



Financial Services Act 2008

Guidance on Rule 2.30 and Appendix 3 (Note 4)

Qualifying Subordinated Loans

STATUS OF GUIDANCE

The Isle of Man Financial Services Authority (“the Authority”) issues guidance for various purposes including to illustrate best practice, to assist licenceholders to comply with legislation and to provide examples or illustrations. Guidance is, by its nature, not law, however it is persuasive. Where a person follows guidance this would tend to indicate compliance with the legislative provisions, and vice versa.

Qualifying Subordinated Loans (“QSL”)

A subordinated loan is a loan which ranks behind other creditors in the event of the licenceholder being wound-up.

A QSL is a subordinated loan which is in a standard form and has been accepted as such by the Authority, as set out in Note 4 to Appendix 3 of the Financial Services Rule Book 2016 (Financial Resources Statement).

QSLs are typically made by related parties such as a parent company, a company in the same group, or a trust in the licenceholder’s ownership structure. They have the option to be interest bearing or non-interest bearing.

QSLs are administratively simple to put in place and to unwind. However, a key feature is that, without exception:

1. They cannot be repaid or unwound (even upon maturity or the insolvency of the licenceholder); and,
2. Interest cannot be paid on them if, immediately after the payment, the licenceholder’s Financial Resources would be less than or equal to the Financial Resources Requirements without the prior written approval of the Authority.

Background

The Authority views QSLs as a useful form of supplementary debt finance for the short to medium term. The Authority does not view QSLs as a suitable alternative to having adequate share capital. A QSL is a form of debt, not equity.

In cases where a licenceholder is well within its financial resources requirements then the Authority is unlikely to have any objection to a subordinated loan regardless of purpose.

Taking the above into account, the main situations where the Authority believes it may be appropriate to consider an application from a licenceholder to use a QSL are to:

- Fund an expansion of the licenceholder's business which is expected to be self-financing over a period of time, for example an acquisition;
- Cover a temporary loss, where the licenceholder has been profitable and expects to return to profit;
- Cover an initial loss in the first year or two of trading of a start-up business. Situations where this is likely to be acceptable are those where the subordinated loan is provided by the controllers / owners of a start-up business that has a credible business plan to achieve profitability but operating costs are not covered by income in the initial stages of trading and / or there are some up-front costs to get the business started. What is unlikely to be acceptable is where the loan is to be provided to fund long term losses or drawings by the shareholder(s). A proposed QSL from an unconnected third party would be looked at very carefully.

In considering a proposal from a licenceholder to put in place a QSL where part (b) of Note 4 does not apply (in terms of net tangible assets not exceeding minimum share capital, before taking into account a QSL), the Authority will expect to see:

- A business case for the use of the QSL funding;
- Profitability achieved within 24 months of the QSL being accepted (irrespective of whether a start-up situation or one where losses have been incurred by a previously profitable company);
- A programme for repaying the QSL over the short to medium term (normally within 5 years);
- Repayment of the QSL being prioritised over paying dividends (normally no dividends to be paid until the QSL has been repaid); and,
- The lenders audited annual financial statements, at the outset.

The Authority would require the licenceholder to report its progress in the repayment of the QSL, and, if a programme for repaying a QSL was not met, the Authority would require that appropriate steps were taken. For example, the Authority can direct that the loan is no longer treated as a QSL (in whole or part) and that the paid up share capital of the licenceholder must be increased accordingly. A decision would be made on the particular circumstances and taking into account how far the repayments are behind the repayment programme.

Proforma Subordinated Loan Agreement

This [proforma agreement](#) has been prepared specifically for use by applicants for, and licenceholders under, the Financial Services Act 2008. If you are not an applicant or licenceholder, you should not copy, circulate or in any other way use or rely on the wording contained in the agreement. Applicants and licenceholders may copy the proforma but must not rely on the wording of the proforma and should take their own legal advice as to the appropriateness of the wording and the document in their own circumstances.