) as set out in the annex of the Life Insurance Ordinance (SR 961.611), this licence continues to apply to insurance policies under class A2 of the new SO.

6. Requirements for unit-linked life insurance

6.1 Underlying assets

According to Annex 1 of the SO, only "fund units" can be used as underlying assets for classes A2.1 to A2.3. The SO does not expressly stipulate any other restrictions on the underlying assets. However, it specifies in article 81, paragraph 1 that these policies may only be secured with units of investment funds "falling within the scope of the Investment Fund Act of 18 March 1994[3]“. Effective 1 January 2007, the Investment Fund Act was replaced with the Federal Law of 23 June 2006 on Collective Capital Investments (Collective

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[2] Open collective capital investments encompass contractual investment funds and investment companies with variable capital (SICAV).

[3] Investment Fund Act, SR 951.31

Investments Act, CIA, SR 951.31). In the view of FOPI, article 81, paragraph 1 SO must now be interpreted in such a way that the tied assets for the savings component of insurance policies falling within classes A2.1 to A2.3 may only be constituted with units of open collective capital investments under the CIA.

FOPI is of the view that it makes no sense to secure unit-linked insurance policies with assets other than those underlying the policies, since the insurance undertaking would otherwise bear an additional investment risk (mismatch). Accordingly, FOPI deems it impermissible to offer insurance policies in the classes A2.1 to A2.3 whose underlying assets are not units of collective capital investments licensed under the CIA. This is not a substantial limitation, since insurance policies based on other collective investments can be allocated to insurance classes A2.4 to A2.6.

In principle, all assets referred to in article 79, paragraph 1 SO as well as indices may be used as underlying and securing assets for insurance classes A2.4 to A2.6. This is entailed by article 81, paragraph 2 SO, according to which only assets referred to in article 79, paragraph 1 SO may be used to secure policies, while policies must also be secured directly by underlying assets, units of these assets, or values underlying the index. The qualitative requirements set out in the investment directives of 12 June 2006 and the limits contained therein concerning "net exposure to a debtor/counterparty" and "securities lending" must also be complied with. The limit concerning "net exposure to a debtor/counterparty" may be exceeded, however, if the policyholder has been expressly informed to this effect before concluding the contract.

6.2 Assumption of biometric risk by the insurance undertaking

Under each insurance policy, the life insurance undertaking must bear a minimum biometric risk. In this connection, biometric risks are understood to be risks depending on the duration of the insured person's life or the insured person's disability or sickness condition. A contract under which the insurance policy does not bear any biometric risk would be classified as a capitalisation contract (insurance class A6). Biometric risk may be assumed by way of various insurance components or constructions:

- Insurance payable at death, going beyond payment of the underlying assets
- Survival guarantee with or without limited death benefits
- Occupational disability insurance (especially waiver of premiums in the event of disability)
- Life annuity insurance

The minimum biometric risk to be assumed for unit-linked life insurance policies is defined in Directive 1/2008 (Life Insurance Directive).

The FOPI requirements on minimum assumption of risk are independent of the requirements set out by the Federal Tax Administration. Compliance with the FOPI requirements therefore does not necessarily entail compliance with the FTA requirements for purposes of tax privileges.

7. Securing unit-linked life insurance

7.1 Formation of tied assets for unit-linked life insurance

According to article 77, paragraph 1(b) and (c) SO, separate tied assets must be formed for the savings components of insurance policies in classes A2.1 to A2.3 and in A2.4 to A2.6. Conversely, this entails that components of the insurance policy going beyond the savings components must be secured in the general tied assets. This primarily concerns the risk component for biometric risk and any guarantees. Provisions must be formed for the guarantees, which are calculated according to actuarial principles and included in the calculation of the target amount of the general tied assets.

Particular attention must be paid to guarantees for which the insurance undertaking replicates the guarantee obligation with assets. A distinction must be made between exact replication of the guarantee and approximate replication[4]. In the case of exact replication, two cases must be distinguished:

a. If the credit risk (risk of default of the third party issuing the assets) remains with the insurer, the guarantee must be secured by the general tied assets.

b. If the credit risk is transferred to the policyholder, the guarantee is secured together with the savings components by the tied assets in classes A2.4 to A2.6 (even if the savings component on its own would belong to classes A2.1 to A2.3).

In analogy to exact replications, two cases must be distinguished also with respect to approximate replication:

c. If the risk that the replicating assets do not cover the guarantee or the credit risk (risk of default of the third party issuing the assets) or both remain with the insurer, the guarantee must be secured by the general tied assets.

d. If these two risks are transferred to the policyholder, the guarantee is secured together with the savings component by the tied assets in classes A2.4 to A2.6 (even if the savings component on its own would belong to classes A2.1 to A2.3).[5]

7.2 Calculation of target amount of tied assets for unit-linked life insurance

In accordance with article 56 SO, the target amounts of tied assets for unit-linked life insurance are composed of the technical provisions under article 55, paragraph 1 SO and a supplement under article 18 SO. According to article 1, paragraph 1(a) of the FOPI Ordinance on the Supervision of Private Insurance Undertakings (FOPI Supervision Ordinance, FOPI-SO, SR 961.011.1), this supplement amounts to 1% for life insurance.

According to article 1, paragraph 2 FOPI-SO, this supplement of 1% on the target amount is waived if the insurance undertaking does not bear any investment risk. This is always the case for the tied assets for fund-unit-linked insurance policies. With respect to the tied assets for insurance policies linked to internal investment holdings or other benchmarks, this condition is only met if the tied assets are constituted entirely by the assets underlying the policies. This is not the case, for instance, if an index is replicated not by derivatives, but rather by assets underlying the index. In this case, the supplement of 1% must be calculated on the entire tied assets, not only on the imperfectly replicated part.

7.3 Constituting tied assets for unit-linked life insurance

According to article 81, paragraph 1 SO, tied assets for fund-unit-linked insurance policies must be constituted with units of collective capital investments licensed under the CIA[6]. As already mentioned in section 6.1, FOPI is of the view that an incongruity between the underlying and securing assets neither makes sense nor is desirable. FOPI therefore deems it impermissible to secure fund-unit-linked insurance policies with assets other than those underlying the policy, since the insurance undertaking would otherwise bear an additional investment risk (mismatch). This does not apply to the cover of any supplement to the target amount under article 1 FOPI-SO, however.

Article 81, paragraph 2 SO sets out clear requirements for the constitution of tied assets for classes A2.4 to A2.6. In particular, congruity between the underlying and securing assets is expressly demanded.

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[4] In this context, exact replication is the holding of assets, especially derivatives, the value of which always – with the exception of the default of the counterparty – exactly corresponds to the value of the guarantee or the amount to be paid pursuant to the guarantee.
Approximate replication means the deposit of guarantees with assets whose price fluctuations are similar to, but not always exactly the same as, the fluctuations of the replicated guarantee.

[5] This case could also be considered exact replication, since the policyholder's guarantee is changed and the effective guarantee exactly corresponds to the replication.

[6] See footnote in section 6.1.

The following exceptions apply to all unit-linked insurance policies:

- If the contract specifies a deadline after the premiums are due to acquire the assets underlying the policy, cash in the amount of the premiums not yet invested may be counted toward the tied assets before that deadline.
- Assets set out in article 79, paragraph 1 SO, which under no circumstances and at no time have a negative value, may be counted toward the tied assets as surplus cover.

7.4 Reporting to FOPI on tied assets

The general reporting rules for tied assets apply to unit-linked insurance similarly to other classes of insurance, but with the following special provisions:

- For tied assets for fund-unit-linked life insurance, only the first page (cover page) of form G2 must be filled out.
- For tied assets for life insurance policies tied to internal investment holdings or other benchmarks, only the first three pages (cover sheet and overview of cover values) must be filled out.

8. Consideration of unit-linked life insurance for Solvency I

According to article 25, paragraph 2 SO, the first result for determining the required solvency margin for insurance classes A2.1 to A2.6 is calculated as 1% or 4% of the mathematical provisions, irrespective of whether the insurer bears an investment risk or not. In the view of FOPI, the following four cases must be distinguished:

- The insurer bears no investment risk (corresponds to 7.1 b and d):
  If the insurer provides no guarantees or if the risks of replication (credit risk and risk of non-exact replication) are transferred to the policyholder, 1% of the insurance policy is to be taken into account for solvency.
- The insurer bears only the credit risk of the guarantee (corresponds to 7.1 a):
  If the insurer has provided a guarantee and replicated it exactly, 4% of the provisions for the guarantee are to be taken into account for solvency – since the insurer bears an investment risk (namely the credit risk) on this component – while 1% of the rest of the insurance policy is taken into account.
- The insurer bears the risk of a missing or approximate replication of the guarantee (corresponds to 7.1 c):
  If the insurer has provided a guarantee and has not or only approximately replicated it, 4% of the entire insurance policy is to be taken into account for solvency.
- The insurer is unable to exactly replicate the benchmark of the insurance policy in the tied assets:
  If the insurer is unable to exactly replicate the benchmark of the insurance policy in the tied assets, e.g. because the insurance policy refers to an index for which no suitable derivatives are available, 4% of the entire insurance policy must be taken into account for solvency.

9. Entry into force

This fact sheet enters into force on 1 June 2008.