



CENTRAL BANK &  
FINANCIAL SERVICES  
AUTHORITY OF IRELAND

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EUROSYSTEM

**CONSULTATION PAPER**

**CP 43**

**CODE ON RELATED PARTY LENDING**

## 1.0 PROPOSAL

- 1.1 The Financial Regulator considers that lending to related parties, in particular where large sums are concerned, is a form of lending that has potential to give rise to conflicts of interest and abuse, bearing in mind the relationship between the borrower and the lender.
- 1.2 In order to guard against abuses arising from exposures to related parties and to address possible conflicts of interest the Financial Regulator is proposing to:
- impose a Code of Practice (“the Code”) concerning lending by banks and building societies (collectively referred to as credit institutions) to related parties which aims to ensure that such lending is on an arm’s length basis and subject to appropriate and effective management oversight and limits;
  - introduce periodic reporting to the Financial Regulator to enable the Financial Regulator to satisfy itself as to compliance with the Code.
- 1.3 Lending to related parties is defined within the Code. In summary it means lending to a director or a senior manager as well as persons connected to these individuals. Related party lending also covers lending to significant shareholders or to entities in which the credit institution has a significant shareholding.
- 1.4 The Code will apply to credit institutions licensed and authorised by the Financial Regulator.
- 1.5 In considering the introduction and terms of this Code, the Financial Regulator has had regard to (i) the interest of customers and the general public, and (ii) the promotion of fair competition in financial markets in the State as well as promoting the best interests of users of financial services in a way that is consistent with the orderly and proper functioning of financial markets, and the orderly and prudent supervision of providers of those services.

1.3 This Consultation Paper is part of a wider strategy to update the domestic regulatory framework applying to credit institutions. The Financial Regulator has recently issued a consultation paper on corporate governance entitled 'Corporate Governance Requirements for Credit Institutions and Insurance Companies'. It is proposed to issue further requirements, including remuneration requirements and a revised fitness and probity framework, in due course. The Financial Regulator will also consider the need for additional requirements in respect of internal governance and risk management as international initiatives in these areas are published.

1.4 The proposed Code requirements are set out at Appendix 1.

## 2.0 LEGAL BASIS

2.1 The Code will be issued pursuant to Section 117 of the Central Bank Act 1989 ('the Act').

Section 117(1) to (3) of the Act provides that:

- "(1) The Bank may, after consultation with the Minister, from time to time draw up, amend or revoke, in relation to any class or classes of licence holders or other persons supervised by the Bank under this or any other enactment, one or more than one code of practice concerning dealings with any class or classes of persons and every such code shall be observed by the licence holders, or other persons so supervised, to whom they relate.*
- (2) In drawing up codes of practice the Bank shall have regard to –*
- (a) the interest of customers and the general public, and*
  - (b) the promotion of fair competition in financial markets in the State.*
- (3) The Bank may-*
- (a) require any licence holder or other person supervised by it to provide all relevant information to the Bank to enable the Bank to satisfy itself as to compliance with the code by such licence holder or other person,*
  - (b) issue a direction in writing to such licence holder or other person to comply with practices specified in the direction where this is necessary, in the opinion of the Bank, to secure observance of the code."*

2.2 The functions of the Bank under Section 117 of the Act are designated to the Financial Regulator in accordance with Section 33C(1)(a) of the Central Bank Act 1942.

2.3 A contravention of the Code will be liable to administrative sanction by the Financial Regulator under Part IIIC of the Central Bank Act 1942. This may expose credit institutions subject to the Code and persons concerned in their management who participate in the contravention to monetary or other penalties. A failure to provide reports as required under this Code, in accordance with Section 117(3)(a) of the Act, is also an offence.

### **3.0 SCOPE**

3.1 The Code will apply to all credit institutions operating in Ireland, other than those incorporated in other EEA Member States and operating here on a branch or a cross border basis (i.e. 'passporting' institutions). This is on the basis that the Financial Regulator considers this matter would be dealt with more appropriately for such firms in the context of any relevant rules applied to them by their Home State jurisdiction and applied to their business as a whole. It is proposed that Irish credit institutions subject to this Code will be required to comply with its terms for lending by those credit institutions conducted in or outside the State.

### **4.0 REGULATORY BACKGROUND**

4.1 Banks incorporated in the State are licensed under Section 9 of the Central Bank Act 1971. Building societies incorporated in the State are formed and authorised under the Building Societies Act 1989. A credit institution may, in addition, be registered as a designated credit institution under the Asset Covered Securities Acts 2001. Regulatory powers in respect of banking business are primarily derived from the Central Bank Acts, the Building Societies Act 1989 and the Asset Covered Securities Act 2001 and various provisions implementing EU Directives.

4.2 The Licensing and Supervision Requirements and Standards for Credit Institutions, last issued in 1995 by the Central Bank of Ireland, are non-statutory requirements which apply to credit institutions as a supplement to credit institutions' obligations under legislation. It is proposed that the Code requirements will supersede Section 8.4 (a) to (c) of the Licensing and Supervision Requirements and Standards for Credit Institutions.

4.3 Section 8.4 (a) to (c) of the Licensing and Supervision Requirements and Standards for Credit Institutions includes the following provisions regarding lending to related parties:

- (a) a credit institution's exposures to any one of its directors, including any exposures to any business in which the director has a major interest, may not exceed 2 per cent of own funds; the aggregate of all such exposures may not exceed 10 per cent of own funds;*
- (b) a credit institution's exposure to any one of its significant shareholders, including exposures to businesses in which the significant shareholder has a major interest, as defined, may not exceed 10 per cent of own funds, unless such shareholders or businesses are also credit institutions; the aggregate of all such exposures may not exceed 30 per cent of own funds; and*
- (c) a credit institution's exposure to a client or group of connected clients, other than a credit institution or financial institution, in which the credit institution has what is considered by the Bank to be a major interest may not exceed 10 per cent of own funds; the aggregate of all such exposures may not exceed 30 per cent of own funds.*

4.4 The principal piece of EU legislation governing banking business is Directive 2006/48/EC ('the Directive'). Article 22(2) of the Directive provides that the systems and controls of credit institutions required under the Directive must be comprehensive and, amongst other things, take into account the technical criteria in Annex V to the Directive. This requirement is transposed into Irish law by Regulation 16 of the European Communities (Licensing and Supervision of Credit Institutions) Regulations 1992<sup>1</sup>. Regulation 16(3) and (4) requires that:

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<sup>1</sup> S.I. No. 395 of 1992, including as amended by Regulation 79 of the European Communities (Capital Adequacy of Credit Institutions) Regulations 2006 (S.I. No. 661 of 2006) to insert Regulations 16(3) and (4).

*“(3) Subject to paragraph (4), every credit institution shall have robust governance arrangements including:*

- (a) a clear organisational structure with well defined, transparent and consistent lines of responsibility,*
- (b) effective processes to identify, manage, monitor and report the risks it is or might be exposed to,*
- (c) adequate internal control mechanisms, and*
- (d) without prejudice to the generality of subparagraph (c), sound administrative and accounting procedures.*

*(4) Every credit institution shall, for the purposes of complying with paragraph (3) -*

- (a) ensure that the arrangements, processes and mechanisms referred to in that paragraph are comprehensive and proportionate to the nature, scale and complexity of the activities of the institution, and*
- (b) take into account the technical criteria set out in Annex V to Directive 2006/48/EC”.*

4.5 Annex V to the Directive includes requirements that credit granting shall be based on sound and well-defined criteria and that the process for approving, amending, renewing and refinancing credits shall be clearly established. It also provides that credit institutions’ management bodies must have defined arrangements concerning the segregation of duties in the organisation and the prevention of conflicts of interest.

4.6 In devising the Code, the Financial Regulator has had regard to Regulations 16(3) and (4), above.

## **5.0 LENDING LIMITS**

5.1 The Code includes in requirement 6(h) a series of limits on lending to related parties. These are proposed on the basis that it is considered by the Financial Regulator that, once related party lending exceeds these limits, the scale of the potential conflict of interest for the credit institution, and the scope for abuse, is such that the procedures set out in requirements 6(a) to (g) no longer provide a satisfactory prudential assurance.

5.2 The Financial Regulator has taken the approach of linking these limits to the concepts of ‘exposure’ and ‘own funds’ in the Directive (transposed in Ireland by the European

Communities (Capital Adequacy of Credit Institutions) Regulations 2006). This ensures that an appropriate range of lending is brought within the Code. This also has the benefit that the concepts are familiar to credit institutions and already form part of their internal monitoring and reporting systems.

## **6.0 EXEMPTION FROM LENDING LIMITS**

6.1 The Code includes an option for a credit institution to apply to the Financial Regulator in writing for an exemption from the limits in III. and IV. of requirement 6(h). While the Financial Regulator will consider each such application on its merits, it is currently of the view that such an exemption would only be potentially available to the extent that an exemption is available in respect of intra-group lending to a parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the supervision on a consolidated basis to which the credit institution itself is subject, in accordance with Article 113(2) of the Directive or with equivalent standards in force in a third country.

## **7.0 OTHER LAWS AND REQUIREMENTS NOT AFFECTED**

7.1 Nothing in the Code impacts on a credit institution's obligations, including disclosure obligations, regarding lending to directors and/or other related parties under other legislation or requirements, including company law or accounting requirements.

## **8.0 REPORTING TO THE FINANCIAL REGULATOR**

8.1 The Financial Regulator proposes to introduce a periodic reporting regime regarding credit institutions' compliance with the Code, under Section 117(3)(a) of the Act.

8.2 The frequency and format of such reports will be as specified from time to time by the Financial Regulator pursuant to Section 117(3)(a). It is proposed that such reports be submitted to the Financial Regulator on a quarterly basis. A proposed reporting format is set out at Appendix 2. On the introduction of this report, elements of the Large

Exposures Reports will be discontinued, in order to avoid duplication of reporting. Of course, submission of the Quarterly Related Party Lending Return will not in any way detract from a credit institution's obligations to report large exposures under the European Communities (Capital Adequacy of Credit Institutions) Regulations 2006, nor will it constitute a substitute for large exposure reports.

- 8.3 Credit institutions will also be required to submit a reconciliation of the differences, if any, between disclosures in their published accounts and related party lending exposures reports to the Financial Regulator. Again, the details of such requirement will be as specified from time to time. However it is proposed, initially at least, that such a reconciliation will be required on an annual basis by reference to a credit institution's annual report.

## **9.0 TRANSITIONAL ARRANGEMENTS**

- 9.1 The Code will, from the date on which it comes into force, apply to all lending, including loans outstanding and lending commitments entered into prior to the Code coming into force. In the event that a loan outstanding or lending commitment entered into prior to the Code coming into force is not consistent with this Code, a credit institution shall take all steps possible to modify the loan or lending commitment so that it is, as soon as possible, consistent with this Code and so advise the Financial Regulator.

## **10.0 CONSULTATION PROCESS**

- 10.1 In this consultation paper the Financial Regulator is seeking views on the proposed introduction of a Code on Lending to Related Parties. Prior to finalising any Code the Financial Regulator will, as required by Section 117 of the Act, consult with the Minister for Finance. The Financial Regulator is also, as part of this consultation process, consulting the Consultative Industry Panel and the Consultative Consumer Panel in accordance with section 57DB of the Central Bank Act 1942.



10.2 The closing date for submission is 16 July 2010. We welcome submissions from all interested parties. Please make your submissions in writing or, if possible, by e-mail. We intend to make all submissions available on our website. We will not publish any material that we deem potentially libellous or defamatory.

Please clearly mark your submission "Related Party Lending" and send it to:

Policy Unit  
International Credit Institutions  
Financial Regulator  
PO Box 9138  
College Green  
Dublin 2

E-mail: [RPLending@centralbank.ie](mailto:RPLending@centralbank.ie)

**International Credit Institutions**  
**13 May 2010**

## **APPENDIX 1**

# **Code of Practice on Lending to Related Parties**

## **1 Overview**

In order to guard against abuses in lending to related parties and to address possible conflicts of interest, the Financial Regulator hereby requires that such lending be on an arm's length basis and subject to appropriate management oversight and limits.

## **2 Legal Basis and Application of this Code**

This Code is imposed pursuant to Section 117 of the Central Bank Act 1989 on banks incorporated in the State licensed under Section 9 of the Central Bank Act 1971 and on building societies authorised under the Building Societies Act 1989. It also applies to designated credit institutions registered under the Asset Covered Securities Act 2001. Separately from this document, the reporting requirements described in part 8 of the Code will be imposed from time to time pursuant to Section 117(3)(a) of the Central Bank Act 1971.

This Code does not apply to credit institutions incorporated in other EEA member states who conduct their business in the State on a branch or services basis pursuant to EU law and Directive 2006/48/EC.

References in this Code to provisions of statute (whether under the laws of the State or EU) are references to those provisions as amended, substituted or replaced from time to time.

## **3. Commencement**

This Code comes into force on [*date*].

## **4. Scope of Loans Covered by this Code**

This Code applies to all loans to related parties, whether granted:

- in the State or outside the State; or

- subject to the transitional provision below, prior or subsequent to the entry into force of this Code.

Transitional Provision:

The Code will, from the date on which it comes into force, apply to all lending, including loans outstanding and lending commitments entered into prior to the Code coming into force. This shall not, however, be taken to mean that any act or omission of a credit institution prior to the Code coming into force shall constitute a contravention of the Code. In the event that a loan outstanding or lending commitment entered into prior to the Code coming into force is not consistent with this Code (including without limitation by virtue of the credit institution thereby exceeding a limit in requirement 6(h)), a credit institution shall take all steps possible to modify the loan or lending commitment so that it is, as soon as possible after the coming into force of this Code, consistent with this Code.

**5. Definitions:**

**Board:** means the board of directors of the credit institution.

**Business Day:** Any day except Saturday, Sunday, bank holidays and public holidays in Ireland.

**Connected Persons and Clients:**

- (a) a spouse, domestic partner or child (whether natural or adopted) of a person;
- (b) two or more, natural or legal, persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others; or
- (c) two or more, natural or legal, persons between whom there is no relationship of control as set out in point (a) but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties.

**Credit Institution:** A bank licensed under Section 9 of the Central Bank Act 1971 or a building society authorised under the Building Societies Act 1989, including a credit institution registered as a designated credit institution under the Asset Covered Securities Act 2001.

**Exposure:** Exposure has the meaning as set out in Directive 2006/48/EC.

**Lending:** The provision of a loan.

**Loan:** Loan includes a cash loan, deferred payment or other similar financial accommodation.

**Own Funds:** Own funds has the meaning as set out in Directive 2006/48/EC.

**Related Party:** A director, senior manager, significant shareholder or entity in which the credit institution has a significant shareholding, as well as a connected person of any of the aforementioned persons.

**Senior Management:** Members of management of the institution or person who report directly to the board of directors or the chief executive (howsoever described) of the credit institution.

**Senior Manager:** A person who is a member of senior management.

**Significant Shareholder:** A person who holds, either themselves or in aggregate with their connected persons, a significant shareholding.

**Significant Shareholding:** 10% or more of the shares or voting rights in that credit institution or business.

## 6. Requirements of the Code

Credit institutions shall observe the following code of practice in granting or otherwise dealing with loans to related parties:

- a) a credit institution shall not grant a loan to a related party on more favourable terms (including without limitation terms as to credit assessment, duration, interest rates, amortisation schedules, collateral requirements) than a loan under corresponding lending by the credit institution to non-related parties. An exemption is permitted for beneficial terms that are part of a remuneration package available to staff of the credit institution generally (e.g. staff loans at favourable rates) provided that such terms have been approved by the Board;
- b) a loan to a related party, or any variation of the terms of a loan to a related party, shall be subject to individual prior approval by the Board. Board members with conflicts of interest shall be excluded from the approval process;
- c) actions in respect of the management of a loan to a related party (e.g. permitting interest roll-up, granting a grace period for payment, loan write-off in whole or in part, provisioning against a loan, decisions to take or not to take enforcement action) shall be subject to individual prior approval in writing by the Board;
- d) policies and processes shall be in place, and adhered to, in order to prevent:
  - (i) members of staff of the credit institution benefiting from lending to a related party (otherwise than the receipt of standard remuneration also available in lending to non-related parties, e.g. bonuses and commission), and
  - (ii) persons related to the borrower from being part of the process of granting and managing a loan to such borrower;

- e) policies and processes shall be in place, and adhered to, in order to identify individual loans to a related party as well as the total amount of such loans from time to time, and to monitor and report on such loans through an independent credit review process;
- f) related party lending shall be subject to a written process, approved in advance by the Board, of ongoing monitoring by senior management;
- g) there shall be in place an obligation on senior management to report to the Board, on at least a quarterly basis, for timely action by the Board, any deviation from a policy, process or limit required by this Code;
- h) a credit institution shall not lend to a related party where to do so would result in the exposures of the credit institution exceeding one or more of the following limits:

<b>Exposure Category</b>	<b>Limit</b>
I. Exposures to any one of the credit institution's directors or senior management, and persons connected to them, including any exposures to any business in which the director or senior manager has a significant shareholding.	0.5% of own funds
II. The aggregate of exposures under I., above.	5.0% of own funds
III. Exposure to any one of its significant shareholders, other than credit institutions, including exposures to businesses in which the significant shareholder has a significant shareholding.*	5% of own funds
IV. The aggregate of exposures under III., above.*	15% of own funds
V. Exposure to a client or group of connected clients, other than a credit institution, in which the credit institution has a significant shareholding.	5% of own funds
VI. The aggregate of exposures under V., above.	15% of own funds

\*Exemption from III and IV:

A credit institution may apply to the Financial Regulator in writing for an exemption from the limit in III. and IV.

- (i) a credit institution shall not:
  - (i) engage in a practice,
  - (ii) enter into an arrangement,
  - (iii) execute a document, or
  - (iv) structure or restructure a loan,in order (whether or not as the sole or primary purpose) to avoid its obligations under this Code.

## **7. Reporting to the Financial Regulator**

- a) Related party exposures shall be reported to the Financial Regulator on a periodic basis and in a format specified from time to time by the Financial Regulator pursuant to Section 117(3)(a) of the Central Bank Act 1989. This is without prejudice to the rights and powers of the Financial Regulator to otherwise request specific information at any point in time or to conduct inspections of a credit institution's compliance with the Code.
- b) Where a credit institution considers that there may have been an error in its conduct by reference to the requirements of this Code (including without limitation reporting requirements imposed in respect of this Code) the credit institution shall within 5 business days inform the Financial Regulator in writing of its proposals for correcting any such error as may have occurred. If any such information is provided to the Financial Regulator orally in the first instance, it shall be provided to the Financial Regulator in writing on the next business day.

