IRISH BANKING FEDERATION

IBF SUBMISSION

CONSULTATION PAPER CP 43

CODE ON RELATED PARTY LENDING

JULY 2010

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CODE ON RELATED PARTY LENDING

The Irish Banking Federation (IBF) welcomes the opportunity to respond to this consultation paper on related party lending. Ireland must achieve best practice in all aspects of corporate governance and this paper provides for further such developments. While welcoming the proposed code, we also offer some proposals for improved application and seek further clarification in certain areas.

IMPROVED APPLICATION

Scope

In order to make this a practical operation for banks, we suggest a deminimus value be applied. We assume that the main aim is to capture major events. As in current Board reporting, the IBF considers that retail activity, including personal loans, overdrafts and credit cards, below €100,000 should be excluded and principal private residences below €1 million should also be exempt.

We are concerned at the broad scope of the requirements. The broader the application, the more difficult it may be to spot an exposure of concern. We suggest that a focus on quality rather than quantity would be more beneficial.

The definition of related parties and senior management needs further clarification. Here again we suggest that, to allow consistency with different applications already in use, persons included under Fit and Proper guidance, who are captured for the Annual Report and Accounts, might also be considered relevant under the senior management definition. Key management personnel are already covered under Accounting Standard IAS 24 and the Companies Act, so a consistency with one of those existing criteria would be more suitable.

Implementation

Approval and management of credit is not normally a Board function. Lending is undertaken through the normal credit sanctioning process, with defined credit standards and agreed checks such as credit standing and history. This proposal appears to involve the Board in day to day management activities. Instead we propose that a high level executive credit committee approve such exposures, with monthly reporting to the Board. Alternatively we suggest such approvals be at least delegated to a standing committee of the Board or Board subcommittee. The need for Board approval would lead to delays in such credit approvals and discourage such business within an organisation.

Identification of connectedness for family or interconnectedness in a business context may be extremely difficult to determine. Examples of this would include estranged family or independent adult children of directors applying for routine banking facilities. For example it may be difficult for staff to identify the fact that a customer is the child of a director. Even if every application made by a person with the same surname as a director is checked, the surname of the applicant

may not be the same as that of the director and so a link is not apparent. In addition, the requirement under Appendix 1, 5 (c) on the definition of connected persons, i.e. financial connectedness, may be difficult to identify. Can 'best efforts' by banks (a definition already under review we accept for Loans to Directors) be considered suitable – possibly with an audit trail to prove same?

Intra – group lending

The definition of related party includes an entity in which the credit institution has a significant shareholding (Appendix 1, Section 5). As such, the Code would apply to wholly owned subsidiaries of the credit institution. We suggest that the Code should not apply to lending by an institution to entities which are wholly owned subsidiaries of that institution, to the extent that the subsidiaries are included in the consolidated financial statements and the prudential returns of the credit institution.

The Code (Appendix 1, Section 6(a)) requires that a credit institution shall not grant a loan to a related party (including a wholly owned subsidiary) 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 to non-related parties.

It is normal commercial practice that a parent company (regardless of whether it is a credit institution or not) would in certain circumstances provide loans to subsidiaries, which are on more favourable terms than would be available from non-related companies. Examples include interest free loans to subsidiaries, perpetual loans to subsidiaries (i.e. no defined repayment date). There are many bona fide commercial reasons why a corporate group may require its activities to be carried out by a number of different subsidiaries and the funding of these subsidiaries may often involve lending from the parent company at more favourable terms than are generally available to the subsidiary on a stand-alone basis.

We are of the opinion that a banking group should not be restricted from organising its corporate affairs in a manner which would disadvantage it as compared to other corporate groups. It should also be noted that the Revenue Commissioners recently introduced transfer pricing legislation which addresses the structure of such transactions.

If the above suggestion is not accepted, we would request that existing lending arrangements to subsidiaries of the credit institution are exempted from the Code (i.e. a grandfathering arrangement) in order to avoid unnecessary restructuring of the corporate group.

Exemptions

Section 6.1 and Appendix 1, Section 6(h) allow for some exemptions under large exposures for intra-group lending. This links to the Capital Requirements Directive (CRD) regulations which are currently under discussion for amendment now and most likely again in future years. While the industry would welcome such exemptions, they are built on evolving guidelines and against a background of eventually removing all national discretions at EU level. We would therefore prefer a more solid, permanent reference be applied, with no need for application of derogations.

In terms of third countries with equivalent standards, in Section 6.1, we assume here that the EEA, USA and Canada are considered as equivalent.

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CLARIFICATION SOUGHT

Appendix 1, Section 5 **defines a credit institution** as a bank licensed in Ireland or authorised building society or credit institution registered under the Asset Covered Securities Act 2001. We consider that the appropriate definition should extend to 'credit institutions' and 'financial institutions', both as defined in the CRD. The limit in Appendix 6(h).III excludes credit institutions but we consider it appropriate that this is extended to the interpretation of 'credit institution' and 'financial institution' in the CRD.

The definition of **significant shareholder** could at present include the Government. Clarity is sought as to what related parties should then be considered – e.g. Semi State Bodies, Local Authorities? We assume that the Government and State organisations should be excluded from Appendix 1, Section 6(h).III. If such parties were included, the range of relevant entities would be extremely wide and so unmanageable. Therefore we suggest exclusion of Government related parties but need clarity on whether this approach is suitable.

Lending to 'senior management' is defined in Appendix 1, Section 5 as "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". This would greatly expand the number of people required for inclusion in the return. Does this definition provide banks with some latitude to define "management" as to who would fall within the list? Each institution could potentially have its own definition so reporting may not be strictly comparable. We would appreciate additional guidance from the Regulator as to what positions would typically be expected to be included.

The Code requires that 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 (Appendix 1, Section 6(b). We would like clarification on the meaning of "any variation of the terms". Would this for example include a change from a fixed to a variable interest rate, or changes to general terms and conditions which apply to all loans? We suggest that materiality be considered here, to prevent overly complicated processes.

The Code also requires that actions in respect of **the management of a loan to a related party** shall be subject to individual prior approval in writing by the Board (Appendix 1, Section 6(c). While the Code does provide examples such as permitting interest roll-up etc., the definition of management is not limited to the examples and is not currently defined. A definition of "management of a loan" would be useful. In its absence, almost any action taken in respect of a loan could be seen to be "management" and require Board approval. We understand that the Financial Regulator wishes to have major decisions (e.g. loan write-off) subject to Board approval, but it is unlikely to expect that all routine decisions in respect of such a loan would require Board approval.

Appendix 1, Section 6(e) mentions an **independent credit review process**. Can this review be undertaken internally, such as by Internal Audit, or is an external party required to undertake it?

There are many references to **timeframes** e.g. periodically, regularly. Any more specifics on intended timing would be appreciated, to assess the practicality of proposed timing.

Reporting timeframes also need clarification. It is assumed that such reporting is by 20 business days but reconciliations to Annual Report and Accounts may be required and should be allowed for.

We are concerned that **data protection rights** could be breached and so consider that information should be published at aggregate level only for all parties reported on, to include their connected parties.

Will the Related Party Lending Return form part of another **COREP report**? It is currently part of the Large Exposure return (Schedules 4 & 5) but will not be so from Q4 2010. Where will the new return sit? The sample format would suggest a stand-alone submission but clarity would be appreciated so that banks can plan for its delivery.

As **Large Exposure Reporting** will be via the new template from Q4 2010, will banks be required to continue submitting a version of Schedules 4 and 5 until the related party lending return is initiated?

Will **foreign banks** in Ireland be required to provide such information in relation to their lending in other jurisdictions? This extra requirement for Ireland may discourage such activity for IFSC companies or discourage foreign senior management from taking up appointments.

Is reporting of a **nil return** necessary for Appendix 2?

Again in Appendix 2 and through the document reference is made to loans, lending and **exposures**. We suggest that the reference should be to 'exposures' as applies in the CRD.

Reference is also made to "**own funds**" in both the Sample Format of Periodic Lending Report in Appendix 2.G and for the calculation of percentages for the purposes of Requirement 6(h). Clarification is sought as to which 'Own Funds' figure is to be used.

The COREP Capital Adequacy solvency template, submitted on a monthly basis, identifies own funds for the purposes of solvency reporting. In addition there is an own funds definition for limits to Large Exposures, which is available from the COREP reporting framework. This current Large Exposures own funds definition would seem appropriate, as it discloses items now to be captured in the draft Related Party Lending return. However clarity on which definition to apply would be appreciated.

In addition, allowance is made in the current Large Exposures return for the input of the actual own funds figure for calculation purposes. The inclusion of such this figure would be an enhancement to the sample report set out in CP 43.

Finally no **date for implementation** is given. Banks will need a reasonable lead in time to put appropriate systems and controls in place to capture the required information. The Central Bank paper "Banking supervision: our new approach" indicates that Related Party Lending requirements will be implemented in October 2010. We would appreciate clarity on what is considered implementation? Is this publication of the final code? Or commencement of the capture of all such applications in the newly agreed credit approval process? When will reporting commence?

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