



**Financial Services
Commission**

Banking Guidance Note No. 2 Policies on Connected Lending

Date of Paper : 31 January 2000

Amended 16 March 2006

Version Number : 1.01





Table of Contents

Introduction.....	3
Definition of Connected Counterparty.....	3
Connected Lending Policy	3
Credit Assessment.....	4
Limits on Exposures to Connected Counterparties.....	4
Reporting.....	5

Published by:

Financial Services Commission
PO Box 940, Suite 943, Europort, Gibraltar
Tel (+350) 40283
Fax (+350) 40282
E-Mail: info@fsc.gi
www.fsc.gi

Introduction

The Core Principles for Effective Banking Supervision issued by the Basle Committee on Banking Supervision in September 1997 included a requirement, in order to prevent abuses arising from connected lending, that banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's length basis, that such extensions of credit are effectively monitored and that other appropriate steps are taken to control or mitigate risks.

The Commissioner of Banking, in implementing the EU Directive on the Monitoring and Control of Large Exposures of Credit Institutions (Banking Ordinance 1992 - Administrative Notice 3) stated in paragraph 18 of the Notice that he would examine particularly closely all exposures to companies or persons connected to a lending bank and that he would deduct them from a bank's capital base if they are of the nature of a capital investment or are made on particularly concessionary grounds.

The purpose of this guidance note is to reinforce the necessity for banks to have systems for identifying connected lending, for applying appropriate credit assessment criteria and for reporting accurately these exposures, internally to senior management and the Board of the bank, as well as to the FSC.

Definition of Connected Counterparty

Parties connected to a bank comprise :

- (a) group undertakings and related undertakings (i.e., fellow subsidiaries or subsidiaries of the same ultimate parent but within different group structures)
- (b) associated companies (i.e., shareholdings of 20 % or more but not subsidiaries)
- (c) directors, controllers and their associates
- (d) non-group companies with which the bank's directors and controllers are associated

A director (including an alternate director) and controller of the reporting bank is deemed to be associated with another company, whether registered or domiciled in Gibraltar or overseas, if he holds the office of a director (or alternate director) with that company (whether in his own right, or as a result of a loan granted by, or a financial interest taken by, the reporting bank to, or in, that company, or even by virtue of a professional interest unconnected with the reporting bank), or if he or his associates, as defined above, together held 10% or more of the equity share capital of that company. For the purposes of the large exposures policy, an employee of the reporting bank who is not a director but who is appointed by the reporting bank to be a director of another company is also treated as a director of the reporting bank.

In the case of consortium banks with no definable parent, the reporting of connected exposures should be discussed with the Banking Supervisor.

Connected Lending Policy

A bank's lending policy must specifically address all aspects of connected lending, including lending to related credit institutions. Quantitative limits should be specified and these limits should be approved by the bank's board of directors. Where banks lend to connected credit institutions in line with group policy these will, nevertheless, be expected to assess from time to time the

strength of the parent or group bank and whether the bank is being disadvantaged by its group's policy on the placement of surplus funds.

Credit Assessment

Because of possible contagion and the risk that the risk assessment of proposed loans to counterparties connected to a bank may be obscured by subjective considerations, the FSC pays particular attention to lending to connected counterparties. The FSC does not expect lending to connected counterparties to form a significant proportion of a bank's assets unless the FSC has agreed in writing a connected exposures concession.

A bank must take special care to ensure that it has systems in place to identify connected exposures. It must ensure that there is proper objective assessment undertaken for proposed exposures to companies or persons connected with the bank, its managers, directors or controllers. Such an exposure may only be justified if :

- (a) it is undertaken for the clear commercial advantage of the bank ;
and
- (b) it is negotiated and agreed on an arm's length basis.

Limits on Exposures to Connected Counterparties

Administrative Notice Number 3 imposed a limit on lending to connected counterparties. The Notice specified that the aggregate of exposures to counterparties connected to a bank will be limited to 25% of the bank's capital base for large exposures purposes. In certain circumstances a limit above 25% can apply, e.g., if certain exposures included in the aggregate can be classified as "exempt" or are guaranteed by its parent (see paragraphs 26-32 and 33-36 of the Notice) or where a concession has been agreed in writing with the FSC. Breaches of these connected exposure limits must be reported to the FSC as soon as realised.

Exposures to a bank's parent, the parent bank's subsidiaries or to its own subsidiaries can be exempt if these undertakings are covered by the supervision on a consolidated basis to which the bank itself is subject.

Where the link with a connected company is fairly remote, e.g., where a non-executive director of a large bank is also a director of the borrowing company the exposure may be considered acceptable up to the normal level for the bank. However, if there is a particularly close connection, the exposure is to be aggregated within the 25% limit for connected lending.

Paragraph 43 of Administrative Notice Number 3 outlines the FSC's policy with regard to large exposures in branches of non-EEA authorised institutions. This policy is effectively that large exposures in such branches will be monitored by the FSC taking into account the capital of the bank as a whole and the balance sheet size of the branch. The FSC will apply the same criteria in assessing lending to parties connected with the bank. The FSC will be concerned particularly with the potential impact of such exposures on the liquidity of the branch. As a general rule, the FSC would be concerned if the aggregate of exposures to parties connected with the bank exceeded 5% of the total assets of the branch. The FSC will discuss with the bank's home supervisor connected lending which it considers to be excessive in accordance with the above criteria.

The FSC does not prescribe any limits in respect of connected lending in the case of branches of EEA-authorised banks. Such branches are not licensed by the FSC and the responsibility for the prudential supervision of these branches is a matter for their home supervisors.



The Commissioner may, at any given time may make a judgement about the existence of connections between a bank and another parties and treatment of the lending.

Reporting

Connected lending is to be reported to the FSC in the quarterly Banking Supervisory Return under the heading LBA6.00 "Connected Loans and Advances".

Financial Services Commission

16 March 2006