

Guideline

Commercial Lending - Consultation Draft

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INTRODUCTION

The guideline sets out high level principles and specific expectations for all B.C. incorporated credit unions that participate in commercial lending activities¹.

The guideline lays out 20 principles that form the foundation of a good governance framework for such specialized lending, from broad policy requirements to risk limits, risk management, reporting, and other best practices. BCFSA expects principles to be proportionately implemented across all credit unions depending on the nature, size, and complexity of their commercial lending activities. For each principle, specific BCFSA expectations are provided which outline the procedures and practices that achieve the objective of each principle. The expectations apply to all organizations regardless of size.

The guideline is organized into three sections aligned with those in BCFSA's [Commercial Lending Assessment Criteria](#):

- Corporate Governance;
- Operational Management; and
- Risk Management.

CORPORATE GOVERNANCE

Principle 1 – Governance and Accountability

A credit union's board of directors ("Board") is ultimately responsible for a credit union's commercial lending activities and is expected to oversee the credit union's monitoring, control, and management of commercial lending risks through a sound governance structure.

Board Responsibilities

The Board should understand risks arising from commercial lending and the controls needed to manage these risks. It should also understand, review, and approve commercial lending objectives, strategies, and plans, at minimum on an annual basis, and more frequently in case of material changes. In addition, the Board should annually review and approve those components of the credit union's Investment and Lending Policy ("ILP") which are related to commercial lending. The Board needs to ensure that those components are responsive to changes in the operating environment and consistent with the credit union's risk appetite. The Board should also establish the frequency of reporting from senior management for the credit union's commercial lending portfolio.

The Board should act independently and demonstrate effectiveness in carrying out its direction and oversight of commercial lending activities. It should also ensure appropriate delegation of responsibility to the Chief Executive Officer and the senior management team for developing and implementing commercial lending policies and procedures. It is also incumbent on the Board to remain current with members' needs, market trends, emerging risks, competitor activities, and new lending practices.

Senior Management Responsibilities

Senior management should ensure that staff responsible for commercial lending activities have sufficient knowledge and experience in evaluating commercial lending risks, measurement metrics (both qualitative and non-qualitative), mitigation techniques, stress testing, provisioning/allowances, and identifying signs of poor/deteriorating credit quality and fraudulent activity.

¹ Commercial lending involves extending credit to businesses and includes commercial mortgages, commercial lines of credit, equipment leasing, interim construction financing, start-up/small business lending, and other commercial lending.

Senior management should also ensure that the credit union has appropriate mandates for staff responsible for commercial lending activities and the mandates should clearly define lines of authority, responsibility, and accountability. Senior management is responsible for communicating these mandates across the credit union.

The senior management team is responsible for the development of commercial lending policies and procedures and the credit union's commercial risk rating system, as well as for ensuring that the policies and procedures are followed by staff.

Senior management should:

- Review commercial lending policies and procedures annually, at minimum, and suggest amendments where appropriate;
- Ensure that there is an appropriate number of staff relative to the size of the credit union and its commercial lending operations, and that staff are adequately trained given the nature and scope of the commercial lending activity; and
- Establish the nature and content of reporting to the Board for the credit union's commercial lending portfolio.

OPERATIONAL MANAGEMENT

Principle 2 – Policies and Procedures

A credit union should ensure that it has appropriate policies and procedures for commercial lending which are clearly defined, documented, and disseminated.

The policies and procedures should set out expectations for prudent management of commercial credit risks and should include, at a minimum:

- A lending philosophy that outlines the responsibility of the Board and senior management for safeguarding the assets of the credit union while providing commercial loans to members;
- Documented lending criteria (for more detail, see Principle 5 - Lending Criteria);
- Established underwriting standards;
- Commercial loan approval authorities; and
- Review frequency (e.g., review cycle).

Note that additional expectations for commercial real estate lending are included in Appendix 2.

In addition to these policies and procedures, the credit union should have:

- A business plan that outlines its strategy for commercial lending activities, markets and market share targets, forecasts, and budgets; and
- A framework for commercial lending activities that includes:
 - Consideration for how the credit union's risk appetite and risk tolerance is being appropriately considered by management in creating and updating commercial lending operational policies and procedures,
 - A requirement for operational policies and procedures to be regularly reviewed by the credit union's internal auditor for appropriateness. Policies and procedures should be reviewed regularly to ensure they appropriately reflect changes in the operations of the credit union, applicable legislation, BCFSa guidance, and the credit union's bylaws, and

- A requirement for staff to fully understand commercial lending practices and remain current with developments in their area of responsibility, including associated risks, emerging issues, new risk management techniques, and changes in the operating environment impacting the nature and level of risk of commercial loans.

Principle 3 – Approval Authority and Delegation

A credit union should have clearly defined accountability for loan approvals, including delegation and sub-delegation consistent with BCFSA's [Delegated Lending Authority Guideline](#).

The Board retains ultimate lending authority in accordance with the credit union's credit authority policy. Underwriting and approval of commercial loans should be made by qualified staff, with appropriate authorization and accountability for the post-loan review process. Formal lending limits should be delegated to commercial lending staff in accordance with their skills, qualifications, and experience.

As outlined in BCFSA's Delegated Lending Authority Guideline, the credit union should also ensure that staff involved in front line loan origination should be independent of credit approval and oversight functions to avoid any potential conflicts of interest. This also aligns with the "Three Lines of Defence" model, as outlined in BCFSA's [Supervisory Framework](#).

The three lines of defence are as follows:

- **First line:** risk-takers who make the decision to take on and manage the risks they generate;
- **Second line:** independent staff within the institution who set risk-taking limits and ensure that all risks are being appropriately managed; and
- **Third line:** independent staff who audit and verify the efforts of the other two lines of defence.

Principle 4 – Identification of Lending Products

A credit union should have a list of commercial lending products and their features that the credit union is currently offering or plans to offer to its members.

These products should be aligned with the credit union's mandate, risk appetite, and staff knowledge and expertise. The credit union should include descriptions of these products in its ILP and its procedures. The descriptions should be clear enough to distinguish between each of the different commercial lending products and minimize inconsistencies in interpretation of the products.

Principle 5 – Lending Criteria

A credit union should establish and maintain underwriting criteria, with both qualitative and quantitative components, for commercial loans.

These criteria should include, but not be limited to:

- Analysis of borrower's financial position (liquidity and leverage) and cash flow to determine capacity of borrower to repay all obligations;
- Security requirements that are appropriate, prudent, and aligned with standard industry practices and risk appetite;
- Minimum criteria and limits that must be met by the borrower before a loan can be granted; and
- Documented justification for an underwriting decision including financial analysis, exceptions granted, and other relevant criteria.

Principle 6 – Commercial Lending Limits

A credit union should establish and implement prudent commercial lending limits that are clearly defined, documented, and disseminated to staff.

The lending limits should consider:

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

As part of establishing commercial lending limits, the credit union should consider the level of concentration risk, which includes the following categories:

- Connected limits (associated borrowers);
- Geographic limits (including out of province);
- Channel limits (including syndication);
- Product and portfolio limits; and
- Industry and sector limits.

Prudent credit risk management dictates continuous monitoring and reporting of concentration risk.

Principle 7 – Policy Exceptions

A credit union should ensure that exceptions to the underwriting policies, and criteria for granting exceptions, are supported by appropriate mitigating factors and appropriately documented and approved.

This includes establishing and maintaining appropriate procedures and requirements for granting exceptions and approving loans which are outside the lending limits, authorities, or other parameters defined by the commercial lending policy and supporting underwriting criteria, or loans that are otherwise considered to be out of order.

Any exceptions to policies set by senior management should be reviewed and approved by senior management according to the credit union's delegated lending authority structure and should be reported to the Board on a regular basis.

Exceptions to the ILP should be reviewed and approved by the Board.

Principle 8 – Syndicated Lending

Before establishing a formal syndication agreement, a credit union should ensure that the syndicated loan it wishes to enter into is consistent with its lending policies, practices, and assessment criteria.

In a syndicated lending situation, all participating partners in the syndicate are required to undertake their own initial and on-going credit risk evaluation of the loan, as they would for any other loan of a similar nature including regular site reviews, where appropriate. The lead lender is accountable to the whole syndicate for transparency and should provide full and timely disclosure of relevant information to allow syndicate partners to effectively perform their independent credit risk analysis.

Principle 9 – Collateral Security Value for Real Estate

A credit union should ensure effective policies and procedures are in place to support accurate valuation of real estate collateral.

In commercial lending activities secured by real estate, the borrower's ability to repay their real estate loans according to agreed-upon terms remains the primary consideration in lending decisions. These loans are structured so that the underlying value of the real estate collateral security is a secondary source of repayment. The credit union should ensure it has effective policies and procedures in place to determine the lending threshold at which appraisal is required, as well as whether the valuation methods, assumptions and value conclusion are reasonable. For example, in the case of land financing, the appraisal should be based on the current as-is value, rather than future potential.

To ensure effective valuation, the credit union should ensure appraisals are aligned with the recorded collateral value. The credit union should therefore establish criteria to select, evaluate, and accept appraisal reports. These criteria may include but are not limited to:

- Securing appraisers with appropriate accreditations;
- Establishing an approved list of appraisers;
- Receiving transmittal/reliance letters; and
- Verifying the validity of appraisals.

The credit union should also consider the impact that site contamination may have on a borrower's ability to repay their loans, as well as potential liability to the credit union arising from financing contaminated sites. To mitigate these risks, the credit union should determine criteria under which it would necessitate a professional Environmental Site Assessment or Borrower's Declaration supported by the indemnity agreement.

Some of the factors to consider in assessing these risks are:

- The industry in which the borrower operates;
- The features of the borrower's operations and property;
- The borrower's ability to manage environmental affairs; and
- The level of loan exposures.

Principle 10 – Monitoring and Reporting

A credit union should ensure regular and adequate monitoring and reporting activities to senior management and the Board.

Monitoring activities are focused on forward-looking risk metrics, while reporting encompasses all relevant risk data.

Monitoring and reporting activities should include, but are not limited to:

- Reviewing the commercial lending portfolio at least quarterly, and in some cases more frequently as required to ensure they reflect the credit union's most current view of the risk level;
- Reviewing the risk rating assessment criteria (see Principle 13 'Prudent Account and Portfolio Management') periodically;
- Ensuring there is sufficient data to perform an effective assessment of the loan portfolio on a periodic basis, including the monitoring of trends within the portfolio;
- Ensuring that monitoring feeds into expected credit loss provisions using forward-looking risk indicators;

- Implementing and maintaining a modeling and stress testing program for the portfolio commensurate with the size and complexity of the credit union and its commercial lending activities, and regularly reporting the results to the Board;
- Evaluating all watch-list accounts; and
- Verifying appropriateness of all exceptions to policies, procedures, and limits.

RISK MANAGEMENT

Principle 11 – Risk Identification and Management

A credit union should include risk identification and risk management in its general commercial lending policies and procedures. These may be included in an existing Enterprise Risk Management (“ERM”) program.

The risk identification and management policies and procedures should, at a minimum, ensure the following:

- The risk management policies align with the “Three Lines of Defence” model outlined in BCFSA’s Supervisory Framework;
- The risk management policies, practices, and limits for commercial lending are commensurate with the credit union’s business activities and related risks, and are also consistent with the credit union’s strategic, capital, and liquidity management policies and practices;
- Reviews are regularly conducted of commercial lending positions against approved commercial lending limits and timely follow-up on material variances;
- Legal advice is available to support loan agreements, guarantees, security agreements, and collateral/mortgage agreements;
- Day-to-day controls are commensurate with the level of risk in each commercial lending activity and sub-activity, and risk management policies, practices, and limits for commercial lending are documented, communicated, and integrated with the credit union’s day-to-day operations;
- Risk management is independent of day-to-day management of commercial lending risks, where possible, and segregated from sales activities;
- A post-loan review process is established to provide an independent quality assurance evaluation of the credit underwriting and approval process, on a frequency that allows for timely feedback and coaching of front-line credit team members;
- A portfolio diversification policy is implemented to mitigate concentration risk wherein appropriateness of the prudential exposures and concentration limits for each sub-activity and the aggregation of them across the whole commercial lending activity are documented in the credit union’s commercial lending policy;
- Regular stress-testing is performed using a range of scenarios that include negative implications to both collateral valuation and borrowers’ ability to repay; and
- Risk management policies, processes, and limits are regularly reviewed and updated to reflect changes in the commercial lending environment and the risk appetite of the credit union.

Principle 12 – Climate Risk Management

A credit union should consider the impact of material climate-related risks on the borrower’s capacity to meet their financial commitments over the lifetime of the loan.

Climate-related risks can include both physical and transition risk. Physical risk can include considerations such as vulnerability of a borrower's assets and income to climate events (e.g., wildfire, flood, or earthquake), whereas transition risk can include considerations such as the impact of market trends/regulatory requirements towards lower greenhouse gas emissions on the borrower's business. While detailed information on these risks may not always be available, the credit union should consider the level of climate-related risk where possible.

Principle 13 – Commercial Risk Rating System (“CRRS”)

A credit union should measure the level of credit risk of the borrower and the borrower's portfolio through use of an appropriate and comprehensive Commercial Risk Rating System (“CRRS”).

When accurately and consistently applied, a CRRS provides a common understanding of risk levels and allows for prudent and active account and portfolio management. Factors within the CRRS should be transparent and definitions should be sufficiently clear to allow experienced and qualified third parties to understand the risk rating. The overall rating should represent meaningful stratification of risk and the obligor's ability to perform through the next 12 months, at which point the rating should be reviewed to ensure continued accuracy.

The credit union should have a documented CRRS that includes:

- A risk rating scale that:
 - Is sufficiently granular for calibrating the likelihood and capacity of a borrower to meet their loan obligations,
 - Consistently assigns the same rating to borrowers of similar risk, and
 - Is forward looking over a sufficient time horizon and considers a range of economic conditions and business cycles;
- Rating definitions, criteria, and processes for distinguishing levels of credit risk;
- Timing and frequency of risk ratings, which should occur:
 - At the time of application for all new or increased loan facilities,
 - As part of the annual review process, and
 - In situations where new information is considered that may materially affect the credit risk of the borrower;
- A requirement to report the aggregate risk rating of the portfolio, or portions within the portfolio, to the Board;
- A periodic review of the appropriateness of the CRRS and the validity of rating criteria by both the Board committee and the risk and oversight function; and
- The content and frequency of Board reporting.

Senior management should take reasonable and proportional steps to ensure the integrity of borrowers' assigned risk ratings.

Risk Factors

The CRRS should contemplate both qualitative and quantitative risk factors. Quantitative risk factors such as financial risk are typically the main driver in defining the overall risk rating. Qualitative risk factors (such as industry risk, market risk, and management risk) can be used to support the rating by allowing subjective considerations. Appendix 1 provides further detail on risk factors that credit unions may want to consider.

The weighting, granularity, and methodologies of risk factors rely on the expert judgment of management within risk and oversight functions. They should also be guided by and conform to the Board-approved lending policies, as well as the credit union's risk appetite and risk tolerance.

Risk Scale and Risk Ratings

The credit union should establish a risk scale for assigning risk ratings to their commercial borrowers. Each separate legal entity to which a credit union is exposed should be separately rated, including both the borrowers and recognized guarantors. The credit union should develop rating policies related to the treatment of individual entities in a connected group, including circumstances under which the same rating may or may not be assigned to some or all the related entities.

For final ratings based on expert judgement, credit unions should clearly articulate the situations in which its staff may override the CRRS rating, including how and to what extent such overrides can be used and by whom they can be used. The institution should have guidelines and processes for monitoring cases where either staff judgement has overridden the CRRS' rating, variables were excluded, or inputs were altered. Senior management approval should be required before staff can override the CRRS rating. The guidelines should identify personnel responsible for approving overrides. Credit unions should identify and track overrides and associated performance and report to the Board as appropriate.

Principle 14 – Watch-List Accounts

A credit union should establish criteria for placing a borrower on the watch list that reflect the level of risk appetite and risk tolerance of the credit union.

The criteria should, at minimum, address:

- The situation or status that qualifies a borrower to be placed on the watch list, which should include:
 - Past due annual reviews (when financial statements are not available seven months after the borrower's fiscal year end and/or the annual credit review is not conducted within 90 days of the established annual review date),
 - Covenant breaches (e.g., not meeting established requirements of coverage, leverage, and liquidity ratios),
 - Potential security shortfalls (e.g., asset sale, loss or damage, fraud, or decreasing value),
 - Potential financial difficulty (e.g., significant deterioration in revenue, income, operating cash flow, or balance sheet),
 - Significant adverse developments (e.g., deteriorated corporate governance, unexpected management departures, loss of major customers, worsening reputation, legal action, labour dispute/strike, or new competition.) and
 - Frequent requests to exceed authorized loan limit;
- Requirement for an approval process to place and remove accounts on the watch list; and
- Content of monitoring reports including strategic corrective action and timeline to bring the loan onside.

Once a borrower has been placed on the watch list, the borrower should be downgraded to the most conservative risk rating above default. This rating signifies the higher level of risk posed by the borrower.

Principle 15 – Delinquent and Impaired Loans

A credit union's commercial lending policies should establish and maintain procedures to actively manage delinquent and impaired loans and ensure that there are appropriate loan loss provisioning and troubled loan workout practices.

Procedures should include specifying the:

- Characteristics that define a delinquent or impaired loan (timing of last contractual payment, credit deterioration and other factors the credit union deems important);
- Responsibilities of management for monitoring and collecting impaired loans (including oversight and evaluation of third-party collection agencies); and
- Requirements and authorization for loan provisions.

A clear, unambiguous definition of what constitutes a default event should also be included within the contractual loan agreement to mitigate the risk of disputes over interpretation.

Principle 16 – Write-Offs

A credit union should ensure it has appropriate loan write-off procedures in place.

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

The credit union should establish write-off authority and approval levels as well as specifications around the conditions under which a loan will be wholly or partially written off.

Principle 17 – Rewritten/Restructured Loans

A credit union should ensure it has appropriate policies and procedures in place for rewriting and/or restructuring a loan.

In exceptional circumstances, commercial loans may be re-written to allow the borrower to continue to service the loan. This may include changing of one or more of the conditions of the loan. Restructuring of credit is not to be undertaken to avoid recognition of a loss or postpone the declaration of default.

Restructured loans should continue to be classified as “non-performing” until the credit union determines that a track-record of satisfactory performance is re-established.

The credit union should ensure their policies include the:

- Definition of a rewritten or restructured loan;
- Criteria under which a loan can be re-written or restructured;
- Authorities required to approve the loan;
- Requirement by management to monitor and follow-up on these loans;
- Established method for identifying and tagging restructured loans to ensure they can be reviewed and reported separately when necessary (e.g., Board reporting or BCFSA data submissions); and
- Criteria under which provisions for loss can be removed for rewritten or restructured loans.

Principle 18 – Management of Annual Credit Reviews that are Past Due

A credit union should ensure it has appropriate policies and procedures in place to manage situations in which borrowers are past due for their annual credit review.

The annual credit review is conducted by credit unions to assess the risk level of commercial borrowers and re-evaluate their ability to meet their loan obligations. While the establishment of review dates is determined by the borrower's risk factors, it is generally set at three months or 90 days after the borrower's fiscal year end.

The goal of the review is to assess the borrower's risk profile and update the borrower's risk rating and should be done, at minimum, on an annual basis. As part of the review, covenant compliance and adequacy of collateral security pledged should be validated and confirmed. Based on the review findings, the credit union can make an informed decision on whether to continue extending credit or terminate the existing relationship with the borrower.

A key aspect of the review entails quantitative analysis in reassessing relevant financial risk factors which would require updated financial statements from the borrower. The credit union should establish appropriate financial statement reporting requirements to allow adequate time to perform and complete the review. Until the credit union receives satisfactory current financial information, the borrower's risk rating should be downgraded and reported as the most conservative risk rating above default, and placed on the watch list for continuous monitoring (see Principle 14 'Watch List Accounts').

Principle 19 – Compliance Management

A credit union should develop a regular process to review adherence to its commercial lending policies and procedures.

The credit union should, at minimum, ensure that its compliance policies and practices:

- Align with industry and applicable regulatory requirements and expectations including ensuring that effective compliance staff is in place;
- Cover new products, characteristics of products, IT capability and systems security, outsourcing, on-going staff training, responsible lending, and customer data privacy and protection;
- Are regularly reviewed to capture new and changing commercial borrower behaviours; new and changing patterns in specific industries' ethos; and changes in the credit union's risk profile;
- Are promptly reviewed as legislation or regulatory guidance is introduced/amended;
- Are documented and communicated to commercial lending staff in a timely manner; and
- Are adequate for resolving significant issues in a timely manner.

Where possible, compliance staff should be independent of the staff managing day-to-day operations.

Principle 20 – Internal Audit

A credit union should ensure that its internal audit program, managed by its Audit Committee, includes commercial lending and verifies that commercial lending policies and procedures are implemented effectively across all activities.

The scope and frequency of the internal audit program with regards to commercial lending should be commensurate with the level of commercial lending risk exposures and the complexity of the loan portfolio. Any high-risk issues identified in commercial lending reviews should be reported to the Board as soon as possible, with timely follow-up activities.

APPENDIX 1 – RISK FACTORS FOR CRRS

The following tables contain descriptions of both qualitative and quantitative risk factors.

Quantitative Risk Factors

Risk Factor	Description
Financial Risk – General Commercial Borrowers	<p>Financial performance is assessed using historical information as well as projected financial health by applying common ratios in the following categories:</p> <ul style="list-style-type: none"> • Debt repayment; • Leverage; • Liquidity; and • Profitability trends.
Financial Risk – Specialized Lending	<p>These factors are used for lending activities to borrowers whose primary source of cash flow for loan repayment is exclusively received from commercial real estate assets or the sale of real estate development projects.</p> <p>The two cash flow characteristics that require a unique approach in assessing financial risk factors are:</p> <ol style="list-style-type: none"> 1. Income Producing Real Estate (“IPRE”), where the source of loan repayment is from stabilized leasing and rental revenue of third-party tenants. The rating is highly dependent on the cash flows of IPRE owned by the borrower. The PD has an inverse correlation with IPRE’s Debt Service Coverage (“DSC”) and by extension, a high direct correlation with the IPRE’s Loan to Value (“LTV”). 2. Land acquisition, development, and construction, where the source of loan repayment is from loan conversion as development and/or construction progresses, sale of the real estate property to third-party buyers, and/or the borrower/sponsor’s resources.

Qualitative Risk Factors

Risk Factor	Description
Industry Risk	<p>The assessment and assignment of risk should be supported by an analysis of industry risk. Management should select an acceptable and reputable source for an Industry Rating Report that is relevant to the regional market of the credit union.</p> <p>Risk assumption is systemic, which is caused by macro-economic, market, social, and/or geopolitical changes faced by all borrowers. Aside from considering sensitivity to economic cycles and industry maturity, assignment of risk should also consider barriers to entry such as competitiveness, vulnerability to substitutes, technological change, and regulations (i.e., production, new entrants, or quotas) if reliable information is available.</p>
Market Risk	<p>Assessment of a borrower’s relative position within its market should include, but is not limited to, the following considerations:</p> <ul style="list-style-type: none"> • The borrower’s ability to set price(s);

	<ul style="list-style-type: none"> • Competitiveness of the borrower's position in terms of leadership of the market; • Value added by the borrower's ability to differentiate the products and services it offers to the market; • Diversity of customer base and concentration risk mitigation; • Relative production costs based on sustainable factors such as diversified supplier base and economies of scale; and • Timeliness and effectiveness of the borrower in responding to changes in regulatory framework, trading environment, technology, demand patterns, and to the macroeconomic environment.
Management Risk	<p>Management structure, experience, quality, track records, and succession plans are key success factors in the borrower's business.</p> <p>Assessment of management risk should include but is not limited to the following considerations:</p> <ul style="list-style-type: none"> • Transparency and understandability of management and organizational structures; • Depth of experience related to the specific business and managing through adverse conditions; • Stability of the team, and their track records of successful execution of plans; • Level of compliance with terms and covenants (financial and non-financial) outlined in the credit agreement, and whether the borrower is operating within their credit limit; • Timeliness and quality of required reporting (financial and security); appropriateness of the management team (i.e., comprised of trained professionals for specific functions, such as CPAs in finance); and • The existence of succession plans and the viability of plan implementation.
Recourse and Alternative Funding Risks	<p>This factor is intended to evaluate the guarantor's future capacity to meet recourse obligation and the availability of alternative sources of financing in addition to the credit union.</p> <p>The assessment should include, at a minimum, the following:</p> <ul style="list-style-type: none"> • Availability of personal and corporate recourses; • Ability of the shareholders and guarantors to inject additional funds through assessment of verified personal net worth statement and guarantor's cash flow; and • History of willingness to invest to support the business at a critical period.

APPENDIX 2 – STANDARDS FOR COMMERCIAL REAL ESTATE LENDING

The table below outlines expectations and best practices for commercial real estate lending.

Real Estate Development Construction Loans	
Definition	Construction loans are multi-draw facilities based on cost-to-date and cost-to-complete. Such loans fund hard and soft cost components of a commercial real estate development project.
Completion Risks Analysis and Assessment	<p><u>Analysis</u></p> <ul style="list-style-type: none"> • Feasibility of market absorption: evaluate the project's potential for sales or lease and conduct a proforma appraisal. • Feasibility of construction: validate construction plans, schedules, and budgets with the help of a project monitor or quantity surveyor. • Contractor experience: assess the experience and track records of contractors and subcontractors. <p><u>Assessment (Underwriting)</u></p> <ul style="list-style-type: none"> • Borrower/developer background: assess their experience and financial capacity to ensure project completion. • Personal and corporate indemnitors evaluation: evaluate their net worth and capacity to inject equity to ensure project completion. • General contractor review: ensure the general contractor has experience completing similar projects.
Underwriting Standards	<p><u>Loan to Cost</u></p> <p>This standard is to set maximum lending values and minimum equity for a development project. The maximum threshold should be conservatively aligned with the risk appetite of the credit union.</p> <p><u>Minimum Pre-Sales</u></p> <p>The primary source of loan repayment should come from the sale or refinancing of the property being developed unless alternate eligible collateral of acceptable lending value is pledged.</p> <p>The credit facility should be secured by a pre-determined minimum qualified pre-sale and must meet the following criteria:</p> <ol style="list-style-type: none"> a) Be at arm's length with a firm sales and purchase agreement; and b) Have deposit levels at the maximum permitted by law. <p>Note: For owner-occupied and income-producing properties, long-term refinancing is usually obtained and approved.</p> <p><u>Terms</u></p> <p>The maximum loan tenor should be appropriate for the development project and within the credit union's risk appetite.</p>

	<p>If an interest reserve is included as part of the loan, the credit union should have policies to establish a buffer to cover potential increases in the prime rate.</p> <p><u>Appraisals</u></p> <p>The lending value of the real property taken as security must be based on the lower of the “as is” value or the actual confirmed purchase price.</p> <p>When adjusting the lending value for new rezoning, rationales and risk mitigation measures must be thoroughly documented.</p> <p>It is industry norm and best practice for the credit union to establish an approved list of appraisers.</p>
<p>Land Only and Predevelopment Loans</p>	<p>The purpose of the loan must be to assist the developer (member) to acquire land or pay for predevelopment costs with the intention to take the project through to development.</p> <p>To manage risks, the credit union should establish the following standards:</p> <ul style="list-style-type: none"> • Maximum lending amount and minimum equity: based on the lesser of the original cost confirmed with a purchase contract at arm’s length or an up-to-date appraisal; • Maximum loan tenor: Management may extend the loan, but this should be approved as an exception thorough documentation of rationales and risk mitigations; • Project details: ensure sufficient understanding of the project to provide confidence that: <ul style="list-style-type: none"> ○ The project can be structured in accordance with the credit union’s policy and standards, including any requirement for additional equity; ○ The total project funding requirement is within the credit union’s single member lending cap, or syndication partners have been arranged; and ○ There is acceptable and credible near-term take-out financing.
<p>Disbursement Controls</p>	<p>Effective disbursement controls are essential for managing construction risk.</p> <p>The credit union should ensure the following:</p> <ul style="list-style-type: none"> • Minimum threshold: establish a minimum threshold where a project monitor, quantity surveyor, or qualified professional third party is employed to assist with the disbursement process; • Construction draws/margins: ensure that construction draws and margins are commensurate with verified improvements; and • Budget balance: maintain the budget in balance with sufficient availability of the credit facilities to fund the completion of the development.

Income Producing Real Estate	
Definition	Long-term financing secured by real estate assets. The product is generally referred to as commercial mortgage and is reliant on stabilized lease revenue from income producing real estate ("IPRE") for debt servicing.
Analysis of Industry Risk	<p>Property cash flow and its sustainability are influenced by specific property type which have unique inherent risks. Property types are retail, industrial, office, and multi-residential.</p> <p>Key macro risk factors impacting IPRE cash flow include:</p> <ul style="list-style-type: none"> • Cyclical factors: general and local macroeconomic conditions significantly affect both demand and valuation of IPRE; • Access to capital: variations in the number of active lenders and the terms and conditions of financing influence purchasers' decisions, impacting property values through the volatility of capitalization rates; and • Oversupply: sectors like office and retail, which have long development cycles, face high revenue stream volatility due to uncertain demand upon project completion.
Underwriting Standards	<p><u>Business Risk</u></p> <p>The evaluation of business risk for IPRE borrowers includes non-financial qualitative factors such as:</p> <ul style="list-style-type: none"> • Tenant quality: influences the property's desirability for other tenants and the sustainability of rental revenue; • Lease maturity profile: affects the variability of revenue; • Property condition: impacts the marketability of the property and its attractiveness to other tenants; and • Location: can either broaden or limit the tenant market and influence the property's marketability. <p><u>Financial Risk</u></p> <p>Both the probability of default and loss given default are directly correlated with the cash flow produced by the IPRE.</p> <p>The evaluation of financial risk focuses on quantitative factors such as the IPRE's Loan to Value ("LTV") and Debt Service Coverage ("DSC") ratios.</p> <p>The LTV is the maximum lending value based on the lower of:</p> <ul style="list-style-type: none"> • The appraised value (within the underwriting guideline period) of the property; • The purchase price (within the underwriting guideline period); and • The underwritten value, which is based on the net operating income ("NOI") of the property over the accepted capitalization rate, as determined by the credit union for different property types/geographies.

	<p>The DSC is the ratio of NOI (after allowances for capital and other reserves as determined by the credit union) to debt service obligations (based on the credit union's underwriting guidelines). The following factors should be considered:</p> <ul style="list-style-type: none"> • Revenue stability: confirmed with a rent roll assessment for vacancy; and • Revenue sustainability: confirmed through an analysis of lease maturity. <p><u>Amortization</u></p> <p>Amortization is a process of the loan being reduced overtime through scheduled payments of both interest and principal. The maximum amortization period has a direct impact on DSC and LTV which in turn affect the overall risk rating of the IPRE borrower. In determining the loan amortization period, the credit union should consider the following areas:</p> <ul style="list-style-type: none"> • Geographical location: ensure to assess vacancy risk related to population size and economic stability of the communities; and • Property condition: notwithstanding population factor, the remaining useful life of the building being financed (assessed by approved professional service provider) is a key consideration in determining maximum amortization.
Stress Testing	<p>To assess the property's sustainable cash flow, the actual cash flow of new deals should be stress-tested to simulate the impact of rising interest rates.</p> <p>A rate shock (test rate) should be applied above the actual rates paid by the member. The credit union should establish an appropriate buffer for both fixed and variable rates in the underwriting policies.</p>
Factors to be included in Annual Credit Review	<p>Cash flow for IPRE tends to be stable once tenants are in place. In addition, loan structure generally prevents major changes to the loan terms. DSC and LTV are typical quantitative financial risk factors used to assess risk ratings annually.</p> <p>The following are four basic tests that should be considered as part of the annual review and refresh of risk rating:</p> <ul style="list-style-type: none"> • Payments made as agreed; • Property taxes paid as required; • Property conditions maintained (site visit); and • Property insurance maintained.