FMA

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FMA Circular

Securities lending transactions in the *Deckungsstock* of insurance undertakings

30 July 2020

I. INTRODUCTORY REMARK

This circular is addressed to all insurance undertakings supervised by the Austrian Financial Market Authority (FMA) pursuant to Article 5 no. 1 of the Insurance Supervision Act 2016 (VAG 2016; Versicherungsaufsichtsgesetz 2016), published in Federal Law Gazette I no. 34/2015. This circular does not constitute a legal regulation. It is intended to serve as guidance and reflects the FMA's legal view on the treatment of securities lending transactions in the cover pool ("*Deckungsstock*") derived from Article 124 para. 1 no. 2 in conjunction with Articles 300 et seq. VAG 2016 and Article 10 in conjunction with Articles 12 et seq. of the Insurance Undertakings Investment Regulation (VU-KAV; Versicherungsunternehmen-Kapitalanlageverordnung), published in Federal Law Gazette II No. 423/2015. No rights and obligations extending over and above the provisions of the law can be derived from this circular. Where designations are used to refer to natural persons, the formulation used applies to both genders.

II. GENERAL FRAMEWORK CONDITIONS

Securities lending usually takes the form of constituting a loan in kind from the lender to the borrower. The **lender** shall have a right to receive the same type and quantity of securities in return and bears the economic opportunities and risks of the securities over the entire term, and thereby remains the beneficial owner.

Ownership under civil law is transferred for the duration of the securities lending to the **borrower**, who may dispose of the lent assets. The borrower provides the lender with appropriate collateral to secure the loan and therefore becomes the **collateral provider**. The collateral taker is obliged to return the collateral to the collateral provider upon the borrowed securities being returned.

Against this background, the applicable legal provisions provide in particular for the following framework:

- In accordance with the prudent person principle pursuant to Article 124 para. 1 no. 2 VAG 2016 securities lending transactions and repurchase agreements are **only permissible at a prudent level** (Article 10 para. 2 VU-KAV). Several quantitative and qualitative criteria are applied in aggregated form when specifying the prudent level. The criteria include the covering or excess covering of the coverage requirement; the ratio of the market values of assets in the *Deckungsstock* to the cash value of the technical provisions discounted by the actual market rate under Section 1 of Chapter 8 of VAG 2016; solvency; the structure of the liabilities side; the investment processes including limits, valuation and due diligence; asset allocation; resources also in regard to operative settlement; transparency with regard to the look through of the funds; counterparty credit risk and the overall securities lending concept (volume, type and range of collateral items, and counterparty risk including diversification).
- Requirements for the prudent level, the best interests of policyholders and beneficiaries and the provision of collateral (Article 10 paras. 1 and 2 VU-KAV) must be observed in securities lending transactions and securities repurchase agreements both in the case that they are held directly in the portfolio, as well as in **investments where there is a significant influence on their management or investment** (Article 10 para. 3 VU-KAV; cf. also Article 6 para. 3 VU-KAV and explanatory notes).[1] Limitation to a prudent level is assessed with regard to the insurance undertaking's segmented portfolio pursuant to Article 3 no. 1 VU-KAV, rather at the level of the individual investments in the fund. This means that insurance undertakings are also allowed to invest in investment funds with higher limits for securities lending transactions and securities repurchase agreements, provided the limits determined for the prudent level

[1] cf. the explanatory notes to the version of the VU-KAV published in Federal Law Gazette II no. 423/2015 (VU-KAV) - in German only https://www.fma.gv.at/national/fma-verordnungen.

pursuant to Article 10 para. 2 in conjunction with Article 3 no. 1 VU-KAV are not compromised by doing so.

- The principles of an appropriate level of **blending and diversification** of investments shall also apply for securities lending transactions and securities repurchase agreements (Article 124 para. 1 no. 7 VAG 2016). Securities lending transactions and securities repurchasing agreements must therefore be taken into account in the internal limit system in calculating the quantitative limits for investments in relation to counterparties (Article 6 para. 1 VU-KAV) and in the credit risk assessment (Article 8 no. 1 VU-KAV) (cf. explanatory notes to Article 10 VU-KAV). The principle of appropriate blending and distribution also applies for collateral. Consequently, not only should excessive dependency on a single counterparty be avoided, but also excessive dependency on a specific type of asset or a geographical region and therefore an excessive concentration of risk in the portfolio as a whole.
- Conditions for securities lending transactions and securities repurchasing transactions must be defined in internal **investment policies** (Article 3 no. 10 VU-KAV). They include permissible counterparties, permissible categories or subcategories of assets as well as their maximum permissible scope as well as criteria for collateral such as their credit quality and diversification in terms of issuers.

III. TREATMENT IN THE COVER POOL ("*DECKUNGSSTOCK*")

Where in the course of a securities lending transaction assets that are allocated to the cover pool ("*Deckungsstock*") are disposed of, then irrespective of how the securities lending transaction is reflected on the balance sheet[2], the following options are generally possible for the treatment of the securities that have been lent, or for any allocation of other items:

Treatment of lent securities:

1. **Removal** of lent assets by deregistering their entry from the *Deckungsstock* list
2. **Zero value approach** for lent assets in the *Deckungsstock* list (i.e. no consideration for coverage of the cover requirement pursuant to Article 301 VAG 2016)

Allocation of other assets to the *Deckungsstock*:

a) no further allocation
b) **Allocation of a secured claim on a loan** ("loan in kind", see also Chapter IV)
c) **Allocation of collateral** ("asset swap")

The choice of options for treatment in the *Deckungsstock* shall be required to be consistent with the respective contractual design of the securities lending transaction. In transferring control over disposal to the borrower, a **removal from the *Deckungsstock*** must therefore occur in any case, or **the lent assets are not allowed to count towards the cover requirement** pursuant to Article 301 VAG 2016.

(Secured) exposures from the securities lending transaction may be allocated to the *Deckungsstock* instead of lent assets (option b), provided they are not **loans pursuant to Article 12 para. 1 no. 1 VU-KAV** that are subordinate and can only be utilised once and provided that, in addition to the requirements for securities lending transactions defined in Article 10 VU-KAV

[2] Cf. AFRAC-Stellungnahme 14, Finanzanlage- und Finanzumlaufvermögen (UGB), November 2019, Question 9.

being observed, the provisions in Article 13 no. 3 as well as Articles 14 et seq. VU-KAV are duly fulfilled. In so doing, the following points in particular must be considered:

- The borrower should sign a **declaration waiving the right of offset or retention** in relation to any transactions other than the securities lending transaction (Article 15 para. 1 VU-KAV).
- In addition to repayments and redemptions, the **lending fee** should also be paid into a bank account that is allocated to the *Deckungsstock* (Article 14 VU-KAV).
- The **value of the loan** to be applied for coverage purposes (Article 301 para. 3 VAG 2016) under the prudent person principle **is limited to the amount of the respective carrying amount of the transferred securities** for valuation (Article 201 para. 2 no. 4 UGB) at all times; this arises from the realisation and imparity principle.

IV. COLLATERAL

Collateral items are to be provided for securities that are part of securities lending transactions and securities repurchasing transactions, that may be considered as been highly liquid and which where applicable have at least a high credit quality (Article 10 para. 1 VU-KAV). In so doing, the following points in particular must be considered:

1. **Highly liquid** collateral includes assets pursuant to Articles 4 et seq. of Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, OJ L 340, 15.12.2016, p. 9 (cf. Article 10 para. 1 VU-KAV).
2. A **high credit quality** of the collateral corresponds to a credit rating of at least Credit Quality Step 3[3] (cf. the explanatory notes for Article 10 VU-KAV).
3. Since the market value of the collateral shall not be allowed at any time to fall below the **market value of the lent securities** (Article 10 para. 2 VU-KAV), the adequate collateralisation of lent securities should be documented on an ongoing basis.
4. The collateral is to be deposited in securities accounts or accounts that cannot be accessed by the securities lending borrower in the event of bankruptcy or insolvency. The collateral must therefore constitute a special fund to be held separately from the accounts of the collateral provider - for example by a third party (Article 10 para. 2 VU-KAV incl. explanatory remarks). Consequently, the following applies:
    a. **Collateral held in cash** should be held in the insurance undertaking's accounts allocated to the *Deckungsstock* held at third party credit institutions.
    b. In the case of **collateral in the form of securities** the custodian should
        - be **informed** about the pledging or pledging as security (this applies irrespective of whether under the applicable law for the provision of collateral a simple remark in the securities lending transaction borrower's business records is deemed to suffice) and
        - Sign a **declaration waiving the right of offset** (logical application of Article 15 para. 1 VU-KAV).

[3] Cf. Article 3 of 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), OJ L 12, 17.01.2015, p. 1, in conjunction with Article 109a (1) of 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), OJ L 335, 17.12.2009, p. 1, as well as the Annex to Commission Implementing Regulation (EU) 2016/1800 of 11 October 2016 laying down implementing technical standards with regard to the allocation of credit assessments of external credit assessment institutions to an objective scale of credit quality steps in accordance with Directive 2009/138/EC, OJ L 275, 12.10.2016, p. 19.

Irrespective of the applicable law for providing collateral, the contract for the provision of collateral should guarantee that the insurance undertaking has a claim for separation based on its right in rem in the event of the bankruptcy of the borrower.[4]

5. Where exposures from securities lending transactions in the form of loans are allocated to the *Deckungsstock* (Chapter III option b), the collateral is then **allocated to the *Deckungsstock***; provided it served to hedge the exposures of the insurance undertaking. Their value is not however added to the *Deckungsstock* fund. The collateral provided are therefore allocated a value of 0. The allocation to the *Deckungsstock* of the collateral securities account / collateral account should be noted in the *Deckungsstock* list by stating the account number associated with the loan. This applies irrespective of whether a simple remark in the securities lending transaction borrower's business records is considered sufficient under the applicable law for the provision of collateral.

6. In the event of the **collateral being realised**, the proceeds from that realisation will be transferred to a corresponding account held by the insurance undertaking that is allocated to the *Deckungsstock* (Article 10 para. 2 VU-KAV in conjunction with the explanatory remarks about Article 10 VU-KAV).

V. APPROVAL BY THE TRUSTEE

It is necessary to differentiate between disposals of the lent assets and collateral disposals in this context:

- The **lending of securities** constitutes a sale and therefore a disposal (Article 305 para. 2 VAG 2016). In all sectors apart from fund-linked life insurance and state-sponsored retirement provision (Article 300 para. 1 nos. 3 and 6 VAG 2016) this requires approval in writing by the trustee. Provided assets of at least an equivalent value are allocated to the *Deckungsstock* at the same time, then the securities lending may occur within the scope of a **general approval** (Article 305 para. 4 VAG 2016). Where a loan is allocated to the *Deckungsstock* on a step-by-step basis (Chapter III option b), then the general approval should be granted subject to the condition that any repayment or returning of collateral shall only be allowed to take place provided that the remaining collateral's value is at least equal to the market value of the lent securities.
- If a **withdrawal of collateral** occurs when adjusting the collateral, then this constitutes a disposal (Article 305 para. 2 VAG 2016), since the collateral provided serves the direct purpose of securing the insurance undertaking's exposure from the securities lending transaction and are therefore allocated to the *Deckungsstock*. This may be approved by the trustee in the form of a **general approval** (Article 305 para. 4 VAG 2016), provided that the amount of coverage of the cover requirement does not change because of the disposal. A suitable way should exist for providing the trustee with the respective market values of the lent securities and the allocated collateral at all times.

[4] Cf. also the requirements for collateral management in Article 207 (4) points a to c and e to g of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 646/2012, OJ L 176, 27.6.2013, p. 1.