Ontario
Deposit Insurance Corporation of Ontario
Société ontarienne d'assurance-dépôts

# Dialogue

## on Sound Business & Financial Practices

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**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.

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FUTURE TOPICS:

- By-law #5 Implementation
- Commercial Lending Practices
- Structural Risk
- Technology Risk

# Commercial Loan Review (CLR) Project

## Background

A Commercial Loan Review (CLR) pilot project was initiated in early 2003. The main objectives of this initiative were to identify the level of credit risk inherent in the commercial and agricultural lending areas and assess how credit unions were managing their commercial lending activities.

The On-Site Verification (OSV) program is designed to assess the quality of management based on adherence to policies and procedures as outlined in By-law # 5. The purpose of the CLR is to complement the OSV process by:

- assessing the overall quality and risk of the commercial loan portfolio
- documenting findings and observations
- providing recommendations incorporating best industry practices

## Results to Date

Since the start of the project in 2003, 16 CLRs have been conducted. Approximately 1,200 loans totaling $1.5 B have been sampled representing approximately 39% of the average commercial and agricultural loans outstanding in the system. The table below provides a summary of findings according to the reviewer's "overall opinion on risk".

| Overall Opinion of Risk | # of MIs | Total Assets ($million) | % of System Assets |
|---|---|---|---|
| Excellent | 2 | 168 | 0.8% |
| Good | 3 | 1,455 | 6.6% |
| Satisfactory | 7 | 6,005 | 27.0% |
| Needs Improvement | 4 | 1,336 | 6.0% |
| Total | 16 | 8,965 | 40.4% |

General comments on findings to date:

- Based on amounts outstanding, 10.4% of the loan portfolio is rated low risk while 10.5% of the loan portfolio is rated high risk
- Real estate based lending represents almost 30% of total loans sampled with average loan to value ratios around 65%

The assessment and opinion of risk is primarily determined from an analysis and consideration of key considerations and practices in the lending process as outlined below:

- Due diligence at origination is in evidence and all aspects covered adequately
- Security held for loans is appropriate for level of risk
- A viable secondary source of repayment is in evidence
- Conditions precedent to participation are sufficient and monitored effectively to ensure borrower's continuing ability to comply
- A current financial statement is on file, completed at a level commensurate with size and complexity of account
- Frequency of financial reporting is adequate to properly monitor financial trends/credit terms
- Interim/draft financial results agree and align with year-end results
- Credit file contains recent business plan/financial forecasts
- Company premises have been visited by portfolio manager within past twelve months
- There is no evidence of frequent excesses over authorized limits, payments on term debts backing into operating loans, or being deferred/amended
- Operating loans do not show heavy usage or

frequent levels beyond forecast levels, without valid reasons recorded or without remedy
- There is no evidence of rapid growth or steady declines in business volumes
- There is no evidence of high levels of returned cheques or frequent chargebacks
- Sales, profits, working capital, cash flows and interest coverage show steady/positive trends
- The relationship between Operating Loans, Accounts Payable, Inventory and Accounts Receivable shows steady/positive trend
- The owner has sufficient investment in the business and/or the ability to contribute funds if necessary
- The owner has adequate business acumen and appropriate background for the business
- Sufficient life insurance and/or a satisfactory succession plan exists to protect the company's continuity
- Sufficient diversification of clients/suppliers exists to ensure continuity of product
- Credit union is sole provider of operating credit and of borrowing entity's chequing account

Three credit granting practices not commonly followed include:

- Obtaining business plans and forecasts
- Life insurance and succession planning
- Completing and documenting site visits.

Representatives from all institutions that were involved with the CLR project attended a symposium on September 28, 2004 sponsored by DICO. The symposium was held to review key findings and determine how best to proceed with future initiatives to help address areas where opportunities for improvements existed. Participants developed a list of issues that they felt they could address over the next three to six months and would be helpful in the commercial lending area.

This involved developing best practice guidelines surrounding:

- Loan Risk Ratings
- The Watch List Process
- Industry Codes and Concentration Risk

Three industry workshop groups were established to help develop and formulate best practices guidelines. Recommendations from each group will be circulated to CLR participants for further review and consideration. Once this is completed, DICO will assist with formulating recommendations into appropriate guidelines which will be shared with all institutions and incorporated into the CLR process and related publications, such as the Reference Manual, as necessary.

The workshop representatives are:

| **Topic** | Risk Ratings | Watch List | Industry Codes |
|---|---|---|---|
| **Date** | November 15/04 | December 13/04 | January 24/05 |
| **Host** | CUCO | St. Willibrord | Mennonite Savings |
| **System Participants** | Peter Collins CUCO | Frank Kennes St. Willibrord | Barry Roth Mennonite Savings |
| | Bruce Rodrigues Heartland | Bruce Rodrigues Heartland | Bruce Rodrigues Heartland |
| | Brian Lawson CS Co-op | Rob Adamson Woodslee | Andre Schroer CUCO |
| | Dan O.Connor Northern | Al Brooks Niagara | Richard Bird Hepcoe |
| | Brian MacDonald Northern Lights | Arnold Denton DUCA | Ron Choma First Ontario |

Individuals are encouraged to provide comments to any of these working group members.

## Enterprise Risk Management (ERM) Workshop-*December 9, 2004*

A one day workshop on ERM has been arranged by CUSOURCE at the CUMIS Group, 151 North Service Road, Burlington. The workshop will build on the foundation of the recently revised standards of sound business and financial practices in Ontario and BC. A group of credit unions in BC along with Stabilization Central have developed an approach to managing risk which builds on the concepts of ERM.

Participants will benefit from hands-on case work as well as an instructional format. The workshop is not limited to credit risk but expands to include regulatory risk, operating risk, and reputation risk. Participants will focus on risk that is important to manage, not risk that is easy to manage. Participants will discover, the concepts of ERM along with the new standards of sound business practices.For more information on this workshop please contact CUSOURCE:

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