ASSOCIATION DES COMPAGNIES D'ASSURANCES ET DE RÉASSURANCES
DU GRAND-DUCHÉ DE LUXEMBOURG

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Q&A: The Luxembourg Triangle of Security and the law of 10 August 2018[1]

The main principles of the Triangle of Security specific to Luxembourg insurance companies were clarified, although not modified, by the law of 10 August 2018.

1. CONTINUITY OF THE MAIN PRINCIPLES

1. What is the "Triangle of Security"?

Luxembourg law requires that insurance undertakings treat the assets representing their insurance liabilities as distinct, and managed separately, from their own assets.

These representative assets must be deposited with a custodian bank. A custody agreement between the insurance undertaking and the custodian bank must be concluded. Prior to the deposit of the representative assets, the Commissariat aux Assurances (CAA) must approve the custody agreement.

This system for the protection of insurance claims is commonly referred to as the "Triangle of Security" because it is based on the involvement of three stakeholders: the insurance company, a custodian bank and the CAA. The Triangle of Security provides a form of legal protection for insurance creditors (policyholders or their beneficiaries) that is unique in Europe. This is one of the significant advantages of a life insurance policy concluded with a Luxembourg insurance company.

In practice, this protection also entails:

- the authorisation and supervision of the insurance undertaking by the CAA;

- regular monitoring by the CAA of the insurance undertaking's technical provisions and the way they are invested;

- the inability of the company's other creditors to satisfy their claims over assets representing insurance claims;

- in the event the insurance undertaking faces solvency issues, the CAA's power to intervene in the operation of custodian bank accounts opened in the insurance undertaking's name.

2. Does the Triangle of Security include a guarantee from the Luxembourg State or a capital guarantee in respect of invested assets?

The Triangle of Security is not a guarantee by the Luxembourg State or the equivalent of a capital guarantee.

3. What is the "super-privilege"?

Since the 1991 European Directive on the reorganisation and winding-up of insurance undertakings, Luxembourg has chosen to give insurance claims absolute priority over any other claims for which the insurance undertaking is liable. It allows insurance creditors to exercise claims under their insurance contracts in priority to all other creditors of the insurance company (and in particular employees, shareholders, social security institutions and the State).This right over insurance receivables is sometimes referred to as a "super-privilege". It is a key element in protecting the rights of creditors of insurance contracts concluded with Luxembourg insurance companies.

4. What is meant by "asset segregation"? What are the consequences in the event of the liquidation of the insurance company?

The underlying assets of a life insurance contract are held by the insurance undertaking. They are said to be "representative of the insurance undertaking's commitments".

Luxembourg law requires that the insurance undertaking treat the assets representing its insurance liabilities as distinct, and managed separately, from its own assets. These representative assets must be deposited with a custodian bank. A custody agreement binds the insurance company and the bank and must be approved by the CAA before the deposit of any representative assets [For more details see the answer to question 1].

[1] http://legilux.public.lu/eli/etat/leg/loi/2018/08/10/a710/jo

In the event of the liquidation of the insurance undertaking, this segregation protects the assets and ensures their availability.

5. What happens if the assets are not sufficient to cover policyholders' claims?

Life insurance receivables for which the investment risk is borne by the policyholder (e.g. unit-linked investments) are valued on the basis of the number of units held on the day the liquidation is opened. The number of units of assets linked to each insurance contract is guaranteed, but their value is determined on the day the liquidation opens. The insurance receivable is therefore in principle equal to the value of all units linked to the insurance contract. However, if the value of the liquidated assets is less than that of the insurance claims, the amount reimbursed to each policyholder (or each beneficiary) is reduced proportionately.

For other types of investment (e.g. guaranteed capital investments), insurance receivables are equal to the value of the corresponding technical provisions on the day the liquidation is opened. If the value of the corresponding technical provisions of the insurance undertaking in liquidation is less than that of the insurance claims, the amount reimbursed to each policyholder (or each beneficiary) is reduced proportionately.

2. CLARIFICATIONS PROVIDED BY THE LAW OF 10 AUGUST 2018

6. Why a new law and what are the main changes?

In the context of financial market risk, the Luxembourg legislator decided, with the law of 10 August 2018, to strengthen the existing system of protection for the clients of Luxembourg insurance companies by further clarifying how the Triangle of Security is to be implemented.

7. In the event of the judicial liquidation of an insurance company, how will insurance claims be assessed?

For unit-linked insurance contracts, the insurance undertaking guarantees a number of units but does not guarantee a given value (whether the initial premium or the capital invested). In the context of the winding-up of an insurance undertaking, the term "unit" refers to the reference units which allow the calculation of the shares of the underlying assets (for example, shares of company X, shares of company Y, etc.). These units of assets are valued at the time of liquidation.

In the case of guaranteed capital investments, insurance receivables are equal to the value of the corresponding technical provisions on the day the liquidation is opened.

8. In the event of the judicial liquidation of an insurance company, how is the "super-privilege" exercised?

Luxembourg law makes the policyholder a first-tier creditor.

Therefore, the assets in which the policyholders' premiums have been invested are first allocated to the satisfaction of policyholders' claims. This means that the claims of policyholders are settled before those of the State, social security institutions, shareholders and employees.

9. Does the protection of the Triangle of Security vary depending on the products concerned? What is the difference in treatment between investment fund products (External Funds, Internal Dedicated Funds (FID), Specialised Insurance Funds (FAS)) and guaranteed rate products?

Although the mechanism of the privilege is common to all life insurance policyholders, it is exercised differently depending on the type of risk covered.

Life insurance contracts linked to investment funds, and life insurance contracts with guaranteed rates, correspond to separate pools of assets.

Each of these pools is reserved primarily for the execution of the commitments of the corresponding contracts.

Therefore, life insurance receivables for which the investment risk is borne by the policyholder (e.g. FID, FAS and other unit-linked investments) are valued by reference to the number of units held on the day the liquidation is opened.

For other types of investments (e.g. guaranteed rate products), insurance receivables are based on the value of the corresponding technical provisions on the day the liquidation is opened.

10. In the event of the liquidation of the insurance undertaking, what is the impact of the new legislation for policyholders who have subscribed a product with a guaranteed rate?

When a policyholder subscribes an insurance product offering a guaranteed rate, the investment risk is borne by the insurance undertaking. This means that the insurance undertaking guarantees the premium, net of costs, and possibly a minimum return on the sums it invests for the policyholder. For this type of contract, the insurance undertaking must have corresponding technical provisions.

In the event of the winding-up of the insurance undertaking, the claim of the policyholder (or his beneficiaries) relating to a product offering a guaranteed rate is equal to the value of the technical provisions corresponding to this type of contract, calculated on the date on which the winding-up begins.

These holders of insurance claims benefit from a joint first-ranking claim over the proceeds of the liquidation of all assets representing these technical provisions. In the event that the value of the proceeds is less than that of the rights of these insurance creditors, their joint first-ranking claim will be reduced proportionately.

11. In the event of the liquidation of the insurance undertaking, what is the impact of the new legislation for policyholders who have taken out a unit-linked insurance contract that is not linked to unlisted assets?

Unit-linked insurance contracts are insurance contracts for which the investment risk is borne by the policyholder. Unit-linked policyholders (or their beneficiaries) are therefore creditors, not of a guaranteed amount, but of a number of units the value of which may vary. The insurance undertaking does not guarantee the value of the assets but the number of units of each asset to which the policyholder's contract is linked.

In the event of liquidation, the value of each unit of an asset is calculated on the basis of the value of the insurance undertaking's holding in the asset divided by the number of units of that asset that have been allocated to insurance contracts.

For an underlying asset (for example, an investment fund Y), policyholders whose contracts are linked to that asset (or their beneficiaries) enjoy a joint first-ranking claim over the value of the asset held by the insurance undertaking once liquidated (for, example, the value of the liquidation of all the units of investment fund Y). The proceeds of the liquidation of this asset are then allocated to these policyholders (or their beneficiaries) in accordance with the number of units that were linked to their contracts (for example, X shares of investment fund Y).

12. In the event of the liquidation of the insurance undertaking, what is the impact of the new legislation for policyholders who have taken out a unit-linked insurance contract and whose contract is invested, at least in part, in unlisted assets?

The premises of the previous question are also applicable in this case.

Additionally, the new law provides that a policyholder (or his beneficiaries) whose contract is linked to a non-listed asset may receive the shares of that asset in the event of the liquidation of the insurance undertaking. To the extent that the insurance contract so provides or with the agreement of the policyholder, the liquidators may transfer in specie to the policyholder (or his beneficiaries) all or part of the assets corresponding to his contract.

13. Does this law make any changes with regard to the failure of a custodian bank?

The new law deals with the liquidation or default of a Luxembourg insurance company and not of custodian banks, which may be abroad and which are subject to their own local regulations.

Within the European Union, rules apply to protect depositors in the event of the liquidation or failure of a bank. This is not the purpose of the new Luxembourg law, which strengthens the protection of policyholders and their beneficiaries in the event of the failure of an insurance company.

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