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Deposit Insurance
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Guidance Note:
Lending

This guidance note is for use by all credit unions. It outlines the basic elements that will be considered in assessing the effectiveness of the credit risk management framework and will be used by DICO to assess whether a credit union is managing its credit risk in a prudent manner. This document also provides information on critical lending areas and additional reporting requirements to assist DICO in monitoring selected credit risk management activities. The Board of directors of a credit union is required to establish, and the credit union is required to adhere to, lending policies, standards and procedures that a reasonable and prudent person would apply to avoid undue risk of loss and obtain a reasonable return in respect of the credit union's portfolio of loans.

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A credit union may make loans for any loan category as authorized in its by-laws and lending policies subject to the limits and restrictions in the Act and Regulation.

Policy

Each credit union is required to establish and implement prudent lending limits. These policies should consider:

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

At a minimum, lending policies must address:

- Each class of loan authorized by the credit union's by-laws;
- Authorized credit instruments;
- Major lending criteria including:
    - permitted loan types;
    - acceptable loan purposes;
    - maximum loan limits and repayment terms;
    - acceptable types and lending values of tangible security;
    - credit evaluation and documentation standards (underwriting)
    - approval processes;
    - monitoring, evaluating and reporting of outstanding advances, undrawn commitments and any irregular loans;
- Limits or prohibitions on credit exposures including concentration risk and syndicated loans; and
- Lender approval limits.

The credit union's credit policy must address minimum competency and experience requirements for delegation of a lending authority to an employee.

Each credit union is required to have written internal procedures outlining how lending policies will be implemented and monitored. Credit unions should ensure that the policies are implemented by persons who have the appropriate level of expertise. These procedures should address exposures arising from both on-balance sheet and off-balance sheet credit items and should also:

- identify responsibilities and accountabilities;
- set out the process for recommending, approving, and implementing decisions; and

- prescribe the frequency and format of reporting.

Aggregate Lending Limits

The maximum aggregate lending limit to a person or connected person for a credit union as outlined in the Regulation section 58 (2) is 25% of regulatory capital for all loans, excluding the portion of the loans that are insured or guaranteed as described in 58 (5) of the Regulation:

For the purpose of this section, the total amount of all outstanding loans made by a credit union to a person and any connected persons excludes the portion, if any, of a loan that,

(a) is insured under the National Housing Act (Canada) or by an insurer licensed to undertake mortgage insurance;

(b) is guaranteed by:

- *i. a federal, provincial or territorial government of Canada,*
- *ii. an agent of a government described in subsection (i), or*
- *iii. The Corporation, or*

(c) is secured by deposits of the borrower with the credit union.

Aggregate lending limits are based on the amount of regulatory capital held by the credit union. For the purposes of determining aggregate lending limits, regulatory capital is the amount as stated in the credit union's ***most recent audited financial statements.***

Special aggregate loan limits exist for credit unions who have less than $50 million in total assets for the issuance of bridge and residential mortgage loans that are uninsured. As outlined in section 58 (7) of the Regulation:

1. *The credit union may make a bridge loan or a residential mortgage loan if,*
   - *i. the credit union's total assets, as set out in the audited financial statements of the credit union that were placed before its members at the most recent annual meeting, are described in a row in Column 1 of the Table to this section, and*
   - *ii. as a result of making the loan, the total amount of all outstanding loans made by the credit union to the person and any connected persons would not exceed the amount of the total lending limit set out in the same row of Column 2 of the Table:*

Table 1: Lending Limits to a Person or Connected Persons

Row	Total Assets	Lending Limit
1	Less than $500,000	Greater of 100% of regulatory capital and $60,000
2	$500,000 or more but less than $1 million	Greater of 100% of regulatory capital and $100,000
3	$1 million or more but less than $2 million	Greater of 80% of regulatory capital and $125,000
4	$2 million or more but less than $3 million	Greater of 80% of regulatory capital and $155,000
5	$3 million or more but less than $5 million	Greater of 70% or regulatory capital and $185,000
6	$5 million or more but less than $10 million	Greater of 60% of regulatory capital and $235,000
7	$10 million or more but less than $20 million	Greater of 50% of regulatory capital and $295,000
8	$20 million or more but less than $30 million	Greater of 40% of regulatory capital and $345,000
9	$30 million or more but less than $50 million	Greater of 30% of regulatory capital and $400,000
10	Greater than $50 million	25% of regulatory capital

EXAMPLE:

A credit union has $32 million in total assets and $1.5 million in regulatory capital. The regulatory limits for connected persons for this credit union are:

1. Regulatory Limit *excluding* uninsured residential mortgages is calculated as: 25% of regulatory capital or **25% x $1.5 million = $375,000**

2. Regulatory Limit *including* uninsured residential mortgages is calculated as: 30% of regulatory capital or **30% x $1.5 million = $450,000**

Illustrated below are two examples loan scenarios that would meet the regulatory limits for connected persons for this credit union.

Scenario 1:

The credit union has the following loans that are related to a connected person:

Total Residential Mortgages (uninsured)	*$400,000*
Personal Loans	*40,000*
Total Loans	*$440,000*
Total Loans included in the aggregate limit	*$440,000*
The total loans to the connected persons above is less than the credit union's aggregate connected persons maximum regulatory limit of $450,000. The $40,000 personal loan is less than the 25% limit of regulatory capital (or $375,000 for this credit union) for all connected loans excluding uninsured bridge and residential mortgage loans.	

Scenario 2:

The credit union has the following loans that are related to a connected person:

Residential Mortgage (insured)	*$720,000*
Residential Mortgage (uninsured)	*240,000*
Commercial Loans	*150,000*
Personal Loans	*50,000*
Total Loans	*$1,160,000*
Total Loans included in the aggregate limit	*$440,000*
The insured residential mortgage would be excluded when calculating the aggregate lending limit for this scenario. The $150,000 commercial loan and the $50,000 personal loan combined ($200,000) is less than the 25% limit of regulatory capital (or $375,000 for this credit union) for all connected loans excluding uninsured bridge and residential mortgage loans.	

Illustrated below is a loan scenario that would NOT meet the regulatory limits for connected persons for a credit union with $32 million in total assets and $1.5 million in regulatory capital.

The credit union has the following loans that are related to a connected person:

Residential Mortgage (uninsured)	*$65,000*
Commercial Loans	*380,000*
Total Loans	*$445,000*
Although the total loans are less than the maximum regulatory limit of $450,000 (as calculated from the Table), the commercial loans of $380,000 represents more than the 25% limit of regulatory capital (or $375,000 for this credit union) for all connected loans excluding uninsured bridge and residential mortgage loans.	

Connected Persons and Related Parties

The definition of a “connected person” is outlined in section 67 of the Regulation. Credit unions are required to establish a process to monitor loans to connected persons.

A connected person includes:

- a person who provides security (including a guarantee) to the credit union for a loan to a borrower;
- a spouse of a borrower who is financially dependent on the borrower; and
- a relative of the borrower or of the borrower’s spouse who lives in the same home as the borrower and who is financially dependent on the borrower or the borrower’s spouse.

In addition to the definition of a connected person outlined in section 67 of the Regulation, credit unions should also consider the following when establishing prudent lending limits and adherence to maximum regulatory single and aggregate lending limits.

A *connection generally* exists where two or more entities are 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.

Lending Values of Security

The credit union's credit policy must address maximum lending values for each type and/or category of acceptable tangible security. While wage assignments can be a useful collection tool, they are not tangible security and hence they have no lending value for purposes of compliance with the credit union's by-laws and lending policy.

The lending value of tangible security is likely to vary according to the type or category of the security. For example, a credit union may establish the lending value of a new vehicle at 100% of its original purchase price. However, for used vehicles, the lending value may be only 90% of its wholesale value established through an appropriate third-party reference source (e.g. black book) and may be less for older vehicles, especially a vehicle more than ten years old.

Likewise, while the lending value of government savings bonds may be 100%, it is not likely to exceed 50% for stocks and other marketable investments where valuations are subject to significant fluctuations over time. In all cases, the lending value of any security cannot exceed 100% of its market or fair value. Where a loan exceeds the lending value of any security, the "excess" amount is treated as an "unsecured" loan and subject to unsecured lending limits.

For residential mortgages, the lending value cannot exceed 80% of the property value when the loan is given unless the loan is insured. Credit unions should outline the process or acceptable reference sources to determine market values for security. For example, "Black Book" values may be acceptable as the source for automobiles while qualified real estate appraisers should be used to provide appraisal values for residential property.

Guarantees

A personal guarantee is considered "supplemental" security and has no security value unless it is supported by tangible security such as a collateral mortgage on property or pledge of other assets.

Repayment Terms

Repayment terms should at a minimum, match the anticipated reduction in the market value of any security that is expected to depreciate over time. This is particularly important for loans secured by used vehicles including recreational vehicles. Credit unions should establish separate maximum terms for used vehicles based on the age of the vehicle.

Loan Deferment/Extension

Where a lending policy contains a provision to defer repayment of a loan during a strike, the loan should be up to date at the time. When the strike ends, the loan should be re-written if the strike exceeds 6 months duration.

Where a lending policy contains a provision for a loan extension, this should be limited to a one-month extension in any twelve-month period and a maximum three-month extension during the entire term of the loan.

Prudent Lender Approval Limits

While maximum lending limits are outlined in the Regulation for each authorized loan type, credit unions should establish specific limits and lending criteria for various loan products, especially for personal loans.

For example, while under-secured/unsecured lending is allowed, different approval levels should be required for larger amounts or which exceed specified criteria. Large exposures to under-secured/unsecured lending should require joint approval of senior management or the Board.

Loan Pricing

Interest rates on loan should reflect the risk involved. Higher risk loans, including under-secured and unsecured loans should have higher interest rates than loans that are fully secured. Likewise, loans to established borrowers with good repayment history and credit worthiness would likely have lower interest rates than loans with similar characteristics to new borrowers or those with higher risk profiles. Also, different classes of security may often warrant different levels of interest rates. Interest rates for loans secured personal use vehicles should generally be lower than those for loans secured be recreational vehicles where valuations have a tendency for higher fluctuations.

Credit Evaluation

Many credit unions have incorporated credit scoring and risk rating tools into their credit evaluation/administration processes. Apart from helping with managing credit concentration exposures, these tools are also often used for pricing decisions.

Credit scoring tools are typically used for lower risk personal loans while risk rating tools are more often used for larger, higher risk commercial, agricultural and large value personal loans where credit scoring is not appropriate. Credit unions are strongly encouraged to consider incorporating a credit scoring system into their credit evaluation processes for personal and residential mortgage loans.

Risk Ratings

Credit unions are expected to employ a risk rating system for all loans other than personal and residential mortgage loans. Risk rating involves the categorization of each loan into one of a series of graduated categories of increasing risk. Risk ratings should be established:

- at the time of application for all new or increased loan facilities;
- as part of the annual review process; and
- at any time when new information or developments may materially affect the credit risk of the loan.

Board policy should optimally set the maximum amount of loans permitted for each risk class and an aggregate maximum portfolio weighted average comprehensive risk rating. The extent of gradation (number of categories) of a risk rating system should be reflective of the size and complexity of the credit union's commercial and agricultural loan portfolio.

A risk rating system incorporating six rating categories was developed by an industry working group ("Working Group") in 2005 and is outlined in the DICO Sound Business and Financial Practices Reference Manual. The Working Group also developed sample risk rating tools that have been made available on DICO's website.

Table 2: Risk Ratings

Risk Rating Model			
Risk Rating		Summary of Likely Attributes	
1	Undoubted	Virtually no risk Government borrower	Full cash security Strongly capitalized Outstanding management
2	Low	Minimal risk of any loss Strong security/ capitalization position	Excellent financial history/trends Strong management Stable/strong industry
3	Moderate	Good security margin/LTV Demonstrable debt service capacity	Sound management Steady financial trends Moderate capital level
4	Cautionary (Watch List)	Deteriorating/lack of financials Covenant breaches	Potential security shortfalls Potential debt service shortfalls Significant adverse developments
5	Unsatisfactory	Need for immediate action indicated Security shortfall/capital crisis	Cessation of operations Adverse management change Interest/principle arrears
6	Unacceptable	Receivership or bankruptcy Definite loss evident	Disappearing assets/security Fraud

Watch List

Credit unions are expected to implement a “watch list” process as part of their credit administration process. A loan should be placed on the watch list when it is assigned a “cautionary” risk rating. A watch list helps to identify loans which, if not closely monitored/ managed, may develop into a loss to the credit union. Credits are placed on the Watch List as a result of the loan review process or in situations where there is evidence of increasing risk, such as:

- deteriorating financial trends or information;
- potential security shortfalls; and
- significant adverse developments.

Board policy should establish the process for reporting and managing watch list accounts. This process should address the materiality or size of loan to be reported, the information to be reported and escalation procedures.

Implementation of an effective Watch List procedure was recommended by the 2005 Working Group and is outlined in the Reference Manual. Sample reporting tools are available on DICO’s website. DICO will review and evaluate the effectiveness of each credit union’s credit monitoring and management practices under its risk assessments programs.

Large Exposures

Apart from establishing general lending limits for authorized credit instruments etc., policy should also address large exposures, other than residential mortgage loans. This should include:

- setting limits for large exposures, including loans to connected persons and related parties, restricted parties and syndicated loans;
- setting aggregate limits for large exposures;
- establishing the frequency and extent for monitoring large exposures; and
- reporting requirements.

Limits for large exposures should recognize the impact impairment or non-payment may have on the credit union’s earnings and capital. Setting limits too high may not provide for sufficient monitoring of higher value loans while setting limits too low may result in excessive and often unnecessary additional monitoring routines. 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 normal member loan demand. 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. Full details of the status and condition of large exposures should be reported separately to the Board.

Credit unions are also encouraged to consider employing an "Out of Order" reporting system which reports all loans that are not in full compliance with the terms of the credit facility. Examples of non-compliance include overdue reports/statements from the borrower, expired fire insurance, unperfected security, overdue annual review, etc.

Syndicated Loans

Under a syndicated loan agreement, each of the parties agrees to contribute a portion of the loan amount that is being provided by the syndicating credit union. The syndicating credit union, undertakes to underwrite, disburse and administer the loan(s) on behalf of all credit unions in the syndicate. This involves conducting appropriate credit risk evaluation, arranging for appropriate security and monitoring and reporting performance and repayment in accordance with the agreed terms and conditions.

The syndicating credit union is also responsible to provide on-going information on the status of the loan to the participating credit unions as required. Notwithstanding that the syndicating credit union undertakes the credit risk evaluation and on-going monitoring and administration of the loan on behalf of all parties, DICO expects that ALL participating credit unions in the syndicate will 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, etc. where appropriate. Status reports to the Board should also be required as with any other credit facility granted by the credit union.

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.

Industry Concentration Risk

Credit policy must address industry concentration for commercial and agricultural loans. At a minimum, it is recommended that the credit union will:

- classify all commercial and agricultural loans by industry category;
- establish concentration limits for each primary industry category;
- establish concentration limits for certain industry sub groups where deemed appropriate (e.g. agriculture, real estate, construction);
- measure and monitor concentration risk on an ongoing basis; and
- review industry concentrations at least quarterly.

DICO expects the credit union to classify and report their commercial and agricultural loans using the North American Industry Code Standards (NAICS). Additional NAICS codes are available for use where required internally and where further classification is appropriate.

Credit unions are required to report summary information on industry concentration using the NAICS primary categories in their monthly information return filing.

Personal Loans

A personal loan is a loan to one or more individuals, other than a residential mortgage loan or bridge loan, where the source of repayment is to a large extent, from personal income. Personal income, for the most part, includes salary or wages (including self employment income), or investment income. The regulation also permit a credit union to classify any loan that does not exceed $25,000 as a personal loan. This includes loans that may otherwise be classified as a commercial or agricultural by reason of its purpose or source of repayment.

Residential Mortgage Loans

A residential mortgage loan is a loan to one or more individuals secured by a mortgage on a residential property where:

- the residential property is owned and occupied by the borrower; and
- the amount of the loan together with all prior encumbrances does not exceed 80% of appraised value at the date the loan is approved unless the mortgage is insured; and
- repayment of the loan is based on scheduled terms and conditions incorporated into the mortgage document which is registered against the title to the property (conventional mortgage) OR the debt (e.g. promissory note, line of credit agreement, etc.) is secured by a mortgage charge which is registered against the title to the property (collateral mortgage).

Residential property is either an individual condominium residential unit or a building with one to four units where at least one half of the floor area of the building is utilized as one or more private residential dwellings. In most cases, the appraised value will be determined by a designated qualified appraiser. If the credit union proposes to grant residential mortgage loans against the security of seasonal residences (such as cottage properties) lending policies should specifically address loan and approval criteria for this type of lending.

Residential Mortgage Loans - Uninsured

A residential mortgage loan that is not insured includes conventional mortgages and collateral mortgages.

Residential Mortgage Loans - Insured

A residential mortgage loan that is guaranteed by a government agency or insured by an insurer approved by the Superintendent is insured. Although these mortgage loans are insured, the credit union is expected to establish and monitor appropriate procedures to ensure that the loan fully meets the conditions of mortgage insurance protection.

Lending Limits: There is no regulatory lending limit for residential mortgage loans that are insured. Credit unions are expected to establish appropriate limits as necessary.

Other Collateral Mortgage Loans – Residential Property

Nothing in the Act or the Regulation prohibits a credit union from taking collateral mortgage security that exceeds 80% of the value of the residential property. However, any collateral mortgage charge, together with all prior charges, that exceeds 80% of the value the residential property will have no lending or security value. In these cases, loan amounts in excess of 80% of value of the residential property at the date the loan is granted will be treated as under-secured.

Investment and Rental Properties

A loan to one or more individuals for the purchase of a residential investment or rental property will be treated as a residential mortgage loan where the property to be purchased is considered a residential dwelling and is occupied by the borrower. Loans that do not meet these criteria will be treated as commercial loans.

Bridge Loans

A bridge loan is a loan for the purchase of a residential property in which the purchaser will reside. Bridge loans are used to facilitate the purchase of a residential property pending receipt of funds from the sale of a residential property by the same person, subject to the following general conditions:

- The term of the loan cannot exceed 120 days;
- The funds from the sale of another residential property owned by the individual will be used to repay the loan;
- The credit union must receive a copy of the executed purchase and sale agreement for both properties before the loan is made;
- The conditions of each of the purchase and sale agreements must be satisfied before the loan is made; and
- The loan is fully secured by a mortgage on the residential property being sold or, before the loan is made, the borrower’s solicitor has given the credit union written confirmation that he is in receipt of an irrevocable letter of direction from the borrower stating that the funds from the sale of the residential property being sold will be remitted to the credit union.

Loans to Unincorporated Associations and Organizations

An unincorporated association is generally defined as an entity that does not have separate legal recognition from the principals or group of individuals which have combined for some common purpose. These associations typically include hobby or sports clubs that operate on a “not for profit” basis.

Where this type of lending is provided, credit unions must have policies that address lending criteria and approval limits.

As part of the lending process, credit unions are expected to:

- Obtain individual loan applications from each member/officer;
- Conduct a credit evaluation of members/officers (as required for loans to individuals);
- Obtain personal guarantees by the members/officers;
- Obtain tangible security to support personal guarantees where appropriate; and
- Conduct annual reviews of loan terms and conditions.

Institutional Loans

An institutional loan is generally any loan given to a government or government agency, a municipality, school Board or entity funded primarily by a government or government agency such as hospitals, etc.

Where this type of lending is provided, credit unions must have policies that address lending criteria and approval limits. As part of the lending process, credit unions are expected to:

- Conduct an adequate analysis of audited financial statements, including the Balance Sheet and Income Statement (and Changes in Financial Position);
- Obtain a copy of the resolutions from the Board of directors of the institution regarding signing authorities and borrowing powers;
- Obtain a copy of the institution's By-laws (to confirm that the institution is authorized to borrow, and the proposed borrowing is in compliance with its by-laws);
- Obtain a guarantee by the appropriate level of government for the institution where warranted;
- Conduct annual reviews and renewals as appropriate; and
- Provide quarterly reports to the Board on the status of each loan.

Loan Reports

As outlined in DICO By-law No. 5, credit unions are required to monitor the level of unsecured and under-secured lending. Credit unions should establish limits on the amount of unsecured lending. At a minimum, reports to the Board on all new loans should include the following information:

- Loan amount;
- Security;
- Lending value;
- Under-secured portion (if any); and

- Aggregate amount of all personal loans made (year to date) in dollars and the aggregate amount of the amount of under-secured/unsecured lending (year to date) in dollars and as a percentage of total personal loans.