Deposit Insurance Corporation of Ontario

Société ontarienne d'assurance-dépôts

Additional Tools:

COMMERCIAL LENDING POLICY DEVELOPMENT GUIDE

Minimum Expectations

Class 2 Institutions

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Ce document est également disponible en français.

COMMERCIAL LENDING
POLICY DEVELOPMENT GUIDE

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Throughout this document, the term “credit union” also refers to “caisse populaire” and “league”.

COMMERCIAL LENDING
POLICY DEVELOPMENT GUIDE

1. POLICY STATEMENT AND GUIDING PRINCIPLES

The policy statement and guiding principles set out the general approach and fundamental expectations for commercial lending activities. They set out the framework for commercial lending which should be aligned with risk appetite, risk tolerance and the risk profile of the credit union as defined in the board approved Enterprise Risk Management (ERM) policy.

Please refer to the ERM Guidance Note, Application Guide and ERM Framework document on DICO's website for more information on risk appetite and risk tolerance.

Policy Statement

The policy statement should state the purpose of developing and maintaining prudent commercial lending policies. Policies should comply with prudent business practices and controls to manage commercial credit risk in line with the credit union's risk appetite. It should delegate responsibility to management, subject to any restrictions, limitations and requirements as set out.

Guiding Principles

This section would generally provide an overview of the underlying philosophy, framework and approach for commercial lending.

a) Lending philosophy outlines the:

- responsibility of the board and management for safeguarding the assets of the credit union, while providing loans to members at competitive rates sufficient to generate revenues to ensure profitability.
- minimum characteristics and qualities of borrowers such as:
  - businesses which operate in a manner that reflects the values of the institution and its membership;
  - strong financial soundness and capacity to repay;
  - good track record of financial management;
  - appropriate management expertise, and
  - acceptable forms of security.

b) Lending framework, procedures and authorities describe:

- the establishment and maintenance of a disciplined framework for commercial credit lending activities;

- the Board's risk appetite and risk tolerances being appropriately considered by management in creating and updating commercial lending operational policies and procedures;
- the requirement that operational policies be regularly reviewed by the internal auditor for appropriateness and confirmation of adherence to both corporate and operational policies;
- the delegation of responsibility to management for:
    - identifying, quantifying, controlling, mitigating and reporting on credit risk - some examples of items to be included in the reporting are:
        - loan origination results (application volume, approval rates, etc.;
        - overall portfolio size and diversification in comparison to the credit union's Risk Appetite;
        - individual situations that are not in compliance with the terms of the authorized credit;
        - delinquency and impaired accounts.
    - prudently managing exposure to potential default and loss;
    - ensuring that appropriately qualified staff are assigned to implement risk measurement and commercial credit risk management processes; and
    - ensuring appropriate segregation of duties and responsibilities.

c) Risk Management principles requiring:

- sufficient diversification within the commercial loan portfolio to mitigate concentration risk;
- sufficient qualified risk assessment based on established lending criteria in line with the size, security and term of the loan;
- updated risk ratings be assigned for all new and regularly updated for outstanding loans;
- loans meet minimum assessment criteria and risk rating;
- the borrower to be fully informed of the terms and conditions of the loan prior to signing loan agreements;
- security documents that clearly record:
    - terms, rates, fees and penalties;
    - financial and reporting covenants;
    - the type of financial statements to be provided by the borrower (for example, prepared "in house", auditor prepared with or without review, consolidated, etc.).
- the performance of appropriate annual commercial credit reviews and risk assessments commensurate with the size and level of risk for each loan.

d) Compliance requirements that adhere to:

- all regulatory requirements and DICO's By-law No. 5 - Standards of Sound Business and Financial Practices and By-law No. 6 – Reserves and Monthly Provision for Doubtful Loans, and related Guidance Notes; and

- the delegation of lending authority for management and staff, and the basis of authority granted to each level of staff (e.g., experience, ability, education).

2. AUTHORIZED COMMERCIAL LENDING PRODUCTS

This section should identify the lending products that the credit union will offer to its commercial members. The type of commercial loans granted should be reflective of the size and complexity of the credit union, its lending capabilities, risk appetite, tolerance and underwriting ability and experience.

These would typically include items such as:

- mortgages, term loans, operating lines of credit
- construction mortgages
- Real estate and rental properties
- letters of credit
- syndicated loans
- leases

3. LENDING LIMITS

Credit unions are required to establish and implement prudent lending limits. Policy limits should take into account the:

- knowledge and expertise of management and staff;
- business environment in which the credit union operates;
- credit union's risk tolerance; and
- strength of the credit union's capital (ability to absorb losses).

Maximum lending limits to individual and connected parties must be in compliance with limits prescribed in the Credit Unions and Caisses Populaires Act, 1994 (the "Act") and Ontario Regulation 237/09 (the "Regulation").

The policy should establish overall lending limits and restrictions, including:

- limits for loans in aggregate to any one borrower or group;
- the maximum size of a single loan by type:
  - maximum amount of a loan either as a dollar limit or as a percentage of regulatory capital reported on their last audited financial statement; and
  - lending limit for each type of loan.
- concentration limits by industry and loan type;
- aggregate limits of large loans;
- loan to value ratios;
- overall portfolio risk levels;

- requirement to obtain prior board approval for any loan to a Restricted Party and all exceptions to underwriting criteria and restrictions; and
- requirement for all lending limits to be reviewed at least annually.

4. LENDING CRITERIA

This section outlines appropriate underwriting criteria that should be established and maintained, including:

- lending criteria and security requirements that are appropriate, prudent and aligned with standard industry practices;
- minimum criteria and limits that must be met by the borrower before a loan can be granted, such as:
  - Credit worthiness/credit rating of borrower;
  - Financial position (profitability; financial performance);
  - Financial performance indicators (ratios);
  - Stress testing of ability to pay (applying higher interest rates/terms);
  - Risk rating level;
  - Nature of business;
  - Completion of appraisals as per standards outlined in the policy;
  - Completion of assessments (environmental and any others, as required)
  - Quality of management
  - Prospects for success of the business; and
  - Other “know your client” requirements, including Anti-Money Laundering provisions.
- documentation required for granting commercial loans;
- analysis of borrower’s financial position and capacity to repay the loan;
- lease analysis (type of lease, maturity dates and stress testing if tenant vacates); and
- justification for underwriting decision on the basis of financial analysis and other relevant criteria.

For credit unions involved in construction developments, land assemblies and land banking (vacant land), additional items to be included are:

- use of expert opinions with reference to market/feasibility studies;
- use of project monitors or quality surveyors;
- conduct due diligence including:
  - requiring Electrical Safety Authority (ESA) report(s) on electrical safety;
  - necessary approvals from appropriate government bodies (e.g. building permits, zoning approvals, easements, etc.);
  - obtaining executed leases;
  - requiring an ethical review;
  - requiring more frequent monitoring or interim reporting prior to the annual review; and
  - other prudent due diligence requirements the credit union may wish to include.

- Progress draw/holdback procedures (required to protect against liens registered under the Construction Lien Act).

5. CREDIT RISK RATING

A credit risk rating system provides a standard by which to measure the level of risk of a loan and the loan portfolio.

This section should identify the:

- responsibilities of management in developing and maintaining a credit risk rating system;
- risk rating methodology used;
- timing and frequency of risk rating:
    - o at the time of application for all new or increased loan facilities;
    - o as part of the annual review process; and
    - o in situations where new information is considered that may materially affect the credit risk of the loan.
- number of rating levels and the criteria for each rating;
- Board's target risk rating for the various loan categories and aggregate loan portfolio;
- requirement to report the aggregate risk rating of the portfolio or portions within the portfolio to the board; and
- content and frequency of Board reporting including strategies to resolve any exceptions.

6. PORTFOLIO DIVERSIFICATION

It is important to maintain an appropriate and prudent portfolio diversification in order to mitigate risk and avoid excessive risk exposure.

The policy should identify the:

- target maximum concentration levels for each category within the portfolio ($ and %);
- target maximum geographic concentration levels;
- requirement and responsibility for monitoring of the loan portfolio;
- nature, content and frequency of Board reporting; and
- requirement for Board approval of any excess positions.

7. SYNDICATED LOANS

While the syndicating credit union undertakes the credit risk evaluation and on-going monitoring and administration of the loan on behalf of all parties, all participating credit unions in the syndicate are required to undertake their own initial and on-going credit risk evaluation of the loan, as they would for any other loan of a similar nature including regular site reviews, where appropriate. Each credit union participating in the loan syndication must ensure compliance with the requirements of section 190 of the Act and section 56 of the Regulation.

Please refer to DICO Lending Advisory #2: "Authorized Participants in Loan Syndication" (issued October 2011)

The policy should identify the:

- maximum limits for syndicated loans;
- requirement for a formal syndication agreement with the syndicating credit union;
- requirement for the borrower to be a member of an Ontario credit union that is one of the lenders in the loan syndicate;
- requirement for the credit union to conduct due diligence of the syndicator with respect to financial soundness;
- requirement that the syndicating credit union' s lending policy and practices and assessment criteria be as comprehensive and stringent as that of the credit union;
- requirement that the credit union, following its own analysis, review and confirm the results of the underwriting for the loan;
- requirement for an initial and on-going credit risk evaluation and risk rating of the loan in accordance with normal lending criteria;
- requirement to conduct regular site reviews where applicable; and
- nature, content and frequency of Board reporting.

8. LARGE EXPOSURES

Establishing aggregate limits for large exposures helps mitigate concentration risk. For example, too many high value loans within the loan portfolio may cause a funding shortfall for member loan demand or a significant loss to the credit union if the loan becomes uncollectible. Apart from establishing general lending limits for commercial loans, the policy should also address large exposures.

This should include:

- establishing thresholds for large exposures;
- setting limits for large exposures;
- setting aggregate limits for large exposures;
- establishing the frequency and extent for monitoring large exposures; and
- establishing the content and frequency of Board reporting requirements.

Monitoring of large exposures should be more frequent and extensive than lower value loans. For example, it may be more prudent to review all large exposures every six months rather than the recommended annual review. The review frequency for different sizes and types of loans needs to be detailed in the policy supported with the appropriate business rules.

9. LOANS TO CONNECTED AND RELATED PARTIES

Section 67 of the Regulation sets out the conditions where individuals and entities are considered to be connected persons. Credit unions should also consider the following when establishing prudent lending limits for connected and related parties and adherence to maximum regulatory single and aggregate lending limits:

- A *connection generally* exists where two or more entities share a ***common risk***. The exposures to the entities comprising a connection should be aggregated for the purpose of applying limits on the credit union's large exposures;
- ***Common risk*** will generally occur where the entities are part of a corporate group and there is material ***financial interdependence*** between the entities;
- *A* ***corporate group*** includes an entity and all of its subsidiaries, whether they are owned directly or indirectly;
- ***Financial interdependence*** *should be assessed* taking into consideration intercompany funds movement and contractual agreements, including common security arrangements, guarantees and letters of comfort;
- A person or entity that provides a guarantee for a borrower should be treated as a connected person to the borrower regardless of whether any specific tangible security is pledged to support the guarantee.

The policy should set out the:

- aggregate loan limits to connected persons and related parties;
- underwriting guidelines for loans to connected persons and related parties;
- requirement for identifying and monitoring connected person and related party loans;
- approval levels required to grant loans to connected persons and related parties; and
- nature and frequency of Board reporting of connected and related party loans.

10. LOANS TO RESTRICTED PARTIES

It is important for institutions to identify full requirements surrounding restricted party loans including loans to officers, directors and staff or commercial entities. Credit unions must comply with the requirements set out in Part X of the Credit Union and Caisses Populaires Act. The credit union's conflict of interest policy should also be reflected in its lending policy.

This section should include:

- a comprehensive definition of restricted parties;
- lending limits applicable to restricted parties;
- the requirement for prior Board approval of any restricted party loan; and
- the nature and frequency of Board reports on restricted party loans.

11. PROCEDURES AND CONTROL SYSTEMS

Fundamental requirements and standards should be set out for an integrated system of operational policies, procedures and sound business practices in commercial lending at the credit union.

This section should address the following key requirements regarding:

Process:

- adhering to an established, documented loan underwriting process which defines the appropriate steps to adjudicate the loan from application through approval and funding;
- underwriting and approving loans should be made by appropriately qualified staff, with appropriate authorization and accountability;
- delegating formal lending limits to lending staff in accordance with their skills, qualifications and experience;
- maintaining proper documentation of loan applicant information and credit analysis and decisions made according to defined criteria;
- aligning loan applications with established credit granting criteria that:
  - determine the borrower's ability, capacity and willingness to pay; and
  - ensure that underwriting criteria meet the institution's standards for loan approval.
- obtaining proper security and registration documentation;
- ensuring that there is separation of duties with respect to the loan being underwritten, approved and funded (e.g. the lending officer underwrites the loan, another individual approves the loan and another individual disburses the funds to the borrower); and
- making loan disbursements only through proper channels as defined by the credit union.

Control:

- establishing monitoring and control procedures that are maintained by management to ensure the appropriate disbursement of loans;

- ensuring the implementation and maintenance of a credit portfolio management system by which loans are appropriately recorded, payments are collected and recorded when due, arrears are noted in a timely manner and regular periodic reports are issued;

Monitoring:

Note: Inadequate timely monitoring and the non-implementation of appropriate and prompt corrective action are primary causes of commercial loan losses.

- establishing and maintaining a reporting system which provides adequate information to allow an effective assessment of the loan portfolio on a periodic basis, including the monitoring of trends within the portfolio;
- implementing and maintaining a modeling and stress testing program for the portfolio (dependant on the size of the credit union) and regularly reporting the results to the Board;
- reviewing the commercial loans and commercial lending portfolio at least annually, and in some cases such as construction financing, more frequently, whereby the level of risk is assessed, leading to adjustments in specific loan provisions and increased diligence in monitoring of commercial loans as required;
- establishing the extent of the loan review which is dependent on the risk profile of the loan;
- monitoring of approvals to ensure they are in line with approval limits and underwriting criteria;
- establishing a requirement for increased frequency of reporting in instances where the risk of a loan has increased (i.e., where the quality of the loan has deteriorated), reflecting the risk appetite and tolerance related to commercial loan performance and the type of loan product; and
- establishing and maintaining a monthly out-of-order report that itemizes and tracks all loans, with all exceptions to authorized credit terms, the length of time the situation has been outstanding (number of times reported) and the steps being taken to address the out of order issue. This report should be provided to the senior management and the board on a monthly basis.

12. SECURITY

Security is an important aspect in the mitigation of risk of every loan.

This section should address the:

- conditions where security is required for a loan;
- value and nature of the security that should be requested;

- details of eligible security by loan type and category;
- requirement for the security obtained to be registered and safeguarded prior to loan advancement;
- requirement that the security accepted should be sufficient and reflect the risk appetite and risk tolerance of the credit union; and
- repayment terms of the loan should be such that the loan to value ratio improves over the term of the loan, especially where the market value of the security may depreciate over time.

13. LOAN APPROVALS AND AUTHORIZED LENDING LIMITS

Approvals:

The manner in which loans will be evaluated and approved and how decisions will be escalated should be indicated in this section that identifies:

- management as being delegated the responsibility to document a loan approval hierarchy in operational procedures;
- approval limits that are commensurate to the qualifications, experience and background of lending staff;
- the dollar amount, type and complexity of loans; and
- all loans that can be made within the lending limits specified by this policy.

Authorized Lending Limits:

This section, usually presented in a tabular format, should set out:

- each category and type of commercial loan the credit union will underwrite; and
- the corresponding lending limits, in dollar amount for designated lending staff and management, including joint limits for large loans.

14. POLICY EXCEPTIONS

This section addresses the granting and approving of loans which are outside the lending limits, authorities or other parameters defined by the commercial lending policy and supporting underwriting criteria, or considered to be out of order.

This section should include the:

- process for obtaining the approval;
- documentation requirements of the Board for approval;
- requirement that the loans be regularly monitored by management;
- nature, content and frequency of Board reporting; and
- requirement that all post funding exceptions to policy require Board (or where appropriate, Credit Committee) approval.

15. WATCH LIST ACCOUNTS

This section identifies the criteria and limits for placing a loan on the watch list. These limits should reflect the level of risk appetite and risk tolerance of the credit union.

Specifically, this section should address the:

- situation or status that qualifies a loan to be placed on the watch list, which should include:
  - deteriorating or lack of current financial information;
  - covenant breaches (e.g., earnings shortfall or losses);
  - potential security shortfalls (e.g., asset sale, loss or damage, fraud);
  - potential debt service shortfalls (e.g., significant revenue decline); and
  - significant adverse developments (e.g., restructuring, unexpected management departures, loss of major customer, legal action, etc., labour dispute/strike, new competition).
- requirement for approvals to place loans on the watch list;
- content of monitoring reports including corrective action to bring the loan on side;
- responsibility for reporting; and
- nature, content and frequency of Board reporting.

16. DELINQUENT AND IMPAIRED LOANS

This section should set out the requirements to establish procedures to actively manage delinquent and impaired loans with the objective of avoiding loss or mitigating the risk.

This section should specify the:

- characteristics that define a delinquent or impaired loan (timing of last contractual payment, credit deterioration and other factors the credit union deems important);
- responsibilities of management for monitoring and collecting impaired loans;
- requirements and authorization for loan provisions; and
- nature, content and frequency of the Board reporting.

17. RE-WRITTEN/RESTRUCTURED COMMERCIAL LOANS

In exceptional circumstances, commercial loans may be re-written to allow the borrower to continue to service the loan. This may include changing of one or more of the conditions of the loan.

This section of the policy should include the:

- definition of a rewritten or restructured loan;
- criteria under which a loan can be re-written or restructured;
- authorities required to approve the loan;
- requirement by management to monitor and follow-up on these loans;
- nature, content and frequency of Board reporting; and

- criteria under which provisions for loss can be removed for rewritten or restructured loans.

18. WRITE-OFFS

The purpose of write-offs is to recognize the diminished or reduced value of a loan once it is deemed to be uncollectible in whole or part.

This section should specify the:

- conditions under which a loan will be wholly or partially written off;
- write-off authority and approval levels; and
- nature, content and frequency of Board reporting.

19. REPORTING

Comprehensive, timely and accurate reporting is important to allow the Board to fulfill its oversight responsibilities and ensure that:

- the level of risk taken by the credit union is in keeping with the established risk appetite;
- sufficient due diligence is taking place over monitoring and managing loan delinquency; and
- the growth and composition of the loan portfolio is in keeping with the institution's strategic plan.

This section of the policy should indicate the:

- requirement for management to report the performance of the commercial loan portfolio to the Board, on both an individual loan and portfolio basis;
- nature and content of reports required by the Board; and
- frequency of each required report.

20. POLICY APPROVAL AND REVIEW

Policies are reviewed to ensure they appropriately reflect changes in the operations of the credit union, the Act, Regulation, DICO By-Laws or the credit union's by-laws.

This section would identify the:

- requirement of the Board (and management) to conduct policy reviews;
- role of Board and management in updating and reviewing policies;
- frequency of policy reviews;
- additional conditions that might trigger a policy review;
- required analysis and impact on risk exposure of any material changes to policy; and
- requirement for Board approval for changes to policies.