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TAX PLANNING INTERNATIONAL REVIEW

International Information for International Business

MAY 2018

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Luxembourg Finance Companies: the Importance of Risk Management

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Luxembourg finance companies must now comply with the requirements of a new transfer pricing circular: the risk management function is of crucial importance for such companies.

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Luxembourg is a prime holding location and a financial center that has traditionally been a preferred location for the implementation and management of intra-group financing activities. Since 2017, Luxembourg finance companies have had to comply with the requirements of a new transfer pricing circular (the "Circular"). This article analyzes the importance of the risk management function for Luxembourg finance companies.

On December 27, 2016, the Luxembourg tax authorities released a new Circular (Circular L.I.R. N° 56/1- 56bis/1 of December 27, 2016) on the tax treatment of Luxembourg companies performing financing activities. The Circular applies as from January 1, 2017 and replaces the previous circular that was released in 2011 (Circular L.I.R. N° 164/2 of 28 January 2011). Notably, the new transfer pricing regime is compliant with the 2017 version of the OECD Transfer Pricing Guidelines, which has been significantly revised as a result of the OECD Base Erosion and Profit Shifting ("BEPS") Project.

The scope of the Circular covers entities that are engaged in intra-group financing transactions. The term "intra-group financing transaction" is to be interpreted very broadly and includes any activity involving the granting of loans (or advancing of funds) to associated enterprises irrespective of whether these loans are financed by internal or external debt (intra-group financing, bank loans, bonds issued on the stock exchange, etc.).

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The Luxembourg transfer pricing regime is characterized by the requirement that finance companies have to assume the risks in relation to their financing activities and actively manage these risks over the lifetime of the investment. This requires that a Luxembourg finance company has control over the risk and the financial capacity to assume the risk. Thus, the amount of equity financing should suffice to cover the risk in relation to the financing activity (i.e., the equity at risk).

The amount of equity at risk should further be remunerated with an arm's length return on equity, resulting in an arm's length net remuneration. The latter is increased by taxes and operational expenses incurred in relation to the financing transactions so as to arrive at the gross remuneration to be earned by the finance company. The amount of equity at risk and the arm's length character of the remuneration need to be substantiated in a transfer pricing study.

The Equity at Risk Requirement

The Circular stresses that a finance company has to bear the risks in relation to its intra-group financing transactions. The equity at risk of a finance company has to be determined on a case-by-case basis, which is a key change compared to the former transfer pricing regime. Until 2016, finance companies had to comply with the so-called real risk requirement that was deemed to be satisfied when the companý's equity at risk amounted to at least 1 percent of the outstanding loan(s) or 2 million euros (in practice, finance companies with a financing volume above 200 million euros complied with the real risk requirement when their equity at risk in relation to the financing activities amounted to 2 million euros).

While, under the former regime, the risks of a finance company were contractually limited to the lower of 1 percent of the outstanding loan(s) or 2 million euros (e.g., through limited recourse clauses or guarantees), under the new regime the risks assumed by a finance company are in general not limited.

With regard to the determination of the equity at risk, finance companies having a profile comparable to regulated financial institutions (entities governed by EU regulation 575/2013 on prudential requirements for credit institutions and investment firms; banks, etc.) need to respect the solvency criteria provided by relevant regulation (Basel III). On the contrary, in the case of finance companies having a profile which differs significantly from that of a regulated financial institution, other methods for the determination of the amount of equity at risk should be used.

In practice, most, if not all, Luxembourg finance companies should have a functional and risk profile which differs significantly from that of regulated financial institutions. Hence, the equity at risk will not be determined in accordance with the solvency criteria relevant for banks. Rather, the equity at risk should be determined on the basis of other economic methodologies as appropriate in a specific case. The equity at risk is commonly calculated as the expected loss of the financing activity, considering the credit rating of the borrower(s).

Finance companies must be financed with an amount of equity that is sufficient to cover the expected loss in case it materializes (see No. 19 of the Circular). Although the Circular does not define the meaning of the term "equity," it should at least include share capital, share premium, contributions to equity account 115 (account 115 of the standard Luxembourg accounting plan is entitled "equity contributions without the issuance of shares" and a flexible equity position comparable to the share premium), reserves and retained earnings. The equity may either finance part of the loan portfolio or be invested in other assets (for example, participations). Considering that the equity should be available to absorb the risks assumed whenever they materialize, the equity should in theory be available at all times and not only upon implementation of the financing activity.

The Risk Management Function

Risk management relates to the risks initially assumed and subsequently borne as a result of the conclusion of the loan agreements. Broadly speaking, the risk management function consists of the monitoring and the management of risks in relation to the financing transactions.

The monitoring of risks involves the review of the creditworthiness of the borrower(s), the monitoring of interest rates and position risk, the analysis of the profitability of the loans and the return on the equity invested. The management of risks concerns the decision as to whether and, if so, to what extent, a finance company should continue bearing the risks in connection with the financing transactions or mitigate them (e.g., transferring credit risk to a third party by means of (credit) derivatives or the loan itself, or deciding write-offs for non-performing loan contracts).

According to the OECD Transfer Pricing Guidelines (see paragraph 1.61), risk management comprises the following three elements:

- the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function;
- the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function; and
- the capability to mitigate risk (i.e., the capability to take measures that affect risk outcomes together with the actual performance of such risk mitigation).

In the past, the risk management function was less important, as a finance company was generally bearing a limited credit risk in relation to the financing activities (which had been contractually limited to 1 percent of the financing volume or 2 million euros). However, under the new regime, finance companies bear all the risks in relation to their financing activities. Accordingly, it is crucial for a finance company to actively monitor and manage the risk in relation to the financing transactions.

From a practical perspective, the regular review of the risks in relation to the financing activities may be performed by employees or directors of the finance companies, or outsourced to other group companies or qualified Luxembourg service providers. In the latter case, it is for the directors of the Luxembourg fi-

nance company to supervise the day-to-day risk management. The directors of the finance company have to assess and respond to the risk in relation to the financing activities as part of their duties; in extreme cases, directors of Luxembourg companies may become personally liable if they do not comply with their duties as a director.

Last but not least, the active management of the financing activities, including the performance of the risk management function, may also have an impact on the parameters to be chosen when determining the amount of the equity at risk (in particular, the time horizon of the probability of default).

Designing a Risk Management Policy

Given the paramount importance of risk management when it comes to financing activities, Luxembourg finance companies should prepare a risk management policy which describes the risk management process, the roles and responsibilities of the people involved and other practical aspects such as the frequency of risk reviews. The policy should also include supporting information that demonstrates the capacity of the people in charge of the risk management function (e.g., CV, description of relevant qualifications and experience).

The risk management process technically begins before granting a loan when (i) analyzing the impact on the risk profile of the loan portfolio and the equity at risk, and (ii) taking a decision on whether or not to grant the loan. The process ends with the repayment of the loan(s). In the meantime, it is necessary to perform regular risk reviews.

The frequency and extent of these risk reviews should be aligned to the specific detail of the financing activities. Factors to be considered when developing a risk management policy include: the quantum of the financing activity; the number of loans granted; the terms of the loans; and the risk profile of the loans. While this needs to be determined on a case-by-case basis, the risk profile of the loan portfolio should be reviewed at least once a year. This might, for example, be done in parallel to the preparation of the financial statements when decisions are taken about potential write-downs in value of loan receivables.

As a matter of best practice, the risk management function should be properly documented and clearly included in the minutes of the board of directors. This includes the documentation of risk reviews, the discussions of the directors that led to the decision-making in relation to the financing activity, as well as the decisions taken by the directors in response to a potential change in the risk profile of a company's loan portfolio. Luxembourg finance companies generally have different options realistically available to respond to a change of the risk profile of the loan portfolio (notably, when the credit rating declines). For example, a finance company may ask for an early repayment, transfer the loan to another group of companies or even third parties (e.g., a debt fund) or perform a write-down in value. Moreover, loan agreements often include clauses relating to an event of default (e.g., if a borrower does not pay the interest) in which a loan becomes due immediately.

Planning Points

Luxembourg finance companies have to actively manage their financing activities and to assume the risks in relation to them. This implies that the companies need to have control over these risks and the financial capacity to assume the risks in case they materialize. The amount of equity at risk has to be determined on a case-by-case basis considering the credit rating of the borrower and needs to be remunerated with an arm's length return on equity.

However, the credit rating of a loan portfolio is not necessarily stable and may change over time. Factors that may trigger a change of the credit rating may, in particular, be linked to the specific situation of the borrower (for example, increased vacancy in a real property or a drop in turnover) or to macroeconomic and political changes in the geographical area in which the borrower operates.

Therefore, it is crucial to continuously monitor and manage the risks in relation to the loan portfolio, which also contributes to a comprehensive and diverse functional and risk profile of the Luxembourg company performing such activities. The way financing activities are handled may even have an impact on the parameters to be chosen when determining an arm's length remuneration for the financing activities.

Ultimately, the risk management function should be described in a proper risk management policy that defines the process of risk management, the roles and responsibilities of the people involved as well as other practical aspects such as the frequency of risk reviews over the year.

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The authors wish to thank Leopold Michaud (Senior Associate, Corporate Finance) and Samantha Schmitz (Chief Knowledge Officer) for their assistance.

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