

# Dialogue

## on Sound Business & Financial Practices

A publication of the Deposit Insurance Corporation of Ontario (DICO)

May 2005, Volume 10, Number 1

**Dialogue** is produced in association with an industry advisory committee to promote discussion between directors and management on featured topics.

Readers' questions are welcome, and may be featured in a future **Dialogue**.

Contact DICO Policy & Research Department@ 1-800-268-6653, (416)325-9444, (416)325-9722 (fax) or e-mail: info@dico.com.

#### Contributors:

**Richard White**

#### Commercial Loans Task Force Members:

- Bruce Rodrigues
- Brian Lawson
- Rob Adamson
- Dan O'Connor
- Al Brooks
- Brian MacDonald
- Peter Collins
- Frank Hakimi
- Frank Kennes
- Ed Boere
- Barry Roth
- John Klassen
- Roger Honsberger

#### FUTURE TOPICS:

- Succession Planning
- Structural Risk
- Technology Risk

## Commercial Lending Practices

In an earlier issue of the Dialogue, background information was provided on the task force on commercial lending. This task force made up entirely of industry representatives undertook to develop best practice guidelines that might be helpful in the commercial lending area surrounding:

- Credit Risk Ratings;
- The Watch List Process;
- Industry Codes and Concentration Risk.

We are pleased to advise that guidelines and supporting tools have now been developed and are available on DICO's website. These materials also provide additional guidance in meeting the requirements in these areas under By-law No. 5 and addressing the considerations outlined in the sample workbook module for Commercial Lending. DICO is currently updating the Reference Manual to incorporate these industry best practice guidelines.

**We wish to thank all members of the Task Force for their participation in the development of these guidelines and supporting tools.**

### Credit Risk Ratings

Risk rating involves the categorization of individual loans, based on credit analysis and market conditions into a series of graduated categories of increasing risk. Risk Ratings should be conducted:

- at the time of application for all new or increased loan facilities;
- as part of the annual review process;
- in situations where new information is considered that may materially affect the credit risk of the loan.

Board policy should optimally set the maximum credit risk allowable by credit classes and aggregate maximum portfolio credit risk. The number of risk rating categories should be reflective of the size and complexity of the credit union's commercial and agricultural loan portfolio. The task force has developed a risk rating model, guideline and supporting Excel spreadsheet that incorporates six risk classifications. A summary of the risk ratings is outlined below.

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

## The Watch List Process

Accounts that require increased or more frequent monitoring should be placed on a Watch List. These may be situations identified under the annual review process or where evidence of increasing risk is noted, such as:

- Deteriorating or lack of financial information;
- Covenant breaches (e.g. earnings shortfall or losses);
- Potential security shortfalls (e.g. asset sale, loss or damage, fraud);
- Potential debt service shortfalls (e.g. significant revenue decline);
- Significant adverse developments (e.g. restructuring, unexpected management departures, loss of major customer, legal action, etc., labour dispute /strike, new competition).

A Watch List account is assigned a risk rating of 4.

## Reports

When a loan is placed on a Watchlist, a report should be prepared providing a full summary of the credit facility and outstanding loans. The report should also include:

- A history and rationale for Watchlist status;
- Comments on recent events;
- Recommendations and action plan;
- Date of next review.

The credit union should establish the process for reporting new Watchlist accounts, the frequency of required updates etc. and outstanding accounts.

This process should cover:

- the materiality/size of accounts to be included;
- the frequency and distribution of individual and summary reports;
- appropriate escalation procedures.

## Industry Codes and Concentration Risk

Credit policies should specify prudent limits on concentration of risk including loan concentrations within certain industries.

### Industry Classification

To facilitate measuring and monitoring loans concentrated within certain industries, it is recommended that all commercial loans are classified using the North American Industry Code Standards (NAICS). For simplicity, it is suggested that only the primary industry codes should be used except for agricultural, construction and real estate loans. Loans in these sectors require further segregation and should be classified by the use of industry sub-codes. Additional NAICS codes are available for use where required and where further classification is appropriate. These can be obtained through the NAICS website at <http://www.census.gov/epcd/naics>.

### NAICS INDUSTRY CODES

Primary Code	Primary Category	Sub Code	Sub-Group
11	Agriculture	111	Crop Production
		112	Animal Production
		113	Forestry
		114	Fish/Hunting/Trap
		115	Support Activities
21	Mining/Oil/Gas Exploration		
22	Utilities		
23	Construction	231	Prime Contracting
		232	Trade Contracting
33	Manufacturing		
41	Wholesale		
44	Retail		
45	Retail		
48	Transportation		

Primary Code	Primary Category	Sub Code	Sub-Group
49	Warehousing		
51	Information/Cultural		
52	Finance/Insurance		
53	Real Estate	531	Real Estate
		532	Rental/Leasing
54	Professional/Scientific/Technical		
55	Management		
56	Administration		
61	Education		
62	Health Care		
71	Arts/Recreation/Entertainment		
72	Accommodation/Food Services		
81	Other Services		
91	Public Administration/Government		