

# Feedback Statement on CP43

## Code of Practice on Lending to Related Parties

### 1. Executive Summary

This paper sets out feedback on the responses we received to CP 43 – Code on Related Party Lending; it outlines our current policy position and describes our next steps.

In May 2010 we published a Consultation Paper on a Code on Related Party Lending. The Code, which replaces previous non-statutory requirements, broadens the definition of a related party and reduces the maximum amount that can be loaned to an individual related party and the aggregate amounts that can be loaned to all related parties. Related parties include a director, senior manager or significant shareholder of the credit institution or an entity in which the credit institution has a significant shareholding, as well as a connected person of any of the aforementioned persons.

The Code has been introduced to seek to prevent abuses arising from exposures to related parties and to address possible conflicts of interest in this area. It requires that such lending is on an arm's length basis, is limited to a percentage of the institution's own funds, and is subject to appropriate and effective management oversight and limits.

Inter alia, the Code requires that:

- Loans to related parties shall not be granted on more favourable terms than comparable loans to non-related parties;
- Loans to related parties or any variation of the terms require prior Board approval or approval by a subcommittee of the Board established specifically to deal with related party lending where that subcommittee reports directly to the Board;
- Actions in respect of the management of such loans (e.g. grace periods, interest roll-up, loan write-off) require prior Board approval or approval by a subcommittee of the Board established specifically to deal with related party lending where that subcommittee reports directly to the Board; and
- Where loans to a related party exceed one million euro the prior approval of the Central Bank is required.

The Code applies to all credit institutions licensed and authorised by the Central Bank of Ireland and it applies to lending in or outside the State. Credit institutions will be required to submit details of related party lending to the Central Bank on a quarterly basis. Non compliance with the Code may be considered under the Administrative Sanctions Procedure.

The Code becomes effective on 1 January 2011.

The Code was subject to a public consultation process beginning in May 2010 and ending in July 2010. Eight responses were received, as follows:

- 2 from banks (AIB and BoI)
- 2 from Solicitors (Matheson Ormsby Prentice and Brian O’Callaghan, Galway)
- 1 each from Industry/Trade Union (IBF and IBOA)
- 1 from the Consultative Consumer Panel
- 1 from the Office of the Director of Corporate Enforcement.

All responses to the consultation were considered and, where appropriate, certain proposals were incorporated in the final version. The responses are on the Central Bank’s website.

Section 2 discusses the main themes occurring in those responses and provides feedback on the issues raised. Section 3 addresses the next steps for reporting under the Code.

## **2. Feedback**

### **2.1 Definitions**

Many respondents commented that the definitions in the Code should be harmonised with definitions in other requirements e.g. harmonised with company law definitions and definitions contained in the accounting standards.

#### **Response**

The definitions and concepts used in the Code should already be familiar to credit institutions since they are based on the definitions used in the Capital Requirements Directive/existing Financial Regulator definitions e.g. Large Exposure Reporting<sup>1</sup>. We believe this should present fewer issues with respect to implementation of the necessary systems and internal controls.

The definition of “senior management” in the Code is based on the definition in the Central Bank’s Fit and Proper Requirements, Instructions Paper December 2008. For clarity the definition of “Senior Management” refers to all members of management of an institution who report directly to the board

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<sup>1</sup> CEBS Guidelines on the implementation of the revised large exposures regime published on 11 December 2009 address the definition of a group of connected clients and the interpretation of control and interconnection.

of directors or the chief executive, as well as any other person who reports directly to the board of directors or the chief executive.

Directors should be taken to include alternate directors and/or shadow directors.

The following suggestions were taken on board and the definitions were updated accordingly:

a) Definition of a Loan

Comments on the definition of a 'loan' included:

- What constitutes "similar financial accommodation" is somewhat unclear.
- Align with company law definition.
- CB needs to be satisfied that any off balance financing vehicles, derivative instruments and the spectrum of letters of comfort through to specific guarantees are properly covered.

The definition was amended to take into consideration the comments received and is now defined as: "Loan includes loan, quasi-loan or credit transaction which results in an exposure or potential exposure, including guarantees."

b) Exemption for Government as significant shareholder

Comments received suggested that for those credit institutions in which the State has a significant shareholding (i.e. 10% or more of the shares or voting rights in that credit institution), the Government-related exposures should be explicitly excluded from the Code.

This comment was accepted and the definition of a significant shareholder was amended to exclude Government.

## **2.1 Related Party Definition**

One respondent suggested that bondholders and CFDs could be included in the definition of related party

### **Our Response**

We considered this to be a valid comment, however, after consideration and given the practical difficulties in identifying bond and CFD holders, it was decided not to amend the definition of related party to include them.

## **2.2 Prohibition regarding non-executive directors**

One respondent commented that consideration should be given as to whether a prohibition on non-executive directors having any financial relationship or dealings at all with institutions which they serve as non-executive directors should be applied.

## **Our Response**

A non-executive director is a director without executive management responsibilities for the institution but may have executive management responsibilities assigned to him within the group, whereas an independent non-executive director is a non-executive director who satisfies the criteria for director independence. It is essential that non-executive directors and particularly independent non-executive directors limit any financial dealings or other obligations to the financial institutions or its directors. This is one of the criteria in the Central Bank's Code on Corporate Governance for Credit Institutions and Insurance Undertakings which must be considered and given reasonable weight when determining if a director is independent.

### **2.3 Limits on Lending and Exemption**

We received some comments suggesting that wholly owned subsidiaries of a credit institution that are subject to consolidated supervision should receive a blanket exemption from the exposure limits in III and IV of Section 6(h). One respondent commented that it is normal commercial practice that a parent company would in certain circumstances provide loans to subsidiaries which are on more favourable terms than would be available from non-related companies and that such loans should be permitted.

## **Our Response**

We discussed the merits of a blanket exemption for wholly owned subsidiaries. However, a policy decision was taken that, for the moment, the Code will not be amended to allow such a blanket exemption but that this policy could be reviewed at a later date in light of experience. In accordance with the Basel Core Principles Methodology, it was considered that it would not be appropriate to allow institutions to lend on favourable terms to their subsidiaries.

### **2.4 Allow institutions to apply for an exemption to section 6(h)(v)**

One comment suggested that a loan to a wholly-owned subsidiary of a credit institution should also be able to be excluded from the exposure limits in Section 6(h)(v).

## **Our Response**

It is not appropriate to allow institutions to apply for an exemption from this requirement. This is intended to capture loans to a group of clients or connected clients that do not fall within the scope of consolidation.

### **2.5 Prior board approval in certain circumstances**

We received some comments suggesting that prior board approval of every loan or variation of the terms of a loan is impractical. One respondent suggested that a high level executive credit committee approve such exposure with monthly reporting to the Board or alternatively that such approvals be at least delegated to a standing committee of the Board or Board sub-committee.

### **Our Response**

We accepted this comment and amended the Code to allow a subcommittee of the Board established specifically to deal with related party lending where that subcommittee reports directly to the Board approve any variation of the terms of a loan to a related party.

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

One respondent recommended that the Central Bank implement a procedure whereby it issues private rulings in relation to how it will interpret particular provisions. In addition the respondent suggested that the Central Bank could publish a guideline setting out the regulatory viewpoint on a particular interpretation. Another respondent suggested that the Code should be updated for any clarifications issued.

### **Our Response**

Credit institutions may request clarifications on any aspect of the Code which the Central Bank will address on a confidential basis. Over time if a number of clarifications are requested on the same topic, the Central Bank will consider collating the requests, on a no names basis, and issuing guidance on the topic.

## **2.7 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**

One respondent commented that 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”. Another respondent queried whether ‘best efforts’ by banks could be considered suitable.

### **Our Response**

It was considered not appropriate to include an express defence in the Code, however, in the event of a breach of the Code we would look at all the circumstances surrounding any potential breach.

## **2.8 Design of the method and manner of enforcement/commitment to review compliance with Code as part of the inspection regime**

One respondent commented that the Central Bank needs to demonstrate how this Code serves to secure compliance with its provisions for related party loans and to include a commitment to address this issue in its inspection regime.

### **Our Response**

It is intended to issue a template for reporting the requirements of the Code and that the completed template would be submitted on a quarterly basis as part of the quarterly reports made by credit institutions. Reports will be reviewed by the Banking Supervision Departments.

## **2.9 Application of the Code**

Some respondents commented that the Code should apply to non-deposit taking lenders and credit unions and that clarification on whether subsidiaries of credit institutions which are not authorised or licensed by the Central Bank are covered by this Code. One respondent also queried whether Irish customers transacting with overseas regulated institutions are protected to the same degree as those that are subject to this Code. Another respondent commented that the Code should extend to financial institutions in addition to credit institutions.

### **Our Response**

Related party lending by credit unions will be considered as part of the Strategic Review of Credit Unions.

The Central Bank has no remit for non-authorised entities, accordingly they cannot be covered by the Code. The Code contains an anti-avoidance provision which aims to deter institutions from circumventing the requirements of the Code through lending by unauthorised subsidiaries. Following implementation of this Code, a decision will be taken whether to extend it to other regulated entities.

## **2.10 De minimus amount to be applied in application of Code**

Some respondents suggested that a de minimus value be applied to retail activity and to principal private residences.

## **Our Response**

It was not deemed appropriate to incorporate de minimus amounts in the Code.

### **2.11 Independent credit review process**

Some respondents sought clarification on the meaning of an independent credit review process and the frequency with which such a review should be conducted.

## **Our Response**

The Central Bank did not consider it appropriate to define ‘independent credit review processes’ for the purposes of this Code. The credit review process is the mechanism that is employed by the institution to independently review the sanctioning of credit.

## **3 Next Steps: Reporting formats/timelines etc**

- 3.1** The Code becomes effective on 1 January 2011. The Central Bank intends issuing a pro-forma report and accompanying guidelines which institutions will be required to submit to the Central Bank as part of the quarterly reporting. Institutions will be given sufficient time to put the necessary reporting systems in place.