

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

**BY EMAIL: [RPLending@centralbank.ie](mailto:RPLending@centralbank.ie)**

16 July 2010

Dear Sirs

## **CORPORATE GOVERNANCE – SUBMISSION REGARDING CONSULTATION PAPER CP43**

Thank you for the opportunity to make a submission in respect of Consultation Paper CP 43, *Code on Related Party Lending* (the “**Consultation Paper**”).

We agree that it is appropriate to impose strict governance standards in relation to related party lending so as to ensure that actual or perceived conflicts of interest and abuse can be avoided and that a financial institution's risk exposures are appropriately managed.

The submissions contained in this letter reflect our views on amendments which could be made to increase the effectiveness of the Code on Related Party Lending (the “**Code**”) in the context of the Irish financial services industry. These submissions reflect our own opinions, based on our experience of the market and discussions with market participants, and should not be considered as representing views held by any of our clients.

If you would like to discuss any aspect of our submission, please contact Joe Beashel in the first instance. We would be happy to meet with you to discuss this matter further, or to take part in any working group which may be convened to assist with finalising the Code.

### **1 CLARIFY DEFINITIONS USED IN THE CODE, TO INCREASE CERTAINTY AND CONSISTENCY OF APPLICATION**

In light of the potentially serious consequences for an institution of non-compliance with the Code (including administrative sanctions and criminal prosecution), we believe that it is of paramount importance that the requirements of the Code be clear and precise. Some of the definitions used in the Code contain terms (such as “*domestic partner*” and “*control*”) which are capable of differing interpretation, making the scope of an institution's obligations unclear. We set out below three suggestions as to how greater clarity may be achieved.

DUBLIN

LONDON

NEW YORK

PALO ALTO

1.1 **Drafting changes to clarify definitions in Code**

One approach which could be taken to achieve greater clarity would be to include additional definitions in the Code. We have highlighted below some terms used in the definitions which we believe are potentially ambiguous, and set out suggestions as to how to deal with such ambiguity.

(a) **“Connected Persons and Clients”**

- (i) Paragraph (a) of the definition refers to the **“domestic partner”** of a Related Party, which is not a term with a legal definition of which we are aware. We suggest that criteria setting out when a person would be considered to be a “domestic partner” should be expressly specified. We refer you to the definition of “cohabitant” and “qualified cohabitant” in section 172 of the Civil Partnership and Certain Rights and Obligations of Co-Habitants Bill 2009, which sets out factors which a court would take into account in determining whether a couple were cohabiting.
- (ii) Paragraph (b) of the definition refers to a relationship of control. We would assume that ownership of more than half of the equity share capital and/or voting rights of a company would constitute control, but the situation would be less clear where an entity is jointly controlled by a Related Party and his Connected Persons, where the control arises over another natural person or an unincorporated entity, or in the case of the relationship between a person and a company of which he is a director. It would be helpful to expressly set out the criteria for establishing “control” for the purposes of the Code, perhaps incorporating reference to legislation which contains relevant criteria. It may be appropriate, for example, to incorporate or cross-refer to the provisions of subsection 26(3) of the Companies Act 1990 (the **“1990 Act”**), which identify when a director will be deemed to control a body corporate.
- (iii) We are concerned that the circumstances in which a person could be **“so interconnected”** with another person **“that, if one of them were to experience financial problems, the other ... would be likely to encounter repayment difficulties”** will be so broad that an institution would have difficulties in determining definitively who are “Connected Persons” as a result of paragraph (c) of the definition. The scope of the definition may also have the effect of applying restrictions on lending in situations where there is unlikely to be any conflict of interest or abuse as a result of the loan. To give some examples:
  - (A) A tenant could be a “Connected Person” of a landlord who had borrowed to acquire the property if failure by the tenant to pay rent would be likely to cause that landlord to have repayment difficulties because the loan is serviced from the rental income.
  - (B) The owner of a business could be a “Connected Person” of his employee with a mortgage if the failure of the business as a result of financial problems of the owner and a consequential inability to pay the employee’s salary would be likely to cause the employee to have repayment difficulties under his mortgage.
  - (C) Co-investors in a leveraged investment could be “Connected Persons” of each other, if one investor were liable to meet payment obligations of another under the terms of the investment documentation.

- (D) A significant customer could be a “Connected Person” of a supplier in circumstances where the customer represented a significant portion of the supplier’s business and a delay in payment by the customer could affect the supplier’s cashflow to such an extent that repayment obligations of the supplier could not be performed. Similarly, a supplier would be a “Connected Person” of a customer where the supplier’s products are essential to the customer’s business and non-delivery could essentially put the customer out of business.

To address these issues, the language of paragraph (c) could perhaps be amended so that it would only apply in circumstances where the ability of one person to perform his payment obligations is known by the lender to such person to be dependent on the other person performing a payment obligation to it. Alternatively, the nature of the relationships which are contemplated by paragraph (c) could be expressly specified (such as partnerships within the meaning of the Partnership Act 1890, co-ownership arrangements where joint and several liability may arise, etc), and/or categories of relationship which do not create a “Connected Person” relationship (such as the express exceptions to the definition of “related party” set out in IAS 24).

- (b) The definition of “**Loan**” refers to a “cash loan, deferred payment or other similar financial accommodation”. What would constitute “similar financial accommodation” is somewhat unclear, and we suggest that it may be preferable for “Loan” to be defined by references to the terms “loan”, “quasi-loan” and “credit transaction” as set out in the 1990 Act.
- (c) The definition of “**Related Party**” refers to “**directors**”. It would be useful if the definition clarified whether this includes alternate directors and/or shadow directors.
- (d) The definition of “**Senior Management**” refers to “**Members of management of the institution or person who report directly to the board of directors or the chief executive (however described) of the credit institution**”. This could be interpreted as applying to either:
- (i) all members of management of the institution, as well as any other person who reports directly to the board of directors or the chief executive; or
  - (ii) all members of management of an institution who report directly to the board of directors or the chief executive, as well as any other person who reports directly to the board of directors or the chief executive.

We suggest that the second interpretation is preferable, as it is much easier to identify persons with direct reporting obligations than it is to determine the full range of people who are “members of management of an institution”. To address differences between reporting lines in different institutions, it may be appropriate to expressly include particular roles which would fall within the definition of Senior Management (such as, for example, Head of Internal Audit, Head of Legal, Head of Compliance etc). Alternatively, it may be useful to define the term “Senior Management” by reference to those employees of an institution (other than directors) who are required to be approved by the Financial Regulator in accordance with the fitness and probity regime.

- (e) In order to be considered a “**Significant Shareholder**”, it is not clear whether a person will be considered to “hold” a significant shareholding if they are both legal and beneficial owner of shares, if they are just beneficial owner, or if they hold legal title on trust. The definition of “Significant Shareholder” would not apply to an interest in a guarantee company without a share capital, or an unincorporated association, in

which a Related Party has a non-controlling interest. We suggest that any interest in shares (or, where a body corporate does not have shares, an ability to exercise voting rights) should be captured, and suggest that the manner in which sections 54 and 55 of the 1990 Act deal with the various distinctions to be drawn may be appropriate in this context.

1.2 ***Harmonising definitions in Code with institutions' pre-existing obligations***

Another approach which could be taken to achieve greater clarity in the Code would be to harmonise relevant definitions with those with which institutions are already familiar, arising under their existing statutory, regulatory and accounting disclosure obligations in respect of loans to directors and their connected persons.

We set out below a table which briefly summarises our understanding of the scope and source of a credit institution's current disclosure obligations in relation to related party lending.

Source of Obligation	Information required to be disclosed
Section 41(1) and (2), 1990 Act	Particulars of all loans (and other section 31 transactions) to directors to be included in the annual accounts, subject to de minimis threshold
Section 43(5), 1990 Act	Annual accounts to include aggregate information on all loans (and other section 31 transactions) to " <b>connected persons</b> " of directors (as defined in section 26 of the 1990 Act), unless the loan was entered into in the ordinary course of business and on non-preferential terms and subject to de minimis threshold
Section 44, 1990 Act	Documentation relating to transactions disclosed under sections 41(1) and (2) or 43(5) to be included in register, and reflected in statement to shareholders
Licence Condition of 11 August 2009	Annual accounts to include aggregate information on all loans to "connected persons" of directors, whether on preferential terms or not. Only applies to loans to connected persons of directors appointed or re-appointed after imposition of condition, and excludes lending to natural persons for their principal private residence if less than aggregate €1 million, or otherwise if less than aggregate €100,000.
Licence Condition of 19 May 2010	Credit institution must maintain a register containing a list of all loans to connected persons of directors that are required to be disclosed under the Companies Acts, or under any licence conditions. To be updated quarterly and made available to shareholders on request during specified time period.
IAS 24	Details of "related party transactions" to be included in the accounts. The definition of " <b>related party</b> " does not reflect the definition of "connected person" in the Companies Acts, and includes members of the "key management personnel" of the entity, and "close members of the family" of such people. Express exceptions to the definition of "related party" are set out.

Section 8.4(a) to (c) of the Licensing and Supervision Requirements and Standards for Credit Institutions	Credit Institutions are required to limit exposures to directors and significant shareholders to below specified individual and aggregate thresholds, and report to the Financial Regulator accordingly.
---	--

Although similar to the scope of the obligations arising under IAS 24, the Code contains different definitions and would result in a different subset of entities being considered to be “related parties” for the purposes of the Code than would be either “related parties” for the purposes of IAS 24 or “connected persons” within the meaning of section 26 of the 1990 Act. The disclosure obligations arising under the Code would therefore differ from those arising under the 1990 Act and IAS 24, and the registers and records maintained by institutions for the purposes of their 1990 Act and IAS 24 disclosures may not include sufficient information to enable institutions to comply with their disclosure obligations under the Code.

If the definitions in the Code were harmonised with those applicable under either the 1990 Act or IAS 24, this would help institutions to establish clearly the extent of the requirements under the Code, as they are already familiar with their pre-existing requirements. It would also reduce the burden of compliance for institutions, as they could rely to some extent on pre-existing systems and registers (such as the systems currently in place to identify loans to directors and their “connected persons” under the 1990 Act, or to identify loans to “Key management personnel” under IAS 24) for the purposes of collating information necessary to make disclosures required under the Code.

**1.3 Provide for rulings or guidance where the terms of the Code are not clear**

We recommend that the Financial Regulator implements a procedure whereby it issues private rulings (within specified timeframes of a request) in relation to how it will interpret particular provisions, or how it would treat particular problematic situations. Where a matter was raised by several institutions, or the Financial Regulator considered the interpretation of a particular provision to be of significance to all institutions, the Financial Regulator could publish a guideline on that particular area.

Even if such guidance did not legally bind the Financial Regulator as to how it would act in the future, setting out the regulatory viewpoint on a particular interpretation would greatly assist institutions in applying the Code. The availability of a private ruling system, and published guidelines, would reduce the compliance costs of institutions and assist in ensuring consistency of approach across all institutions. In our view the costs of implementing such a system would be justified by the increased levels of compliance which would be likely to arise as a result.

**2 PERMIT EXCEPTION TO SECTION 6(A) AND 6(H) FOR LOANS TO SUBSIDIARIES**

A credit institution may apply for an exemption from the exposure limits in respect of lending to significant shareholders in III and IV of section 6(h). We submit that a loan to a wholly-owned subsidiary of a credit institution should also be able to be excluded from the exposure limits in V. of section 6(h). This appears to be anticipated by paragraph 6.1 of the Consultation Paper, but not reflected in section 6(h) of the Code. Intra-group lending is a very common feature in group situations, and we believe that lending to wholly-owned subsidiaries does not give rise to the concerns which the Code is intended to address.

A loan to a subsidiary of a credit institution should also be excluded from the application of section 6(a) (which prevents loans on preferential terms). Intra-group loans may not be done on terms which mirror those which would be offered to a third party but, once again, we do not

believe that such lending between wholly-owned members of a group of companies would give rise to the concerns which the Code is intended to address.

**3 RECONSIDER WHETHER INDIVIDUAL APPLICATIONS FOR EXEMPTIONS TO EXPOSURE LIMITS AND ANY OTHER PROVISIONS WILL BE REQUIRED**

The Code requires that exemptions to the exposure limits for exposures to significant shareholders or companies in which the institution has a significant shareholding requires an application to the Financial Regulator.

We submit that certain categories of loans (for example, loans to wholly-owned subsidiaries, or loans to a sole shareholder where the subsidiary / shareholder is covered by the supervision on a consolidated basis to which the credit institution itself is subject) should be automatically exempt, unless the Financial Regulator expressly applies the limits to a particular institution. This would reduce the burden on the Financial Regulator of administering the consent system, and ensure that there are not undue delays in making any such loans for the purposes of the business of the relevant group.

**4 PROVIDE FOR A DEFENCE IN CIRCUMSTANCES WHERE AN INSTITUTION WAS NOT AWARE, AND COULD NOT HAVE REASONABLY DETERMINED, THAT A LOAN WAS MADE TO A CONNECTED PERSON**

As discussed above, the definition of “Connected Person and Clients” set out in the Code is broad, and we consider that even with appropriate identification and reporting systems and procedures in place, circumstances may arise where an institution is not aware that a person is a “Connected Person or Client” at the time that a loan is made.

Although directors are subject to certain reporting obligations under section 194 of the Companies Act 1963 relating to contracts with their “connected persons”, the senior managers of an institution do not currently have any statutory obligation to provide information relating to their family to their employer, and the Code does not impose any obligation on them to do so. Although the Financial Regulator’s Individual Questionnaire requires some information regarding financial investments of persons completing the questionnaire, this does not cover personal relationships, or address the full range of business relationships which could be said to lead to a relationship of “control”, or a person being so “interconnected” with a Related Party as to bring the person within the definition of “Connected Person and Clients”.

Although an institution can put in place a system whereby directors / senior managers are required to regularly update information on their “Connected Persons”, the institution cannot obtain much of this information independently and must necessarily rely on information provided by the directors / senior managers.

In our view, consideration should be given to including an express defence against the imposition of administrative sanctions or the prosecution of an offence where, although an appropriate system was in place for obtaining information from directors / senior managers and identifying “Connected Persons” based on this information, the institution was not aware at the time of making a loan or submitting a report that the borrower was a “Connected Person”. The defence should only apply where the loan is on an arm’s length basis and on the same terms as would be provided to non-related parties in an equivalent financial position.

**5 CONSIDER WHETHER CODE SHOULD EXTEND TO A BROADER RANGE OF TRANSACTIONS THAN JUST “LENDING”**

We submit that the Financial Regulator should consider extending the scope of the Code to apply not just to “Lending”, but also to other transactions which could potentially affect an institution’s exposure to a Related Party. This could include, for example, the provision of guarantees in respect of a liability incurred by the Related Party, or other transactions of the

kind described in section 31 of the 1990 Act. Even if a transaction is not in the form of a "Loan", where the arrangement is made for the benefit of a Related Party and could potentially be detrimental to the financial institution (through, for example, the creation of a contingent liability) there is a similar potential for conflict of interest and abuse as would arise in respect of a Loan.

We hope that the above submissions are of assistance to the Financial Regulator in its review of the Code. We would be more than happy to discuss any aspect of our submission, or any matters arising from the Code which we have not addressed, with you at your convenience.

Yours faithfully

*Matheson Ormsby Prentice*

**MATHESON ORMSBY PRENTICE**