



# Dialogue

## on Sound Business & Financial Practices

**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**.

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### Help Us Reduce Costs!

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### FUTURE TOPICS:

- OSV - FAQ's
- Board Planning Tools
- Business Planning
- Privacy Considerations
- Lessons from the past

## BY-LAW #5

### Credit Management Standard

Recent findings from On-Site Verifications (OSVs) indicate that improvement is being made in the credit management area, although some further progress is required, particularly with respect to lending criteria, to ensure effective ratings are achieved.

As required under By-law #5, credit management policy must set out lending criteria for each loan class. The credit management policy, and any changes to it, must be approved by the board and must be included as part of the annual policy review. The board must ensure that the credit management policy is adequate for its size and complexity taking into account considerations such as asset size, number and expertise of staff, range of products and composition of loan portfolio etc.

Credit management policy should outline the general requirements to evaluate a loan application, including considerations of the minimum credit information and level of credit evaluation required. Different types of credit evaluation may be appropriate for various lending decisions.

For example, policy requirements for certain RRSP loans may include the option of using an abridged or simplified application form and a modified evaluation process. Likewise, policy may provide some latitude for other types of loans (e.g. short term and low value loans, or loans where the loan to value ratios are low).

### Credit Evaluation

#### **Personal Loans and Residential Mortgages**

#### Credit Bureau

One of the most effective tools used in the credit evaluation process is the credit bureau report. This report provides information on outstanding credit and a summary of the payment history of creditors including credit cards etc. Credit Bureau reports are helpful in:

- confirming a member's liabilities and credit history;
- confirming the extent of credit information identified on the loan application;
- evaluating the capacity of the borrower to repay all borrowings;
- establishing a public record of the member's obligations to your institution;
- establishing a level of risk for appropriate pricing.

It is recommended that a Credit Bureau report is obtained for all loans unless a recent report is already on file. A credit bureau report **should be obtained** for all new borrowers, rewritten loans, any loan of a material\* amount and in situations where borrowers have minimal net worth.

\* Materiality should be considered in the context of lending license limits.

Information from Credit Bureau reports can be very useful, when combined with a credit scoring system to evaluate levels of risk, loan pricing and security requirements.

## Employment and Income Verification

Verification of employment and income should always form part of the credit evaluation process and should be a requirement for new borrowers, rewritten loans, and any loan of a material\* amount.

Income verification can be accomplished by requesting a copy of the latest pay stub. In situations of a change in employment or where members are self-employed, alternative evidence might include:

- direct payroll deposit records;
- salary grids;
- income tax assessments;
- confirmation from employer.

When employment is unsure, confirmation should be obtained through direct contact with an employer or from an employment letter on company letterhead.

Regardless of the method used to confirm income and employment, a suitable notation should be recorded in the loan file together with copies of any supporting documentation where applicable.

## Debt Service Ratios

Policy should specify the extent of credit analysis for each loan class. For personal and residential mortgage loans, this should include an evaluation of debt servicing capacity. There are two debt service ratios that are used for Personal and Residential Mortgage credit evaluation:

- Gross Debt Service Ratio - GDSR (for servicing of Mortgages);
- Total Debt Service Ratio - TDSR (for servicing of Personal and Mortgage Loans).

GDSR is based on total housing costs such as mortgage payments (principal and interest), property taxes, any fees (e.g. condo fees) and a percentage of heating costs (especially for insured mortgages).

Policy should establish a maximum range for GDSR for mortgage lending purposes. In most circumstances, it is recommended that the GDSR not exceed 35% of gross annual income.

TDSR includes all regular payments including total housing costs (i.e. mortgage payments, condo fees, rent, etc.) loan and credit card payments, vehicle leases, alimony and other support payments, etc. In normal circumstances, it is recommended that the TDSR not exceed 40% of gross annual income. When considering income, it is important to note that the income of a spouse can only be used if the spouse co-signs the loan. In these situations, all joint obligations including household expenses, along with any commitments of the spouse, must also be included in the calculation of debt service ratios. Also, care should be taken with respect to the inclusion of other income, including overtime which may not be sustainable in the future.

When determining monthly credit card payments for debt service purposes, 5% of the authorized credit limit is generally used rather than a percentage of the outstanding balance. While this may not be a requirement in all cases, this more conservative approach is recommended for new borrowers and in situations where there is evidence that the borrower's total debt is increasing.

## REFERENCES:

**DICO By-law #5: Standards of Sound Business and Financial Practices; Sound Business and Financial Practices Reference Manual: Chapter 5; Guide to DICO's On-Site Verification (OSV) Process; DICO's OSV Manual.**

## OSV Review Process

Member Institutions are encouraged to contact DICO in writing if there are any inaccuracies in OSV findings.

Concerns should be addressed to the attention of the Risk Analyst who will review the OSV findings with the inspector involved and provide a written response to the member institution on the issues raised. If the member institution requires further clarification, a request for a second review can be made to DICO's Risk Management Committee, a sub-committee of DICO's Board of Directors.