Commercial Lending Activities

Prepared by: Frank Chong, Samantha Lundy, and Shirley-Anne Blackadder

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Stabilization Central
CREDIT UNION

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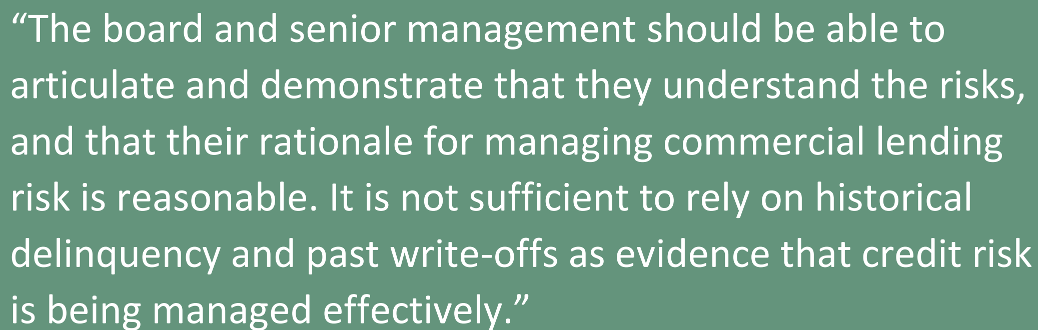

Background

Commercial lending has become a significant business activity for credit unions across BC and Canada. Credit unions have steadily established themselves as key contributors[1] to small and medium businesses across a variety of sectors in both rural and urban regions. According to available data[2], commercial loan portfolios account for approximately 32% of total loans for the BC credit union system; and this is expected to rise in the future. The historically low-interest rate environment has put pressure on financial margins; coupled with commoditization and competition in the retail lending space, this has resulted in credit unions turning to commercial lending as a way to improve revenues and diversification. Further, commercial lending is a key strategy for many credit unions to make a difference in the communities they serve by supporting local businesses.

Commercial lending is a broad term that can encompass several different areas, including broad segments such as commercial loans, mortgages, and lines of credit. There is also specialized commercial lending for construction, equipment financing, business start-up, and non-profit organizations. Credit unions have also pursued loan syndications to partner with other lenders on commercial loans as a way to serve members with larger borrowing needs or to participate while not having to assume the entire risk of these complex deals. It is clear to any credit union that there are numerous opportunities to explore and pursue. This has inevitably drawn increased attention from regulators in their efforts to assess whether credit unions have the capability and capacity to manage the risks associated with commercial lending activities.

As part of its Lessons Learned series, Stabilization Central Credit Union (“Stabilization Central”) herein explores the common regulatory issues associated with commercial lending. By building upon decades of direct experience, Stabilization Central shares some of the common reasons why credit unions have ended up staged or restricted by the regulator during their commercial lending journey. The decision to pursue and prioritize commercial lending activities is up to credit unions and their leadership team, and Stabilization Central is here to provide advisory support so credit unions can be proactive in their risk management and governance practices in this area.

Why are regulators paying attention to credit unions and their commercial lending activities?

The simple answer is that commercial lending is inherently riskier relative to retail lending, despite how credit unions may be managing their risks. This means that a commercial loan can lead to greater potential for financial losses that can impair regulatory capital and put credit unions at higher risk of insolvency. For some credit unions, a troubled commercial loan could amount to a large proportion of their capital base and create situations where they might contravene internal or regulatory capital requirements. For others, growth in the commercial loan portfolio can reveal weaknesses in areas such as underwriting, monitoring, reporting, and board oversight. Commercial lending can represent an opportunity, but expertise is needed in underwriting and originating loans as well as reporting, managing, and understanding emerging issues.

[1] According to the Canadian Credit Union Association **2020–2021 Community & Economic Impact Report**.
[2] BCFSA Regulatory Filings for BC Authorized Credit Unions as of June30, 2022.

Most regulators have some form of regulatory guidance or assessment criteria on commercial loan activities. As an example, the regulator in BC has documented its standard criteria, [3]outlining how it assesses the riskiness of a credit union's commercial lending activities and the core areas it examines. Other provinces have similar assessment criteria [4]and can serve as helpful resources. In many ways, these criteria constitute a "checklist" and should form the basis for benchmarking in relation to regulatory expectations.

In addition to the assessment criteria used by regulators, Stabilization Central has compiled a list of tips to avoid or reduce regulatory complications associated with commercial lending activities.

Board Oversight of Commercial Lending

Issue: Ineffective board governance over commercial lending activities

As the Board is critical in setting a credit union's strategy and risk appetite, it is vital that the management team bring the Board along the journey of the credit union's commercial lending activities.

The Board and management should know the reasoning behind the credit union's desire to grow its commercial portfolio. Specifically, the Board should be able to articulate how this will align with the strategic plan as well as the credit risk appetite and how capital has been set aside to support the commercial lending line of business.

Credit union management teams need to be providing regular, established reporting on commercial lending activities to ensure the Board, by way of the Investment and Lending Committee (ILC), understands the level of risk being taken and how management is managing the risk within the credit union's risk appetite. Reporting should be aggregated at the portfolio level, incorporating historical trends to enable the Board's oversight and understanding. Too much detail can make it difficult for the Board to tease out critical risks. It is not necessary for the Board to delve into detailed operational procedures; instead, its members need to understand, at a portfolio level, commercial lending risks and trends.

The Board should be regularly updating its training and development in the area of commercial lending so that it can provide effective oversight. The regulator will seek documentation of Board and ILC discussions to demonstrate effective challenge by asking questions on management assumptions and risks associated with the commercial loan portfolio. The regulator wants to ensure that the Board has a grasp of the risk at the credit union in relation to its commercial lending activities. If the ILC does not have sufficient commercial lending experience, it should seek out and hire an expert contractor who can act as an independent resource for the ILC and the Board. As an example, the Board could engage an independent consultant or advisor if the credit union is exploring a new strategy or riskier form of commercial lending. Ongoing director education programs are also helpful in improving the level of credit expertise on the Board.

Internal Audit – Commercial Lending

Issue: Insufficient frequency and/or scope of internal audits of commercial lending operations

[3] Commercial Lending Assessment Criteria | BCFSA

[4] Commercial-Lending-Criteria-2017-06.pdf (cudgc.sk.ca)

Credit unions should consider the frequency and scope of internal audits of their commercial lending operations. Regulators will examine the audit planning process and assess whether the frequency and scope of audits are commensurate with the significance of the commercial lending activities. The credit union's Audit Committee can be proactive by assessing whether the scope and frequency of internal audits is commensurate with the significance of the commercial lending operations (i.e., risk-based audit plans with the scope and objectives validated by the Management Risk Committee and the Audit and Risk Committee).

As part of a credit union's internal audit universe, commercial lending audits should be conducted regularly (if possible, on an annual basis in larger or riskier portfolios) to stay aligned with regulatory shifts and maintain industry best practices. Any internal audit findings in the commercial audit should be followed through an audit tracking document and signed off by management when each finding has been remediated. This report is then provided back to the third line of defense, who will validate the finding's completion.

Commercial Lending Expertise and Succession Planning

Issue: Lack of commercial lending expertise, resulting in inadequate risk management

The complexity of commercial lending requires unique skills and experience that are sought after in the industry. The credit union should have expertise in originating and underwriting commercial loans and in conducting post-loan reviews, as well as monitoring, controlling, and managing risk at the portfolio level. It is critical for a credit union to develop succession plans and a pipeline of talent for its commercial lending areas to ensure that if one or more people leave the organization, cross-training has been undertaken to address any gaps. Specifically, succession plans should be developed for the most senior commercial lending roles within the organization to ensure a documented mitigation strategy is in place for any unplanned departures. Pending permanently filling positions, the credit union can consider engaging individual consultants or making arrangements with a third-party organization. Recruitment for commercial lending skillsets is competitive, so it can take time to fill these critical positions. The regulator looks at the expertise of credit unions' commercial lending teams to ensure the requisite skills and expertise to conduct this kind of lending are in place.

Segregation of Duties

Issue: Inadvertently incentivizing staff to take on unacceptable levels of risk

Credit unions, often larger ones, frequently have senior positions responsible for credit adjudication. It is very common for regulators to look at whether such positions are also involved with business development. Regulators [5]insist that positions combining credit adjudication with business development accountabilities can create independence and potential conflicts of interest. In particular, regulators are concerned that positions with delegated lending authority could be incentivized through sales, growth, or similar targets. Credit unions with such combined accountabilities should consider

[5] Regulators in British Columbia are expecting to release a guideline later in 2022. Credit unions should start considering organizational implications sooner rather than later, as often there are significant change management challenges to overcome.

implementing controls or ways to remove/minimize conflicts of interest between the loan origination and underwriting functions. Possible solutions include one or a combination of segregating some or all decision making (e.g., Senior management roles), implementing post-loan reviews, removing growth targets from lenders, and adjusting incentive plans.

Data Quality and Portfolio Analysis

Issue: Insufficient understanding of the risk within the commercial loan portfolio and any segments that may represent a higher risk

Credit unions with commercial lending business should focus on their data availability and quality. This involves being able to gather, extract, and report on commercial loan data at a portfolio level. Credit unions should be able to aggregate information at the portfolio level to identify trends and highlight segments of the loan portfolio that are at higher risk or trending unfavourably. Regulators often examine a credit union's ability to monitor the entire portfolio at the Board and senior management level, not just the individual loan level.

It is very common for regulators to request that credit unions build metrics and trends for leading or forward-looking' risk metrics that are easily reportable. These forward-looking metrics can be as simple as debt-to-equity ratios, current ratios, loan-to-value or debt-service coverage ratios, industry trends, average distribution of risk ratings and credit expiry levels. Combining these metrics into layers helps identify, monitor, and develop actions to address segments that may be disproportionately impacted by future adverse events. For example, loans with high loan-to-value and weaker debt-servicing ratios may be at heightened risk in a rising interest rate environment.

Portfolio analysis can be a real challenge for credit unions if the data is not easily extracted from a database or if data gaps exist. Data quality is equally important since inaccurate data can potentially distort management's understanding of the risk. At a minimum credit union should be able to extract credit exposure to different industries. Credit unions can consider making data quality a metric to encourage improved data quality. For larger credit unions, effective data collection may not be achievable with manual origination processes; these credit unions should consider moving to a loan origination system to automate data collection and reporting. By addressing fundamental data issues, credit unions become better positioned to build metrics and reports that help monitor the risks of the entire commercial loan portfolio.

Commercial Loan Underwriting

Issue: Lack of appropriate credit risk assessment and analysis

Regulators will sample loan files and evaluate the commercial underwriting within a credit union. Complications can be avoided by considering the following points within commercial lending guidelines and practices.

Credit Unions should:

- Document the analysis of the borrower's financial statements and debt serviceability
- Provide and document the analysis and understanding of construction projects, which includes marketability, absorption rates, break-even analysis, and repayment timelines
- Assess the borrower's ability to cover financing costs from outside sources or carry the loan for an extended period on construction loans, raw land loans, or land assembly loans where there is a

reliance on interest reserves. An assessment of interest reserves where appropriate.

- Ensure clarity around when a second opinion is required for commercial loans over a certain threshold or level of complexity
- Understand the stability of cash flow that will support servicing of the loan on rental buildings by undertaking due diligence with respect to details such as type of tenant, lease terms, credit history, and vacancy rates
- Ensure that commitment letters have fully incorporated the loan covenants and that terms and conditions have been documented and communicated to borrowers
- Ensure commitment letters are signed correctly, and any material changes are reviewed by the credit union's solicitors
- Ensure financial covenants are included in the commitment letters. Calculate ratios (such as debt-service coverage) correctly so that results are not an overstatement. Credit unions should have documented procedures for staff on financial on ratio calculations. Avoid handwritten calculations
- Evidence analysis of appraisal documents that show reasonableness based on comparable properties and adjustments that were made to determine the final value
- Review and update, at least annually, the training plans and budgets for staff involved in commercial lending activities
- Undertake a site registry search on the subject property and surrounding properties to determine whether there are any environmental issues that may result in additional project costs
- Determine when to undertake a site visit, or when other options are sufficient
- Check for arrears owing to tax or legal matters
- Implement controls on disbursements and ensure the borrower meets conditions for funding (e.g., timelines and budget)

Credit Unions should not:

- Rely too much on personal guarantees or lower loan-to-value ratios. Regulators will look for the fundamentals of credit analysis (the 5Cs of credit: character, capacity, capital, collateral, and conditions).
- Underestimate the need for an exit strategy on land development and construction loans. The concern is that higher-risk commercial loans only generate cash flow and repayment through sale or refinancing. An exit strategy should identify an alternate course of action to repay the loan should the development plan not proceed as anticipated.

At the policy level, the credit union should ensure that the minimum debt-service coverage) is either in line with industry peers or can be explained with regards to the credit union's differentiation, targeted commercial members, and risk appetite. The credit union should be able to document their rationale and thought process in determining their overall approach to lending and in determining key lending criteria. Policy and management limits should ensure that a commercial loan does not create a significantly large exposure relative to the credit union's capital.

Commercial Loans – Post Loan Reviews

Issue: Commercial loans are not underwritten according to policies and procedures.

While internal audit has a role to play in conducting compliance reviews for commercial lending, it does not replace the need for post-loan reviews. It is imperative that credit unions regularly conduct post-loan reviews to assess underwriting quality, identify negative trends, and provide appropriate guidance to the sales and credit teams. Credit unions should have risk-based processes in place, ensuring that higher-risk and complex loans underwritten are included. Post-loan review requirements should be documented in their commercial lending guidelines, with, at minimum, regular reporting to management on themes, risks, and areas of improvement. In addition to the credit quality audit, credit unions should also include audits of loan documentation quality and compliance.

Post-loan reviews are considered part of the second line of defense, from a risk perspective. As such, these reviews should not be conducted by the lending team but rather by someone from the risk department to ensure the proper segregation of duties. If this option is not available, the post-loan review can be formally reported to the Chief Risk Officer (or equivalent in your credit union) to ensure there is independence from the lending team.

Commercial Loans – Annual Reviews[6]

Issue: Risk is not accurately reported for the commercial loan portfolio.

Regulators pay attention to whether the credit union carries out regular annual reviews of its commercial loans to assess the current credit risk of the borrowers and guarantors. This includes the credit union providing evidence that it has analyzed the borrower's financial statement.

Regulators carefully scrutinize whether credit unions are classifying the risk of loans appropriately. Regulators may indicate certain loans should be given a higher risk rating, which could have a bearing on regulatory capital or accounting requirements. At a minimum, credit unions should have a process to undertake consistent and documented annual reviews of the loans that make up their commercial portfolio. As a baseline regulators will look for annual touchpoints on financial covenants and annual risk rating updates. Credit unions can decide to undertake this using a tiered or risk-based approach; either way, the method should be very clearly documented ahead of time.

The timing of annual reviews should not be based on the anniversary date of the loan (the funding date). Credit unions should establish a key risk indicator around annual reviews to ensure an escalation process is in place if certain percentage thresholds for the number of annual reviews outstanding are breached.

Syndicated Lending

Issues: Insufficient understanding of the additional risks associated with syndicated lending, and an overreliance on the underwriting and analysis conducted by the lead lender.

Syndicated lending can present additional risk to a participating credit union relative to conventional commercial loans:

- absence of direct member relationships
- absence of onsite visits, and reliance on third parties, such as consultants, who are typically engaged by the lead financial institution and are not known to the participating credit union
- reliance on the lead to manage the risk associated with the loan, including collection activities and regular reviews

[6] As an example, refer to CU-2010 – 01 in British Columbia.

Credit unions seeking to participate in syndicated loans should think about how best to undertake due diligence for each transaction. As part of reviewing loan files, regulators comment on credit unions that summarize and rely on the lead lender's write-up. Each credit union should determine ways to conduct its own due diligence with respect to syndicated loans, so it clearly conforms to its own policies and risk appetite. At a minimum, credit unions should have procedures that relate to their due diligence, which could include:

- use of consultants (for example, appraisers, quantity surveyors, environmental assessors)
- reviews of project budgets and financial projections on profitability to ensure there are appropriate buffers to absorb price and cost fluctuations. This may include evidencing analysis of appraisals, comparable projections on similar projections, or capitalization rates.
- when to seek a second opinion on large or complex loans
- when to implement onsite visits
- an exit or workout plan to address distressed loans

- regularly assessing their partners' risk appetite, market knowledge, underwriting expertise, and other key factors

Credit unions should ensure they are able to conduct business in the geographic region where the loan is occurring. For example, if BC credit unions are not licensed or authorized to operate in the province of Ontario, they should not participate in syndicated loans in the Ontario markets. When it comes to syndicated loans, the credit union needs to have a sound understanding of the geographic region and market it participates in, even if it is not the lead lender.

Regulators generally view syndicated loans as higher risk due to their complexity and the participating credit union's lack of direct control. Credit unions should reflect this in their risk appetite and implement a commensurate level of risk management and controls, such as limits. Credit unions with commercial loan portfolios that contain more syndicated loans should consider their monitoring tools and metrics (e.g., total exposure, geographic breakdown, growth rate, partner caps) and their frequency of reporting to the Board, even if they are not lead lenders.

Risk Rating Models and Processes

Issue: Outdated or invalid risk rating models

With regards to risk rating models and processes, regulators tend to expect:

- loans to be risk rated at the time of loan approval and annually thereafter
- loans to be risk rated consistently and accurately
- final risk ratings should be based on the primary risk drivers of the commercial deal, and not an average of each component of the rating

For larger credit unions with significant commercial loan portfolios, also expect risk rating models to be more advanced than the standard models[7], provide additional levels of granularity to differentiate risks, and be regularly reviewed to confirm accuracy. These models can be internally developed or sourced from other external parties.

[7] An example is the standard Central 1 Credit Union risk rating model.

Reporting on Watchlist, Impaired, and Out-of-Order Loans

Issue: Insufficient understanding and inconsistent reporting on the risk associated with problem loans

Regulators want to see evidence that credit unions have reported on loans that are watchlisted, impaired, or out-of-order. They pay attention to the frequency and recipients of these reports. To ensure reports are consistent, credit unions should have procedures that describe the definitions and classifications of such loans. In particular, there should be detailed policies, or procedures in dealing with problem loans. As an example steps taken once a loan is delinquent, personnel responsibility, when to involve third party professionals, and max days before loans are written off.

Credit unions should capture this reporting from a management level but also regularly report on high-risk loans to the Board's Investment and Lending Committee. It is imperative that the credit union have a process for following up with members on problem loans to ensure these issues are being resolved in a timely manner and do not become long-term delinquencies on the books. The regulator will also look for evidence that specific provisions are realistic and appropriately estimated.

There will likely come a time when a Credit union has on its books one or more loans that are risk rated (RR) 4/5, watchlisted or impaired. This can have several impacts. Credit unions must hold more of a loss provision for these loans and more actively manage the resolution of these files. All Credit Unions should have a key risk indicator as part of their enterprise risk management framework associated with RR 4/5 loans to ensure there is a proper escalation framework and reporting structure in place for these particular loans. Some resolutions may take months or years, and some resolution tactics require involving lawyers, which can be quite costly in terms of time and resources. In addition, where the loan has multiple syndicate partners involved, resolution can be more complex, as these partners must be involved in the discussions.

Commercial (Third-Party Brokered) Loans

Issue: Inconsistent alignment of third-party brokered loans to strategy and risk appetite

It is common for regulators to examine commercial deals that originated through a third-party broker. Even if certain commercial loans are low loan-to-value, the regulator will view these as higher risk if there is no cash flow or income associated with servicing the loan. In these third-party brokered commercial loans, regulators will want to see:

- "asset-based lending" through brokers reflected in organizational plans, a risk appetite statement, risk management, and controls
- increased due diligence to mitigate money laundering risks, including documentation pertaining to the borrower's source of funds and wealth

Role of the Board and Senior Management

In preparing for a regulatory review or responding to regulatory questions, the Board and senior management should be able to articulate and demonstrate that they understand the risks and that their rationale for managing commercial lending risk is reasonable. It is not sufficient to rely on historical delinquency and past write-offs as evidence that credit risk is being managed effectively.

How Stabilization Central Can Support

Stabilization Central has several template policies and procedures available on its **website** to support credit unions with commercial lending. In addition, Stabilization Central has access to contractors who can provide training to credit unions' commercial lending teams or boards.

For more information on how Stabilization Central can support your credit union with commercial lending advisory services or resources, please contact **info@stabilizationcentral.com**.

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