MFSA

MALTA FINANCIAL SERVICES AUTHORITY

CONSULTATION DOCUMENT

CONSULTATION ON INTRA-COMPANY LOANS WITHIN A GROUP (INTRA-GROUP LOANS)

[MFSA REF: 03-2016]

1st April 2016

Closing Date: 2nd May 2016

Note: The documents circulated by the MFSA for the purpose of consultation are in draft form and consist of proposals. Accordingly, these proposals are not binding and are subject to changes and revisions following representations received from Licence Holders and other involved parties. It is important that persons involved in the consultation bear these considerations in mind.

Note for Consultation

1. Purpose

1.1 The MFSA is issuing for consultation an amendment to Chapter 5 in Part B of the Insurance Rules issued under the Insurance Business Act, entitled *Valuation of assets and liabilities, technical provisions, own funds, Solvency Capital Requirement, Minimum Capital Requirement and investment rules.* The amendment will consist of an additional new paragraph 5.7.12, and an Annex to Chapter 5. The purpose of this Annex is to establish the minimum parameters within which authorised undertakings will be permitted to grant intra-group loans to undertakings or companies within its group.

1.2 Any comments and feedback are to be addressed to the Insurance and Pensions Supervision Unit by email on ipsu@mfsa.com.mt. Interested parties are kindly asked to submit any comments in writing by not later than **2nd May 2016**.

2. Intra-group loans

2.1 As opposed to Solvency I, Solvency II has moved to a total balance sheet approach. In this respect, all the assets and the liabilities of an authorised insurance undertaking, an authorised reinsurance undertaking, a captive insurance undertaking and a captive reinsurance undertaking (“an authorised undertaking”) are valued in terms of Solvency II. Such assets are then charged in order to arrive at the Solvency Capital Requirement of the authorised undertaking. There are essentially two issues emanating from Solvency II which impact intra-group loans as follows:

2.2 *Encumbrances*

In terms of the Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (“EU Commission Delegated Regulation”), basic own-fund items shall be free from encumbrances and not connected with any other transaction, which when considered with the basic own-fund items, could result in those basic own-fund items not being available, or able to be called up on demand, to absorb losses on a going-concern basis, as well as in the case of winding-up.

In this respect, Guideline 13 (Encumbrances) of the *Guidelines on classification of own funds* states that authorised undertakings should:

(a) assess whether an own-fund item is encumbered on the basis of the economic effect of the encumbrance and the nature of the item, applying the principle of substance over form;

(b) consider encumbrances as including, but not limited to:

(i) rights of set off;
(ii) restrictions;
(iii) charges or guarantees;
(iv) holding of own-fund items of the undertaking;
(v) the effect of a transaction or a group of connected transactions which have the same effect as any of points (i) to (iv);
(vi) the effect of a transaction or a group of connected transactions which otherwise undermine an item's ability to meet the features determining classification as an own-fund item;

(c) consider an encumbrance arising from a transaction or group of transactions which is equivalent to the holding of own shares as including the case where the undertaking holds its own Tier 1, Tier 2 or Tier 3 own-fund items.

Where the encumbrance is equivalent to the holding of own shares, undertakings should reduce the reconciliation reserve by the amount of the encumbered item.

Intra-group loans could in some cases be considered to be creating encumbrances on the own funds of an authorised undertaking. In order to assess the level of encumbrance that the intra-group loan would have on the available own funds of an authorised undertaking, the MFSA is guided by the following principles:

(a) the terms of the intercompany loan;

(b) whether the borrower servicing the intercompany loan;

(c)the financial strength of the parent undertaking and whether such parent undertaking is in a good financial position to repay the loan;

(d) whether the parent undertaking is using the dividend payments from the authorised undertaking to repay the loan, and if not, how the loan is going to be repaid;

(e) the terms of the loan repayment;

(f) ‘Look through’ into the parent undertaking to understand how the intra-group loan has been used in order to assess if there is an over-inflation of the parent undertaking’s financial position; and

(g) whether the timing between when the capital is invested in the authorised undertaking and then loaned backed to the parent undertaking, is close and information on where and why the loaned back funds are being used by the receiving company.

2.3 Prudent Person Principle

Article 132 of the Solvency II Directive lays down the prudent person principle which requires that all assets, in particular those covering the Minimum Capital Requirement and the Solvency Capital Requirement, are to be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole. In addition the localisation of those assets shall be such as to ensure their availability.

This article requires that the assets held to cover the technical provisions shall also be invested in a manner appropriate to the nature and duration of the insurance and reinsurance liabilities. Those assets shall be invested in the best interest of all policy holders and beneficiaries, taking into account any disclosed policy objective. In the case of a conflict of interest, authorised undertakings, or the entity which manages their asset portfolio shall ensure that the investment is made in the best interest of policy holders and beneficiaries.

The prudent person principle also requires that:

(a) investment and assets which are not admitted to trading on a regulated financial market shall be kept to prudent levels;

(b) assets shall be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings, or geographical area and excessive accumulation of risk in the portfolio as a whole;

(c) investments in assets issued by the same issuer, or by issuers belonging to the same group, shall not expose the authorised undertakings to excessive risk concentration.

The significance of intra-goup loans for some authorised undertakings could mean that such undertakings will fail the prudent person principle test. In order to test the prudent

person principle, the MFSA should therefore test the extent of intra-group loans when compared to the other assets held by the authorised undertaking.

3. Proposed way forward

3.1 The Solvency II guidelines do not prohibit intra-group loans, nor is it the intention of the MFSA to prohibit them. However, in view of the enhanced requirements of Solvency II, the MFSA is proposing minimum parameters which intra-group loans should meet. Authorised undertakings have been classified under three different buckets depending on the type of undertaking and the risks associated with them:

Bucket 1 – Authorised insurance undertakings
Bucket 2 – Authorised reinsurance undertakings
Bucket 3 – Captive insurance undertakings or captive reinsurance undertaking

3.2 The proposed requirements are without prejudice to the authorised undertakings meeting their capital requirements under Solvency II.

Communications Unit
Malta Financial Services Authority
1st April 2016