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RE: CCUA Response to Public Consultation 2024-001 "Commercial Lending Guidance"

To the Reader(s),

CCUA is pleased to provide feedback on the proposed Commercial Lending Guidance note for Ontario credit unions (#2024-001). We are happy to see that the current version supports the sector in continuing critical lending support to Ontario businesses without material changes, at a time when the sector and Ontario businesses are facing broad macroeconomic challenges. We are comfortable with this guidance replacing FSRA's Lending Risk Advisory #3, DICO Commercial Lending Policy Development Guide, and DICO Lending Guidance Note. CCUA trusts that FSRA has ensured that specific principles-based items and definitions that may be beneficial and relevant from the previous notes are included in the current note to ensure a smooth transition for the sector. reduction in overall documents and notes is always welcomed in supporting burden reduction and ease of use.

Our members play a critical role in Ontario's economy by supporting and strengthening small businesses across the province including SME lending, larger commercial lending, and agricultural lending. Our response highlights member feedback received and CCUA views. Ensuring that credit unions can continue to compete and take appropriate risk to support Ontario's growing economy is a priority of the sector.

Review of Principles

Principle 1 – Board Governance of Commercial Frameworks and Activities

We recognize that Boards, along with Senior Management, play a strategic role in developing, reviewing, and approving the overall framework for commercial lending activities. We believe that governance is a prudent principle for consideration when it comes to commercial activities. The note calls out six specific high-level prudent person expectations and CCUA believes all six are fair and appropriate. The sector reminds FSRA that separation of Board governance and operational matters is needed within FSRA's guidance and approach. Language presented could be considered as shifting Board responsibility into process and controls, which we believe is operational in nature. Operational activities and approval should rest with senior management alone. Ensuring distinction to create appropriate separation is important for maturing governance structures across the sector, alongside commercial lending activities.

Diversified Lending Portfolios

Within the approach section FSRA notes an expectation that credit unions "diversify commercial portfolios to mitigate risk". We agree this is generally a prudent position, we also note that there may be times in which regional geography, composition, and market perspective may reduce diversification opportunities. This is also true when considering a market-based approach, as credit unions generally compete in certain commercial areas when it comes to skills and expertise however, our resources are not as extensive as federal banks, and as such markets can be somewhat restrictive leading to higher weightings of real estate backed financing (assets and projects). Members noted that portfolios should not be judged from a single perspective (asset or loan type) as it could be deemed to lack sufficient diversification. Additionally, the opposite effect of forced diversification could mean credit unions venture into industries where they may have less experience and expertise, possibly resulting in increasing credit risk. In most cases, quality of collateral contributes to loan safety, and often this is through tangible collateral such as real estate or land. We believe that finding a balance on diversification will be necessary, alongside realization of collateral backing to ensure credit unions both have a diversified position, while also being able to support members.

Commercial Lending Review Process

We appreciate FSRA's mindfulness that smaller and medium-sized credit unions may be challenged to have multiple verification options within their commercial teams. When that is not possible the approach of a secondary independent review and transactional verification is important as outlined. Credit unions should be expected to make every reasonable attempt to separate duties however, we welcome the understanding by FSRA as noted within Principle #1. This type of approach (when applicable) should not harm the RBSF scoring matrix of smaller to medium sized credit unions, we trust that FSRA will ensure this is communicated to assessment teams and is considered within commercial review process moving forward.

Independent Third-Party Reviews

Independent third-party reviews can be an effective risk mitigation strategy and approach for credit unions. FSRA notes that it expects to be able to replicate decisions made by a credit union in relation to commercial lending. Members shared that additional clarity would be welcomed in relation to these expectations, to ensure that any third-party review works from the exact period and environment that the credit union worked form at time of review and funding. This should include and take into consideration economic conditions, portfolio review, data shared, and borrower information provided at the time of initial review and not allow for hindsight observations and analyses. At this time this is not called out explicitly and assessment teams could create their own interpretation using hindsight or new information/data which could harm the effectiveness of this type of review/audit. We believe additional clarity would benefit credit unions and assessment teams.

Financial Ratios and Stress Testing

Members shared concerns that FSRA's supervisory approach may not be taking into consideration types of lending where other repayment metrics beyond traditional debt service ratios are used in credit decision-making (e.g., homebuilders and other types of construction projects). There are cases within commercial where approaches and types of loans need flexibility and standard traditional reviews may not apply. Ensuring that the guidance reflects this type of need for specific commercial projects is needed. Additionally, members shared that stress tests based on financial ratios is more applicable at individual loan levels, and not necessarily portfolio levels. Portfolio level references should be considered for removal, as the applicability of them is generally low.

Agricultural Lending

Agricultural lending lands within commercia lending per the CUCPA and regulations. It is however unique and distinct in its form and nature. This is not called out within the note and could be an area worth exploring somewhat separately. Ontario credit unions are critical lenders to agricultural producers across the province and some commentary was shared by our members. Within concentration risk we believe that agricultural should be distinguished between various industries within the sector (I.e. dairy, hog, beef, soy, etc.). This would help credit unions who do heavier lending within this space avoid concentration concerns, where risk is low, but industry standard may place pressure on the individual credit union due to agricultural being considered as one entire entity, when it is not. Current ratios, solvency ratios, and lending ratios may not always align within agricultural lending, as it typically does within standard commercial lending, as they are uniquely different in approach. As for ESG agriculture accounting standards are fairly recognized already within approaches that our members use. There may be instances where flexibility will be needed pending future approach and requirements. Generally, we heard from members that FSRA should consider how it continues to build long-term knowledge and expertise within agricultural lending and risk to ensure that credit unions engaged in this form of lending are well supported.

Principle 2 – Use of Technology for Commercial Lending

Credit unions employ various commercial portfolio, risk, and lending management systems to support commercial risk, lending, implementation, reporting, and monitoring. The note outlines expectations of these systems and frameworks that credit unions will need to work within. We anticipate that most professional systems in place generally adhere to FSRA's expected standards, this view is based on discussion with members and FSRA. Where a system deficiency exists, we trust that FSRA will work with that credit union to ensure transition time to correct the system gap. Commentary noting this on final release of the guidance note would be helpful for the sector. For example, FSRA notes that streamlining of administrative actions, annual review creation, and root cause analysis are expectations. Current systems may not have streamlined administrative, annual review, or root cause analysis functions, and as such the credit union would not be meeting the desired regulatory principle and expectation. Technology changes can take numerous months to years to transition, as credit unions often need to work with third party providers and understanding by FSRA of this need will be critical.

Additionally, we heard from most members that they must take a cost benefit approach to employing LOS systems and new technologies, this was heard by both large and small members as costs for these solutions often are prohibitive or need to be considered over the course of a strategic planning period (I.e. three years). Proportionality will be important within FSRA's review and analysis of systems being run by credit unions today, as well as support deficiency transition timelines that are fair and appropriate over the course of a strategic planning period. This is likely an area where economies of scale and enhanced sectoral sourcing could improve efficiencies and cost.

Increasing Data Production and EDC

Increasing expectations to produce and extract data about borrowers that may not be captured in loan systems could become a burden to credit unions over time through this guidance, if not run in parallel with the current and ongoing EDC project. We recommend ensuring alignment to commercial expectations within EDC, while also factoring in cost benefit and timelines for credit unions to navigate, as commercial data is often more complex and difficult to get/extract and in many cases won't be fully available at this time across the sector. Several commercial EDC data points won't be met for various reasons through traditional platforms and current systems. A long-term transitional view that is aligned to the EDC project, and one that doesn't place additional burden on credit unions is necessary. FSRA should engage commercially active credit unions through the EDC project to discuss how transition can work to support prudent and appropriate data needs, while also recognizing that certain data points may not be feasible or necessary to access risk appropriately.

Human Processes Within Commercial Lending Decisions

We respect FSRA's views around the need to increase technology within commercial lending. We would however note that commercial lending, especially at scale, requires human judgement, discussion, and manual intervention as part of the credit granting process. This is true of not only credit unions, but also banks in their approach. Loan management systems remain prohibitively costly, even for larger credit unions, and a long-term approach to digitizing commercial lending processes and files will be necessary to ensure regulatory burden doesn't hinder credit union growth and competitiveness within commercial lending activities.

Proportionality in Platforms

In relation to commercial platforms members have shared with us that a proportionate approach to commercial platforms should include and consider the robustness of a credit unions overall enterprise risk management (ERM) systems and platform, as a supplementary system to that of a standalone commercial system. Some smaller credit unions may be using their ERM platforms to support and supplement commercial lending activities due to size, scope, and limited commercial volumes. The management of risk versus actual activities is important to consider alongside the proportionality of the platform in use. FSRA should consider proportionate expectations where commercial lending volumes are low, or conservative in nature.

Cyber Insurance and Technological Security

Principle 2 specifically calls out the requirement of cyber insurance. First, we believe that cyber related insurance considerations should be removed and shifted over to the IT Risk Management Guidance Note. Placing it within the Commercial Lending Guidance Note creates the possibility that credit union IT Teams fail to meet the desired outcomes by FSRA as natural placement lends itself to the IT Guidance Note. This similar notion could also be considered for security and privacy measures, technology risk assessment, and internal technology controls. These technological items are better situated within the IT Risk Guidance Note. Secondly, we have concerns that cyber insurance requirements may need additional prescriptive language, which could include minimum levels relating to technological assets, data, and portfolio balances. It is our understanding that members have enterprise-wide cyber relate insurance, and as it stands there appears to be different expectations within commercial lending, which has created confusion from members. We trust that FSRA will shift this out of the note and ensure it lands in the appropriate place.

Principle 3 – Effective Risk management Framework for Commercial Lending

<u>New Commercial Entrants</u>

The note does not independently highlight transition for credit unions who wish to begin commercial lending. We believe that a principles-based approach should allow transition runway and support to ensure a new credit union entrant in commercial lending can be successful from a regulatory perspective. Costs will be high for new entrants within commercial lending activities, and we hope that the regulator will work with those new entrants as they build up expertise, knowledge, and operational capacity to support Ontario small businesses. This is important to ensuring member growth within the sector.

<u>Re-Evaluation</u>

Expectations relating to the re-evaluation of collateral is a bit vague and clarity is sought. Understanding what constitutes the need for a re-evaluation and ensuring that this process can be completed internally is welcomed. Practicality around re-evaluation expectations by FSRA is important, so that credit unions do not become burdened by ongoing evaluation in cases where non-material changes have occurred, or where loans are in good standing. We believe FSRA's is seeking to address material macroeconomic conditions, commercial risk ratings, or other red-flag activities and events, this should be called out. Additionally, there is commentary around LTV and valuation over time. It is difficult to accurately assess market forces and fluctuations over the term of the loan, especially given current economic conditions. LTV may not always be assured to improve over the term of the loan due to numerous factors. The loan can still be in good standing and operating appropriately even in these types of situations. FSRA should consider reviewing language around LTV to reflect greater flexibility aspects.

<u>IFRS9 and SICR Reviews</u>

The note speaks to expectations relating to IFRS9 and SICR reviews. It is our general understanding that most credit unions use this method/approach for accounting and commercial expectations. There may be credit unions who are using alternative or additional methods and calculations around loan loss provisioning, these should be considered by FSRA case by case. A transition window for credit unions to shift to an IFRS 9/SICR reporting functionality with commercial activities would be welcomed. We do not anticipate this to be a major shift. It is our understanding that ESG requirements are under review through IFRS9 at this time, credit unions are awaiting results of consultation and where requirements will land. This should play into FSRA's long-term considerations relating to ESG in the future and alignment to commercial lending activities.

<u>ESG Considerations</u>

We recognize the need for ESG considerations as part of risk ratings moving forward and would welcome continued dialogue and transition time for this type of change. Greater clarity and understanding are always welcomed when it comes to new risk entrants by FSRA, such as ESG and social considerations within commercial portfolio and lending activities. We would recommend that ESG considerations remain at portfolio levels rather than individual member levels, additionally ESG considerations should be considered in support of already established accounting standards and generally accepted approaches. Finding balance between principles, values, and social impact, while serving members will be important to the sector and its members.

We trust that FSRA will work with credit unions around ESG metrics and risk rating expectations. Assessment considerations should focus on evidence-based discussions and ensure flexibility as the sector transitions. Initial RBSF assessments and understanding will be important to ensure ESG is captured appropriately, while not hindering the ability of credit unions to support current and future commercial members. It may be challenging to integrate highly subjective elements into systematic risk rating methodology consistently early on, further discussion with the prudential team is welcomed on this topic, it is our understanding that banks are currently selectively deploying ESG questionnaires, but not necessarily integrating ESG risk ratings into commercial practices overall. We want to ensure that credit unions remain competitive when it comes to commercial lending, ensuring a consistent approach between federal institutions and provincial credit unions is critical to the sector, as it supports our ability to compete and take prudent risk.

Our role as a cooperative based financial institution is to work with all potential commercial members, when aligned to strategic plans, values, and policies. Many credit unions have enhanced and improved their ESG policies and practices over the past few years through enterprise-wide activities. Inclusion of commercial within an enterprise-wide approach should be accepted by FSRA, as well as understanding that this transition will take time, especially within commercial portfolios. Additionally, commercial lending expertise tends to rest within credit risk and not as much along environmental risk, this expertise is shifting and should also be considered within transition timelines.

Additional Feedback

RBSF Considerations

The RBSF process is still new for the sector and is in its early phases. Commercial lending discussions and assessments will be critical to ensuring that small businesses and commercial members remain supported moving forward. CCUA will be monitoring how commercial lending activities impact ORR results within the overall RBSF matrix. We believe that a proportionate and flexible approach is needed as credit unions transition to RBSF and come to understand expectations relating to commercial activities, and as this guidance note is introduced over time. Commercial lending is often viewed as inherently higher risk, we trust that FSRA will use an evidence-based assessment approach against frameworks, policy, controls, and risk mitigation strategies for credit unions engaged in commercial lending and that ORR scores will be reflective of this based on the guidance note and dialogue between the credit union and assessment team. CCUA will be monitoring short term outcomes of RBSF results in line with this guidance note to ensure that credit unions are not impeded by continuing to serve commercial members and grow commercial portfolios.

Third Party Support for Commercial Lending Activities

The Guidance Note does not call out requirements relating to commercial third-party support activities (I.e. underwriting support, analysis, etc.). It would be our view that FSRA has no concerns with credit unions responsibly engaging third parties to support credit risk and loan application activities, so long as proper controls, reviews, and assurance from the credit union is in place treating the engagement as if it were in-house. Credit unions can improve scale and expertise by engaging third parties which we believe is important for long-term efficiency and success. Within the commercial lending there are also external parties that need to be engaged including appraisers, surveyors, consultants, legal, among others. If for some reason FSRA has different expectations of views than what we have shared here we would welcome additional clarity within the note.

Internal Skills and Expertise

It is critical for FSRA to have internal expertise within commercial lending to effectively review and assess credit unions. Ensuring that FSRA has the right compliment of commercial expertise and skill within assessment teams would be beneficial to our members who have a higher volume of commercial lending portfolios. This will ensure appropriate understanding and discussion of commercial lending activities, risks, and factors as part of the RBSF assessment process. We look forward to seeing how this need evolves over time.

Sharing of Data and Insights

It was noted from members that commercial data held by FSRA should be made available back to credit unions regularly to support sector improvement and benchmarking. Commercial lending is constantly evolving, and more insights and data are welcomed by credit unions. We believe this will help to strengthen approaches, frameworks, and potential internal policies and processes. EDC should be shared, when possible, back to credit unions to help strengthen their approach, frameworks, and operations in a proactive manner by FSRA. Broadly speaking the insights should also support better conversations as part of RBSF assessments overall.

Members' Interest

FSRA proposes that they will consider credit union commercial lending activities against "whether members' interests are being served". We respect the approach by FSRA as a regulator to ensure protection of members and depositors across Ontario. Credit unions work as financial cooperatives to support our members and putting their interests first is imperative to the success of their business models. Additional clarity around the term may be helpful to better define how FSRA views member interests in relation to commercial lending activities specifically, as the term is vague and broad.

The sector currently employs a market conduct code that would also cover and support commercial members interests. There may be times where the credit unions best interests do not necessarily align with members' best interests pending risk, profit, rate, and case by case situations. We believe FSRA is seeking to ensure that consumers are not taken advantage of and receive proper treatment and response within commercial lending products and services. We would propose the concept of usury rates as a potential addition to the document to help define further "members' interests", along with a reference to the market conduct code. We would appreciate additional clarity and context towards "members' interests being served" to try and reduce vagueness for sector understanding.

Concluding Thoughts

We welcome the principles-based approach that FSRA is taking when it comes to the new commercial lending guidance note. Additionally, we appreciate that FSRA is not making material changes to expectations of credit unions engaging in commercial lending at a time when challenging macro economic conditions prevail for both the sector and Ontario small businesses. Credit unions continue to play a critical role in Ontario's economy through SME, commercial and agricultural lending. The note will help align previous advisory and guidance, while enhancing commercial expectations through a principles-based approach.

We trust that FSRA will consider the items shared above and will act accordingly to adjust and enhance the note provide. CCUA will be keenly monitoring possible changes to the consultation draft, as we believe there are several items that should be reconsidered to better strengthen the document and support the sector.

If CCUA can support our consultation response further, please do not hesitate to connect with us for further discussion.