

# Guidance

☒ Interpretation

☒ Approach

☐ Information

☐ Decision



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## Commercial lending Guidance

### Purpose

This Guidance outlines the Financial Services Regulatory Authority of Ontario's ("FSRA"):

1. Interpretation of requirements set out in applicable provisions under the *Credit Unions and Caisses Populaires Act, 2020* (the "Act") and Rule 2021-001 Sound Business and Financial Practices (the "SBFP Rule"), which obligate credit unions and caisses populaires ("CUs") to adopt and adhere to prudent commercial lending policies and practices.
2. Principles supporting desired outcomes for prudent commercial lending by CUs.
3. Approach for assessing how effectively CUs are meeting the desired outcomes of the principles outlined in the interpretation section of the Guidance, including FSRA's considerations for assessing adherence to the principles under the [Risk-Based Supervision Framework for Credit Unions \(the "RBSF-CU"\)](#), and examples of how CUs may achieve these desired outcomes.

Please note that FSRA considers proportionality in the application of this Guidance by taking into consideration the CU's size, complexity, risk profile, and the potential consequences of a CU's failure.

## Scope

The Guidance applies to CUs incorporated under the *Act* that engage in commercial lending activities.

## Rationale and background

Commercial lending is a significant and growing activity of CUs and Commercial Loans (as defined) represent the second largest asset group of the CU sector.

As commercial lending inherently poses risk to CUs, the quality of a CUs' commercial lending portfolios is instrumental to its financial well-being, the protection of depositors, and the ongoing ability to serve members.

Proprietorships, partnerships, co-operatives, and limited companies have their own unique credit and legal implications for both the CU and its members. This demonstrates that commercial lending is a complex financial relationship between the CU and its business members, requiring a careful balance between:

- providing a variety of specific and sufficient financial solutions to meet the needs of business members, as well as earning returns for their overall members
- ensuring the CU, depositors, members, and the borrower are not exposed to undue risk

## FSRA objects

This Guidance supports FSRA's statutory objects under s. 3 of the *Financial Services Regulatory Authority of Ontario Act, 2016* (the "*FSRA Act*"), including FSRA's duties to:

- 3(1)(a) to regulate and generally supervise the regulated sectors
- 3(1)(b) to contribute to public confidence in the regulated sectors

- 3(2)(a) to promote high standards of business conduct
- 3(2)(b) to protect the rights and interests of consumers
- 3(2)(c) to foster strong, sustainable, competitive, and innovative financial services sectors.
- 3(4)(b) to promote and otherwise contribute to the stability of the credit union sector in Ontario with due regard to the need to allow credit unions to compete effectively while taking reasonable risks.
- 3(4)(c) to pursue the objects set out in [clause s. 3(4)(b)] for the benefit of persons having deposits with credit unions and in such manner as will minimize the exposure of the Deposit Insurance Reserve Fund to loss.

## Definitions & Interpretation

Please note that throughout this Guidance:

- “Board” refers to board as defined under s. 1 of the *Act*
- “Senior Management” refers to senior management as defined under s. 1(1)(iii) of the SBFP Rule
- “Commercial Lending Framework” or “Framework” refers to the establishment and maintenance of disciplined commercial lending activities which include the development and maintenance of the commercial lending and underwriting policies, procedures, and controls

## Scope of Commercial Loans

In addition to “Commercial Loan” as defined under s. 66 of O. Reg. 105/22: General (the “*Regulation*”), for the purpose of this Guidance, FSRA considers the following types of loans to be “Commercial Loans”:

- agricultural loans as defined under the *Regulation*
- institutional loans as defined under the *Regulation*
- loans to unincorporated associations as described in s. 72(a)-(b) of the *Regulation*
- syndicated loans in Ontario as described in clauses (1)-(5) of s. 70 of the *Regulation*
- syndicated loans outside Ontario as described in clauses (1)-(5) of s. 71 of the *Regulation*

# Interpretation

The following three principles set out FSRA's views relating to prudent CU commercial lending and the outcomes that CUs must achieve for FSRA to conclude that the CU is in compliance with the requirements under the *Act* and the SBFP Rule.

## Principle 1: The Board approves the CU's prudent Commercial Lending Framework

### Intended outcome:

#### A prudent Board-approved Commercial Lending Framework:

- sets the parameters for the establishment of commercial lending activities in which the CU will engage and the development and maintenance of commercial lending and underwriting policies that facilitate sound decision-making and risk-taking
- aligns with the Board-approved risk appetite
- incorporates internal controls and oversight functions

**to enable CUs to engage in commercial lending, effectively mitigate risks (the “Framework”), and protect the CU’s deposits and assets against loss.**

S. 153(1) of the *Act* provides that “[a] credit union shall establish investment and lending policies for the credit union and the credit union shall adhere to those policies.” In order to comply with this requirement, CUs must have a Board-approved Framework.

S. 153(2) of the *Act* provides that “[t]he investment and lending policies of a credit union shall consist of policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans in order to avoid undue risk of loss and obtain a reasonable

return”. FSRA’s interpretation is that a reasonable and prudent person would be unable to conclude that the Framework will avoid undue risk of loss and obtain a reasonable return unless it considers the following but not limited to:

- adopting a risk-based approach aligned with the Board-approved risk tolerance and risk appetite statement
- providing direction to Senior Management in developing and implementing the commercial lending and underwriting policies
- reflecting the CU’s size and complexity
- aligning the CU’s members needs and the CU’s objectives
- aligning with and integrating into the Framework
- processes, criteria, and documentation standards for assessing the risk of a Commercial Loan, collateral management, and ensuring compliance with applicable legal requirements

The Board must approve and review at least annually the CU’s commercial lending and underwriting policies under s. 153(3) of the *Act* to ensure that the CU’s commercial lending and underwriting policies are effective. As part of the responsibility to implement the Board’s directions and decisions under s. 6(2)(ii) of the SBFP Rule, Senior Management must implement the CU’s commercial lending and underwriting policies.

## Principle 2: CUs employ effective portfolio management systems

### Intended outcome:

**CUs employ a portfolio management system which effectively supports a CUs ability to identify and proactively manage and mitigate risks in its commercial lending portfolio by integrating appropriate technology and processes to streamline the administration, control**

**and oversight of related activities, including underwriting, forward-looking monitoring and reporting.**

S. 15(1)(i) of the SBFP Rule requires Senior Management to create, develop, update, and implement, and the Board must, with support from the CU's oversight functions, oversee, and approve, a reasonable and suitable management and control system and framework for the CU's businesses, operations and activities and its management and employees. FSRA's interpretation of "a reasonable and suitable management and control system and framework" in s. 15(1)(i) of the SBFP Rule is that to be reasonable and suitable, a management and control system and framework must allow for:

- support for decision making from both an underwriting and strategic perspective
- performing at a minimum, annual reviews of loans, collateral and industry sectors
- the analysis and monitoring of borrower relationship/management reports
- appropriate loan provisioning and considerations of capital and liquidity adequacy
- a portfolio analysis of delinquencies and other breaches, including root causes

Because financial institutions can use technology and automation to improve the efficiency of their management control systems and achieve outcomes identified in this Guidance, FSRA's interpretation of "a reasonable and suitable management and control system and framework" in s.15(1)(i) of the SBFP Rule is that to be reasonable and suitable, a management and control system and framework must also:

- include appropriate data privacy and security measures to protect the integrity of the data and information of its Commercial Loan members and is available to those authorized to access it
- integrate with other corporate technologies provided internally or by third-party suppliers
- have automated information management systems that support the underwriting, monitoring, and reporting needs of the CU's Commercial Loan portfolio

## Principle 3: CUs commercial lending activities are captured in an effective Risk Management Framework

### Intended outcome:

**An effective Risk Management Framework establishes practices and processes, and utilizes technologies, to enable a CU to identify, assess, analyse, mitigate, and proactively manage risks within its commercial lending activities.**

S. 5(3)(i)(g) of the SBFP Rule provides that the Board is “responsible for providing oversight, supervision and direction to management, and shall oversee and approve, the credit union’s... risk management”.

This requirement applies to a CU’s entire operations, including its commercial lending activities.

FSRA’s interpretation of this provision is that overseeing and approving the CU’s Risk Management Framework cannot be achieved unless the Board, with support from the CU’s risk management function, performs the following but not limited to:

- oversees and approves the CU’s credit Risk Management Framework
- assesses the quality of controls and oversight of the CU’s commercial lending activities
- ensures that other risks such as operational risk, and market risk remains within risk appetite limits
- monitors deviations and exceptions to the underwriting policy
- provides effective challenge to Senior Management both directly and through specialized expertise such as internal audits



S. 6(2)(iii) of the SBFP Rule provides that Senior Management is responsible for “the day-to-day management and operation of the credit union within the parameters set by” the Board.

FSRA’s interpretation of this requirement is that effective day-to-day management and operation of a CU can only be achieved if Senior Management ensures that the CU adheres to the following but not limited to:

- maintaining adequate capital and liquidity to effectively mitigate the risks the CU is exposed to through the underwriting of Commercial Loans
- diversifying risk of the Commercial Loan portfolio by measuring and monitoring concentration levels and making necessary adjustments and/or adding restrictions to mitigate against any foreseeable risks
- identifying inherent risks within the CUs commercial lending activity and ensuring there are effective oversight functions and adequate controls to mitigate such inherent risks
- developing and implementing procedures, policies, and processes to identify, understand, evaluate, and mitigate risks
- regularly reporting to the Board if its commercial lending activities, including credit underwriting and portfolio monitoring, comply with and are performing in accordance with business plans and the risk appetite of the CU

# Approach

FSRA uses its supervisory framework, the RBSF-CU, to assess the extent to which commercial lending activities are prudent and identify commercial lending practices that may negatively impact the CU or its members. FSRA will exercise supervisory judgement by assessing the level of inherent risks in a CU's commercial lending activity with the CU's quality of controls and oversight ("QCO"). FSRA will assess the extent to which CUs can identify, assess, and manage these inherent risks, as well as achieve healthy Commercial Loan portfolios.

FSRA's risk-based supervision of such activities allows CUs to compete effectively while taking reasonable risks, but FSRA will increase its level of supervisory engagement and possibly intervention if it is concerned about the financial viability of a CU, whether members' interests are being well-served, or when there may be potential adverse impact on CU depositors or the stability of the CU sector.<sup>[1]</sup>

FSRA's assessment of a CU's commercial lending activity is a factor in determining a CU's Residual Risk rating ("RR") and Overall Risk Rating ("ORR") under the RBSF-CU. FSRA assesses risks on an inherent basis (i.e., before the application of controls and oversight), and on a residual basis (i.e., after the consideration of the quality of controls and oversight). As such, FSRA will monitor and assess adherence to the principles and achievement of the intended outcomes set out in the Interpretation section of this Guidance and requirements set out in the *Act*, SBFP Rule, and the Regulation, as part of its risk-based supervisory approach in accordance with the Approach set out below.

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<sup>1</sup> *Credit Unions and Caisses Populaires Act, 2020*, SO 2020, C 36, Sched 7 at ss. 228(1)-(4), 229, 230(1)-(7), 233(1)-(3), 234(1)-(4) and 235 [CUCPA 2020].

## Approach to principle #1

### Overall Commercial Lending Framework

**FSRA will assess how effectively a CU's commercial lending and underwriting policies, including internal controls and oversight functions, are aligned with and operate within the Board-approved Framework.**

The Board provides direction and oversight to Senior Management in the development of the Framework for its commercial lending activities by taking into consideration the CU's strategy and business environment, local economy, industry sectors and regional demographics. As a result, the Board establishes the CU's risk appetite and risk tolerances which are appropriately considered in creating and updating commercial lending and operational policies and procedures. Senior Management monitors the Framework for suitability with the CU's overall business plan and together with the Board, adjusts the Framework as needed but within the limits of the Board-approved risk appetite statement.

For example, FSRA will assess whether a CU has developed and implemented:

- a Framework which adequately protects the CU's depositors and assets against loss and enables CUs to engage in commercial lending while effectively mitigating risks
- prudent lending limits in accordance with the CU's risk appetite by accounting for its size, complexity, and capital strength to absorb losses
- commercial lending policies, practices and controls that align with the Framework
- risk management procedures and controls which are appropriate to the level of risk associated with the CUs commercial lending activities and align with the Board-approved risk appetite

## Approach to commercial lending and underwriting policies and procedures

**FSRA will assess the extent to which a CU's commercial lending and underwriting policies support prudent commercial decision making, loan growth and risk taking in accordance with the Board-approved risk appetite statement, and the CU's strategy.**

Commercial lending and underwriting policies guide its decision-making processes with respect to extending credit to members and managing associated risks. A well documented commercial lending and underwriting policy enables the CU to make informed lending decisions while minimizing risk and promoting member satisfaction. CUs regularly review the commercial lending and underwriting policies to reflect evolving market conditions and member needs.

For example, FSRA will assess whether commercial lending and underwriting policies:

- are clear, comprehensive, and align with the CU's risk appetite
- provide for diversification to mitigate risk and avoid excessive exposure
- include the use of credit risk ratings
- incorporate prudent underwriting criteria that align with applicable lending policies and the risk being undertaken

## Credit decision-making process

Effective credit decision-making involves receiving, underwriting, evaluating, approving, and disbursing funds from loan requests. Prudent commercial lending and underwriting policies contain a well-documented and defined structure for the separation of responsibilities associated with the loan decision-making process and independent risk oversight with consideration given to the CU's organizational structure, expertise, and resources. As a prudent risk management practice, and to minimize any potential conflicts of interest, functions such as the approval and disbursement of loan

funds are performed independently. However, in circumstances where this is not possible, an independent second person reviews and verifies the transaction.

For example, FSRA will assess the extent to which a CU has:

- a well-documented credit decision-making process that contains defined procedures as to how loans will be received, underwritten, and approved with the appropriate level of approval authorities within the CU for Commercial Loan decision-making
- ensured independence is preserved and provides for a separation of duties with respect to loan underwriting, approval, and funding
- provided for situations where a second approval authority and/ or verification of the transaction is required
- clearly articulated how decisions and exceptions to the commercial lending and underwriting policies will be escalated within the hierarchy of operational procedures including Board approval, review, and reporting

As a prudent practice occasional reviews should be conducted by a qualified and sufficiently independent individual on sample basis and where risks are rising, to confirm the credit decisions as determined by the original adjudication process by replicating:

- all aspects of the underwriting criteria for a commercial loan
- the time period during which the commercial loan was approved and funded

## **Collection of information, documentation, and data infrastructure**

Underwriting and approval processes hinge on the collection and evaluation of pertinent, accurate and up-to-date information collected about the borrower. Effective data infrastructure is critical to

support and protect the collection and storage of the borrower's information, and the associated documentation.

For example, FSRA will assess the extent to which a CU has:

- appropriate data infrastructure for collecting, verifying, and storing a sufficient level of accurate information about the borrower
- methods to evaluate credit exposures, credit risk, conditions of loan approval, collateral valuation standards, re-evaluation standards and debt servicing needs
- a data system that supports identification of early warning signs of potential increased risk to a Commercial Loan or the portfolio of loans

## **Participation in a syndicated Commercial Loan or mortgage by a third-party**

The risks involved in a CU participating in a syndicated Commercial Loan or mortgage are no less than those for loans originally by the CU. A CU's policies for underwriting a syndicated loan, will require that the CU will perform its own due diligence and analysis of the syndicated loan to:

- ensure that the borrower, debt service coverage, collateral management, loan to value ratios, etc. are consistent and/or meet the same standards as the CU's own Commercial Loan underwriting policies
- evaluate, address, and satisfy any concerns
- make a sound decision to participate in or amend the CU's percentage of participation in the syndication

For example, FSRA will assess the extent to which a CU:

- applies its own commercial underwriting standards to a loan syndicated by a third-party

- ensures the CU is not taking on any risk that it would not normally take on according to its internal underwriting standards

## Underwriting criteria and assessment

A CU's commercial underwriting criteria provide standards to evaluate the creditworthiness of the applicant(s) and guarantor(s), if applicable. The underwriting criteria are comprehensive so that loans granted to members align with the CU's risk appetite. The commercial underwriting criteria also include processes to rigorously assess the:

- borrower's ability and demonstrated willingness to service debt obligations in their current and future capacity
- soundness of the loan
- risks of the loan

For example, FSRA will assess the extent to which a CU's underwriting criteria support prudent commercial lending decisions, align with the CU's risk appetite, and consider:

- **Capacity:** the past and the current financial performance of the borrower as well as considering financial performance on a forward-looking basis
- **Capital:** the appropriateness of borrower's level and quality of capital at current state and prospectively based on applicable financial statements, budgets, and other relevant documents
- **Collateral:** the assets and/or covenants used to support and mitigate the risk of the loan
- **Conditions:** the approval conditions and criteria to be satisfied
- **Character:** the management style and level of expertise of the borrower, including historical financial statements and credit reports

For example, where the CU requires a guarantee to support the loan, FSRA will assess the extent to which the CU has considered the following in its underwriting assessment of the guarantor:

- financial strength and ability to support the loan
- level of commitment
- assessment of liquidity and net worth
- demonstrated willingness by evaluating their track record supporting other loans
- assessment commensurate with the level of reliance placed on the guarantor

## Pricing

To effectively price Commercial Loans, numerous factors are considered, including cost of funding, Commercial Loan type, market conditions, collateral, borrower creditworthiness and the associated loan risk. These considerations assist the CU to determine appropriate rates and fees for borrowers. Risk rating models can be used to strike a balance between offering competitive loan interest rates and taking on the risk of the loan.

For example, FSRA will assess the extent to which the Commercial Loan pricing:

- aligns with the risk ratings, funding, and margin framework
- is implemented and based on a credit risk rating model and methodology that provides a standard to measure the level of risk of a loan and loan portfolio
- reflects in its interest rate pricing the risk of the Commercial Loan
- offers commercial lending products that are suitable for the needs of commercial lending borrowers



- provides for exceptions to the model with the appropriate level of approval authority, supported by the rationale for the deviation

## Financial ratios and stress testing

A CU's commercial lending and underwriting policies contain financial ratios and stress testing requirements to evaluate the borrower's ability to repay the loan under normal and stressed conditions. Stressed testing is performed at an individual and portfolio level using accurate financial statements and other relevant financial information.

For example, FSRA will assess:

- the extent to which a CU's underwriting policy establishes prudent policy limits for debt servicing and other relevant financial ratios, which are appropriately stress tested for varied financial and economic conditions; and the appropriateness of the above stress tested scenarios to ensure they are both realistic and robust

## Lending collateral

A CU's commercial lending and underwriting policies contain appropriate safeguards to protect the CU when extending Commercial Loans. A CU takes into account the industry sector, the expected lifespan of the collateral and risk assessment when determining the appropriateness of the collateral. Collateral and other financial covenants are used to offset the risk of the loan and reduce exposure to loss.

For example, FSRA will assess the extent to which a CU's lending and underwriting policy considers:

- the appropriateness of the collateral based on the loan type, category, risk factor and expected life cycle of the collateral
- structuring the terms of the Commercial Loan in such a manner that the loan to value ratio improves over the loan term, particularly where the collateral's market value may depreciate overtime or is subject to volatility

- different types of collateral depending upon the nature of the commercial credit facility, industry sector and anticipated realizable collateral value

In the event of a borrower default, a CU relies on both tangible and intangible collateral to provide adequate recourse for repayment of the debt obligation. A CU's commercial lending and underwriting policies clearly identify acceptable forms of collateral and the steps to secure such collateral against the credit facility.

For example, FSRA will assess the extent to which a CU's commercial lending and underwriting policy addresses:

- the processes and procedures needed to ensure relevant security is enforceable and appropriate to the level of risk of the loan
- acceptable types of collateral and their corresponding maximum loan to value ratios and maximum loan terms
- the necessity for searches to ensure the collateral is free of outstanding liens and/or encumbrances prior to registering any tangible collateral and takes them into account when determining maximum loan-to-value ratios
- perfection of its security interest and its enforceability throughout the lifetime of the loan by verifying the accuracy of its security documentation and registration through its oversight and control processes

## Valuations

A CU's commercial lending and underwriting policies should identify acceptable valuation tools and methods to prudently evaluate different types of collateral based on the industry and type of collateral as well those methods being used in combination to arrive at an accurate value.

For example, FSRA will assess the extent to which a CU uses a risk-based approach when evaluating tangible collateral and considers:

- a combination of valuation processes and procedures which are suitable to the collateral being valued
- a CU's underwriting and lending policies explicitly provide which valuation or combination of valuation tools and or methods should be used to determine prudent loan to value ratios
- a CU takes into consideration aspects of the collateral, including life cycle, residual value, and loan size to determine maximum loan to value lending ratios

## Property appraisals

A CU's commercial lending and underwriting policies should address the acceptable method and type of appraisal required for the evaluation of a commercial property. For example, FSRA will assess the extent to which a CU's commercial lending and underwriting policies:

- operate with prudent and transparent commercial (real estate) property valuation policies and procedures that produce realistic and supportable valuations
- provide a process for an independent and professional appraisal of commercial property by a qualified entity, such as those with credentials issued by the Accredited Appraiser of the Canadian Institute
- specify which commercial property valuation approach, or combination of approaches, is appropriate and prudent in particular circumstances (i.e., a direct comparison of market value approach, income approach and/or cost to replace approach)

## Re-evaluation

A CU's commercial lending and underwriting policies should contain the CU's methodology for the revaluation of collateral, along with risk indicators that warrant taking further action. The revaluation of collateral involves periodically assessing the value and condition of pledged collateral within the loan term and ensures the CU maintains an accurate understanding of the collateral's realizable value to mitigate risks, make informed choices and protect the interests of its members.

For example, FSRA will assess the extent to which a CU's commercial lending and underwriting policies:

- clearly articulate the underlying factors and early warning indicators that would warrant a re-evaluation of collateral
- include credit risk management practices and procedures for monitoring collateral pledged as collateral
- provide for the type of re-evaluation of collateral upon review, renewal and/or due to other risk indicators

## Approach to principle #2

### Use of technology for commercial lending

**FSRA will assess the extent to which a CU's portfolio management system integrates the use of technology to support prudent commercial lending activities.**

To remain competitive, some CUs provide seamless member experiences and innovative new products by building adaptable business platforms.

Although the use of advanced digital technologies increases the speed and transparency of loan transactions, it may also introduce new operational risks. These risks include data privacy and security breaches that can be addressed through effective data governance.

For example, FSRA will assess the extent to which:

- the portfolio management system provides:
  - granular reports for loan portfolio managers, such as loan portfolio performance by industry and loan type against expected performance and loan provision adequacy reporting

- more consolidated information for Senior Management, such as key trends and analytics on credit risk appetite and limits
- more aggregated information for the Board with a particular emphasis on exception reports, portfolio risks and mitigation strategies
- channels for the independent review of portfolio information by a CUs oversight functions
- the technology is appropriately integrated and aligned with the CU's risk appetite
- the CU has appropriate insurance to address the potential risk of loss due to a cyber-breach and/or personal information being compromised
- the CU assesses and mitigates the technological risk associated with its commercial lending activities and this risk forms part of the Enterprise Risk Management framework
- appropriate data privacy and security measures are implemented to protect data integrity and the personal information of the CU's members
- Senior Management has implemented appropriate internal controls with respect to the technology to ensure that it functions as expected and continues to meet the organizational needs
- the data is collected and retained in the system and continues to be accurate and complete
- the information is well protected both in transit and at rest
- the system continues to be available with minimum disruptions

## Approach to principle #3

### Effective Risk Management Framework for commercial lending

**FSRA will assess the extent to which a CU's Risk Management Framework adequately provides a set of practices, processes, and technologies that enable a CU to identify, assess, analyze, and mitigate risk within its commercial lending activities.**

An effective Risk Management Framework enables a CU to create enhanced accountability for data protection and identifying where failures may occur. By proactively addressing issues through monitoring practices and processes, unforeseen adverse events may be reduced.

For example, FSRA will assess the extent to which:

- CUs have appropriately skilled and qualified individuals responsible for risk management activities who have sufficient resources, status, authority and independence to perform their roles and responsibilities
- the Risk Management Framework and technologies capture the accuracy, completeness, and currency of risks
- the CU adequately and effectively monitors its commercial lending portfolio and provides comprehensive reporting to the Board

### Commercial risk management and the Board

The Board, as part of its oversight role, supports the CU in achieving its expected commercial lending results by providing effective oversight and challenge to Senior Management's underwriting and lending decisions to ensure they are consistent with the CU's control environment and Board-approved business strategy for the CU.

For example, FSRA will assess the extent to which the Board:

- reviews the soundness and alignment of the controls and oversight functions of the CU's commercial lending activities to the Board approved risk appetite and business strategy
- receives accurate, independent, timely, and objective reporting on controls, and oversight processes for the Commercial Loan business, including from the second line (risk management) and third line (internal audit) of defence
- receives exception reports on related commercial lending risks
- reviews all such reports in respect of the Framework and ensures that a plan of action is created and implemented to rectify in a timely manner any issues identified in the risk management of the Commercial Loan portfolio

## **Commercial risk management and Senior Management**

FSRA will assess the extent to which Senior Management has effectively implemented the appropriate controls of the commercial lending activities and ensured that:

- qualified staff are performing appropriate functions and meeting set expectations
- risk management functions are working properly, including by separating the Commercial Loan origination and funding functions
- exceptions to the commercial lending and underwriting policy are identified and approved in exception reporting to the Board and/or an audit committee

## Remuneration

A CU's remuneration policies and practices should align with the CU's risk profile to promote prudent Commercial Loan growth with appropriate risk taking. These policies are consistent with the CU's approach to commercial credit risk management, deter fraud and incent prudent credit decision making.

For example, FSRA will assess the extent to which a CU's remuneration policies:

- promote the growth of Commercial Loans while supporting prudent risk management practices by aligning with the Board-approved risk appetite and strategies
- include commercial credit quality metrics and are aligned with the commercial lending credit risk appetite for variable and other forms of remuneration
- balances short-term, mid-term, and long-term risk taking for variable remuneration of the staff involved in commercial credit granting
- are reasonable and consider the rights and interests of members for all remuneration policies and practices related to Senior Management and employee activities

## Credit risk management practices and internal controls

An effective Risk Management Framework establishes a credit risk management practices and internal controls designed to effectively provide assurance that a CU's commercial lending objectives are being met.

Credit risk management practices involve developing internal control frameworks to capture, measure, manage, mitigate, and report credit risk. A CU's internal control framework and credit risk management supports robust and appropriate credit risk taking, analysis and monitoring throughout the life cycle of a credit facility.



For example, FSRA will assess the extent to which a CU's effective Risk Management Framework:

- has established the risk level of its internal controls with respect to commercial lending activities
- has a risk rating system that is periodically updated
- has a monitoring and reporting system that is appropriate to prompt corrective action to reduce loan losses
- maintains a prudent portfolio diversification to mitigate applicable risks
- has established aggregate limits for large exposure loans to mitigate concertation risk

## Credit risk monitoring

An effective Risk Management Framework establishes a process to monitor credit risk through both individual transactions and active portfolio management. The main objective of monitoring credit risk is to detect in advance any circumstances hindering credit quality or weakening guarantees. This allows the CU to act promptly to reduce the risk of loss and other financial difficulties.

For example, FSRA will assess the extent to which a CU's commercial credit risk monitoring processes:

- consider key attributes of loans within the Commercial Loan portfolio to effectively detect the deterioration of loan performance
- take into account large exposure risks, industry sector and concentration risks
- assess the quality of applicable credit exposures; use key commercial risk drivers
- use quantitative and qualitative early warning indicators of potential increased risk to a Commercial Loan or the portfolio of loans

- includes performing a portfolio analyses, with root cause analysis and proactive loss mitigation, [e.g., processes to guide renegotiation, de-marketing, partial repayment, additional collateral, full repayment and enforcement], for commercial loans for which there are delinquencies or other breaches, or which are no longer within the CUs risk appetite
- generate accurate reports, including exception reports

## Adequacy of loan loss provisioning

An effective Risk Management Framework includes an assessment methodology to regularly and rigorously determine adequate loan loss provisioning against Commercial Loan losses. This assessment methodology includes the determination and assessment of a significant increase in credit risk (“SICR”) in accordance with International Financial Reporting Standards (“IFRS 9”). The process of determining SICR involves a forward-looking approach based on the information available about the borrower and public information, including macroeconomic indicators that may impact the portfolio’s performance. In addition to the delinquency and impaired loan reports, the assessment methodology may include “watch list” or “out of order list” reports, which enable the CU to closely monitor any emerging risks associated with these Commercial Loans.

## Industry risk rating and concentration risk

An effective Risk Management Framework sets out parameters for a risk rating system that categorizes individual loans based on credit analysis and local market conditions into graduated categories of increasing risk. A CU’s risk rating methodology should also take into account the probability of default, loss given default, and exposure at default. Risk ratings are conducted at the time of application, as part of the annual review process and in situations where new information arises that may materially affect the credit risk of the loan. A CU’s risk rating system should measure these categories, sets limits, gauges, and assesses risks on an individual and portfolio level.

A prudent risk rating system considers, among other things, environmental, social and governance (“ESG”) factors and incorporates such factors into industry risk ratings, credit concentration limits and business strategy reviews (see Appendix 1).

For example, FSRA will assess the extent to which a CU's risk rating system provides:

- a standard for measuring the level of risk for both individual Commercial Loans and the overall Commercial Loan portfolio
- for the categorization of individual Commercial Loans based on credit analysis, market conditions and partly based on objective criteria, into a series of graduated categories of increasing risk identified by numbered or named levels of risk. This system is applied using the CU's own methodology, timing, and frequency

## **Stress testing and sensitivity analysis**

As part of an effective Risk Management Framework's practices, a CU should perform stress testing and sensitivity analyses of its Commercial Loan portfolio and activities to ensure appropriate identification and assessment of potential risks that may negatively impact the CU. The result of the assessment provides the CU with direction as to what, if any, action may need to be taken. This would include updating its business strategy and the Framework.

A CU should develop parameters for stress testing and sensitivity analyses, including by outlining an approach for the manner, timing, and triggers for testing.

For example, FSRA will assess the extent to which a CU:

- stress tests and conducts appropriate sensitivity analyses of its commercial lending portfolio and activities
- stress tests for loss of revenue and increasing loan defaults
- stress tests when there are emerging local and national economic changes

## Appendix I

### Environmental, Social and Governance (ESG)

ESG factors are increasingly becoming important in commercial lending activities because of their impacts on industry and sector performance. ESG factors can negatively affect the viability of a borrower's industry and sector with implications for the performance of loans granted to that borrower and the overall Commercial Loan portfolio of a CU.

This Guidance highlights the ESG considerations likely to impact the industry or business the CU is considering lending to.

1. Environmental-related risk can emanate from, for example:
  - climate change
  - water security
  - environmental health risks
  - the waste burden
  - biodiversity loss and extinction
2. Social criteria include, but are not limited to, community involvement and co-operative values, human rights initiatives, diversity and inclusion, anti-harassment, anti-discrimination, and fair labour standards.
3. Governance criteria include such factors as corporate structure, financial operations, issue management, anti-bribery, and anti-corruption policies.

## Effective date and future review

The effective date of this Guidance is July 1, 2024

As at its effective date, this Guidance replaces:

- Deposit Insurance Corporation of Ontario (DICO) – Lending Risk Advisory #3, August 2018 Authorized Syndicating (Lead) CU's (CUs) in a Loan Syndication.
- DICO – Commercial Lending Policy Development Guide Advisory February 2014
- DICO – Lending Guidance Note January 2018

The latest date for FSRA to initiate a review of this Guidance is July 1, 2029.

## About this Guidance

Interpretation guidance sets out FSRA's view of requirements under its legislative mandate i.e., legislation, regulations, and rules) so that non-compliance can lead to enforcement or supervisory action.

Approach Guidance describes FSRA's internal principles, processes and practices for supervisory action and application of Chief Executive Officer discretion where applicable. The Approach section of this Guidance may refer to compliance obligations but does not in and of itself create a compliance obligation.

Visit [FSRA's Guidance Framework](#) to learn more.

**Effective date:** July 1, 2024