



Client Update

NEW CODES PRESENT AN IMPLEMENTATION CHALLENGE

(February 2009)

The Financial Regulator issued its new codes of conduct in respect of business lending to small and medium enterprises (the “**SME Code**”) and in respect of mortgage arrears (the “**Mortgage Code**”) in February. The Mortgage Code will come into effect on 27 February and the SME Code on 13 March. The codes seek to impose minimum lending standards for Irish regulated entities with the exception of credit unions. The codes follow a similar approach to the Financial Regulator’s other codes, notably the Consumer Protection Code (“**CPC**”), by providing a list of high level principles together with some detailed rules. In particular, both codes emphasise the importance of retaining proper records, implementing documented procedures and handling client complaints. Each regulated entity must interpret the codes, apply them to their business and, most importantly, document both the processes and the reasons for the particular process. Both codes are issued under Section 117 of the Central Bank Act 1989 which provides for criminal sanctions where a breach occurs and enables the Financial Regulator to impose its administrative sanctions regime.

SME CODE

The SME Code applies to regulated entities (typically banks, building societies, retail credit firms) when providing one or more of the following products in Ireland:

- Overdraft
- Loans
- Term loans
- Leasing
- Hire Purchase, and
- Invoice Discounting

We would note that the latter three products are not regulated activities therefore unregulated providers of these products will not be required to comply with the SME Code. The SME Code specifically excludes lending to other financial institutions, syndicated lending and lending to SPVs as well as stating in clear terms that nothing in the code should prevent a regulated entity from acting where the SME is in liquidation, receivership, examinership or where there is evidence of fraud, terrorist connections or misrepresentation.

An SME for these purposes is a regulated entity with fewer than 250 persons and which has an annual turnover not exceeding €50 million, and/or an annual balance sheet total not exceeding €43 million. Unfortunately regulated entities will have to apply yet another client categorisation as an SME for this purpose is not the same as a consumer for the purposes of the CPC.

The SME Code’s specific objectives are to facilitate access to credit for “sustainable and productive business propositions”, promote fairness and transparency in lending and to ensure that SMEs in arrears are assisted where possible, and where not possible that the situation is dealt with in an orderly manner. The SME Code expressly requires that regulated entities must be able to demonstrate they are in compliance with the code. This may prove challenging as many of the requirements are not strict rules and leave a significant amount of room for interpretation. For example, in the context of applications for credit, paragraph 4 requires a regulated entity to have “appropriate” procedures in place to assess a loan application. What are “appropriate procedures” and how can an entity “demonstrate that they are in compliance”? Similarly paragraph 7 prohibits “unreasonable collateral

requirements” and paragraph 8 prohibits the imposition of “unreasonable personal guarantees”. In order to ensure compliance we recommend that regulated entities should document the process by which policies and procedures are to be formulated and implemented. It may be prudent to ensure that procedures are reviewed on an annual basis or whenever there is a relevant change to the business model of the regulated entity.

Paragraph 26 of the SME Code further provides that all information provided under the SME Code must be supplied on paper or such other form that is accessible to the Financial Regulator. It mentions that verbal communications may be sufficient where it is adequately documented. It will therefore be very important to create and maintain good file notes of conversations or meetings with customers.

Changes to Documentation

The two primary issues for a regulated entity when a new code such as the SME Code is introduced is whether existing documentation needs to be updated and what changes will have to be made to existing procedures and whether new procedures will need to be introduced. In respect of changes to documentation, the SME Code requires that all information be clear and comprehensible and that key items must be brought to the attention of the customer. Documenting how a regulated entity complies with this requirement will not be easy. Where an application for credit has been approved, the customer must be supplied with the terms and conditions attaching to the credit, in particular those that relate to default, fees, charges and interest rates. This document must give a “fair and balanced description of the credit facilities being offered” and must include a general description of the regulated entity’s policy on collateral. The customer should also be supplied with details of how to draw down the loan.

Customers must be informed, we would suggest in writing, of the length of time the application will take to process. This can be an estimated time based on past experience. The documentation should also address the notification period for changes to the terms and conditions or fees and charges applicable to the credit. Where debt factoring occurs, details must be given to the borrower and the basis on which interest is calculated and charged, including unauthorised overdrafts, must also be disclosed.

Where an application for credit is declined, the customer must be told the reasons why the credit was declined. It is unclear whether this could be a generic statement or whether because each application for credit must be assessed on its own merits it may be that some degree of personalisation is required. A “reasons why” letter must also be supplied where the lender seeks to amend or withdraw credit facilities although no strict notification periods are indicated. In these cases a reasonable period could be calculated looking at the amount of the credit facility, impact on the customer and availability of similar credit facilities in the market.

The SME Code also imposes a number of ongoing obligations on lenders following a successful application for credit. These include an obligation to notify the customer of any changes, including increases and decreases to the interest margin. Such notification must be prompt which would seem to suggest that the borrower should be notified once the change has occurred. General interest rate changes can be notified via adverts in an appropriate medium, most likely a newspaper, but other media may also be appropriate. SMEs will need to be offered the an option of an annual review meeting to include all credit facilities and security. The lender is also obliged to provide statements for the loan accounts to the customer at regular intervals, although no specific intervals are provided, and each statement must contain details of the interest rate applicable for the period.

Changes to Procedures

The SME Code requires lenders to adopt or amend their procedures in respect of applications for credit, taking security, dealing with arrears, handling complaints and retaining documentation. The SME Code requires that each application for credit should be considered on its own merits and that “appropriate” procedures be in place to assess loan applications. Lenders must also have procedures that deal with collateral and guarantees, in particular the level of collateral and the extent of guarantees sought should not be unreasonable (in respect of nature, liquidity and value) having regard to the value of the credit. Deciding where and when collateral or guarantees are appropriate will be a difficult task as each case will be different based on the creditworthiness, history and assets of the

borrower. This will make applying any general guidelines difficult and it would appear that lenders would be well advised in each case to document why they believe that collateral was reasonable on the facts. Any decision to withdraw or amend credit facilities must also be made on its merits and it would be necessary to document such a decision.

Lenders must now also have a procedure in place for handling arrears, no definition is provided of when a SME will be considered to be in arrears and a definition will need to be adopted by regulated entities in this regard. The SME Code requires that borrowers be given a reasonable time having regards to the circumstances of the case to resolve the arrears problem and lenders must endeavour to agree an approach that will assist the borrower to resolve the problem. What is reasonable and the extent to which a lender must assist a borrower is unclear. Each case will need to be judged on its own particular circumstances but regulated entities would be well advised to develop clear guidelines to assist in making these decisions.

The SME Code also lays down complaint handling guidelines which are similar to those in the CPC and therefore it may make sense to amend existing CPC procedures so that they meet the requirements under the SME Code. A record retention procedure is also required as the SME Code specifically required regulated entities to retain all applications for credit and all declined applications. While no specific document retention requirements are laid down in respect of complaints handling or handling of arrears, regulated entities should retain such documentation in order to demonstrate their adherence to the SME Code.

MORTGAGE CODE

The Mortgage Code must be read as one with the CPC and applies to mortgage lending activities to consumers in respect of their principal private residence in Ireland, thereby excluding investment properties or properties situated outside Ireland. While the full impact of the new code will become more apparent over the coming months, it is clear that at a minimum, regulated entities will need to amend their procedures and terms of business to reflect the change to the remedies available to the lender in the case of default. As with the SME Code, lenders must be able to demonstrate how they adhered to the requirements of the Mortgage Code and therefore processes and procedures should be documented and all client communications and decisions in respect of individual mortgages should be retained and made available to the Financial Regulator on request.

Arrears

The Mortgage Code identifies that a mortgage arrears problem arises as soon as a borrower fails to make a mortgage repayment by the due date. This is at odds with the definition under the Capital Requirements Directive which gives up to 90 days to resolve the issue before a case of default is established unless it is clear that the borrower is unable to pay. The onus is put on the lender to contact the borrower to establish why the payment has not been made and how the situation may be rectified. The Mortgage Code emphasises that any procedures drafted in this regard must be flexible and capable of dealing with each case on its merits.

Once contact has been made with the borrower, the Mortgage Code provides that lenders should distinguish between borrowers who are genuinely unable to pay and those who could pay some or all of the arrears but refuse to do so. The Mortgage Code requires that the former be treated more sympathetically than the latter and permits the lender to seek repossession of the property without engaging with the borrower where the borrower is deliberately not engaging with the lender to resolve the arrears situation.

Remedying Arrears

The Mortgage Code obliges the lender to work with a legitimate borrower to identify all repayment options available taking into consideration the borrower's repayment capacity, previous payment history and any equity remaining in the property. The lender must also look at the borrower's overall indebtedness when assessing his ability to repay including details of household income and expenditure. The options that should be explored include amending the monthly payment, deferring payment, extending the term of the mortgage, changing the type of mortgage and capitalising the arrears. If necessary, other options such as trading down, voluntary sale or alternative financing

through another lender should also be examined. Following this conversation, the borrower must be provided with a clear written explanation of each of his choices and any additional interest or administration charges that may arise. In addition, the borrower must be advised to take appropriate independent advice and must also be advised that it is in his interest to ensure that his income is being maximised and that a budgeted approach to expenditure is maintained. It is unclear what the consequences would be for the transaction if such independent advice was not obtained but the use of the word “must” would seem to suggest that it is not optional and the lending conditions should not be changed without receipt of such advice. Regulated entities should also consider whether it is necessary to issue the borrower with a new CPC suitability letter depending on the option chosen.

Enforcement

If the voluntary process described above does not successfully resolve the arrears issue the lender may, after a third payment is missed, issue a formal demand for the full amount due or for possession of the property. The borrower should also be informed in writing of the total amount of the arrears, any excess interest and should be advised on the consequences of failing to respond. Failing this, the lender may commence an enforcement action once they have notified the borrower of their intention and at least six months have passed from the time when the arrears first arose. This period is extended to one year in the case of AIB and Bank of Ireland. Even where legal action has been taken, the lender must maintain contact with the borrower to establish if a repayment agreement can be reached. In all cases the borrower must be informed that irrespective of the amount realised on the possession of the property, the borrower will still remain liable for all outstanding debts including interest, charges, legal, selling and other related costs in the event of any shortfall.

CONCLUSION

For affected regulated entities, the codes represent a challenge of implementation as not only must the customers be treated equitably and on the merits of his or its case, his or its case must also be clearly documented and there must be consistency of decision making across similar situations. This will require clear but flexible guidelines to be developed by regulated entities which ensure that the requirements of the codes are met. Procedures and documentation will need to be updated and regulated entities may choose to implement the requirements in a way that will give them strategic advantages over their competitors. Given the speed with which the codes are being introduced and the high public profile they have been given, we believe the risk of significant regulatory sanction for any breaches of the codes is high. While effective implementation of regulatory change is always important, at this sensitive time, it is particularly so. We would recommend boards of directors take particular care to ensure that they receive robust assurance (including, if necessary, third party validation) that the codes have been effectively implemented throughout their organisation.

For further information, please contact:

[Joe Beashel](#)

Partner

70 Sir John Rogerson's Quay
Dublin 2, Ireland
D: +353 1 232 2101
E: joe.beashel@mop.ie

[William Prentice](#)

Partner

70 Sir John Rogerson's Quay
Dublin 2, Ireland
D: +353 1 232 2255
E: william.prentice@mop.ie

[Patrick Molloy](#)

Partner

70 Sir John Rogerson's Quay
Dublin 2, Ireland
D: +353 1 232 2259
E: patrick.molloy@mop.ie

[Niall Horgan](#)

Partner

70 Sir John Rogerson's Quay
Dublin 2, Ireland
D: + 353 1 232 2619
E: niall.horgan@mop.ie

[Elizabeth O'Connor](#)

Partner

70 Sir John Rogerson's Quay
Dublin 2, Ireland
D: + 353 1 232 2428
E: elizabeth.oconnor@mop.ie

[Libby Garvey](#)

Partner

70 Sir John Rogerson's Quay
Dublin 2, Ireland
D: + 353 1 232 2220
E: libby.garvey@mop.ie

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