

Credit Unions Virtual Town Hall

Commercial Lending Thematic Review and What to Expect from Continuous Supervision



FSRA

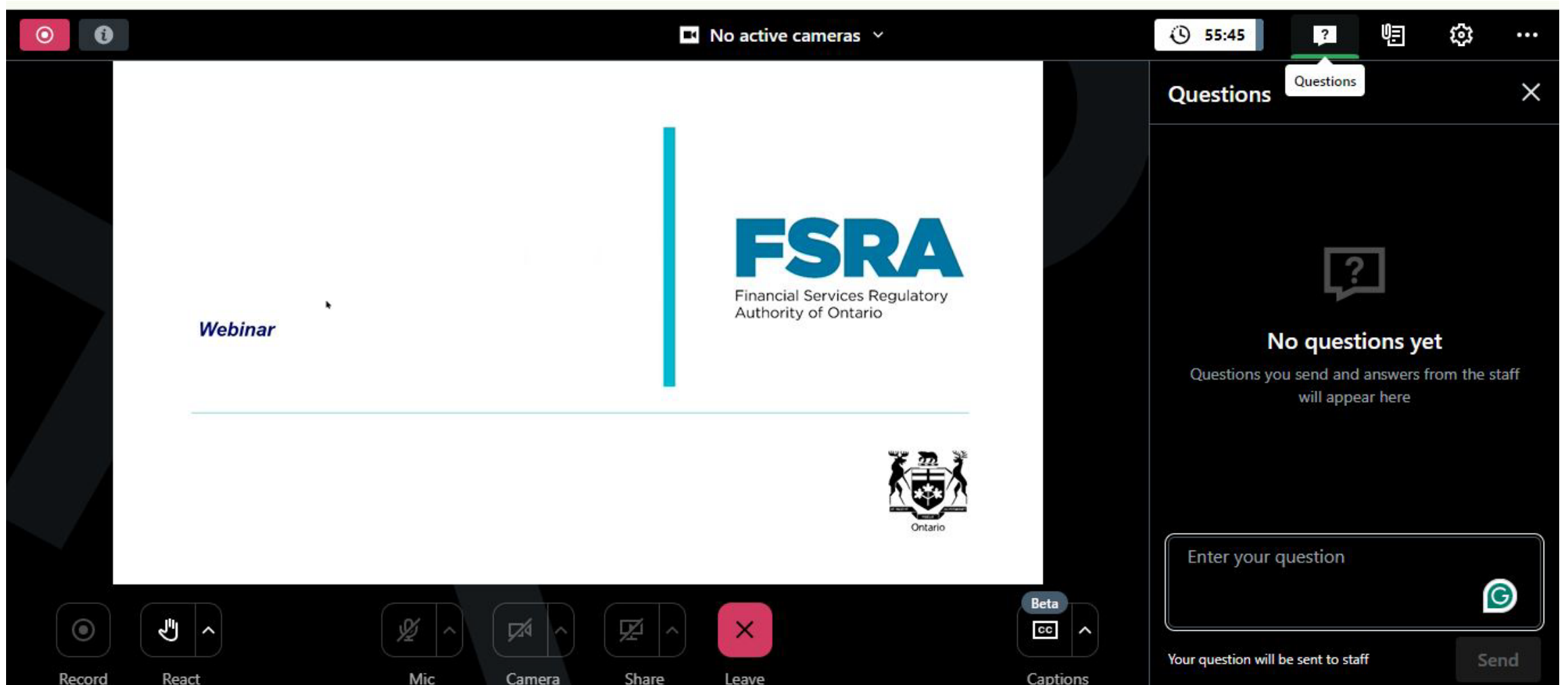
Financial Services Regulatory
Authority of Ontario

Date: December 12, 2024

Speakers: Dan Oprescu, *Head – Credit Union Prudential Supervision, FSRA*
David Maxwell, *Head – Regulation and Strategic Initiatives, FSRA*



Ontario



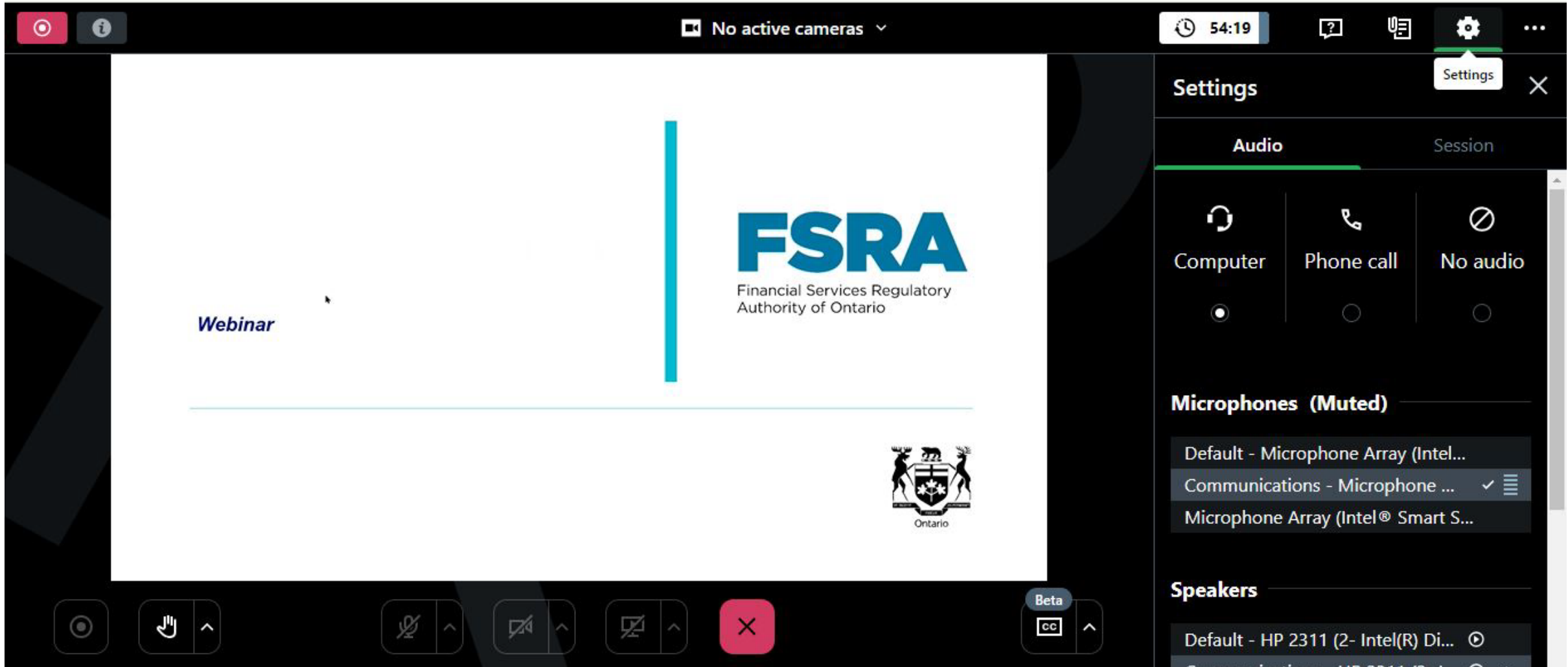
The screenshot shows a Zoom meeting interface. The main window displays a slide with the following content:

- Top left: **Webinar**
- Center: A vertical blue line.
- Right side: **FSRA** logo, with "Financial Services Regulatory Authority of Ontario" below it.
- Bottom right: The Ontario coat of arms logo.

The Zoom interface includes a top bar with "No active cameras", a timer at "55:45", and a "Questions" icon. A sidebar on the right is titled "Questions" and contains the following text:

- A question mark icon in a speech bubble.
- No questions yet**
- Questions you send and answers from the staff will appear here
- An input field with the placeholder text "Enter your question".
- A "Send" button.
- Below the input field, it says "Your question will be sent to staff".

The bottom toolbar contains icons for Record, React, Mic, Camera, Share, Leave, and Captions (with a "Beta" label).



The screenshot shows a Zoom meeting interface. The main window displays a slide with the FSRA logo and the text "Webinar". The top status bar shows "No active cameras" and a timer at "54:19". The right-hand settings panel is open to the "Audio" tab, showing options for "Computer", "Phone call", and "No audio". Under "Microphones (Muted)", a list of devices is shown, with "Communications - Microphone ..." selected. The bottom toolbar contains icons for mute, video, chat, and a red "X" button.

Agenda

- Land Acknowledgement
- Introductions
- Commercial Lending Thematic Review (15 min)
- Q&A
- Continuous Supervision (30 min)
- Q&A

The logo for the Financial Services Regulatory Authority of Ontario (FSRA) features the letters "FSRA" in a large, bold, blue sans-serif font.

Financial Services Regulatory
Authority of Ontario



Land Acknowledgement

We acknowledge the land we are on is the traditional territory of many nations including the Mississaugas of the Credit, the Anishnabeg (ah-nish-naw-bek), the Chippewa, the Haudenosaunee (hoodt-en-oh-show-nee) and the Wendat peoples and is now home to many diverse First Nations, Inuit and Métis peoples. We acknowledge that Toronto is covered by Treaty 13 with the Mississaugas of the Credit and the Williams Treaties signed with multiple Mississaugas and Chippewa bands.

Dan Oprescu, Head – Credit Union Prudential Supervision

David Maxwell, Head – Regulation and Strategic Initiatives

Commercial Lending Thematic Review

Earlier this year FSRA launched a Commercial Lending Thematic Review, focusing on exposure to Commercial Real Estate (CRE), due to significant challenges observed on the CRE market.

- Increased office vacancy rates caused by post-pandemic hybrid work arrangements
- Increased retail vacancy rates in some spaces caused by post-pandemic online shopping
- Increased construction costs caused by high interest rate and high inflation environment
- Reduced investors interest (e.g. pulling out of preconstruction condo developments)



These challenges lead to reduced profitability for lenders to businesses seeking funding secured on CRE as well as to real estate developers.

44/55

Ontario CUs participated (those carrying on the vast majority of CRE lending in the sector)

17,470

Loans have been reviewed

100%

Review of risk controls (lending practices, policies, etc.) and oversight (Board and Senior Management) of all CUs involved

The CRE Thematic Review took advantage of the Risk and Regulatory Data Specification (RRDS), an integral part of the Enhanced Data Collection (EDC) project

CUs provided two sets of data to support the review

- 1.** Portfolio metrics in commercial real-estate lending and loan-level data
- 2.** Questionnaire focusing on risk management practices and governance

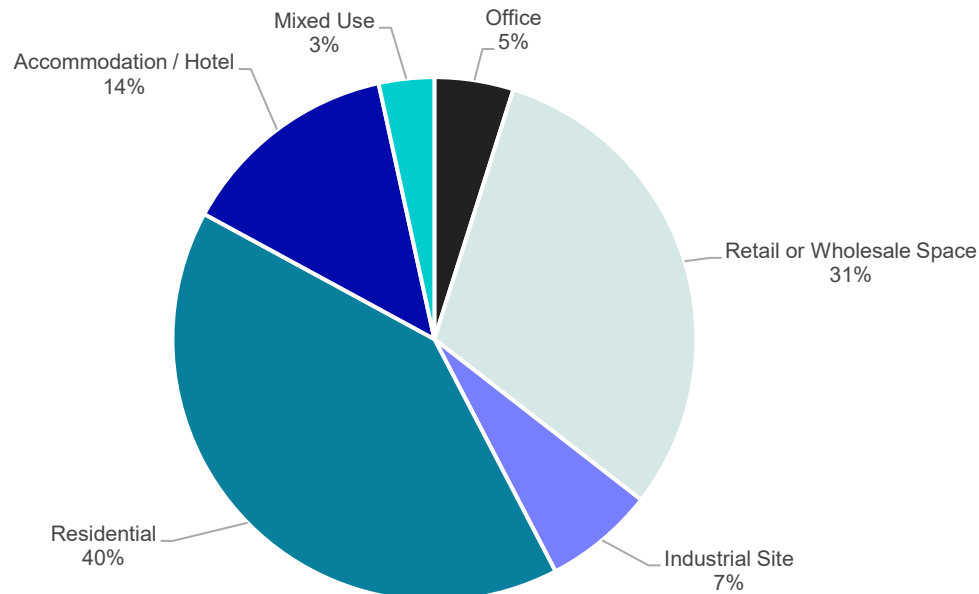
- Commercial lending is a key activity for Ontario CUs, accounting for 30% of the sector's total loan exposure (\$28Bn), **44 out of 55** CUs are engaged in commercial lending
- Exposure to CRE is the largest component of commercial lending amounting to **~70% of the sector's total commercial loans** (\$20Bn)
- High interest rates contributed to **elevated credit risk in commercial lending**, particularly in real-estate

- In a market environment putting pressure on financial margins, **CUs see opportunities** for higher margins in the commercial segment
- However, commercial **lending requires special skillsets and experience**, not all CUs can demonstrate
- **Data quality remains a challenge** (availability of key metrics needs to be improved – LTV, DSCR, vacancy rates, etc.)

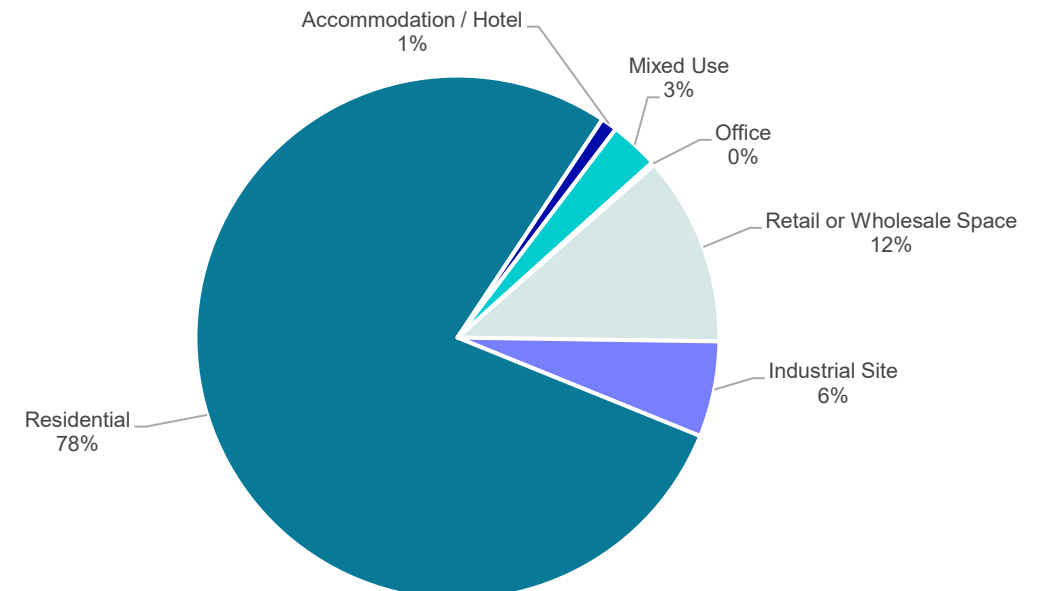
CRE Loan Composition and Office Segment Risk

- ~**67% of CRE loans** are in **income-producing** (rental), remaining **33% non-income-producing** properties (construction and land development).
- Office CRE has been flagged as a **high-risk segment** due to high funding costs and elevated vacancy rates. Ontario CUs have **limited exposure** to this segment, only 5% of their portfolio in income-producing loans and less than 1% in non-income-producing loans.

Income Producing CRE Loans



Non-income Producing CRE Loans



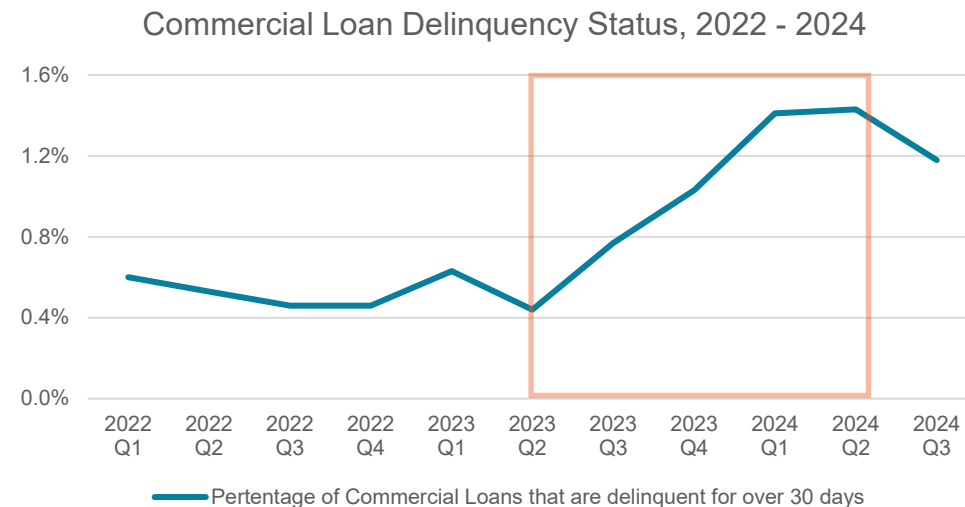
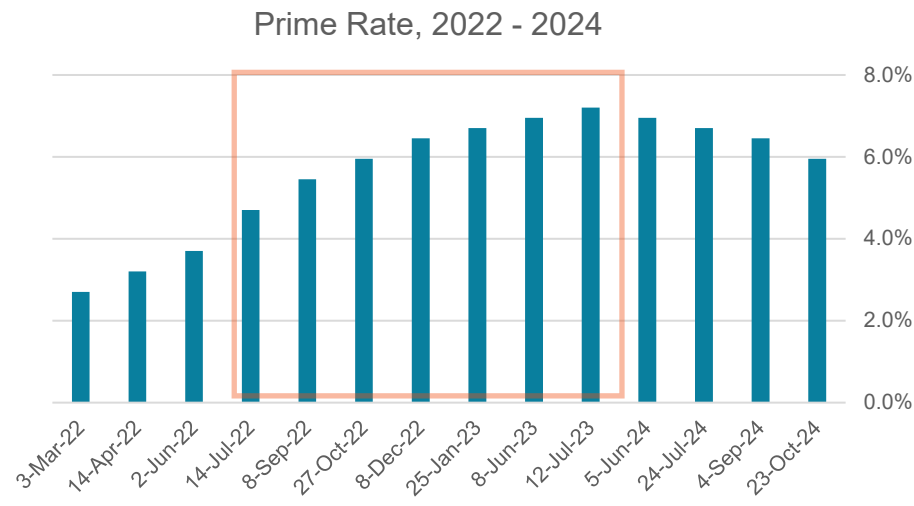
- **Office-related CRE** shows **highest delinquency** of 2.29% which highlights the sector’s vulnerability to high funding costs and elevated vacancy rates. **Residential CRE**, has \$1.2 billion in equity exposure and 2.03% delinquency rate which reflects **moderate credit and market risk**.
- **Future potential risk** can arise if there are liquidity constraints, such as redemption halt where owners may face significant challenges in accessing equity to fulfill their obligations in paying off the loans.

Use of Property	Credit Loans		Market Value
	Exposure	Delinquency %	Equity
Residential	10,752,073,434	2.03%	1,160,363,215
Accommodation / Hotel	1,924,131,367	0.10%	72,700,000
Retail or Wholesale Space	4,958,178,580	1.25%	115,048,498
Office	680,019,071	2.29%	143,511,133
Mixed Use	670,643,922	0.49%	270,864,121
Industrial Site	1,325,176,078	0.18%	43,414,956

Note: Equity exposure does not include mutual fund, commercial loans are estimated at \$200 millions for the sector.

Commercial Lending Risk is On The Rise

- **72% of total commercial loans¹** are CRE. Observed increase in delinquency rate (30+ days past due) is driven mainly by the increase in prime rate between July 2023 to July 2024.
- CRE delinquency rates are significantly lower for **income-producing loans (0.08%)** compared to **non-income-producing loans (2.82%)**. Property cash flow from income-producing loans naturally reduces the likelihood of default.



¹ Commercial loans include two sub-categories: Other commercial and CRE loans. Other commercial loans are either not secured by real property, or the servicing of the loan does not materially depend on the cash-flow generated by the property.

Overall, CUs have implemented FSRA's Rules and Guidance as it relates to developing, updating, and implementing Commercial Lending policies and procedures.



Current evaluations of CUs processes highlight that a majority have a Commercial Lending Framework (CLF) in place which establishes the parameters for their commercial lending activities.



Evidence highlights that for the CUs reviewed the CLF is reviewed and approved by the Board at least annually.

Areas of deficiencies have been identified:

- 1 Majority of CUs reviewed have not documented in their policies and procedures the segregation of roles in respect to underwriting, credit adjudication, loan approval, and funding of commercial loans.
- 2 While many CUs have processes in practice to verify the source of equity down payments, several of them lack documented procedures outlining how this process is carried out.
- 3 Several CUs do not have policies and procedures that specify clear guidelines on valuation of the property for the purpose of underwriting, including a definition of which valuation or combination of approaches to valuation.
- 4 A vast majority of CUs did not have a threshold for loans with exceptions/non-conforming loans as percentage of total commercial loans.

Overall, CUs have implemented FSRA's Rules and Guidance as it relates to governance structures and availability of data and reporting to support effective oversight of CUs' Commercial Lending activities.



Current evaluations of CUs' processes highlight that for most of the CUs' information reported to the Board and Senior Management is sufficient for effective oversight.

Areas of deficiencies have been identified:

- 1** Majority of Credit Unions do not have adequate oversight on strategy as it relates to specific type of commercial loans. For instance, FSRA notes that most CUs reviewed offer land development loans however, only a small percentage of CUs have a strategy that documents the rationale and strategic motivation for engaging in land development/land servicing loans.
- 2** A large proportion of CUs do not have a process for the validation of the ECL which is critical to lending, credit risk pricing and capital allocation decisions.
- 3** Most CUs do not have an adequate audit scope that covers the risk and controls for Commercial Loans.

Questions



Continuous Supervision

FSRA's Objects in respect of the Financial Services Sector include:

- (a) to promote high standards of business conduct;
- (b) to protect the rights and interests of consumers; and
- (c) to foster strong, sustainable, competitive and innovative financial services sectors.

While maintaining the safety and soundness and standard of conduct of the institution, credit unions need to take risks to serve their members and make a profit:

- A credit union is compensated to take credit risk, but not interest rate risk or IT risk
- The strategic objective is to maximise compensation for a tolerable amount of risk
- The risk that comes with the business is adjusted with risk controls to achieve the desired risk appetite – ensure that available resources are not overwhelmed by losses

The Board's role in risk oversight:

- Business strategy and risk appetite: business opportunities to pursue, risks involved and resources available while maintaining high standards of business conduct
- Risk management framework: the elements (policies, reports, etc.) that allow the board to ensure that the institution's risk profile is maintained by management within the approved risk appetite

Supervisors assess the quality of risk oversight alongside the quality of risk controls to arrive at the Overall Risk Rating

Risk is also part of Board oversight (see FSRA's SBFP Rule)

RISK ASSESSMENT TOOLS

1. Review of lines of business: portfolios, operations and oversight
2. Analyze and assess the risk profile
3. Scenario analysis and stress testing
4. Supervisory methodology: RBSF-CU (2022)
5. Comprehensive, thematic and targeted reviews

Between April 2022-October 2024

- 55** Credit unions comprehensively assessed
- 6** Thematic Reviews completed or underway
- 2** Targeted Reviews: Liquidity Management

Outcomes-focused supervision requires frequent interaction between FSRA supervisors and the CU Board

The following six themes were consolidated from all assessments. Of the 55, requirements and recommendations were issued to most of the CUs for each of the six themes:

55/55

Enterprise-wide
Board Oversight

51/55

Risk
Management

47/55

Internal
Audit

41/55

Operational Risk
Management and
Resilience

41/55

Treasury and Liquidity
Management

36/55

Capital Management
and Profitability

***79% of requirements and recommendations were issued to the Board.
These cannot be delegated to Senior Management.***

Board oversight of credit unions addressing outstanding issues

- Board/FSRA Supervisor interaction

Monitoring financial performance

- Stress testing and scenario analysis

Foster collaboration

- Mergers, alliances, shared services, and joint ventures to support long-term viability
- FSRA Supervision and Approvals collaboration

Continuous supervision

- Biggest difference from previous regulatory regime
- High tech (data and analytics) as well as high touch (“always open”) supervision
- Thematic Reviews and Targeted Assessments

Continuous supervision requires frequent interaction between FSRA supervisors and the Board

FSRA's Expectation

- Board materials, board meeting attendance, roles
- Individual directors' fiduciary duty – direct representation
- Board Chair and committee chairs

Director Expectations

- Relationship Managers
- Quality assurance and supervisory support: Directors, Head, and EVP

Board oversight is every director's accountability, and the supervisory engagement is not limited to the Board Chair

1

While there is increased accountability for the Board under PBR, credit unions have more flexibility to tailor their strategy to their credit union's particular circumstances

2

Board directors are encouraged to engage in bilateral, transparent, and open communication with FSRA

Maintaining a view of a
credit union's risk profile through

← **continuous supervision** →

Supervisory
Assessments

Thematic
Reviews

Monitoring

What is monitoring?

- Regular review of information about a credit union, its industry, and external environment to keep abreast of changes and to identify emerging risks and issues
- Communication with the credit union's management and board

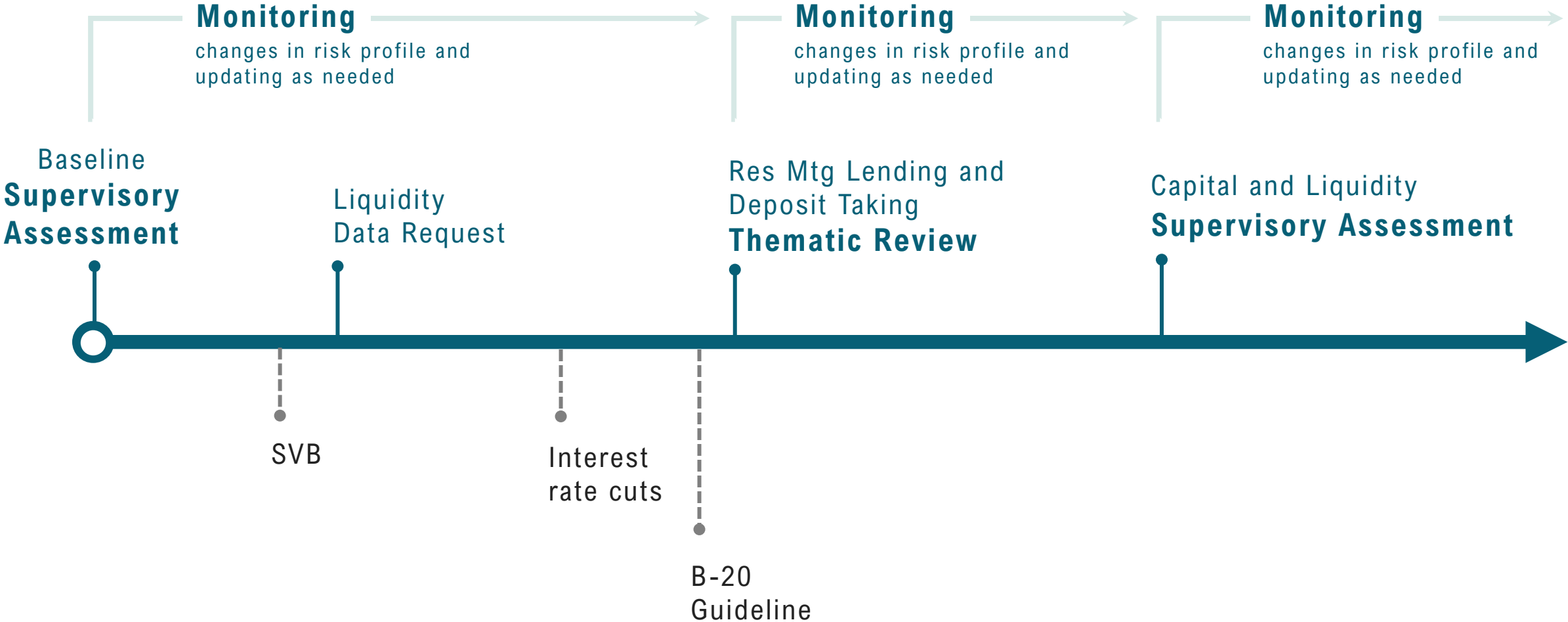
Updating assessments

- The assessment and ratings will be revisited and changed to reflect the current state of the CU if new information indicates a material change in a CU's risk profile
- Subject to FSRA's rigorous quality assurance process

Reporting to and communicating with CUs

- The Interim Supervisory Letter is used to communicate the credit union's supervisory ratings (i.e., ORR and IL) and provide timely feedback on issues arising from a specific body of supervisory work
- FSRA considers transparency, communication, and the provision of feedback to the CU an important part of its supervisory process

Risk Based Supervision in Action



Questions

