Submissions/ Views In Response To Consultation Papers CP41 and CP43

Corporate Governance Requirements for Credit Institutions & Insurance Undertaking
Code on Related Party Lending

Section A – Introduction

Part 1 – Rush to Regulation

A balance must be struck between effective Regulation and appropriate risk taking. The rule-based Sarbanes-Oxley approach in the U.S.A was as much a failure as the principles-based approach adopted here. "There is no way round the fact that the Authorities must protect the public first, to save the vitally important role finance is playing for the economy as a whole and secondly, to fulfil the role as a de facto owner of a significant part of the financial sector and a potential owner of the not yet fallen part (Ref: "Convergence of Risk and Regulation from FRS Global")". This requires full data disclosure to Regulators.

Principled–based approach still being advocated in the U.K. Walker Review on Bank Governance completed and new U.K. Corporate Governance Code has replaced the old Combined Code. Comply or explain approach continues. In U.S.A., Europe and here in Ireland rules–based approach supreme. This involves serious culture change for Ireland. A number of Irish Credit Institutions are obliged to report to U.S.A (SEC etc.), FSA / Central Bank in London and to Irish Regulator as many are listed on all three stock exchanges. In addition new Regulations on financial services are being prepared under the auspices of the President of the E.U. Council for adoption at the October 2010 Summit. Basel III with new capital and liquidity rules for banking supervision due to be completed by yearend 2010. G20 proposing inter alia to tax bank balance sheets at November Summit. E.U. Directive on alternative Investment Fund Managers ongoing with new powers being proposed for a planned Pan – European Regulator. The Financial Services Bill in the U.S.A awaits clearance through Congress which would cover such items as a new Consumer Financial Protection Bureau (within the Fed), a new Resolution Authority, new Transparency Rules on Derivatives, a new Financial Stability Oversight Council (within the treasury) and of course the Volcker Rule being applied to deposit taking Banks.

The "moral hazard" syndrome being replaced by the "no free lunch" approach in the E.U. – we provide funding and we control what you do and how you do it.

In June of 2006 the then Chairman of AIB, Mr. Dermot Gleeson, gave quite an interesting speech to the Institute of European Affairs entitled "Developing the Regulatory Landscape in Financial Services" which was subsequently repeated in an article in the November 2006 issue of the Irish Banking Federations Magazine "About Banking". He expressed in a personal capacity his views on the issue and in essence made the point that rules should not be made for rules sake but regulatory rules must be effective to ensure compliance and enforcement. He referred to the multiplicity of rules which were then in existence which were quite frankly not being enforced. He argued for a more slim-line system which would be more effective and would be of greater assistance to both business and the Regulator.

Part 2 – Conflicts in Regulation

There appears to be no oversight or streamlining of all these new regulatory systems so as to make their applicability and enforcement compatible. Already conflicts are arising. For example here in Ireland, the Auditing and Accounting Supervisory Authority (established in 2003) has recently been given new corporate governance and audit related powers under the

Statutory Audits Directive of 2010. This includes, inter alia, a direction that all Audit Committees of public interest entities must be established with at least two independent Directors. Independence is defined in these Regulations firstly, that at no time during the period of three years preceding the appointment did the person have a material business relationship with the entity, directly or indirectly or a position of employment in the entity. These Regulations direct that such Audit Committees have four basic responsibilities. This Statutory Code / Regulation creates different definitions of Director independence and of composition of Audit Committees.

Financial Services Ombudsman (FSO) looking for more powers to name and shame the subjects of any of his adverse findings. Again different definitions appear under the Ombudsman's Scheme.

Issues of privilege and confidentiality and minimum requirements appear throughout the Anti-Money Laundering Legislation particularly as applying to Auditors / Accountants.

Solvency II (as applies to the insurance industry) under its Qualitative Governance Review Processes sets out further principles with regard to internal control and risk management which potentially clash with this proposed Code and in particular, create a further set of definitions under different headings.

The Acquisitions Directive defines a substantial shareholding or a "qualifying holding" as a 10% acquisition or more of capital or voting rights. A different definition of substantial shareholding is proposed in this Code.

There is a risk of a severe gap opening up between the law / regulations as applicable to regulated Credit Institutions and the general law applicable to "Non- Regulated Companies". To some extent this gap will have to be filled. Accordingly many of the changes being proposed must be brought through to apply to all companies or public entities including those outside of Financial Regulation.

Presently we have Executive, Non-Executive, Alternate (Substitute), Shadow and De Facto Directors under our existing Company Laws. Our present laws make no distinction between Executive and Non-Executive with regard to their roles and responsibilities – the unitary board approach applies.

Someone who is a Director by reason of his nomination as such by a Financial Institution which has given credit to the company or by a Venture Capital Company in connection with its shareholding in the company cannot be treated as simply a Non-Executive Director. A third type of Director must be created and acknowledged. We must have Executive, Non-Executive and Independent Directors. Shadow Directors must be treated in exactly the same manner and have the same duties and responsibilities as Executive Directors.

The recent TASC Report shows up the small pool of personnel with experience to be Directors in Irish Companies and the huge interlocking of Boards or Cross Directorships present here. Grant Thornton reported just last year that "camaraderie over competence defines a large chunk of Irish corporate culture".

The recent Supreme Court decision in Mitek Holdings is informative setting out as it does the views of that Court as to the duties and responsibilities of Company Directors (albeit in the context of a Section 150 Application). "There will usually be a real difference between the duties of Executive and Non-Executive Directors. The latter will usually be dependent on the former for information about the affairs and of the finances of the Company, a fact which

will impose correspondingly larger duties on the former. Tralee Beef and Lamb was a notable example of a Non-Executive Director with little role or influence in the Company. As, in the present case, the inter-relationships of Companies in a Group may affect the extent of a Director's responsibilities" (Para 80).

Section B – Proposed Regulations

Part 1 – Structure

The fact that a licensed regulated Credit Institution has an authorisation from the State to collect money from the public implies that there should be embedded in any Regulation a requirement that that Institution, particularly if a Private Company, should be obliged to produce on an annual basis a Declaration of Ownership.

The Regulations should stand on their own without reference to any other Legislation save Irish Legislation. For example to include (as in the case of the Code on related party lending) a definition of "own funds" as having the meaning as set out in Directive 2006 / 48/ EC is with respect ill-advised. The definition should be fully set out. To do otherwise will result in such definitions being amended in Europe without any input or direction from the Regulator with the result that the Regulator loses control of the meaning and effect of his own Code.
The Code / Regulations should not be minimalistic (i.e. what Europe demands).
There should be three piers to any proper regulatory system:

- **Pier 1**

  Trust / Conduct. The Mirror Test. Personal Integrity and Judgment. Imposition of new culture. Chinese or Firewalls or information barriers should be the absolute exception and not the norm as we have now. Conflicts of interest must be transparently addressed. In changing to a rules-based system one runs the risk of the "play the ref "or "blame the ref" attitude. It is right if it is not in breach of the rule. If something goes wrong but we follow the rules, blame the rules.

- **Pier 2**

  Regulation. Rules and Principles. Directors cannot be Borrowers or be on the Boards of Borrowers. What level or scope of business is permitted? For example at present the main Banks provide services which include deposits, loans and overdrafts, mortgages, hire-purchase and leasing, card services, foreign exchange, general insurance, life assurance, investments and pensions, investment management and advice, corporate finance, treasury and share dealing (this list appears on an AIB Offer of Loan issued eight weeks ago). Regulated Financial Institution which is part of a Group and which has as its Parent Company an unlimited corporate structure. Executive and Non-Executive Directors also on Subsidiaries are on Boards of Companies advising.

- **Pier 3**

  Enforcement – Effect on conduct. Again classic Irish attitude of playing the ref to be avoided. Total lack of protection for whistleblowers. Prevention of Corruption (Amendment) Bill narrowly confined to area of bribery. UN Convention against Corruption signed almost eight years ago. This Legislation will not protect any employee in any Credit Institution who wishes honestly to report irregular loans for example to Directors. Civil Sanction as opposed to Criminal Sanctions. Penalties for example should be multiples of

the gain, savings or benefit accruing from the misdeed. Existing Criminal System totally unsuitable for many trials which would be long and Juries incapable. There should be blanket prohibition on the acceptance by Credit Institutions of its own shares as security for borrowings. As this System is a licensed based System the Civil Sanction regime can be fully employed without any constitutional impediment.

Part 2 – Suggested Amendments / Additions

(a) Governance

- Impact of presence of regulatory "Supervisors" on the Independence of the Institutions Board to be carefully clarified. A serious question of potential liability being placed on the Regulator by the Board in the event of business losses sustained arising from "contribution" of supervisors to the conduct and content of Board meetings. "Intrusive supervision" at management and Board level could quite easily provide a free Insurance Policy for the Board and should be carefully reconsidered.
- Creation of what is in effect three types of Directors to be warmly welcomed, i.e. Executive, Non-Executive and Independent (Non-Executive) Directors.
- Director Independence. This definition is obviously more extensive than in other regimes (e.g. see above). Would suggest the following amendment – "The criteria to be considered and given reasonable weight when determining if a Director is independent shall include:
  Any financial or other obligation the individual (or a Company of which he is a Director, Employee or significant Shareholder) may have to the Financial Institution or its Directors etc.".
  It is noted that the proposed Code/ Regulations would permit the one individual to be a Director of a maximum of three Regulated Institutions. Would recommend that a further criteria of Director independence be added whereby, if the individual holds a Directorship (of whatever type) in more than one Regulated Institution he shall not be considered an Independent Director in any of them.
- Clarification is required of the possible conflicts between provisions relating to the Audit Committee in Paragraph 17 of the proposed Code as compared to the provisions of the recently introduced Statutory Audit Directive Regulations.

(b) Third Party Lending

- Would suggest in particular that external Auditor and any employee thereof should be included as a connected person.
- Suggest that any definitions should be written out and particularly not referenced to any non-Irish Legislation.
- Would suggest that the definition of "Lending" should read "the provision of a Loan or facilities of whatever nature, directly or indirectly, which facilitate the related party obtaining a Loan from any Credit Institution".
- Again would suggest that the definition of "own funds" should be set out in the Code and not defined by reference to non-Irish Legislation.
- Would suggest in Paragraph 6(b) that the Loans to related parties should also require not just the approval by the Board but also the approval of a majority of the Non-Executive Directors on the Board.