Credit Risk Management

Executive Summary

Sound credit management is a prerequisite for a financial institution's stability and continuing profitability, while deteriorating credit quality is the most frequent cause of poor financial performance and condition. The prudent management of credit risk can minimize operational risk while securing reasonable returns.

Ensuring lending staff comply with the credit union's lending licence and by-laws is the first step in managing risk. The second step is to ensure board approved policies exist to limit or manage other areas of credit risk, such as syndicated and brokered loans, and the concentration of lending to individuals and their connected parties (companies, partnerships or relatives).

The board and management should also set goals or targets for their loan portfolio mix, as part of their annual planning process. The loan portfolio should be monitored on an ongoing basis, to determine if performance meets the board's expectations, and the level of risk remains within acceptable limits.

Standardized lending procedures should be adopted to reduce risk of transactional error, and ensure compliance with regulatory requirements and board policy. Approval and disbursements, documentation, lending staff and loan security are just some of the procedures recommended in this chapter.

A credit union can meet standards of sound business and financial practices by ensuring it has developed and implemented credit policies, risk and performance measurement techniques, and risk management procedures comparable to those contained in this chapter. Policies, measurement techniques and procedures should be appropriate for the size

Legislative Summary

Management and lending staff should be apprised of the comprehensive lending legislation set out in the Act and Regulation 76/95, as well as relevant legislation in other Acts. Members of the board should also be familiar with the major aspects of lending legislation. Referring to or repeating lending legislation in board policy and operational procedures is an effective means to ensure compliance.

The following is a summary of important lending legislation which defines lending powers, limits and restrictions, both in the Act and Regulations, as well as in other relevant statutes and bodies of law.

Lending Powers

A credit union's lending powers are formally defined by its lending licence, which it obtains either by designation under the Act, or through an application to FSCO.

Credit union by-laws also impact lending powers. A by-law is required to request a change to the credit union's lending licence, and determines membership eligibility for the credit union, thereby impacting who can borrow from the organization.

The Act additionally prescribes lending powers, restrictions and limits. Refer to Schedule 5.1 for a summary of important lending legislation. For actual text, refer to the appropriate sections of the Act and Regulation 76/95. Violations of the Act will cause manager/director liability, and may lead to penalties or economic damages.

Lending Licences

Under section 196(5) of the Act, a grandfathering provision effective March 1, 1995 established for each credit union a deemed lending licence comparable to the lending powers prescribed by the credit union's then existing by-laws.

The legislation proclaimed in 1995 introduces different classes of loans, each associated with a different class of lending licence, which are as follows: agricultural, commercial, institutional, personal, residential mortgage and bridge loan, syndication and unincorporated association lending. The loan classes are defined in sections 51 to 57 of Regulation 76/95.

Schedule 5.1 *RELEVANT LENDING RELATED LEGISLATION*		
	The Act	**Regulation 76/95**
Adherence to lending policies and procedures	190	
Establishment of written lending policies and procedures	191	50
Loans to be made in accordance with lending license and the Act	193	59
Loans to members only	194(1)	
Loans to unincorporated associations	194(2)	194(3)
Lending limits and variations	195	
Lending licences	196	
Loan classes		51
Definition of loan classes		52-57
Classes of lending licences		58
Syndicated loans		60
Individual and aggregate lending limits and lending matrices		61, 62
Aggregate limits on commercial and agricultural loans		63
General restrictions on security for loans		64, 65
Advertising regarding credit products and services	100	76

In order to make a loan of a particular class, the credit union must have the appropriate lending licence. A credit union may only make an agricultural loan if it has an agricultural lending licence. It may only make a commercial loan if it has a commercial lending licence.

A credit union must apply to the Superintendent of Financial Services (the Superintendent) for a new lending licence if it wishes to expand into a new class of loans, or to expand lending limits for a particular class. When considering expanding the line of loan products, it is recommended that an adequate study of required liquidity, equity and qualified, experienced staff resources be made prior to such a request.

Licence Non-Compliance

The Superintendent may revoke or amend a lending licence at any time, should the credit union fail to comply with its licence or with a provision of the Act or Regulation 76/95.

An amendment might include the addition of conditions or restrictions, or the reduction of a lending limit on a particular class of loans. Revoking a lending licence is considered a last resort by the Superintendent, and would most likely only follow should other remedial measures (conditions or restrictions, or a reduction in lending limits) prove ineffective.

Lending Limits and Lending Limit Matrices

Lending licences can carry lending limits that are either set at fixed amounts, or determined under growth matrices set out in sections 61 and 62 of Regulation 76/95. Where a lending licence has a limit fixed in the licence, the credit union will have to apply to the Superintendent any time it wants to increase the limit due to increased loan demand or increased asset size and lending expertise.

However, where the lending licence utilizes lending limit matrices, lending limits will automatically adjust with growth in the credit union (growth being measured by total regulatory capital and deposits as per annual audited financial statements). There are two separate lending limit matrices. The first matrix, authorized under section 61 of Regulation 76/95, details three sets of graduated limits on the amount of personal, residential mortgage and bridge loans, that can be made to an individual. (Loan limit matrices do not exist for commercial or agricultural lending) The second matrix, prescribed by section 62, provides graduated limits on the amount of total loans (any number of loans of any type) that a credit union can make to a particular person and his/her connected persons.

Not every credit union will automatically qualify for the use of lending limit matrices. A credit union must specifically request the use of a lending limit matrix through a lending licence amendment, and must provide the Superintendent with a rationale for the use of the graduated lending limit matrix.

Illegal Credit Transactions

Any loans in excess of a credit union's lending limits, as defined by the organization's lending licence and by-laws, are illegal. Additionally, a credit union may only offer those loan classes authorized in its lending licence (e.g. personal loans, mortgages, commercial, agricultural, etc.) to authorized members, otherwise it is lending illegally.

Authorizing illegal loans is a contravention of the Act and is considered an offence under section 322 of the Act. Any director, officer or agent of a credit union who commits such an offence, authorized, or acquiesced to the offence, is liable. (Penalties prescribed in the Act include a maximum fine of $100,000 or maximum imprisonment for two years). Therefore, it is recommended that directors, officers and credit committee members object to the existence of illegal loans known to them, and advise the Superintendent in writing of any loans which violate the Act, the lending licence, or the by-laws.

In order to assist the credit committee and staff in their responsibilities to grant proper loans, board policy should define what constitutes a legal and an acceptable loan. Additionally, senior management, the credit committee and the board should monitor for illegal loans and large loans that approach regulatory limits.

Syndicated Loans

Should a credit union find that periodically it must decline borrowers for loans exceeding its legal lending limits, the credit union can seek to syndicate loans with its league or another financial institution. Before a credit union can syndicate a loan on behalf of one of its members, it must possess a syndication lending licence. If it does not have one, it must apply for one from the Superintendent.

A credit union does not require a syndication lending licence to participate in a syndicated loan where it is not acting as the syndicating credit union (i.e. the credit union is not organizing the deal on behalf of one of its members, but is participating in a syndicated loan organized by another credit union). Further restrictions and conditions of loan syndication can be found in section 60 of Regulation 76/95. The credit union, for example, can underwrite a portion of a syndicated loan only if it is within an applicable loan category and the limits of its own lending licence.

Other Lending Statutes and Common Law Obligations

In addition to ensuring compliance with the Act, Regulation 76/95 and its own lending licence and by-laws, the credit union must comply with other lending statutes, and should be aware of its lending liability under contract and tort law. Schedule 5.2 summarizes the major common law obligations of a lender. Schedule 5.3 highlights the content of specific statutes to which Ontario lenders should adhere. More detailed information on any of the statutes summarized below should be obtained, as required, from legal counsel. It is recommended that loan personnel be broadly informed of all relevant legislation affecting their loan portfolio.

Schedule 5.2 ***SUMMARY OF LENDER LIABILITY***
Major Obligations of a Lender under Contract and Tort Law • Duty to perform in accordance with the terms of a loan contract. • Duty to honour oral representations, especially to the extent they alter the terms of written agreements. • Implied duty to exercise reasonable care and skill in carrying out banking business. • Implied duty of confidentiality on a member's transactions. • Duty to avoid misrepresenting an existing state of facts to a member. • Duty to avoid slanderous or libelous treatment of a member. • Duty to avoid offering financial investment advice which can cause economic damage to a borrower.

Schedule 5.3 ***KEY LENDING LEGISLATION IN ONTARIO***	
Act	**Content**
Absconding Debtors Act	Provides remedies against debtors who attempt to avoid creditors.
Assignments and Preferences Act	Prevents debtors giving unjust preference to one creditor over another.
Bankruptcy and Insolvency Act (Canada)	Permits debtors to legally nullify creditor liabilities through realization and distribution of their assets.
Bulk Sales Act	Protects unsecured creditors in the event of a sale of all or most of business's assets.
Companies' Creditors Arrangement Act	Facilitates compromises and arrangements between financially distressed companies and their creditors.
Construction Lien Act	Provides supplier of services and materials with a lien against property under construction.
Creditors' Relief Act	Gives all creditors right to share in proceeds of a debtor's assets, where debtor has been successfully sued by one creditor.
Criminal Code (Canada)	Limits the amount of interest or fees chargeable on loans.
Debt Collectors Act	Governs and restricts methods of debt collection.
Environmental Protection Act	Prohibits any person from discharging contaminants into the natural environment in excess of prescribed levels. The act empowers the Government to issue administrative clean-up orders on persons with management or legal control of a contaminated property, which could include, in certain circumstances, credit unions in their capacity as mortgagees. Any such order is binding upon the successor or assignee of the property.
Execution Act	Establishes a procedure for enforcing court judgments against a debtor's property.
Family Law Act	Governs the rights to property between spouses that arise upon marriage, separation and divorce.
Farm Debt Mediation Act (Canada)	Provides protection to a farmer facing insolvency, including possible delays in the realization of security.
Farm Improvement Loans Act (Canada)	Facilitates and encourages the provision of intermediate and short term credit to farmers for the improvement and development of farms.
Fraudulent Conveyances Act	Prohibits debtors from conveying property to others with the intent of defeating, hindering, delaying or defrauding creditors.

Schedule 5.3 (continued) ***KEY LENDING LEGISLATION IN ONTARIO***	
Act	**Content**
Interest Act (Canada)	Prescribes the manner in which interest costs are disclosed by a lender to a borrower. In certain circumstances, it also limits the amount of interest which can be charged on loans.
Land Titles Act and Registry Act	Provide for a system of registration of interests in real property. The registration systems provide notice to third parties of the interest being registered.
Landlord and Tenant Act	Deals with rights between tenants and landlords. Under this Act, a landlord is entitled to seize property of a tenant, including property pledged to a financial institution as security whenever rent is in arrears.
Limitations Act	Denies creditors a right of action for damages for breach of contract after a lapse of a specified time (generally 6 years).
Mortgages Act	Provides for two remedies for the mortgagee upon default by the mortgagor: power of sale and foreclosure.
Personal Property Security Act	Governs the taking of security against personal property in Ontario. The Act also establishes a registry whereby priorities in rights to security are established and notice to third parties of security interests in a debtors assets is given.
Wages Act	Governs the assignment of wages to settle debts, fixing the maximum assignment to 20 per cent of wages, without a court order.

Policy

It is recommended that the credit union adopt a credit policy that addresses:

- authorized credit instruments;
- limits or prohibitions on credit exposures including concentration;
- connected, restricted party and staff loans;
- lender approval limits;
- major lending criteria;
- securing loans;
- loan process;
- conditions for rewritten and restructured loans;
- frequency, form and content of board reporting.

These recommended objectives of credit policy are discussed in greater depth in Sections 5201 to 5211. Adopting a credit policy will assist the credit union to manage risk and to comply with the Standards in DICO By-law No. 5. The board's credit policy must be sufficiently flexible to allow for managerial scope and the application of professional lending judgment without being so general that effectiveness is lost. The specifics of managerial scope in lending as much as possible should be documented in operational procedures. For recommended operational procedures, refer to Section 5500.

Reference Materials

Examples of credit policy are available in the DICO publication Sample Policies, and are available to the industry for customization as appropriate. As well, the information provided in Sections 5201 to 5211 will also assist in establishing policies of credit management.

Regulatory Policy Requirements

Section 191(2) of the Act also requires credit unions to establish credit policies and procedures. FSCO has published Guidelines for Prudent Investment and Lending Policies and Procedures, which sets out guidelines for establishing lending policies and procedures. When establishing credit policies and procedures, management and the board should ensure they meet FSCO requirements as well as By-law No. 5 requirements. In addition to By-law No. 5 criteria and FSCO policy, credit unions may elect to establish other credit policies as they see fit.

Regulatory Compliance

Credit policies must not conflict with requirements prescribed by the Act, Regulation 76/95 and any interpretative bulletins or guidelines issued by FSCO. It is optimal for key regulatory requirements to be repeated in lending policies for greater lender clarity and ease of reference.

Credit Management Philosophy

Adopting a credit management philosophy is an important first step in drafting credit policy. The philosophy should set out the broad goals and objectives of a credit union's lending activities, as established by the board of directors. Developing a credit granting philosophy provides the board with an opportunity to express their vision for the credit union's lending program. This vision should govern all lending policy constraints and help address new situations where policy does not yet exist.

Credit management philosophies will vary amongst credit unions, reflecting the differences between members needs, and the credit union's goals and objectives. Some aspects of credit philosophy, however, should be the same for every credit union, such as first and foremost, protecting the safety of members' deposits.

Other possible considerations or principals that can form part of the credit management philosophy include the following:

- Lending is the credit union's core business. All loans must be considered in the context of providing creditworthy members with borrowing opportunities, at a reasonable rate of return for the credit union, while safeguarding the overall assets of the credit union.
- The credit union may return a portion of the income derived from lending to eligible borrowing members in the form of a loan interest rebate.
- The loan portfolio will be, as much as possible, diversified with the objective of spreading risk.
- Borrowers will be provided with a full explanation of the terms and conditions of loans before loan agreements are signed.
- Loan agreements and security documents will contain clear statements of terms and conditions, including fees and penalties, to the degree that is legally possible.

Authorized Credit Instruments

An important lending parameter that must be established by board policy is a list of authorized credit instruments. This section summarizes some of the more common credit instruments. Credit policy should state for each credit instrument the following: the maximum loan amortization period, credit offering circumstances (i.e. eligible loan purpose) and where applicable, special types of authorized products (e.g. various types of mortgages).

Schedule 5.4
SAMPLE CREDIT PRODUCTS

Loan Class	Credit Instruments	Credit Purposes
Agricultural Loans	• Mortgage • Term Loan • Line of Credit	Farm home, crop production, equipment, land, working capital
Bridge Loans	• Bridge Loan	Provide transitional financing for new home purchase.
Commercial Loans	• Mortgage • Term Loan • Line of Credit • Leases • Letter of Credit	Operating requirements, rental income properties, business premises, equipment purchases, capital
Institutional Loans	• Term Loan • Line of Credit	A loan made to a government body or agency, a municipal body or agency, or a school board.
Personal Loans	• Demand Loan • Term Loan • Line of Credit (secured and unsecured) • Automobile Lease • Overdraft Protection	Vehicle purchase, investments, RRSP purchase, education, vacation, gifts, home improvements, home construction, consolidation of loans
Residential Mortgage Loans	• First Mortgage • High Ratio Mortgage • Second Mortgage • Bridge Loans • Reverse Mortgage • Construction Mortgage	Principal residence, vacation home, non-profit use properties

Over time, as a credit union gains further experience and expertise in new lending areas, it may be able to expand the lending instruments offered within its lending classes. Product diversification is an important strategy which should be considered by management and the board. Refer to Schedule 5.4 for a sample list of credit products by loan class. Selection of a diversified mix should be based on the availability of demand and the internal resources required to offer these loan products.

Personal Credit Instruments

Schedule 5.5 outlines a number of credit instruments that are available for personal lending. These are summarized along with a list of common forms of security that are taken by credit unions for personal credit, not all of which are equally effective.

Schedule 5.5
PERSONAL CREDIT INSTRUMENTS AND SECURITY

Instruments	Security
Term Loan	Personal Property Lien
Demand Loan	Collateral Mortgage
Personal Line of Credit	Assignment of Securities
Credit Card	Pledge of shares and deposits
Financial Leases*	Assignment of moneys receivable**
Conditional Sales Agreements	Personal Guarantee**
	Wage Assignment**
	Lodgment of Title**

* For financial leases, security is not required as the credit union obtains ownership of the personal property upon execution of the agreement.

** A personal guarantee, a wage assignment or assignment of moneys receivable are viewed as supplemental forms of security which should be attributed a no dollar security value. A lodgment of title is generally viewed as a sub-optimal form of security. Refer to the following paragraphs for additional information.

Credit Management - Authorized Credit Instruments

Term and demand loans have historically been the most common forms of credit offered to members; these loans are for a fixed amount and are normally secured by major assets that are being financed. Recent consumer trends, however, have increased demand for personal lines of credit. These loans provide the borrower with a revolving sum of money up to a maximum limit, that can be used repeatedly, and is frequently unsecured. Whenever a personal line of credit is offered to a member, its availability should not be for an unlimited period of time, but rather, it should be subject to scheduled review and renewal, and where appropriate, collateralized. Lines of credit should be periodically monitored for the usage of these credit facilities and confirmation of upward and downward fluctuations.

A personal line of credit should be offered to all credit worthy members who might otherwise experience overdrafts in their chequing accounts. Under section 181 of the Act, overdrafts are prohibited, unless provided for, to a specified amount, in an overdraft protection agreement. For those credit unions that issue their own credit cards and hold the associated receivables, credit policies of the credit union should also require a line of credit to be approved for all members requesting credit cards.

Types of Residential Mortgage Instruments

There are several types of residential mortgages that may be offered by credit unions. Three of the more common types include:

- conventional first mortgages;
- high ratio, insured mortgages;
- conventional, second mortgages.

These credit facilities can be used for the purchase or construction of a home. (Construction mortgages are discussed later in this chapter).

Conventional First Mortgage

The conventional first mortgage is the instrument most commonly used to finance a home purchase. It entitles the lender to have first claim of the property in the event of a borrower default. In accordance with section 57 of Regulation 76/95, the principal amount for this kind of mortgage must not exceed 75 per cent of the value of the property when the loan is made. The value of the property should be determined by the property's appraised value or purchase price, whichever is the lesser amount.

High Ratio Mortgage

A high ratio mortgage is one in which the loan to property value ratio exceeds 75 per cent. These loans must be insured by a government agency (e.g. the Canada Mortgage and Housing Corporation created under the National Housing Act) or some private insurance company approved by the Superintendent. High ratio mortgage insurance protects the credit union against default and is required for compliance with section 57 of Regulation 76/95, although it is the borrower who pays the insurance premiums. It is technically possible to finance a property up to 95 per cent of its value if mortgage insurance is obtained.

Second Mortgage

Another type of residential mortgage is the second mortgage. A second mortgage is one in which the lender, in case of default, is behind the first mortgage in claim against the security (property). As this type of mortgage is higher risk, it should command a higher rate of return. Section 57 of Regulation 76/95 permits credit unions to offer second mortgages, as long as the total of the first and second mortgages on a property does not exceed 75 per cent of the property value, or unless mortgage insurance is obtained. When underwriting second mortgages, credit unions should consider the:

- maturity date of the existing first mortgage;
- size and interest rate of the first mortgage;
- ability of the proposed borrower to service both mortgage payments;
- potential depreciation or appreciation of the secured property.

Bridge Loans

All credit unions which have a mortgage lending licence can offer bridge loans. Bridge loans provide interim financing to a member for a property purchase with a closing date prior to that of an existing property being sold by the same member. Terms of up to 90 days are generally applicable. Repayment of the principal is not required until the closing date of the sale of the member's property. The following steps should be required by policy before advancing bridge loans:

- Executed unconditional agreement of purchase/sale for both the property being purchased and the property being sold.
- Irrevocable, acknowledged, letter of direction, from a lawyer stating that the funds from the sale of the property will be remitted to the credit union to extinguish the bridge loan.
- Written statements of mortgages outstanding from all mortgagees (other than the credit union) to determine the net equity in the property being sold after all deductions (i.e. real estate commissions, legal fees, etc.). This net equity must be equal to or greater than the amount of the bridge loan.
- Bridge loans may not exceed the limits prescribed in the by-laws/lending licence and compliance with regular lending policy.
- Sub-search for other registered liens, outstanding taxes, work orders, clouds on title, etc.

Reverse Mortgage Line of Credit

The reverse mortgage line of credit is a unique type of credit facility which requires adherence to special lending criteria. Like a conventional mortgage, the reverse mortgage involves the conveyance of an interest in land (real property) as security for debt, in particular a line of credit permitting demand drawings. As a result, a sound knowledge of mortgages is required before offering this product. A reverse mortgage differs principally from a conventional mortgage, in that there are no loan payments until maturity, at which time the original principal advanced plus all compounded interest must be repaid.

The reverse mortgage product is beneficial for two types of borrowers:

- Seniors who need additional cash to finance their needs but are unable to borrow due to income limitations.
- Individuals who are temporarily unemployed due to the pursuit of a higher level of education or persons taking a leave of absence from work for family, health or travel reasons.

The product generally offers two amortization options:

- Fixed Term (e.g. three years): for individuals who will re-enter the work force and resume normal mortgage payments or who plan to eventually sell their home and move to other accommodations.
- Life Tenure (approximated): for elderly individuals who wish to have the loan balance repaid from the eventual proceeds of their estate.

For a lender, reverse mortgages pose a number of risks including: term or credit risk, collateral risk, liquidity risk and interest rate risk. The following caveats are recommended to mitigate against these risks:

- The conditions of the reverse mortgage should be discussed in detail with the member so that he/she comprehends and fully accepts the credit costs and conditions of the program (e.g. settlement of the debt is expected when the homeowner dies or moves and sells the home). Members should be required to discuss their decision with their lawyer (members must receive independent legal advice) and a financial planner as appropriate. Powers of attorney and estate issues should be discussed.

- The credit history of the borrower should be confirmed as being satisfactory, and the original level of equity in the home should be significant. A conservative lending policy would set a loan to value ratio of 50 per cent at maturity; a moderate scenario might show the loan to value ratio at 60-70 per cent; under no circumstances should the loan to value ratio be expected to exceed 75 per cent at maturity.
- The arrangement should require a renewal every five years with a maximum program limit of 15 years. For life tenure reverse mortgages, actuarial tables must be consulted to estimate life expectancy since age is the critical determinant in calculating the credit limit. It is strongly recommended that a time cushion (e.g. an extra two to four years) be applied in order to reduce term uncertainty.
- Collateral risk should be minimized by selecting homes in neighbourhoods with proven capital appreciation rates. Annual reviews should be conducted to investigate the member's financial needs, to check collateral and recalculate the credit limit. A qualified property appraisal should be obtained at least every five years.
- Liquidity risk should be managed by establishing annual withdrawal limits, taking into account the loan term and the credit limit. Additionally, a portfolio limit for aggregate reverse mortgages should be approved, closely monitored and reported to the board annually.
- Interest rate risk should be managed by obtaining appropriate term funding. For life tenure reverse mortgages, the credit union should stipulate that renewals every five years are subject to interest re-pricing.

In summary, the reverse mortgage is an innovative instrument that may be very useful for certain members who are experiencing a shortage of cash and cannot borrow using conventional debt. The credit union, where applicable, can therefore provide a significant new service and in doing so be rewarded; reverse mortgages normally generate an extra 50 to 200 basis points over the conventional mortgage rate to cover associated risks. Credit unions should be aware that specialized personnel training is required to offer this product, and ensure that the member obtains independent legal advice.

Automobile Leases

Due to the increasing cost of new automobiles, automobile leasing has become an increasingly popular method of vehicle financing. For credit unions that have sufficient financial and other resources to offer leasing services to their members the following benefits can be pursued: improved servicing of member needs, increased loan penetration, increased member retention rate, and increased revenues.

Benefits

The benefits to members of automobile leasing include the following: up-front security payment is usually lower than a down payment on a conventional car purchase; monthly payments are smaller than on a conventional car loan and maintenance costs are usually lower (because most customers dispose of their vehicle long before any major repairs are needed).

Disadvantages

Automobile leases, however, also have disadvantages. From the member's perspective, leasing usually carries higher financing rates and charges than a conventional car loan, and it may not be economical for a consumer to purchase the vehicle at the end of the lease. From the credit union's perspective, the two major disadvantages include the liability insurance required for leased vehicles and the expertise and financial risk associated with the disposal of previously leased cars.

A credit union may meet market demand for leasing services either directly or through a subsidiary. For credit unions investigating automobile leasing, a number of factors must be considered, some of which are as follows:

- Under a car leasing arrangement, the credit union does not need to take chattel security as it owns the lease vehicle.
- In order to sell leased automobiles other than to the lessor, the credit union will need to obtain an automobile broker's licence.
- In order to protect itself from accident liability which is attached to the ownership of a vehicle, special insurance must be obtained, and appropriate documentation created for lessees to also acknowledge liability.

Given the above factors which expand legal liability for credit unions, it is recommended that leasing, where possible, be arranged through a limited liability subsidiary, or alternative car loans should be considered (discussed later in this chapter).

Before entering into the provision of lease products, a credit union which does not already have the necessary experience in leasing can contact a league, other credit unions with leasing experience, the Credit Union Central of Canada or the Caisse Centrale Desjardins.

Commercial Credit Instruments

Three fundamental instruments can be extended for commercial credits:

- commercial mortgages;
- commercial term loans;
- operating lines of credit.

A general overview of the three types of commercial credit is described below.

Commercial Mortgages

Commercial mortgages are defined as mortgage loans for business use, properties or multi-residential buildings. Commercial mortgages normally finance apartment complexes, retail and office buildings, or industrial properties providing warehousing and manufacturing facilities. (Under Regulation 76/95, mortgage rental properties in excess of four units, regardless of whether a building is owner occupied, constitute commercial loans. These can only be underwritten where a commercial lending licence permits.)

Construction Mortgages

Commercial construction mortgages and/or interim financing offered to construction companies and real estate developers for the building of new properties is a highly specialized type of lending which is not addressed in this reference manual. Cost overruns, structural defects, labour shortages, property liens under the Construction Lien Act and volatile real estate markets are risks which can lead to large potential losses for businesses in this industry. In order to engage in this type of lending, it is recommended that the credit union have significant real estate expertise and lend only on a strictly controlled basis to credit worthy contractors. Highly developed internal policies and specialized criteria for credit granting to real estate and construction companies are recommended.

Commercial Term Loan

A commercial term loan is a credit facility generally obtained to finance the fixed assets of a business (e.g. equipment, vehicles). Advances may be drawn down and are to be repaid over a fixed term according to a formula or schedule agreed upon by the credit union and the borrower. The amortization period of a commercial loan offered by a credit union must not exceed the economic life of the asset. Balloon payments (if any) at the end of the term loan should be restricted in size by lending policy and not exceed the value of the asset at the time of the balloon payment.

Operating Line of Credit

A commercial operating loan (also referred to as a line of credit) is a loan which supplements the day-to-day cash requirements of a business. Caution should be exercised when approving operating loans as they may represent higher credit risk than commercial mortgages or business term loans due to the nature of the security taken (e.g. inventory and receivables) and the lack of a definite draw down and repayment schedule. Additionally, operating loans utilize more resources of the credit union as extra manpower is required to monitor advances and security on a daily basis, and extra liquidity is needed by the credit union to accommodate potentially large fluctuations in loan demand.

Letters of Credit and Letters of Guarantee

A letter of credit is a promise of payment made by a financial institution on behalf of a member and for the benefit of a third party. Letters of credit are payable by the financial institution when stipulated conditions are met. A letter of guarantee is a similar undertaking by the credit union on behalf of a member, to a third party, which ensures compensation for non-performance of a contractual obligation (e.g. bid bond or performance guarantee). The purpose of a letter of credit or letter of guarantee is to substantiate a member's commitment to a contract with a third party.

The Act and Regulation 76/95 contain restrictions on letters of credit and letters of guarantee. Under subsection 178(1) of the Act, letters of credit and letters of guarantee must be (i) for a fixed sum of money and (ii) must require that the recipient has an unqualified obligation to reimburse the credit union for the full amount of the letter of credit or letter of guarantee. Under section 45 of Regulation 76/95, a letter of credit or letter of guarantee must have a fixed term and the credit union must have security at least equal to the amount of the obligation guaranteed.

When advanced for business purposes and for an amount greater than $25,000, a letter of credit or letter of guarantee constitutes a business loan for the purposes of the Act. As a result, the credit union must have a commercial lending licence (or deemed commercial lending licence under subsection 196(5) of the Act) before offering these instruments.

Letters of credit which are required by individuals, for purposes of court proceedings, should be classified as personal credit, and would be covered under the personal loan lending licence (or deemed lending licence) and the personal loan lending limits set out in section 61 of Regulation 76/95. (Refer to Section 5101 for more on lending licences and loan limits).

Limits

Apart from the lending licence restrictions, subsection 178(4) of the Act and section 46 of Regulation 76/95 prescribe a cap on the aggregate value of letters of credit and letters of guarantee that can be made by a credit union and its subsidiaries. This limit is prescribed in Regulation 76/95 as 10 per cent of regulatory capital and deposits of the credit union. (However, a credit union may petition the Superintendent for exemption from this limit under certain circumstances.)

Letters of credit and letters of guarantee provide financing to a member. As a consequence, these instruments require credit approval in the same manner as any other type of borrowing.

Documentation

A promissory note and a signed indemnification agreement (which may be combined in one document) must be obtained from the member, once the letter of credit or letter of guarantee has been duly approved. Standard forms for indemnification should be obtained from a league or a lawyer. The indemnification agreement should authorize the collection of a fee for this service, generally one per cent to three per cent per annum of the face value of the instrument. Letters of credit and letters of guarantee must be fully securitized in the same prudent manner as all other loans. Generally, these instruments note an expiry date. Where they are open (e.g. subject to the third party's cancellation) a condition of the credit facility must be that they must be renewed annually. Letters of credit should be recorded separately in the books of account and disclosed in the monthly loan report approved by the board, and reported in the notes to the annual financial statements.

Loan Volumes, Portfolio Mix and Industry Classification

Credit policy must limit the overall volume and mix of credit risk to be included in the loan portfolio. Credit policies should specify prudent limits on concentration of risk as follows:

- for each loan class, specify aggregate loan limits (as a percentage of capital and deposits) and individual loan limits (e.g. maximum dollar amount for individuals and their connected parties) - it may be prudent for these to be lower than what is allotted in the lending licence;
- establish prudent limits (either as a percentage of total loans or of total assets) and/or prohibitions on higher risk loan categories, including syndication loans, brokered loans, and loan concentrations within certain industries (refer Industry Classification below) , or riskier categories of loans within authorized lending classes such as personal loans for commercial purposes, social conscience loans, consolidation loans etc;
- establish limits on connected and restricted party loans (which may be lower than what is required by statute) as well as any policy restrictions or conditions for the approval of such loans.

Although authorized lending classes are clearly set out in the credit union's lending licence, it is nevertheless a prudent practice to acknowledge these lending classes in lending policy for easy reference by board and staff. Policy should state that the credit union must comply with its lending licence, and should set out those areas where policy restricts lending below the licence limit.

Industry Classification

To faciliate measuring and monitoring loans conectrated within certain industries, is is recommended that all commercial loans are classified using the North American Industry Code Standards (NAICS).

For simplicity, only the primary industry codes need to be used except for agricultural, contruction and real estate loans. Loans in these sectors require further segregation and should be classified by the use of appropraite industry sub codes.

Additional NAICS codes are available for use where required internally and where further classification is appropriate. These can be obtained through the NAICS website at – http://www.census.gov/epcd/naics

A listing of minimum industry codes is provided in Shedule 5.5.1 below.

Schedule 5.5.1 *NAICS INDUSTRY CODES*			
Primary Code	**Primary Category**	**Sub-Code**	**Sub-Group**
11	Agiriculture	111	Crop Production
		112	Animal Production
		113	Forestry
		114	Fish/Hunting/Trap
		115	Support Activities
21	Mining/Oil/Gas Explorartion		
22	Utilities		
23	Construction	231	Prime Cntracting
		232	Trade Contracting
33	Manufacturing		
41	Wholesale		
44	Retail		
45	Retail		
48	Transportation		
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	*Accomodation/* Food Servics		
81	Other Services		
91	*Public Administration/* Government		

Volume Restrictions on High Risk Loans

In addition to specifying areas in which it will lend, it is also prudent for a credit union to specify in its credit policy those high risk categories in which it will not lend, or which it will lend to a relatively limited extent. Such categories of high risk may include:

- high risk industries with which the credit union is not familiar, or lacks the required lending expertise;
- specialized areas of lending, including brokered loans, syndicated loans, and any other area of lending the credit union is not comfortable lending to, or lacks the required lending expertise.

For instance, a credit union may choose not to lend to gas stations, due to environmental risk, even though they are able to under their commercial lending licence. Similarly, a credit union may choose not to provide mortgages on vacant land, although they are permitted under their residential mortgage lending licence. Such restrictions should be clearly stated in credit policy, and communicated to all lending staff.

The following schedule summarizes areas of lending that often represent high risk to some credit unions, either because of the lack of staff expertise in those particular areas, or because of certain environmental factors.

Schedule 5.6 ***AREAS OF HIGH RISK LENDING***
• consolidation loans • student lending • loans to gas stations • loans to restaurants • mortgages on vacant land • investments loans

Connected, Restricted Party and Staff Loans

Credit unions are required under the Act to limit the amounts of loans to individuals and their connected persons, and to restricted parties that may have undue influence over the credit union. The credit union should establish policies and procedures which address these requirements.

Connected Party Loans

All loans to connected parties must be approved in accordance with the lending licence limit set for such loans. Two members will be "connected" when one of the following relationships exist (members can be corporations, businesses or partnerships):

- The two members are related companies.
- One member belongs to a partnerships which is also a member.
- One member has guaranteed repayment of another member's loan to the credit union.
- One member is a dependent dwelling with the other member (refer further to FSCO's Interpretation Bulletin 1/96 for more detailed related person criteria).
- Any of the other relationships listed under section 73 of Regulation 76/95.

When approving loans in accordance with credit policies, the total lending limit of a borrower should be calculated to include loans to "connected persons" in accordance with section 62 of Regulation 76/95.

Restricted Party loans

Restricted parties include all directors, officers and committee members. Policy should require that director, officer and committee member loans be granted based on the normal financial tests and other criteria applied to arm's length borrowers as described in this Reference Manual. Each officer, director or committee member loan which exceeds that member's total shares and deposits must without exception be approved by the board and the credit committee of the credit union (see section 208 of the Act, and FSCO Administrative and Interpretive Bulletin 1/96).

Credit policy should also deal with staff loans, although under statute, staff are not considered to be restricted parties. For conflict of interest purposes, however, any person, (including directors, staff or a committee member), whose loan or that of a business associate, spouse, relative or related corporation is being considered, should not participate in any part of the loan approval process and shall absent himself/herself from any meeting or discussion about such loans. The credit union may choose to have a policy which provides loan benefits to staff, officers and directors, at preferred rates. These practices should be determined relative to other forms of compensation being offered. The practices should be well documented and strictly applied.

Reference should be made to Schedule 5.7 below, which sets out legislative restrictions on restricted party loans. Policy should recognize and reflect these restrictions, and provide for even tighter restrictions where it is felt necessary.

Schedule 5.7 ***RESTRICTED PARTY LOANS***	
(R denotes Regulation 76/95; subsections noted)	
R. 82	"Restricted Party" is defined to include a director, officer, committee member, a spouse or relative of a director, officer or committee member, an auditor (if an individual), a corporation if 10 per cent is owned by a director, officer or committee member, and an affiliate of the credit union. ("Officer" is defined in section 1 of the Act. Relative" is defined in FSCO's *Interpretation Bulletin 1/96.*)
R. 208	Loans to officers, committee members or directors may be made in excess of the deposits of these persons, if so approved by the board and the credit committee (if any), before the loan is advanced.
R. 86.7	A residential mortgage loan in favour of a restricted party is permitted, if it is approved by two-thirds of the members of the board of the credit union.
R. 86.8	A personal loan in favour of a restricted party is permitted, if it is approved by two-thirds of the members of the board of the credit union.
R. 86(4)	Residential mortgage loans, personal loans and other loans made to directors, officers, committee members or employees may be made where two-thirds of the members of the board have approved in advance the terms of the loan and the policies and procedures governing them. Where the loan is a residential mortgage or personal, it may be made on terms more favourable than those offered to its members.

Lender Approval Limits

Maximum dollar limits for the authorization of individual loans by credit category and the authorization of total loans to any one member should be assigned to every lender in the credit union based on that lender's credit experience. Schedule 5.8 highlights the various categories of lenders which should be considered in the policy on lending limits.

Schedule 5.8 SAMPLE LENDER CATEGORIES	
Lender Categories	**Lender Limits**
Apprentice Lender	No lending authority
Junior Lender	Up to $5,000 in personal loans
Intermediate Lender Senior Lender Senior lender and credit committee and/or board	Credit policy must determine lender limits per loan category and individual borrower in accordance with by-law limits

Lending approval limits may also vary depending on the nature of security received.

As discussed earlier in this Reference Manual, where possible, the co-existence of a credit committee and a lending department is recommended for joint approval of large loans. Where there is no credit committee, the board should co-review and approve large loans at or approaching the credit union's regulatory limits that have undergone the normal credit approval process. The size of loan requiring board approval will therefore vary depending on the asset size of the credit union. A definition of large loans requiring board approval should be documented in credit policies.

Lending Criteria

It is important for credit policy to document key lending criteria and required credit investigations. Policy should set general requirements to evaluate a borrower's character, cashflow, capital and collateral security, mandate special investigations relating to environmental risk, commercial and agricultural credits. Operational procedures should detail the minimum terms and conditions for different loan classes. Operational procedures are covered in section 5500 of this chapter.

Required Credit Information

It is prudent for a credit union to establish a policy outlining the minimum required credit information necessary for loan processing by loan category. For larger credit unions these details may be set out in operational procedures which are periodically reviewed by the board. Recommended detail on required credit applications, investigations and security requirements, by loan category, can also be found in Sections 5503, 5504 and 5505 of this chapter.

Required Credit Evaluation

Policy should mandate a formal credit evaluation of each loan being considered. Policy exceptions may be possible in this regard with respect to social conscience loans which provide community assistance and are limited to a prescribed percentage of the total loan portfolio.

Prescribed lending criteria must always include two general factors for evaluating a borrower's credit worthiness: (i) the ability and (ii) the willingness to repay the debt. The first consideration is a matter of financial background, while the second is a matter of character background. These considerations are often summed up in the expression "Know Your Borrower", which is essential for prudent lending.

The financial background of a borrower is basically assessed in terms of a member's cashflow capacity and existing capital (i.e. net worth) base. Character is assessed from personal information relating to the borrower's residential and employment history, in addition to his/her credit bureau rating. For further details and procedures on application of credit criteria and credit evaluation, refer to Section 5504 of this chapter.

Loan Process

Board approved policies on credit management must mandate a consistent lending process and related internal controls. Policies should provide for the following elements of a properly functioning loan approval process:

- loans decisions are made and approved by appropriate staff, with the appropriate authorization and accountability;
- lenders should be delegated formal lending limits in accordance with their lender credentials/experience;
- loans follow a pre-established loan processing flow, which sets out the proper movement of loan applications within the credit union;
- loan information and credit analysis are properly documented on standardized forms;
- loan applications are analyzed against established credit criteria;
- loan funds are disbursed through proper channels, with proper safeguards against theft or fraud;
- generally, loan renewals are subject to the same criteria and credit evaluation process as when first approved.

While the scope for these processes and controls must be documented in policy, the actual detail or content do not. Due to the level of detail, and the need for flexibility, this detail can be documented in operational procedures. Recommendations on the content of the above procedures and controls are covered in more detail in section 5500 of this chapter.

Securing Loans

Policy should establish the minimum prescribed types and amounts of security required for various classes and categories of loans. Details of such requirements, if lengthy, may be delegated to operational procedures. Policy and procedure requirements should be compatible with lending licence and by-law restrictions.

Security should be obtained before funds are advanced, with the notable exception of mortgage funds, which may be advanced in trust through a lawyer. Due to the significance of security as a legal remedy for collecting delinquent loans, credit management policies should require all security documents be physically safeguarded by the credit union. For a detailed discussion on the procedures for registering and/or protecting security, refer to Section 5505 of this chapter.

Board approved policies should document the maximum amount of unsecured loans allowed under regulatory limits, and under the credit union's lending licence and by-laws, as applicable. Generally, unsecured loans should only be considered for short-term loans and for members with the highest credit rating who have a previous and satisfactory borrowing history at the credit union.

While an evaluation of the financial history and future prospects of a potential borrower are crucial in determining whether a loan is sound, the taking of collateral or security is a method of ensuring that the loan is also safe. Unforeseen, adverse developments can affect the earnings of any borrower; as a result, security should be taken in order that a secondary, or back up, source of loan repayment is available to the lender. The taking of collateral should never be viewed as the rationale for making an unsound loan or a loan for which no credit investigations have been conducted since security realization often results in losses due to asset impairment or liquidation costs. The objective of successful lending is for every loan to be equally safe and sound.

Delinquent and Impaired Loans

A loan is delinquent if any of its scheduled payments are in arrears by a period greater than one day. A loan generally becomes impaired where, as a result of deterioration in credit quality, the lender no longer has a reasonable assurance of timely collection of the full amount of the principal and interest. Where this is the case, the carrying amount of the loan should be reduced, through the use of a loan loss allowance.

Policy on Delinquent and Impaired Loans

Loans which are in arrears or are considered to be a potential problem for the credit union should be actively managed with the intent of avoiding loss, or mitigating it to the greatest extent possible. The credit union should establish a process whereby loans in this category are effectively dealt with in a timely way. Refer to Section 5211 on Loan Rewrites and Restructuring. Refer to Section 5507 for procedures on the Collection of Delinquent Loans.

Management must make allowances for impaired loans on a monthly basis, in accordance with the requirements of DICO By-law No. 6, section 90 of the Act, and section 22 of Regulation 76/95. (Refer to the discussion of By-law No. 6 below). All write-offs of a loan in whole or in part must the approval of the board of directors.

The board of directors should receive reports no less frequently than monthly on the status of delinquent and impaired loans (see section 24 of the Act and Section 5400 on Risk Measurement and Board Reporting).

DICO By-law No. 6

In order to simplify compliance with the accounting principles on impaired loans in Section 3025 of the Canadian Institute of Chartered Accountants (CICA) Accountant's Handbook, DICO, in co-operation with the CICA, developed an interpretation standard for use by Ontario's credit union system. The resulting interpretation standard developed by DICO is prescribed in By-law No. 6. This interpretation standard prescribes specific guidelines as to when a loan should be considered impaired.

DICO By-law No. 6 is accompanied by an Application Guide, published by DICO, which is an instruction manual created to assist management with the implementation and application of the By-law. Reference to the actual text of the By-law and the Application Guide is recommended when accounting for impaired loans.

Loan Rewrites and Restructures

Policy should address conditions for authorizing loan rewrite, loan postponements, and formally restructured loans.

Loan Rewrites

A loan rewrite involves changing any of several conditions of the loan, such as the maturity date, the amount of the monthly payments, or the security taken. For example, the credit union may wish to reduce the size of monthly payments to accommodate a permanent decline in the borrower's cashflow (e.g. borrower has taken a part-time job at a lower salary), thereby lengthening the loan's repayment period.

The rewrite of a loan provides an opportunity for the restoration of the lender/borrower relationship and an opportunity to review, or where possible, increase security values. All rewritten loans, for which ultimate collection is not in doubt (regardless of previous delinquency or impairment), should be considered for accounting purposes to be new loans. As long as the rewritten loan does not significantly defer full payment of principal and interest (e.g. as might result from repeated loan rewrites) and as long as the rewritten loan does not permit any forgiveness of principal (or interest), such loan is not considered to be impaired.

Loan Postponements

A loan postponement, or loan extension, is a specific type of loan rewrite, in which the original maturity date of a loan is extended, generally by one or two payment dates, without changing any other loan conditions. A credit union may wish to postpone the maturity date of a loan if the cause of the borrower's delinquency is temporary (e.g. strikes or sickness). A loan postponement/extension may only be granted upon the written request of a borrower.

Policy Considerations

Policy should emphasize that a loan postponement or loan rewrite should only be considered in the event that the financial circumstances of the borrower have changed, but ultimate repayment of the loan is not in doubt. Under no circumstances should either a loan postponement or loan rewrite be used to hide loan delinquency. (Once a loan has become "impaired", it must remain "impaired" until brought up to date or formally restructured in accordance with DICO By-law No. 6.) The following factors should exist before offering a member a rewritten loan (which would include any loan extensions):

- A reasonable explanation exists for rewriting or postponing the loan (e.g. sickness, parental leave, temporary loss of employment, i.e. strike, major unscheduled expense).
- The member has a current and verified source of income which is sufficient to meet the payments of the loan or has retained employment status with an employer (e.g. despite being on strike or on parental leave).
- The collateral which has been pledged has been reviewed by the loan officer, and the present security value is deter-mined to be adequate.
- The member has demonstrated a strong willingness to ultimately repay the debt. The member has shown co-operation to the loan officer in terms of discussing the problem promptly, sharing future cashflow information and agreeing to increased security requirements for the loan, where applicable.

Where the above conditions are met, a credit union may consider postponing or rewriting a loan. A loan should not be rewritten more than once a year; if it is, it would generally be considered impaired. Ongoing rewrites would also be an indication of loan impairment.

Authority for Rewrites

The decision to make a loan postponement or loan rewrite should be made either by the credit committee, or where there is no credit committee, by a designated loan officer, and should be initiated upon a written request from the member filed with the credit union. Upon arranging a loan postponement or rewritten loan for a member, management should consider charging an administration fee for this service.

Where the amortization period of a rewritten loan is extended, credit risk increases, particularly where the new amortization period exceeds the useful economic life of the pledged security. Due to the change in credit risk of a rewritten loan, it is necessary that the same or higher approval level apply to the rewritten loan as to the original loan.

Whenever a loan rewrite or postponement is granted, the borrower should be required to sign a confirmation of the details of the new arrangement.

Monitoring

Initially, rewritten loans should be monitored closely to ensure they perform according to their new terms. Management should track the volume of loans rewritten throughout the year and summarize these for the board. (Refer to Section 5400 on Risk Measurement and Board Reporting and Section 5406 on Loan Monitoring).

Policy on Commercial Loan Rewrites

Where applicable, credit policy should separately address loan rewrites for large commercial loans. In these cases, cashflow projections for the business over the remaining term of the loan on a "best case", "worst case", "likely case" basis, in light of industry activity, should be required prior to any loan rewrite. Where it is assessed that the future cashflows of the company can be restored to support the repayment of the debt over an extended term, a loan rewrite should be considered.

Where significant changes to the business operations of a commercial borrower are required in order to generate sufficient cashflow for loan repayment, the credit union should be assured of the following additional conditions before consideration of a loan renegotiation:

- establishment of detailed workout strategies to improve cashflow;
- borrower's undertaking to co-operate in the loan workout and the consent of any guarantors to new loan terms and conditions;
- establishment of comprehensive reporting requirements to the loan officer on key performance measures of the business;
- agreement on the immediate actions required to initiate the loan workout.

Commercial lenders should take care not to control or manage the operations of a borrower in a workout situation as this may expose the credit union to claims for economic damages not only by the borrower but potentially from the borrower's other creditors as well.

Policy on Formally Restructured Loans

In some cases, when a credit union is dealing with a delinquent borrower (often a commercial borrower) who is near bankrupt or who seeks an out-of-court settlement of his debt, the credit union may elect to negotiate a compromise loan agreement, as a last resort collection strategy. The compromise loan settlement will result in some principal or interest being written off in exchange for the borrower's full co-operation to repay the residual debt without further collection efforts.

These types of loans are referred to as formally restructured. The recorded values of all formally restructured loans must be written down to their compromised value, and such write-downs charged to income, in accordance with DICO By-law No. 6 on Impaired Loans (refer to Section 5210 on Delinquent and Impaired Loans). Credit policy should require senior management and board approval of all restructured loans.

Ongoing monitoring of these loans is recommended (refer to Section 5406 on Loan Monitoring), although once restructured, these loans, for accounting purposes, can no longer be considered delinquent or impaired.

Planning

Management and the board of directors must develop an annual business plan, summarizing the credit union's goals and objectives for the coming year.

This annual business plan includes a strategic financial plan that addresses each area of risk management, including credit. As part of the strategic financial plan, management and the board must set financial targets and plans for credit management. The elements of a credit plan are set out in Chapter 1 on Planning, and should be referred to for planning purposes.

Risk Measurement and Board Reporting

It is recommended that the credit union measure the performance and risk level of the credit portfolio and report these findings to the board.

Risk Measurement

The following are minimum risk and performance measures of credit, required by sound business and financial practices:

- Compliance with the board approved credit policy, and with regulatory requirements.
- Loan portfolio volumes and portfolio mix by credit category (e.g. term versus demand, or by varying loan purposes) and credit yields, compared to historical and planned volumes.
- Any overdrafts or loans exceeding by-law limits or author-ized credits.
- Volume of rewritten loans and formally restructured loans.
- Volume of delinquent and impaired loans by loan class, in accordance with DICO By-law No. 6, and related collection efforts.
- Identification and volume of large loans (as defined in board policy).
- The identification and volume of loans to restricted parties.
- The identification and monitoring of rewritten, consolidated and formally restructured loans for a probationary period.
- Other reporting requirements to be compiled by the credit committee as set out in section 24 of Regulation 76/95, and summarized below.

The credit union must also meet credit measurement requirements set out in the Act and Regulations. Under section 24(1) of Regulation 76/95, the credit committee is also required to provide the board with a report on credit management. The contents of the section 24(1) report are listed below, under the heading Statutory Reporting Requirements. The credit union may track any other measures of the loan portfolio as it sees fit.

These measurements should be compared to financial targets in the annual business plan and the budget, so that management can determine whether the credit union is meeting its goals. Management can also assess whether there are material variances from the plan which need to be addressed.

Comparison of these measurements against historical performance, where possible, can also identify significant trends which may need to be addressed by management.

Risk Measurement Techniques

Sections 5401 to 5406 provide techniques for measuring the risk inherent in the credit union's loan portfolio.

Board Reports

The above measurements should be reported to the board of directors, so that the board can also monitor credit management and ensure adherence to regulatory requirements and to the annual business plan. Material variances from plan, and their causes, as well as management's plan to correct the variance should also be included in the report. Management should also provide the board with a summary on compliance with credit policy and regulatory requirements.

Frequency

Management should provide the board with a report on credit monthly.

Form

Schedule 5.10 on the following pages illustrates a Sample Board Report on Credit Management, which can be used by the management to monitor the loan portfolio, ensure regulatory compliance and report findings to the board. The report compiles and compares all the volumes, targets and policy limits required to properly manage the risk of the credit union's loan portfolio. This report can be adopted or amended for use by the credit union.

Information contained in the report can be expressed on a periodic basis (monthly, quarterly), or on a year-to-date, or both, depending upon the preferences of the board and the frequency of reporting.

Statutory Reporting Requirements

The credit committee must also provide the board with a report containing the information specified under section 24(1) of Regulation 76/95, and which include the following:

- The number of loan applications received by the credit union.
- The number, type and aggregate value of loans that were granted.
- The number of loan applications that were denied.
- The security obtained for each loan of an amount greater than that specified by the credit union's lending policies and procedures.
- The number and status of delinquent loans and the details of each loan that is more than 90 days in arrears.
- The number of and status of loans, (i) for which the due date was postponed for all or part of a payment of interest or a repayment of any principal, (ii) for which any security was substituted or released, or (iii) that were re-negotiated because of a change in the borrower's circumstances.

The frequency, form and content for board reports on credit management should be set out in credit policy.

Schedule 5.10
SAMPLE BOARD REPORT ON CREDIT MANAGEMENT

Part I: Loan Volume and Portfolio Mix

	Loan Volume($)	**Portfolio Mix (%)**	**Average Yield (%)**	**Policy Limits (%)**	**Previous Period (%)**
Sample Loan Categories **Personal Loans** Unsecured Leases Secured					
Category Total					
Residential Mortgages Residential Bridge Insured (e.g. CMHC)					
Category Total					
Commercial Loans Term loans Commercial mortgages Lines of credit					
Category Total					
Unincorporated Association Loans					
Agricultural Loans					
Institutional Loans					
Unincorporated Association Loans					
Agricultural Loans					
Letters of Credit					
TOTAL					

Part II: Loan Delinquency and Impairment

	Volume of Delinquent Loans ($)	**Volume of Impaired Loans ($)**	**Summary of collection efforts:**
Personal Loans	$	$	
Residential Mortgages	$	$	
Commercial Loans	$	$	
Institutional Loans	$	$	
Unincorporated Loans	$	$	
Agricultural Loans	$	$	
TOTAL			

Schedule 5.10 (continued) *SAMPLE BOARD REPORT ON CREDIT MANAGEMENT*
Part III: Summary of Loan Exception Reports
$ volume of accounts in overdraft_______________ # of accounts in overdraft _______________ ________
$ volume of loans exceeding by-law limits_______________ # of loans exceeding by-law limits ____________________
$ volume of loans re-written _______________ # of loans re-written_______________ (Re-written loans can include postponed loans but not loans which have been formally restructured whereby some principal or interest has been forgiven. Restructured loans are recorded below.)
$ volume of loans formally restructured _______________ # of loans formally restructured _________________
$ volume of large loans _______________ # of large loans _______________ (Large loans are defined in policy.) ________
$ volume of loans to restricted parties _______________ # of loan to restricted parties _______________
Part IV: New Loans
# of loan applications received _______________ # of loan applications denied _______________ ________
# of loan applications approved _______________ $ volume of loans applications approved _______________

Type of loans approved	**Volume of loans approved**	**Type of loans approved**	**Volume of loans approved**
Personal Loans		**Unincorporated association loans**	
Residential Mortgages		**Agricultural Loans**	
Commercial Loans		**Letters of Credit**	
Institutional Loans		**TOTAL**	

Security Obtained for Large Loans (as defined in policy): Loan # _______________ Security _______________ ____ _______________ Loan # _________________ Security _______________
Part V: Corrective Action/Strategies

Variance	**Corrective Action/Strategy**

Portfolio Mix, Volume and Yields

Management must measure its loan portfolio mix, volume and yields by loan category. Measuring by loan category requires that the total loan portfolio be broken down into all loan classes (i.e. personal loans, residential mortgages, commercial loans, etc.) and where applicable into further classifications which relate to higher risk loans (e.g. construction loans, consolidation loans, personal loans for small business purposes, etc.). Additionally, management should measure the distribution of its loans by term to maturity categories. This measurement is needed for asset/liability management purposes.

Loan mix, volumes and yields should be compared to historical and planned measurements. Where information is reported monthly, this requires comparison to the previous month, and the corresponding one month period from the previous year. Where information is reported quarterly, then volumes should be compared to volumes from the previous quarter, and from the same quarter from the previous year.

It is important to monitor for variances from the business plan in the volume of loans and the loan portfolio mix, as this could have serious effects on net financial margin. Different types of loan categories will provide different yields. Measurement of the loan portfolio mix can alert management to declining margins caused by an unfavourable shift towards lower yielding loans. Different loan categories also represent different levels of loan risk (e.g. consolidation loans tend to represent higher risk than a mortgage), and therefore an unplanned change in the loan portfolio mix may mean increased portfolio risk. Where possible, management can control this risk by adjusting the portfolio mix through new business.

Loan volumes should be compared to plan and historical volumes to assess the extent and rationale for loan growth. Stagnant loan growth should be analyzed in terms of the competitiveness of the institution's pricing and marketing, membership demographics and new product needs, as well as lending staff capabilities. Confirmed causes of low loan growth should be addressed immediately given that this situation is often the cause of declining credit union viability. Loan volume should also be monitored relative to aggregate regulatory limits and the credit union's lending licence.

Average yields should be periodically measured by loan category and compared to budget and to average industry yields to determine if pricing is both competitive and operationally adequate.

Refer to Schedule 5.11 for sample reporting on monthly new loan volume, which can be used to report loan portfolio volumes and mix.

Schedule 5.11
SCHEDULE OF NEW LOAN VOLUME
FOR THE MONTH OF _______________

# of loan applications received _____# of loan applications approved _____

# of loans re-written*________________$ of loans re-written* ______

Loan Category	New Fixed Loans	New Variable Loans	New Loans	Total Portfolio	Mix
Personal Loans					
Unsecured					
Leases					
Secured					
Category Total					
Mortgages					
Residential					
Bridge					
Insured					
(e.g. CMHC)					
Category Total					
Commercial					
Term Loans					
Commercial Mortgages					
Lines of Credit					
Leases					
Category Total					
Agricultural Loans					
Letters of Credit					
Grand Total					

* Re-written loans can include postponed loans but not loans which have been formally restructured whereby some principal or interest has been forgiven.

Credit Risk Ratings and Watchlist

One recommended risk measurement and monitoring technique to be used for loans other than personal and mortgage loans, is the technique of credit risk ratings. Risk rating involves the categorization of individual loans, based on credit analysis and local market conditions, into a series of graduated categories of increasing risk. Risk ratings are most commonly applied to all loans other than personal and residential mortgage/bridge loans.

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

A primary function of a risk rating model is to assist in the underwriting of new loans. As well, risk rating assists management in predicting changes to portfolio quality and the subsequent financial impact of such changes. Risk rating can also lead to earlier responses to potential portfolio problems, providing management with a wider choice of corrective options and decreased exposure to unexpected credit losses. Finally, risk ratings are useful for pricing loans and regulating the commercial portfolio exposure to maximum levels of risk. Board policy should optimally set the maximum credit risk allowable by credit classes and aggregate maximum portfolio credit risk. The extent of gradation (number of categories) of a risk rating system should be reflective of the size and complexity of the credit union's commercial and agricultural loan portfolio. Generally, a larger and more extensive a credit portfolio may require a more sophisticated risk rating system including a greater graduation of risk ratings.

In many situations, however, a system comprised of six risk levels of increasing credit risk is appropriate. Under this system, the lowest risk rating (1) is assigned to undoubted borrowers with vitually no risk. The highest risk rating (6) is assigned to borrowers where there is little or no likelihood of repayment. Loans should only be granted for risk ratings of 1, 2 (low risk) or 3 (normal risk). Ratings of 4, 5 and 6 are reserved for existing loans where the risk rating has deteriorated from the time of the original approval. Risk rating 4 is a “cautionary” rating assigned to higher risk loans. Loans in this category should be placed on a “watch list” for increased monitoring. (Further information on the watch list process is provided on page 5-47.2). Risk rating 5 is for “unsatisfactory” loans that are impaired in accordance with DICO By-law No. 6.

Schedule 5.12 below provides a more detailed overview of a risk rating model which has six risk rating categories combined with risk rating trends. The table also includes the types of assessment criteria or considerations which should be used to determine risk ratings. Compliance with the risk rating requirement as outlined in Schedule 5.12 satisfies the "credit rating band" requirement found in FSCO's Lending and Investment Guideline and meets DICO’s expectations for an appropriate risk rating model.

Schedule 5.12 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/capitalization position	• Excellent financial history/trends • Strong management • Stable/strong industry
3	**Moderate**	• Good security margin/LTV • Demonstrable debt service capacity	• Sound management • Steady financial trends • Moderate capital level
4	**Cautionary**	• Deteriorating/lack of financials • Covenant breaches	• Potential security shortfalls • Potential debt service shortfalls • Significant adverse developments
5	**Unsatisfactory**	• Need for immediate action indicated • Security shortfall/capital crisis	• Cessation of operations • Adverse management change • Interest/principle arrears
6	**Unacceptable**	• Receivership or bankruptcy • Definite loss evident	• Disappearing assets/security • Fraud
Risk Rating Trend		**Attributes**	
I		Increasing risk	
S		Stable or Steady risk	
D		Decreasing risk	
Risk Component		**Assessment Criteria/Considerations**	
Financial		• Debt Service • Debt to Equity	• Quality of Financial Reporting • Working Capital • Financial Trends
Security		• Cash conversion • Quality of evaluation	• Asset coverage
Management		• Skill and tenure • Commitment • Infrastructure and support	• Succession planning • Quality and frequency of information
Environmental		• Issues, evaluation and insurance	• Industry risk • Competition

Delinquent, Impaired and Formally Restructured Loans

Monthly, management must measure the volume of delinquent loans, impaired loans and loans formally restructured in accordance with DICO By-law No. 6. These loan accounts should be uniquely coded in order to track their existence for ongoing reporting purposes. Coding of impaired and delinquent accounts should be updated to reflect their status. Reports must also be generated showing the progress of all delinquent loans, and the status of legal actions related to those loans. The concept of Impaired Loans and Formally Restructured Loans are prescribed in DICO By-law No. 6, but are discussed below for purposes of Risk Measurement Techniques.

According to section 3025.03 of the Accountants' Handbook issued by the Canadian Institute of Chartered Accountants, a loan becomes impaired where there is a deterioration in the credit quality to the extent that the lender no longer has reasonable assurance of timely collection of the full amount of principal and interest. By-law No. 6 sets out the following common circumstances under which a loan must be classified as impaired, despite any other evidence (other circumstances could arise which could cause the loan to be impaired):

- payment on a not fully secured loan, or a restructured loan, is 90 days in arrears;
- payment is 180 days in arrears regardless of security;
- loan is with a collection agency or part of a bankruptcy proceeding/creditor proposal or the debtor has absconded;
- loan has been unrealistically postponed so that the recovery of principal is significantly deferred beyond the loan's original term.

Loan impairment should be recognized sooner than the conditions as noted above if assurance of timely and full collection of principal and interest is in doubt. Loan impairment is discussed fully in DICO By-law No. 6 and in DICO's Application Guide to By-law No. 6.

Connected, Restricted Party and Large Loans

Management should measure the volume of loans held by connected parties, directors, committee members and staff, and other restricted parties, by credit class. Monthly monitoring of these loans should ensure they do not exceed the limits set out in the credit union's lending licence, or as set out in board policy. Refer to Section 5205 of this Reference Manual for definitions of connected and restricted party loans. Also refer to section 199 and Part IX of the Act and section 73 and Part X of Regulation 76/95.

Connected party and restricted party loans which exceed prescribed limits have historically been a significant cause of credit union failure. Careful review of these loans by the external and/or internal auditors should be encouraged in addition to monthly board reviews of this information. Computer tracking of connected and restricted party loans is recommended, where possible.

Management should also monitor the existence of large loans. Large loans should be defined in either board policy or operational procedures and monitored to ensure they do not exceed policy limits. Refer to Schedule 5.13 which is a sample report on large loans.

Schedule 5.13
SCHEDULE OF LARGE LOANS*

For the month of ____________________

(prepare for cumulative borrower credits over $________)

Account #/ Name Of Borrower**	New Advances This Month:		Total Advances	Purpose & Term	Security	Operating Within Credit Terms?
	Amount	Rate				
Page Total						

* Large loans should be defined relative to the credit union's by-law limits or by policy and will vary among organizations.

** Borrower is defined to include any group of connected parties.

Rewritten, Restructured and Consolidated Loans

For a probationary period of two or three months, management should monitor all of its rewritten, consolidated and restructured loans, to ensure they are operating within their terms and conditions.

Loan Rewrites

A loan rewrite involves changing any of several conditions of the loan, such as the maturity date, the amount of the monthly payments, or the security taken. A loan postponement is a specific form of loan rewrite, whereby the original maturity date of a loan is extended, generally by one or two payment dates, without changing any other loan conditions. Loan rewrites are discussed in Section 5211 of this chapter.

Formally Restructured Loan

A formally restructured loan is a loan rewrite where a portion of the principal or interest being written off in exchange for the borrower's full co-operation to repay the residual debt without further collection haggling. Formally restructured loans are discussed in Section 5212 of this chapter.

Consolidation Loan

A consolidation loan is defined as a loan to assist a member who has overextended his/her use of credit facilities and needs to rearrange his/her debts as a prudent measure to avoid insolvency. Generally, a consolidation loan allows a member to consolidate existing credit facilities (usually credit cards) under one loan agreement, over a manageable amortization period. Additionally, it enables a member to simplify his/her borrowing arrangements and to reduce borrowing costs, as a result of a lower interest rate relative to card credit.

Consolidation loans are an area of high risk lending, given that most borrowers requiring a consolidation loan have not managed their credit prudently in the past. Additionally, some borrowers utilize consolidation loans to further increase credit limits, because they are experiencing continued financial difficulty. Consolidation loans should therefore be carefully evaluate and monitored.

Loan Monitoring

A number of activities are recommended to effectively monitor the loan portfolio on an ongoing basis. The purpose of loan monitoring is to detect problem accounts early and to mitigate against probable losses either through loan restructuring or the termination of poor quality loans. Loan monitoring is a comprehensive process, which includes:

- routine review of borrowers' accounts (including lines of credit) to detect unusual activity;
- annual and interim review of commercial loans;
- interim review of problem mortgages;
- Use of exception reports recording loan irregularities;
- internal audit or league reviews of loan portfolio.

Each of these activities will be discussed in further detail below.

Routine Reviews

A certain percentage of loans in every loan portfolio will become delinquent due to unexpected adverse changes in the financial condition of certain borrowers. The credit union should be alert to, and investigate, any warning signals which indicate unusual borrower behaviour that could result in loan delinquency. Initial warnings of loan repayment difficulties by a borrower should result in that borrower being risk ranked accordingly as a watchlist loan and subject to ongoing monitoring by the credit union. Late or missed payments are generally the first sign of a potential problem; however, other early warning signs are common for individual borrowers. Refer to Schedule 5.14 in this regard. Credit unions can assist members experiencing loan repayment difficulties by referring them to, or offering, credit counselling.

Commercial Loan Reviews

For commercial accounts, an annual loan review should be under-taken three to six months after the date of the borrower's year end. Where updated financial information cannot be obtained, credit should not be renewed. All annual reviews of business loans should include a visit to client premises to confirm that business operations and security are intact. The annual review of loans should be explained to members as an important method for the credit union to reacquaint itself with the needs of its borrowers. An annual review provides an opportunity to market new products and broaden member services.

Schedule 5.14 ***COMMON WARNING SIGNS OF INDIVIDUAL BORROWER FINANCIAL DISTRESS***
• Liabilities exceed assets • Escalating debt • High level of unsecured debt • Overdrafts • Urgent requests for loans • Repeated requests for higher credit limits • Late payments and requests for maturity extensions • Returned cheques (as indicated in the overdraft report) • Returned mail to credit union or telephone disconnected • Inquiries from other creditors on member's credit worthiness • Loss of employment (e.g. strike, local plant closure) • Borrowings from lenders of last resort (e.g. finance companies)

Loans which are subject to an annual review (e.g. this should represent the entire loan portfolio excluding mortgage and personal term loans that are in good standing) should be logged by the credit union according to the month that they are due to be reviewed. A senior officer should monitor and document the completion of these loan reviews. Where an annual review is more than 30 days overdue, this should be diarized in an exception report to the general manager, with valid explanations for the delay and a revised annual review date documented.

Certain commercial loans which are higher risk than average may necessitate financial review more frequently than annually. Conditions of a business credit may stipulate that the loan is subject to quarterly reviews because of the volatility of the business conditions or recent credit violations. Interim loan reviews should additionally be performed given the following circumstances:

- Member requests additional borrowings.
- Member experiences an adverse economic event.

Exception Reporting

In order to assist lending personnel in their loan monitoring function, routine exception reports should be generated (a separate report for each branch location, if applicable).

The following loan exception reports are recommended. Irregularities in the loan portfolio should be summarized on a particular date of each month on a lender by lender basis before compilation into the following reports:

- List of Delinquent and Impaired loans (based on system generated report);
- List of Loan Advances in excess of member's authorized credit (e.g. unauthorized overdrafts or off margin lending for commercial borrowers);
- List of Overdue Annual Reviews;
- List of Security Documents to obtain or register;
- List of Member Reporting Deficiencies (e.g. late interim financial information or receivables/inventory listings).

Some or all of these reports could be compiled in to one loan exception report, where appropriate.

The above reports should be reviewed and signed by the senior loan officer and the general manager. Reasonable explanations for deficiencies should be recorded on these reports by the individual lenders responsible, with the expected date for problem correction documented. Where a serious deficiency continues for a lengthy or indefinite period of time, an allowance for the loan should be established (refer to Delinquent and Impaired Loans in Section 5210 of this Reference Manual) and the loan categorized as an unsatisfactory credit risk. A significant number of unexplainable and sustained loan irregularities is evidence of a poorly managed loan portfolio.

System Generated Reports

System generated reports prepared by the accounting staff can provide additional useful information on borrower activity and staff compliance with the credit union's authorized loan processing flow. In larger credit unions, the following reports should be prepared daily (unless otherwise noted) reviewed daily by the senior loan officer, signed and dated. The general manager should randomly spot check these reports for evidence of exception follow up. In smaller credit unions, where the manager directly reviews the reports, the credit committee, the board or a sub-committee of the board should conduct random spot checks on the following loan reports (original computer printouts should be reviewed):

- Loan Disbursements Report should list all new loans issued by amount and borrower name.
- Report on Loans exceeding Authorized Limits should list all loans in excess of the credit union's policies and lending limits, and all unauthorized over-drafts.
- Large Debit Report should list deposit withdrawals over a certain size (size to be specified by management, to track member activities).
- Loan status report should list all adjustments to member accounts, both non-financial and financial fields (this report should be reviewed to detect account fraud).
- Delinquent and Impaired Loans Report should list all loans with overdue payments.
- Accrued Interest Report should list uncollected interest revenue (this report should be reviewed monthly for reasonableness based on total loans outstanding).
- Improperly Authorized Loan Advances Report should list those funds which were released without two appropriate authorizing signatures (this report must be prepared manually).
- Summary of all daily or weekly reports produced to ensure that exception reports have been reviewed (and not destroyed).

Credit Administration Diary

An important procedure in managing a loan portfolio and its accompanying security is the use of a Credit Administration Diary System. A Credit Administration Diary is an information system which keeps track of dates which are significant in the credit monitoring process (e.g. loan renewal and review dates, fire insurance expiry dates, etc.). These systems can be quite sophisticated (computerized), or can be simplistic (card catalogue), depending on the needs and size of the loan portfolio.

The Credit Administration Diary system can also be broken down into numerous diary systems (e.g. mortgage diary, insurance diary, security diary), again, depending upon the needs and the dynamics of the lending department. Where duties are segregated among staff, the Diary system may be divided in the same manner.

The following is a non-exhaustive list of important dates which could be monitored using a diary system:

- PPSA expiry dates;
- loan expiry dates;
- mortgage expiry dates
- credit facility annual review dates;
- fire insurance expiry dates;
- chattel insurance, non-filing insurance, expiry dates, etc.;
- loan collection follow-up dates;
- probationary periods for ongoing monitoring of rewritten and restructured loans;
- real estate tax arrears dates;
- inventory valuation review dates.

Security Diary

A registered security interest that is taken against a member's property must be renewed periodically to remain legally enforceable. If a credit union's registered first lien is allowed to lapse, a second lender can become first lien holder. Both of these risks can be mitigated through the use of a security dairy. A security diary is a monthly list of security documents in the loan portfolio requiring registration renewal.

As soon as a security document is registered, the borrower's name, account number, security instrument, and the security's renewal date should be diarized in the security diary for future renewals. In order to account for processing delays in registration, it is recommended that the diary page for the following month be reviewed 30 days in advance to initiate required renewals.

Due to the many technical requirements and continual revisions to Ontario's security legislation, it is recommended that the credit union contact its league and/or its lawyer to provide information updates on changes to this legislation.

Audit of the Loan Portfolio

The final component of an ongoing loan monitoring system includes the examination of a portion of the loan portfolio by persons independent of the credit granting process. For credit unions which do not have an internal audit department a number of alternatives may be considered. Loan reviews, for example, may be performed by a subcommittee of the audit committee, the league, the stabilization authority, DICO as part of their on-site verification process, or external accountants as part of a periodic review of annual business practices. The objective of a loan review is to obtain an independent opinion on the quality of a number of randomly selected loans. The following details should be examined for each loan:

- Compliance with the credit union's policies, by-laws, lending licence, lending limits, the Act and Regulation 76/95 (e.g. lender approval limits not contravened).
- Existence of valid and sufficient security (e.g. proof of PPSA registration).
- Existence of adequate documentation, including sufficient credit analysis and investigation which supports the credit decision.
- Evidence of a well performing loan (e.g. operating according to terms).

Risk Management

Corrective Action

An important activity in the effective management of risk is management's timely response to an-authorized risk or poor performance developments. As a follow up to the credit risk measurements taken by the credit union (discussed in Section 5400), management should investigate all significant performance variances relative to the annual business plan and to historical performance, and respond by taking action to correct these variances. Management must similarly respond to any contravention of board policy or regulatory requirements, or other unauthorized risk.

Operational Procedures

Procedures can assist management to monitor the loan portfolio, to monitor compliance with regulatory and policy limits, and to monitor loan delinquency. It is recommended that the credit union have the following documented procedures in place:

- Reliance on qualified and competent lenders
- Loan approval and disbursement process
- Loan documentation
- Credit Investigation and Analysis
- Loan security
- Loan renewals
- Collection of delinquent loans
- Use of real estate appraisers
- Use of lawyers for mortgage transactions

These procedures are discussed in Sections 5501 to 5509. **To assist in implementation, procedures should be both appropriate and cost effective given the size of the credit union's operations.**

It is a sound business and financial practice for credit unions to document procedures. Written procedures result in higher staff productivity and better control over resources.

Qualified and Competent Lenders

Each credit union must ensure that qualified and competent persons control credit management activities and that there are procedures in place to ensure credit authority is both appropriately delegated and implemented. Under DICO By-law No. 5, the board must be advised annually of the general quality and competence of human resources.

This objective can be partially met by the development and implementation of detailed job procedures and human resource systems which set out the qualifications for lending staff or volunteers (e.g. credit committee members), as well as measure their job performance relative to plan and policy expectations. (For more information on this, refer to Chapter 3 on Human Resources and Performance Appraisal.)

The board needs to ensure that members of the credit committee have adequate lending skills and/or obtain adequate training. Refer to the subsections below for recommended qualifications and training for lending staff and the credit committee.

Under the Act, the duties of the credit committee can be entirely or partially delegated to a loan officer. This common arrangement is also discussed below.

The Credit Committee

The duties and authority of the credit committee are prescribed in sections 110 to 124 of the Act. The Committee must be comprised of at least three persons who have been elected by the members of the credit union. The term of office for credit committee members should be set out in the by-laws. Officers, directors or members of the audit committee may not serve on the credit committee.

The credit committee must meet at least monthly to consider all applications for loans, and to make prudent lending decisions within the lending limits provided in the credit union's lending licence or by-laws or policies if they are more restrictive. Members of the credit committee may be liable for deficiencies on loans that violate the by-laws or the Act: section 238(3).

Loan Officers

Under sections 122 and 123 of the Act, authority to approve loans may be transferred from the credit committee to individual loan officers in two ways: (i) a by-law may be passed whereby loan officers are appointed to assume all duties of the credit committee, resulting in the elimination of the Committee, (ii) the credit committee may retain its advisory capacity, but delegate its lending authority and responsibilities to individual loan officers.

When delegating lending authority to officers, the continued existence of a credit committee for the purpose of periodic loan review results in an effective method of retaining control over the lending function. The co-existence of the credit committee and loan officers is also appropriate for providing joint approval of large loans that exceed certain dollar amounts.

It is important to note, that under section 124 of the Act, the board of directors in its monitoring activities cannot overturn a decision of the credit committee or of the loans officer to reject a loan application, as long as policy and regulatory requirements have been followed.

Credit Committee Qualifications and Training

For credit unions where loans are authorized by a credit committee, rather than a lending officer, the following recommendations for qualification and training apply:

- Well qualified individuals should be recruited for the credit committee and recommended for election by a nominating committee that has researched member qualifications. A person should be nominated to the credit committee because of his/her ability and willingness to fill the position and for no other reason.
- Members who are nominated to the credit committee should be able to demonstrate that they have a sufficient understanding of financial matters (e.g. through previous work and voluntary experience, or educational background).
- New members should attend a mandatory orientation program which instructs them on the credit policies of the credit union (e.g. required credit investigation/analysis policies and lending by-law limits).
- Each member of the credit committee must receive ongoing training on security legislation and/or credit risk evaluation. Reliance on league or other training programs which teach credit granting and financial analysis is recommended.

Lending Staff Qualifications and Training

In the case of lending officers, effective recruitment practices, supplemented by appropriate training and development, will contribute to the quality of the lending team, and in turn, the quality of the loan portfolio. Different lending positions demand different qualifications which management should consider when allocating staff to job posts. Commercial and agricultural lending, for example, require staff with special lending expertise.

In order to be an effective lender, an employee must have both an adequate educational background and the appropriate job training. Schedule 5.16 outlines sample employee qualifications recommended for various lending positions in a credit union. It is recognized that some individuals may require more or less job training experience to become qualified than what is recommended in this Reference Manual because of certain mitigating factors (e.g. previous work history, the complexity of their present assignment and personal aptitude).

Until such time as the necessary qualifications are met, employees should not be given lending authority. When lending authority is assigned to an employee, he/she should be required to sign a "Statement of Lending Authority" on which the following is acknowledged:

- The lending licence and lending policy limits (or, if applicable, internal by-law limits) of the credit union for each type of loan.
- The loan approval limits which have been specifically assigned to him/her unilaterally, and/or in conjunction with other senior lenders.

It is recommended, where this is possible, that credit unions adopt a team approach to training, as an effective method of staff development. An apprenticeship period of 12 to 36 months is recommended for novice lenders depending on the nature of their lending assignment and their individual aptitude. New lenders should receive close supervision for their initial period on the job (e.g. first six months). While the extent of such supervision would diminish over time, the requirement for ongoing monitoring and feedback by an experienced lender should continue for the full term of training. The experienced lender on whose team the novice lender is apprenticing should delegate job assignments with increasing difficulty and monitor employee progress frequently, recording and sharing performance observations with the employee. It is also recommended that the employee have his/her knowledge of products, lending policies and procedures tested on a formal basis through written or oral examinations, conducted by an experienced lender.

Schedule 5.16 ***RECOMMENDED QUALIFICATIONS FOR LENDING PERSONNEL***	
Type of Lender	**Suggested Qualifications**
Personal Lender	• Appropriate knowledge of products, personal lending policies and procedures. • Appropriate knowledge of the relevant lending legislation and lending licence restrictions. • Enrollment in consumer lending and mortgage course. • Instruction on security evaluation and registration. • Months of monitoring under an experienced lender.
Mortgage Lender	• Good understanding of products, mortgage lending policies and procedures. • Appropriate knowledge of the relevant lending legislation and lending licence restrictions. • Completion of consumer lending and mortgage course. • Knowledge of mortgage appraisals, documentation and registration. • Months of monitoring under an experienced mortgage lender.
Commercial Lender	• Adequate knowledge of products, commercial lending policies and procedures. • Appropriate knowledge of the relevant lending legislation and lending licence restrictions. • Satisfactory previous lending experience in personal loans or mortgages. • Months of monitoring under an experienced commercial lender. • College level accounting, business law course. • Financial statement training. • Completion of an advanced lending course (e.g. CUIC, or courses offered through a league).

For smaller credit unions where the team approach to training is not an option, the general manager should be held accountable for supervising new lending staff. This situation may require the hiring of part-time staff to relieve the manager of other administrative duties until the training of lending staff is completed. Alternatively, larger credit unions in the vicinity should be contacted and arrangements investigated for smaller credit unions to participate in neighbouring training courses.

When the manager or the assigned senior lender is sufficiently satisfied with the progress of the novice, a recommendation should be forwarded to the board and/or senior management that the lender is indeed qualified to receive a lending limit. Subsequently, the credit committee, the audit committee and/or senior management should continue to monitor the lending activities of the lending officers. Routine investigation of delinquent loans will assist in determining competence of a lender by determining the underlying causes of failed loans. (See Loan Monitoring, section 5406). Evidence of negligence or poor credit granting skills should be recorded on the employment record of the lender and taken into consideration when assigning him/her with additional lending responsibilities.

Lending personnel must receive ongoing training regarding new products, lending policies, and changes to security legislation. Where a credit union wishes to expand its lending services (e.g. into commercial lending) but does not have sufficiently qualified staff to offer these services, it is recommended that new personnel be recruited with the appropriate experience. Recruitment of new lending staff should be carefully conducted with satisfactory references received from the applicant's previous employer confirming that he/she holds appropriate qualifications for the job. Recruitment assistance from the league should be considered whenever job vacancies occur at the credit union.

When developing individuals for the credit granting function, it is important to train them as lending "counsellors". Professional lenders owe a duty of care to prospective borrowers to ensure these individuals do not overextend themselves in debt, jeopardizing their financial stability. Refusing a member's request for credit, where there is insufficient means of debt repayment or security, should be viewed as a natural and expected part of the lender's function. Consideration of loan requests must be based on factual information obtained and not in any way influenced by a member's standing in the credit union or in the community.

Loan Approvals and Disbursements Process

The loan approval process comprises of processing and evaluating loan applications, documenting loan decisions and distributing loan funds. It is important that management establish a loan approval process which includes controls over lending authority and accountability.

A properly functioning loan approval process requires the following:

- loans follow a pre-established loan processing flow, which sets out the proper movement of loan applications within the credit union;
- borrower information and credit analysis are properly documented against established credit criteria;
- loans decisions are made and approved by appropriate staff, with the appropriate authorization and accountability;
- loan funds are disbursed, after applicable security is in place, through proper channels, with proper safeguards against theft or fraud.

Loan Processing Flow

Every credit union should establish a standardized loan processing flow, and document this process in operational procedures. The following are the general steps in the loan process:

- The loan process begins with a lender establishing credit for a member in accordance with board policy.
- A security custodian would then register and file the security.
- A disbursements officer should advance the funds and the accounting staff should record the transaction. Two signatures should appear on the journal voucher sent to the disbursements clerk who advances funds to the member. The originating loan officer and either the general manager, or his designate (e.g. assistant manager) should authorize the journal voucher, after examining the supporting file.
- Advances should be totalled on a daily basis by accounting. The sum of the advances should be compared by senior management to the value of promissory notes or other evidence of indebtedness. Any discrepancies should be followed up immediately.
- Before a loan file is stored, it is recommended that it be reviewed against an accompanying loan checklist by senior management and initialled as evidence of such review.
- Finally, senior management and the credit committee, should receive detailed loan disbursements summaries on a monthly basis (where it exists).

Schedule 5.17 provides an illustration of this process.

Schedule 5.17 ***RECOMMENDED LOAN PROCESSING FLOW FOR LARGER CREDIT UNIONS***	
Procedure	**Responsibility**
1) Loan application	Loan officer
2) Credit investigation, verification, analysis and security valuation	Loan officer
3) Loan recommendation	Loan officer
4) Credit approval per loan limits	General manager (or designate)
5) Receipt of security documents and promissory note from member	Loan officer
6) Registration of security documents	Security custodian
7) Review of security registration and completion of debit journal voucher	Loan officer
8) Filing of security documents	Security custodian
9) Review and cosigning of debit journal voucher	General manager (or designate)
10) Loan advanced per debit journal	Loan clerk
11) Loan recorded in accounting records and in report on new advances	Accounting
12) Comparison of report on new advances and promissory notes received	Security custodian
13) Final review of loan checklist and file documents	General manager (or designate)

Limited Staff Resources

Where there is insufficient staff in a credit union for a complete segregation of duties, the following minimum recommendations apply:

- The credit approval and disbursements functions should be performed by two separate individuals.
- The accounting and disbursements functions should be performed by two independent individuals (this may necessitate the active involvement of committee or board members in the disbursements function). Total funds advanced should be balanced against the accounting records daily.

Loan Disbursements

In addition to the requirement for loan approval controls, there is a need to closely monitor the loan disbursement function. Individuals who have lending authority (including the general manager) must not be assigned unilateral disbursement authority by the board, the credit committee, or management, due to the conflict of interest this situation may create. It is generally recommended that an independent employee act as funds disbursement officer, empowered to release funds upon evidence of at least two other authorizing signatures. The disbursement of loan funds should not be authorized until all required security is in place.

Loan Documentation

Proper assessment of credit risk, loan monitoring and delinquency control begin with well documented member files. Maintaining orderly and adequately documented loan files is an important element of credit risk management. Proper documentation provides the following major benefits:

- It constitutes evidence of the terms and conditions of a member's indebtedness.
- It creates valid security which can be realized if it is in compliance with legal requirements.
- It provides an audit trail of the loan decision (e.g. that the loan was authorized in accordance with policy and good lending judgment).
- It allows easy and efficient follow up of problem situations (e.g. skip tracing) or routine member inquiries.
- It establishes a member's credit history for future lending decisions.

Ideally, it is recommended that security documentation be maintained physically separated from the loan application and credit investigation information. Alternatively, credit and security files should be stored together in a fire-proof environment. Negotiable security should be subject to the dual control of a security custodian and a designated senior management person. All files should be purged on a regular and periodic basis by the appropriate lending officer to ensure their continuing validity.

Schedule 5.18 outlines the recommended contents of both the credit and security files for various loan categories. For commercial borrowers, current account documentation will include additional data which supports credit transactions; refer to the Schedule 5.19.

It is recommended that in each credit file, a loan checklist be included, summarizing the various steps that have been taken to properly establish a new loan. This loan checklist should be completed by the lending officer responsible for the loan or by a designated credit committee member, where applicable. It should be reviewed and initialled by the loans supervisor/manager to ensure the credit and security files are in order before these files are stored.

Schedule 5.18 *RECOMMENDED FILE DOCUMENTATION*	
Credit File	**Security File**
For Personal Credit: • Loan checklist • Approved loan application • Credit investigation • Credit analysis • Life and disability insurance application or waiver • Copy of bill of sale for chattel purchased • Member correspondence • Record of telephone conversations	• Chattel mortgage or other security documents • Promissory note • Payroll deduction authorization (if applicable) • Insurance endorsement (if applicable) • PPSA search • PPSA registration
For Mortgages: • Loan checklist • Approved loan application • Credit investigation • Credit analysis • Member correspondence • CMHC application (if applicable) • Record of telephone conversations	• Mortgage document • Lawyer's letter of final report and opinion with supporting documentation • Pledge of fire insurance Independent legal advice certificate (if applicable) • CMHC approval (if applicable) • Qualified appraisal report • Commitment letter/mortgage loan offer • Instructions to lawyer • Certificate of title insurance
For Commercial Credit:· • Loan checklist • Approved commercial loan application • Borrower's financial statements • Supporting financial sum-maries (e.g. budgets and/or aged listings of receivables, payables, inventory and fixed assets) • Credit investigation • Credit analysis • Member correspondence • Record of telephone conversations	• Loan agreement and/or loan commitment letter • Promissory note • General security agreement and/or other security documents • PPSA search • PPSA registration • Assignment of fire/life insurance • Independent legal advice certificate (if applicable) • Any applicable guarantees • Lawyer's opinion letter

In the event of litigation, the contents of a credit file may be required to be disclosed to a member or another party. It is strongly recommended that a credit file not include any information (for example, in the form of notes, correspondence or memoranda) concerning matters not relevant to the loan decision and the maintenance of the loan.

Schedule 5.19 ***COMMERCIAL LENDING REQUIRED ACCOUNT DOCUMENTATION***		
Sole Proprietor	**Partnership**	**Corporation**
Certified copy of registration of commercial name Photocopy of birth Certificate of proprietor Current account agreement	Certified copy of the registration agreement or declaration of persons operating under a trade name Photocopy of birth certificates of partners Partnership agreement which should include certified copy of borrowing and pledging resolution Current account agreement	Articles of incorporation Declaration of company operating under a trade name Certificate of corporate status Certification as to officers and directors of company Certified copy of borrowing and pledging resolutions/by-laws Resolution appointing signing officers per title Current account agreement

Personal/Mortgage Loan Application Forms

Personal loan or mortgage loan applicants should complete standardized loan application forms. The following information fields must be fully documented on these forms:

- Borrower's legal name
- Loan class
- Purpose of the loan and source of repayment
- Amount of loan
- Loan maturity
- Loan price (variable/fixed interest rate and fees)
- Terms and conditions of the loan
- Security (nature, value and ownership)
- Financial details of borrower (e.g. earnings, assets, liabilities, net worth)
- Credit investigation
- Credit analysis
- Rationale/recommendation for credit approval

Credit unions should consult their league for a sample loan application form.

Commercial Loan Application Forms

Whenever a commercial loan application is completed, it is recommended that a complete loan package accompany the business loan summary form. A complete loan package should include financial statements, cash flow statements and budgets, credit risk analysis, history of the business and qualifications of the principals (including credit history), description of assets/liabilities and security, as well as industry and market analysis. Application forms may be obtained from a league or developed independently. Forms which are developed internally by the credit union should be approved by legal counsel and reviewed periodically to ensure their comprehensiveness.

In each commercial loan application or loan summary form, the lender should document clearly and concisely the credit rationale supporting his/her recommendation for credit approval. The rationale should explain how the loan represents a satisfactory (or better) credit risk, referencing briefly the applicant's character, capacity to repay, capital base in addition to the value of loan collateral. The credit rationale (e.g. investigator's remarks) should summarize, generally in a few sentences, the basis for the credit decision; it should not ignore or unduly rationalize shortcomings of the applicant but should consider the facts of the credit and provide a conclusion which is consistent with the facts. The credit rationale must leave the reader fully convinced that the credit risk is acceptable within parameters established in policy and therefore should be approved, or that it is unacceptable and should be declined.

Loan Agreements

With the exception of the financial highlights of the borrower and the credit analysis/rationale, all details of the credit facility should be communicated to the borrower by way of a loan agreement. For consumer loans, a variety of forms may constitute the loan agreement per Schedule 5.20.

Schedule 5.20 *SAMPLE CONSUMER LOAN AGREEMENT DOCUMENTATION*	
Loan Type	**Sample Documentation**
Fixed rate loan	Promissory note
Variable rate loan	Variable rate loan agreement
Home equity line of credit	Loan agreement for line of credit

For residential mortgages, the standard mortgage document will constitute the loan agreement. For commercial loans, all the important information summarized in a commercial loan commitment (or offer) letter should be set out in greater detail in a document called a commercial loan agreement. The loan agreement, for example, should state the financial statement reporting requirements and general conditions of credit (e.g. a required working capital ratio, assignment of insurance, etc.).

Credit Investigation and Analysis

Regardless of the types of loans offered to members, standardized processes, credit investigation and analysis should be conducted. Credit analysis should examine three basic types of information:

- borrower identity;
- employment and income information;
- financial details of the borrower (e.g. earnings, assets, liabilities, net worth).

The above information comprises what is often called the "3 C's" of lending analysis: Character, Cashflow and Capital. Often called the fourth C, "Collateral" should be considered subsequently by the credit union when structuring the terms of a loan. (Note that the C's of lending can be organized in a number of different manners, utilizing varying types of groupings; up to eight in some methodologies, depending upon the breadth of definition used. For example, some methodologies give separate credence to "Credit Bureau"; however, under the "3 C's" methodology this is covered under "Character").

The major objective of obtaining information on a member is to ascertain whether the person may be considered responsible and reliable. Income information is required to give the lender needed data on the cashflow capacity of the borrower. A borrower's ability to repay can usually be determined through an analysis of annual earnings against fixed expenditures and proposed new debt servicing commitments.

Finally, financial information on a member should be obtained to establish the borrower's net worth. A balance sheet is required, recording the value of major assets, and detail all liabilities, by individual creditor name, the balances owing and the debt payments due each month.

Credit Investigation for Personal Loans

It is important that a member applying for a loan, authorize, by signature on the loan application form, the credit union's right to verify all information provided.

A personal credit investigation requires the review of a member's personal background. The results of this investigation should be documented in the member's file. The following procedures are recommended:

- Length of membership in the credit union should be investigated and his/her previous borrowing history. Where the member is relatively new to the credit union, a credit inquiry to the member's previous financial institution should be made, and/or other personal references on the member should be obtained.
- A credit bureau report should be obtained (unless a recent report was filed in the past six months). The report should contain the credit rating of the individual, balances owing and payment history of major creditors, age, address, employer and record of legal judgements. Any negative information or undeclared borrowings should be verified and discussed with the member.
- Residential status should be investigated. If the member is a home owner, the mortgage holder should be contacted and the amount of the mortgage verified. Where the member is a tenant, his/her landlord may be contacted to verify that the applicant is a responsible tenant and makes timely rent payments.

- Verification of employment status should be undertaken (e.g. a telephone inquiry to the personnel department of the member's workplace to confirm position, salary and prospects for continued employment there).
- The size and reliability of other income (spousal or investment income) should be verified, if required for making the borrower eligible for the loan, (e.g. review of spousal employment pay stubs or tax returns).

Operational procedures should set out the minimum financial tests and conditions which must be met to obtain a loan. See Schedule 5.21 for a list of common ratios calculated, and some sample target conditions which an eligible borrower would be expected to achieve for total existing and proposed debt obligations. Whenever a credit union experiences increasing loan losses, particularly during a recessionary period, it should review and tighten its policies governing the minimum financial tests and conditions which must be met in order to grant credit. The maximum acceptable gross debt service ratio and the maximum acceptable total debt service ratio should be reduced, for example, under these circumstances, and whenever a particular borrower's net worth or the loan security available is not strong.

Schedule 5.21 ***RECOMMENDED FINANCIAL TESTS FOR EVALUATING A BORROWER'S DEBT CAPACITY***	
	Sample Maximum Condition
Gross debt service ratio: Monthly rent/mortgage, heating and taxes divided by monthly gross income	25% to 30%
Total debt service ratio: Total monthly debt payments divided by monthly gross income	35% to 40%

In calculating the total debt service ratio, it is recommended that the following items be included in total monthly debt payments: personal accommodation expenses (including average utility monthly bills), monthly vehicle leasing costs, alimony and other support payments, garnisheed wage commitments, and required monthly payments on the proposed new loan and other loan commitments (including five per cent of the balances of all lines of credit arrangements and credit cards).

When investigating a borrower's credit card history, it may be appropriate, where it is found that a borrower has large outstanding balances on several cards, for the credit union to calculate the debt service ratios using five per cent of all of the borrower's authorized credit card limits. This more conservative approach to calculate the total debt service ratio is warranted only in cases where the prospective borrower has relatively high unpaid credit card balances, and is therefore a likely candidate to utilize his/her full authorized limits.

With respect to including the spouse's income in the denominator of the debt ratios, this is entirely appropriate if the spouse co-signs or co-guarantees the loan (a spouse as co-signer or co-guarantor is discussed in Section 5505, under the heading "Loan Guarantees"). If this is done, however, the spouse's relevant loan commitments should also be included in the numerator of the ratio. This is necessary because the lender is relying on two separate parties to service the total new debt load. Finally, the extent of the borrower's equity or net worth should be evaluated, as an indicator of fiscal responsibility (e.g. commitment to savings and ownership), and available loan security. In this instance, a numerical chart is not practical since an individual's personal equity is normally expected to increase with age. Generally, the more equity an applicant has, the greater assurance of an individual's credit worthiness, assuming the applicant has satisfactory cashflow capacity and character.

Required Credit Investigations for Residential Mortgages

Verification and documentation of a potential mortgagor's personal employment income and financial information should be executed in a like manner as was recommended above regarding personal loans. It is recommended, however, that a written letter confirming a member's salary position, length of time on the job and probability of continued employment, be obtained from the employer in the case of a mortgage. Additional verification on the quality of property mortgaged should also be taken prior to granting credit approval. The loan officer must arrange for a real estate appraisal and review the purchase and sale agreement. Additional steps, which must be taken prior to funds disbursement are listed in Schedule 5.22 below and must be undertaken by a licensed real estate lawyer.

Schedule 5.22
REQUIRED PROPERTY INFORMATION AND VERIFICATION FOR RESIDENTIAL MORTGAGES

Property Information from Member	Property Verification
Legal address and property particulars: • detached home • basement, garage, • number of stories • exterior materials	• Confirm title and legal description of the property, from Land Registry or Land Titles office or from property tax assessment notices. • Obtain surveyor's certificate confirming that the house is within property boundaries. • Check with Tax Assessment Office as to status of property taxes. • Request a search on the property for existing charges registered against it. • Required Credit Analysis for Residential Mortgages

Required Credit Analysis for Residential Mortgages

Once all the information on an applicant and subject property has been compiled and verified, the credit evaluation should begin. Credit approval can be granted if the borrower meets three minimum borrower ratio tests. Like personal credit analysis, the two debt service tests of Gross Debt Service Ratio and Total Debt Service Ratio must first be met. Finally, the minimum equity test applicable to residential mortgages (e.g. five per cent to 25 per cent equity depending on whether the loan is conventional or high ratio mortgage) must be achieved. Ideally, the borrower should provide the full equity from his/her own resources; however, funds provided by parents or other relatives of the borrower which have no definite repayment term can be considered as coming from the borrower's own resources. The existence of secondary financing for conventional mortgages only (e.g. a second mortgage obtained elsewhere) can be considered acceptable to the credit union, provided the total debt service ratios are within the acceptable range.

Required Credit Investigations for Commercial Loans

For a commercial account, it is recommended the following credit verification/investigation work be performed (written consent for credit investigation must be obtained from any borrower which is not incorporated.):

- Obtain the commercial borrower's financial statements for the past three to five years and credit report from previous bankers.
- Obtain copy of business incorporation document (if applicable) and resolutions from the borrower's board of directors regarding signing officers and borrowing powers.
- Analyze available credit reports (e.g. Commercial Credit Bureau or Dun & Bradstreet reports) on the business (and its principals if the business is a sole proprietorship) to determine if credit history is satisfactory.
- Follow up employment record of key management players to assess adequacy of technical, marketing and financial management expertise.
- Substantiate net worth statements of principals whenever personal guarantees are taken; (these should be a requirement of all commercial loans) and investigate assignment of "key man" life insurance.
- Investigate major creditor/bank references for the business entity by telephone inquiry.
- Ensure the business has adequate insurance coverage (fire, property and casualty, equipment insurance).

The amount of required credit investigation will vary depending on the size and amount of the commercial account. For larger commercial enterprises, more research should be conducted on the quality of management strategies and plans.

Verifying Accuracy

In order to verify the accuracy of the financial statements, an audit opinion or "Review Engagement Report" should accompany the financial statements delivered to the credit union. A public accountant's association with the financial statements, either by audit or review engagement, confirms to some degree, the reliability of the financial statements, in addition to their compliance with GAAP (generally accepted accounting principles). Typically, a small business (e.g. revenues under five million dollars) would not be able to afford the accounting fees for a full scale audit, so the requirement for a review engagement should suffice.

For certain businesses, the financial statements may only have a "Notice to Reader" attached to them indicating that a public accountant has prepared the financial statements (usually for tax purposes) but did not attempt to verify the accuracy or completeness of the information or its consistency with GAAP. Users of these statements receive no assurance that these financial statements are reliable. As a result, a credit union relying on such statements should solicit further evidence of financial soundness, such as evidence of property title, confirmation of bank balances, etc. Alternatively, the credit union may insist that a Review Engagement be performed.

Required Credit Analysis for Commercial Mortgages

Credit analysis of commercial mortgages for income earning properties (i.e. those properties which generate income from rentals) can generally be considered on an individually financed basis. This means that the loan's cashflow assessment can be based on property revenues only. Assessment of commercial mortgages for properties which are categorized as non-earning or special-use property (e.g. head office, warehouse), however, must involve a broader analysis of the borrower's total cashflows.

Required Credit Analysis for Other Commercial Loans

Commercial credit analysis must focus on evaluating the debt servicing capability of a business (e.g. its cashflow and earnings) and its supporting capital base (e.g. working capital and investor capital). Trend analysis should first be conducted on the earnings and cashflow statements for a three to five year period. Additionally, the current year's budget and cashflow statements should be compared to current year's actual results, and the next year's forecasts to assess the reasonableness of the projections, the quality of management's planning and material performance variations. The following schedule summarizes factors that should be considered in the credit analysis of a commercial loan.

Schedule 5.23 ***CREDIT ANALYSIS FOR COMMERCIAL LOANS***	
Revenue Trend	Is there steady growth in sales (after allowing for inflation)? Determine reasons for a declining or erratic sales volume. Will these factors disappear? Consider the outlook for the industry in general; is it positive or negative? Is this consistent with budget forecasts for the business?
Gross Profit Trend	Explain any unusual fluctuations in the gross profit margins; a decline in the margins could mean that the business is facing tougher competition and finding it difficult to pass on increases in inventory costs. Compare gross profit to industry statistics to assess production efficiencies and pricing strategies.
Operating Expenses Trend	Each major expense item should be calculated as a percentage of sales, and any unusual fluctuations should be examined and explained. Are fixed costs relatively large, resulting in high operating risk?
Net Profit After Taxes Trend	The net profit amount should be examined to ensure that it does not include any non-recurring or extraordinary item such as a gain on the sale of a fixed asset. Calculate net profit as a percentage of sales, and explain trends; compare to industry statistics.
Operating Funds Trend	Determine operating funds as a measure of cashflow. Operating Funds are defined as net profits after tax plus non-cash outlays (non-cash outlays include depreciation, depletion allowance, special amortizations, etc.) plus deferred income tax. Operating funds, which measure cashflow, should be sufficient to cover the interest and principal portion of term debt payments, plus any investment in fixed assets required to maintain normal operations. Determine what the business' forthcoming capital expenditure requirements will be.

Calculate Key Income and Cashflow Ratios

See Schedule 5.24 below for a summary of two key ratios which measure debt servicing capacity. These ratios should be calculated on combined existing and proposed debt levels.

The credit union's commercial lending policy should recommend acceptable targets for the above ratios. The first ratio, for example, should generally not exceed 80 per cent, since this would indicate possible future loan defaults due to insufficient operating cashflows.

Schedule 5.24 *KEY CASHFLOW RATIOS*	
Ratio	**Calculation**
Debt Service Ratio	Sum of annual principal and interest payments divided by annual operating funds
Times Interest Ratio	Sum of annual operating funds and interest payments and taxes paid divided by interest payments

Generally, with respect to the second ratio, the higher the value of the ratio, the better the applicant's credit risk since a bigger earnings cushion exists for interest payments. However, the ratio should also be examined in the context of the industry in which the borrower is operating. Borrowers in high risk industries with more volatile earnings should have a higher interest coverage to permit a greater margin of safety. It may also be useful to compare the ratio of the borrower against other companies in the same industry.

Borrower ratios should be compared to Dun & Bradstreet industry ratios or Robert Morris industry ratios to determine their reasonableness. (The Robert Morris Ratio Report is an annual publication which records financial ratios by industry and asset size and can be found in most business libraries.)

Where key cashflow ratios are marginal, the reliability of cashflows needs to be investigated (e.g. are revenues by contract?). Both ratios should be calculated over a three to five year period with apparent trends explained as either positively or negatively impacting credit risk.

Review of Liquidity

Once the trend analysis has been completed on the income statement, trend analysis should be conducted on the balance sheet, in particular on the adequacy of business liquidity (e.g. working capital indicators). Working capital reflects the ability of the business to meet its obligations as they come due and is vital for the immediate survival of the business, particularly if business has a rapidly growing sales base. It is additionally important because elements of working capital may be taken as loan security.

In a review of key liquidity ratios, the lender should examine closely the level of aged payables to ensure the applicant is satisfying his/her creditors on a timely basis. The level of aged receivables should be examined to ensure the business is not suffering from a collection problem. Inventory turnover should be reviewed to determine the likelihood of inventory obsolescence.

Review of Equity

Besides a careful review of working capital indicators, the extent of investor capital, or equity, in the business must be assessed on the balance sheet to determine the credit worthiness of a borrower. A reasonable cushion of owner's equity is required to insulate the business against unforeseen setbacks, and also permit access to additional financing in the event of need.

Policy or operational procedures should set reasonable debt to equity limits for potential borrowers, which ensure that the credit union doesn't extend credit to a company already heavily leveraged. Debt to equity limits will vary depending on the nature and risk inherent in the borrower's business, and on the risk adversity of the credit union.

When calculating equity, assets of the borrower should be measured for their realizable or market value, as book value does not reflect the true value of the underlying assets. Lenders may also measure the disposable value of the underlying assets of the business, in order to obtain a more conservative estimation of the value of the borrower's equity.

In the loan agreement, the credit union should consider incorporating certain conditions which will mitigate against the withdrawal of equity, including the specification of minimum debt to equity conditions. The following additional measures are recommended:

- Postponement of claim on shareholders' loans.
- Undertaking not to redeem shares or shareholders' loans.
- Undertaking to restrict dividend payments.
- Restrictions on management salaries or partner's/ proprietor's drawings.
- No loans to others or guarantees on behalf of others.

If the equity position of a borrower is presently weak, the owners should be requested to increase the equity position before a loan is granted. Where the business is growing rapidly, ongoing equity investments should be made regularly by the principals to sustain growth.

Environmental Liability

Credit analysis for commercial loans should also include an assessment of the environmental risks that are assumed by the commercial enterprise. Lenders should avoid the risk of security devaluation of a contaminated commercial property and/or the cost of required pollution cleanup. This can involve an investigation of the historical land use of the premises of a prospective commercial borrower, by visiting the premises of all prospective commercial borrowers, particularly those enterprises engaged in farming, manufacturing and fuel distribution, and, if necessary, by commissioning an environmental audit of the property. Lenders should inspect premises for environmental risk indicators, including:

- damaged vegetation, stained soil odours;
- site that is adjacent to landfill site or an industrial facility;
- above or under ground storage tanks, drums or piping systems;
- remnants of old buildings;
- waste disposal areas including waste water ponds;
- significant on-site use of PCBs, pesticides or other hazardous chemicals (consult leagues for detailed

Where future environmental risk cannot be ruled out, the following safeguards should be considered for inclusion in the loan agreement:

- member covenants to have an environmental audit performed periodically;
- member covenants to provide management certification of statutory environmental good standing;
- member covenants to indemnify and hold harmless the lender from expense, loss or liability arising out of environmental damage resulting from the member's activities.

Required Credit Investigation/Analysis for Agricultural Loans

The credit analysis for a farm loan should be similar in form to the credit analysis conducted on any other type of commercial with special consideration paid to the following factors:

- Does the farm operation generate enough revenues to pay all operating expenses, mortgage debt plus provide sufficient living income to the farmer and his family?
- Is the borrower adequately knowledgeable in farming? Does the farm have good quality crops and/or livestock? Does productivity approximate the industry average? (Refer to industry statistics published annually by the Ministry of Agriculture and Food.)
- Does the business enjoy a stable market and adequate prices for its product? Is there a marketing agency or other government programs supporting the farmer?
- How does legislative change impact farm risk (e.g. free trade)?
- Is the farm well equipped with up-to-date equipment and are farm buildings in good repair? Is there good marketability of property?
- Does the farm have adequate insurance coverage (e.g. fire and wind insurance for buildings, livestock or crop insurance, and equipment insurance)?

Where the above factors are investigated and determined to be satisfactory, the credit union may consider extending credit to the prospective farm borrower. For farm land and/or buildings, mortgage loans should be granted only after a qualified appraisal has been obtained which substantiates the security value of the farm.

Loan Security

The extent of a borrower's net worth, an applicant's annual cashflow and the required term of the prospective loan should determine the nature of loan security requested. Where credit risk is high, for example, due to marginally achieved debt service ratios, unstable applicant work history or other risks, a maximum amount of security should be obtained, preferably "hard" security on specific chattels, and guarantees from individuals that have positive net worth and cash flow. Where credit risk is low (e.g. the loan is short-term), there is adequate net worth, and debt service ratios are easily achievable, supplemental forms of security (e.g. wage assignment) or no security may be considered (within authorized limits).

It is recommended that a personal property security search always be conducted on borrowers from whom collateral will be requested, in order to determine whether assets are already pledged. In order to conduct the search effectively, credit unions should obtain birth certificates, marriage certificates or Canadian passports confirming the borrower's current legal name. Once the borrower has authorized the taking of security, the security should be registered under the Personal Property Security Act (PPSA). Refer to following paragraphs for further recommendations on security searches, documentation and registration.

Extra-provincial Security

While an Ontario credit union would not be permitted to engage in the business of lending in another province, unless a reciprocity agreement is in place, there is no statutory prohibition on the taking of security in another province or country to secure a loan made in this province. Consideration, however, should be given to any restrictions on security realization that may arise under the laws of other jurisdictions.

Before taking security in a real or personal property in another province or country, it would be advisable to obtain a legal opinion as to any restrictions or requirements necessary to register and enforce security in that jurisdiction.

Security for Personal Loans

Chattel Security Interests

When a personal loan is extended for a car, boat or some other fixed asset purchase, it is recommended that a security interest be obtained on the item purchased. The amortization period of the term loan should not exceed the useful life of the chattel which is being pledged, in the event that the loan defaults and the security must be realized. Evidence of the market value, or realizable value, of the asset must be ascertained by the credit union to ensure that the value of the chattel exceeds the principal amount of the loan.

Recently dated purchase invoices recording the price of a new asset would generally suffice, unless the item purchased is personal property whose value might fluctuate significantly (e.g. art work, antiques); additional appraisals for these items should be requested. For currently owned property, reference should be made to published price lists on used goods. Depending on the credit quality of the borrower, where the market value of the security pledged marginally exceeds the principal amount of the loan, additional security (e.g. a general security agreement covering all personal assets of the borrower) should be considered.

Collateral Mortgage

A collateral mortgage may also be used as security for personal loans. A collateral mortgage is a real property mortgage that is taken as security for a loan; the mortgage security is in effect only for the term of the personal loan, and is often in the form of a second mortgage. Collateral mortgages are generally used for multi-purpose financing. Collateral mortgages should be substantiated by a qualified mortgage appraisal where the borrower has an existing mortgage which together with the collateral mortgage approximates 75 per cent of the property value. Prior encumbrances on the property should be confirmed in order to determine available collateral equity. Where a prior first mortgage exists on the collateral, the mortgage document should be reviewed to determine whether there is a provision for fluctuating balances (e.g. common for Home Equity line of credit products). It is recommended that the status of prior encumbrances on loans secured by collateral mortgages be investigated annually. A collateral mortgage should always be registered in the appropriate land registry office, and a legal opinion obtained as to title, registration and priority.

Assignment and Pledging of Financial Instruments

Loans may also be secured by an assignment of negotiable securities (note that RRSP's are not assignable), or a pledge (or hypothecation) of other financial instruments may be obtained, such as deposits or receivable instruments.

Taking a financial instrument as security for a loan can be an excellent way to securitize advances, given that certain financial instruments are liquid and can simply be retained in the credit union's custody without registration of a security interest. However, it must be done in a vigilant manner and with due care, so to ensure that the security interest in the instrument is valid. Staff must possess the requisite knowledge and expertise to properly monitor security margins on instruments with fluctuating values.

Hypothecation (pledging) and lodgement of Canada Savings Bonds or term deposits provide the best security because the value will not fluctuate. (The lender must always ensure that the security is transferable; this can be facilitated by contacting the financial institution which issued the security). Hypothecation or assignment of other financial instruments, such as mutual funds, however, can cause problems due to fluctuating valuations or complex security taking procedures. Refer to Schedule 5.25 for a summary of important precautions applicable to the assignment or hypothecation of financial instruments.

Deposits and shares with a credit union, or deposits with other financial institutions, can be pledged as security for a loan. Membership shares, savings or terms deposits may be pledged, but not chequing accounts, due to fluctuating balances. Generally, the hypothecation is for an agreed amount, not usually the entire balance. It is prudent to assert control over the pledged account. If the accounts are deposited with the lender, then a flag should be set up in the computer to indicate that a portion of that account has been pledged. If the pledged account is with another institution, a letter should be sent to that institution notifying them of the pledged amount, which they should similarly monitor to ensure pledged amounts are not withdrawn.

Lodgement of Title

A lodgement of title on real property is generally viewed as a sub-optimal way to secure loans. Taking a lodgement in title is accomplished by taking and physically possessing a borrower's real estate title documents to secure a personal loan. A lodgement of title is not equivalent to a registered collateral mortgage. A lodgement of title does not create a priority interest in security, does not involve a search process which ensures that realty title is free and available to securitize, and will not prevent a borrower from granting mortgage security to another financial institution. Additionally, lodgement of title does not create a right to initiate enforcement, such as power of sale (a remedy under a mortgage). Instead, enforcement requires a court order. For these reasons, lodgement of title is not a recommended form of security.

Schedule 5.25 ***PRECAUTIONS FOR THE HYPOTHECATION OF FINANCIAL INSTRUMENTS***
• Any financial instrument that is part of a RRSP cannot be pledged as collateral in accordance with federal law. • The terms of any financial instrument should be reviewed to determine if it can be negotiated or assigned. • Policy should specifically define the types of "blue chip" securities acceptable to the credit union. Common or preferred shares, for example, should be listed on a Canadian stock exchange with a minimum market share value preferably above $10, but certainly not less than $5. In order to obtain the highest priority of security interest, a member pledging common or preferred shares should obtain a certificate representing the shares and deliver the certificate into the credit union's possession. If share securities are not certificated (i.e. book entries), the credit union should advise the transfer agent of the pledge of the shares and have the credit union noted in the transfer agent's records as the pledgee of the shares. • Bonds should be federal or provincial government, municipal or major corporate issues, and credit unions should determine whether they are coupon bonds, and that all coupons are present. There are strip coupon bonds available in the market which have a substantially lower realizable value than the face value of a bond with coupons. • If a credit union is not familiar with a share or bond security, consideration should be given to obtaining assistance from a broker in establishing its market value and in verifying that the paper is genuine. • A significant margin over advances should be obtained and the value of security be periodically (e.g. monthly) monitored. A significant decline in unit share value may indicate a fall in investor confidence or be the result of a stock split, in which case the credit union should be enforcing its margin requirements, either for a reduction of the loan or, in the case of a stock split, lodgment of new shares. • Security margins should be specified in operating policy; a lending value of 80-90 per cent for municipal bonds and 70-90 per cent for public corporation bonds is recommended depending on the organization's risk rating. For public corporation shares, a security margin of 70-80 per cent of bid market prices would represent a reasonable level. • For stocks, bonds and term deposits, the credit union should obtain a signed power of attorney which conforms exactly to the name(s) under which the security is registered, and a hypothecation to ensure the items are negotiable. • If a financial instrument has been issued by another financial institution, the issuing office should be advised of the assignment and requested not to pay the borrower without the consent of the credit union; additionally the assignment should be accepted and acknowledged in writing before funds are advanced. • There should be strict controls over the safekeeping of liquid securities. Pledged security should be physically segregated from the assets of the credit union, recorded on collateral cards and maintained at all times under dual custody.

Loan Guarantees

Personal guarantees should be viewed as a form of supplemental security due to the many enforcement difficulties lenders face in realizing on guarantees. Frequently, guarantors have reneged on their obligations, claiming the following defences:

- forged signature;
- unsound mind;
- duress;
- lack of understanding of the implications of the guarantee;
- lack of consideration for the guarantee;
- lack of notice of borrower's default;
- lack of independent legal advice;
- inadequate independent legal advice.

In order to avoid these possible defences, it is recommended that the following precautions be taken when requesting a personal guarantee:

- The guarantee must not be taken from a minor or from someone who is not of sound mind.
- The signature must be witnessed, and preferably a legal seal should be placed next to the signature at the time it is provided, since the courts have found the existence of seals on a document import value or consideration.
- Every guarantor which is not a principal of a corporate borrower should be required to obtain independent legal advice with respect to the implications of the guarantee before the guarantee is signed, evidenced by a certificate of independent legal advice. (Refer below for further elements necessary to ensure the validity of independent legal advice.)
- The guarantor must be notified of (and ideally, should agree to) any material changes to the loan as well as all technical defaults on the loan.
- Where possible, a guarantee should be drafted so as to include an indemnity. The benefit in combining an indemnity with the guarantee is that an indemnitor has fewer defences to his or her performance in the event a claim is made than would a guarantor.
- Preferably, any corporate guarantee should be drafted to include a postponement of claim by shareholders.

Guarantor Versus Co-makers

A guarantor pledges to repay the debt of a primary debtor should they not satisfy the debt. A guarantee does not entitle the credit union to realize on the guarantor's assets without first obtaining judgement. The credit rating and credit worthiness of a guarantor, therefore, must always be investigated in the same manner as for a borrower. Similarly, a guarantor should be required to supply security for their guarantee in the same manner as a borrower.

In contrast, a co-maker of a loan (often called a co-signer) is an individual who receives some benefit from the loan proceeds and becomes a co-borrower. The c-maker is legally liable, jointly and severally, with the member requesting the loan. Generally, the co-maker of a personal loan would be a spouse (or some other relative) who has independent income which may be relied upon to help service the loan and thus reduce credit risk. Since the co-maker is considered as a co-borrower, it is required that this individual also be a member of the credit union and have a satisfactory credit rating.

Where a spouse co-signs or guarantees a loan, the debt service ratios should be adjusted to include the spouse's income.

Independent legal Advice

Failure to obtain a certificate of independent legal advice, even where a waiver of independent legal advice is provided in its place, may result in the unenforceability of a guarantee. Where a spouse or family member acts as guarantor, independent legal advice must be obtained from a lawyer whose firm is independent from that of the family lawyer due to possible conflict of interest issues. Independent legal advice should never be obtained from the lawyer who acts for the credit union. The cost of the legal consultation should be borne by the borrower.

Wage Assignments

Another form of supplemental security for personal loans (which is available only to credit unions) is a wage assignment. A number of disadvantages apply when using this type of security. In the event that borrower becomes unemployed, self-employed, or absconds, a wage assignment has no value. If a borrower retires, an assignment of pension income is not legally enforceable. As well, the filing of a Consumer Proposal under the Bankruptcy and Insolvency Act or a voluntary assignment into bankruptcy automatically nullifies the enforcement of any wage assignment.

Since a wage assignment cannot be converted into loan proceeds unless the borrower is employed, it should be considered more as a collection tool than security. For this reason, whenever a credit union requests a wage assignment, it is recommended additional security such as an Assignment of Moneys Receivable also be obtained. Under the terms of an Assignment of Moneys Receivable, should a borrower become self-employed or retire, the credit union would become entitled to other sources of a member's income.

Registering Personal Property Security

In Ontario, the only method of registering a specific security interest in specific personal property (or a general security interest in all the personal property of a debtor), is to register a security agreement under the Personal Property Security Act (PPSA). A minimal cost is incurred when conducting a PPSA search of security interests on a prospective borrower; how-ever, this is commonly borne by the applicant. Where the search result is free of liens, and the borrower has consented, the credit union should act quickly to register its own lien on the security pledged. In the case where a member is discovered to have an outstanding general security interest on all its assets with another creditor, the credit union must investigate whether this other creditor will permit a subordination of its rights to the credit union or whether a purchase money security interest can be arranged before offering credit to this member.

Under the PPSA a security interest in personal property is perfected by the registration of a form called a "financing statement". With the borrower's consent, the financing statement can be registered at any time before or after the security agreement is signed. This does not apply to situations where the collateral is consumer goods, in which case the financing statement can only be registered after the security agreement is signed. In this case, registration should be executed as quickly as possible, preferably within five business days.

For all collateral other than consumer goods, PPSA registration can be effective for a period of one to 25 years or in perpetuity. For consumer goods, the registration period cannot exceed five years.

The cost of each registration period will vary. If the registration period selected is not perpetual, registration must be renewed by the registration of a financing change statement, designated as a renewal, before the expiration of such registration period.

Once a financing statement or financing change statement is registered, a copy of these statements, or of the verification statement, must be delivered to the debtor within 30 days after the date of such registration. After a loan has been extinguished, the security interest that was placed on the collateral must be discharged by the credit union, also through registration of a financing change statement. A copy of the discharge notice must be sent to the borrower within 30 days in order to confirm the cancellation of the lien, if requested by the borrower.

When registering security agreements under PPSA in Ontario, a variety of debtor and security details must be investigated and properly documented. The debtor can be an individual, a corporation, a partnership, unincorporated association, syndicate, joint venture, church or other religious organization, estate of deceased person, trade union, or other artificial body.

The most important detail which must be included in the financing statement is the exact, legal name of the debtor. In the case of individuals, this should be verified by reference to a birth certificate or citizenship document. For corporations, the document governing the corporation should be reviewed (e.g. articles of incorporation, letters patent, etc.).

Unless the name of the debtor and in the case of an individual, the birth date, is accurate, the financing statement and security registration may be of no effect.

Collateral Insurance

Various insurance products are offered which can enhance the security taken on a loan, as well as protect against PPSA registration error. These insurance products are summarized below in Schedule 5.26. Numerous underwriting conditions apply for these products to provide full insurance coverage. Reference should be made to the details of specific insurance contracts. Management should consider carefully the caveats applicable for each type of insurance, as well as the costs of these various products and the likelihood of loss if insurance is not purchased. Human error can contribute to loan loss, however, in some cases, the purchase of insurance may also create negative effects such as looser lending administration, or loan losses if an insurance claim is later denied due to a technical breach in the insurance agreement.

In many instances, personal property security need not be registered under the PPSA. Some of these instances include but are not limited to the following:

- Where the underlying security is in the possession of the credit union, as might be the case with a hypothecation of securities or a pledge of shares or deposits, PPSA registration would not be necessary.
- Where the security is an assignment of life or disability insurance, PPSA registration would not be necessary if the borrower's insurer acknowledges that the credit union is the only assignee of the insurance policy.
- A personal guarantee does not constitute a security agreement as it is merely a promise to pay should the primary borrower default. Therefore a personal guarantee need not be registered under the PPSA (unless the wording of the guarantee also includes an assignment and/or postponement of claims).

Schedule 5.26 ***TYPES OF CHATTEL INSURANCE***		
Type of insurance	**Coverage**	**Common underwriting conditions**
Filing errors and omissions insurance	Insures against: • an error in the completion of a security agreement; • failure to register the agreement; • loss resulting from the registration of a third party's security interest in the chattel during the time period between the insured's initial registry search and the actual registration of the security agreement; • error or omission made by the Registry Office.	• there must be a customary procedure for the insured to file security agreements within 15 days of disbursing funds; • there must only be 15 days between insured's initial registry search and the registration of the agreement; • within 105 days of delinquency, insured must commence repossession proceedings.
Chattel impairment	Insures against: • direct physical loss or damage to a chattel prior to taking physical possession.	• security agreement must require the debtor to procure and maintain insurance, and insured gives written notice of loss to debtor's insurer, if any; • does not apply if the insured has had knowledge for 30 days of lack of or insufficient insurance by the debtor; • within 105 days of delinquency, insured must commence repossession proceedings.
Repossessed chattel	Insures against: • physical loss or damage to a chattel after insured takes physical possession.	• does not apply to chattel <u>owned</u> by the insured.
Chattel non-filing insurance	Insures against: • loss realized if insured chooses not to register security agreement; • an error in the completion of a security agreement; • loss resulting from the registration of a third party's security interest in the chattel during the time period between the insured's initial registry search and the actual registration of the security agreement; • error or omission made by the Registry Office.	• insured should conduct a registry search prior to releasing the funds, to ensure there is no prior charge; • insured must have completed the security agreement before releasing the funds to the debtor, in the customary manner; • within 105 days of delinquency, insured must commence repossession proceedings and file the security agreement at the registry office.

- Where a personal loan is secured by a collateral mortgage, the collateral mortgage must be registered in the appropriate land titles office in order to legally perfect this security, but not under the PPSA.
- Where non-filing insurance is obtained, given the relevant terms and conditions of the policy.

Security for Mortgages

The mortgage security file should include, at a minimum, the registered mortgage document, property appraisal, fire insurance endorsement, sheriff's certificate, property tax certificate and lawyer's final report to the credit union regarding the transaction which should include an opinion on title. Complex real estate transactions may require additional documentation. Credit unions should be guided by their lawyers in this regard.

Registration of mortgage documents by the Land Titles or Land Registry Office should be delegated to a designated real estate lawyer. Refer to Section 5509 on Use of Real Estate Lawyers for objectives in this regard.

Title Insurance for Mortgage Security

Title insurance is available for both residential and for commercial properties which are being mortgaged. For a one-time premium, title insurance protects the lender against title defects, liens, encumbrances, fraud and forgery. The lender is protected against losses suffered as a result of defects that would have been revealed by an up-to-date survey, thus eliminating the need to obtain a survey. The policy also insures against future unmarketability of title, errors or omissions made by the lawyer, or by any third party on which the lawyer is relying. (Title insurance does not protect against any environmental matters). A title insurance policy will not only satisfy any valid claims made against title, it will also pay costs and legal expenses to defend title. Title insurance is offered for both residential and for commercial properties.

Despite the potential protection afforded by this insurance, a credit union must remember that it is ultimately responsible for ensuring it is adequately protected against loss resulting from a defect in title. When deciding to use title insurance, the credit union should therefore confirm the following:

- that the terms, conditions and limitations of the policy of insurance are satisfactory, and that the policy provides proper protection;
- that the credit union's obligations under the policy are understood, and that procedures are put in place to ensure that coverage is not lost through failure to comply with these obligations;
- that the credit union receives benefit commensurate with the expense, and is not exposed to additional risk through use of the insurance;
- that the insurer has sufficient financial capacity to meet potential claims.

It is further recommended that the credit unions refer to legal counsel on the use of the product, and ensure that counsel reviews the specific policy wording to determine the exact coverage provided.

Security for Commercial Term Loans

With respect to a business term loan, the following procedures for loan security are recommended:

- Examine the balance sheet to determine what fixed assets are owned by the company. Generally, those assets which are being financed should be taken as security. Perform a PPSA search on the borrower to verify there are no prior claims on these assets.
- If security available appears inadequate, enquire whether other hard security or guarantees are available (e.g. personal or corporate).

The most common instrument for securing a commercial loan is a general security agreement (GSA). The GSA establishes a security interest for the credit union, in all non-real estate assets of the business (e.g. equipment, vehicles, inventory, receivables and intangibles). Security interests created under the GSA should be registered under the PPSA (refer to previous paragraphs for further details).

Security interests in real estate assets (e.g. land and buildings), cannot be arranged under a GSA or by the PPSA. As a result, where the underlying business assets being financed include real estate, a commercial mortgage should be obtained in addition to a general security agreement. Alternatively, when dealing with large commercial borrowers which are incorporated, consideration may be given to obtaining a debenture. A debenture places a charge over real estate and can also place a charge over personal property. A debenture is the most comprehensive form of security for commercial loans; however, it is not generally requested of small borrowers due to the legal complexities and associated costs.

Two final steps are required in evaluating security for a commercial term loan:

- Determine the realizable value of assets to be pledged.
- Determine the collateral value of these assets. Both of these values should be supported by written documentation.

To determine the realizable or market value of the assets, the following methods are recommended:

- For property - obtain an appraisal, preferably not more than six months old, prepared by qualified appraiser.
- For equipment and machinery - consult equipment dealers, auctioneers, inspect invoices, etc.
- For vehicles - consult reliable car dealers and reliable used vehicle price books.

Once the market value of the security has been established, the collateral value (i.e. the ratio of dollar security to dollar advances), must be determined with appropriate allowance made for age, condition and marketability of the fixed assets being pledged. The size of loan advances compared to collateral value (i.e. loan value ratio) should be monitored on a sufficiently frequent basis to ensure adequate security coverage.

Security for a Commercial Line of Credit

An operating loan may be secured by a security interest in working capital assets such as accounts receivable and inventories under the PPSA. Advances are normally restricted to a fixed percentage of these assets. Depending on the quality of the inventory (function of inventory turnover, obsolescence risk) and the quality of receivables (function of receivables turnover, age and the diversity/credit quality of the customer base), the margin requirement may be higher or lower than the generally applied 50 per cent margin.

Where the credit union takes an assignment of account receivables as specific security (or as part of a general security agreement), the following factors should be investigated:

- Quality of the receivables: is the ageing consistent with the industry? Have receivables over a certain age been deducted for margin purposes (e.g. over 90 days)?
- Concentration of receivables amongst a small number of debtors: what is the credit rating of major customers? Have receivables from debtors with poor credit ratings been deducted for margin purposes?
- Existence of receivables out of province or out of the country: have these been deducted in the calculation of margined receivables?
- Existence of receivables from related parties: have these been deducted from the total receivables pledged to determine collateral value?

Where a credit union takes an assignment of inventories as security for a commercial loan, the following factors should be investigated:

- Type of inventory pledged: under the Bankruptcy Act, as amended in 1992, inventory that (i) remains identifiable as to the originating supplier and that (ii) has been delivered within 30 days of a creditor becoming bankrupt, or being placed into receiver-ship, can be seized by the unpaid supplier to the detriment of the secured credit union. Farmers or fishermen suppliers are further entitled to a super-priority on the debtor's inventory for debts relating to agricultural or fish products that are delivered within 15 days prior to bankruptcy.
- Quality of inventory pledged: is there any obsolete inventory which should be deducted for margin purposes? Has inventory turnover been consistent with the industry?
- Validity of inventory descriptions: have inventories been physically inspected by credit union personnel (e.g. plant tours)?
- Existence of inventory on consignment: have these inventories been deducted from total inventories pledged to determine collateral value?
- Identification of all inventory locations: have all locations for inventory been documented on the security form?
- Existence of adequate inventory insurance: has the insurance been assigned to the credit union?
- Competing security interests, including purchase money security interests: have appropriate searches been undertaken? Have landlords on leased locations acknowledged the priority of the credit union's security?

Where operating lines of credit are in place for commercial borrowers, there will be occasions when one or more of these lines of credit will be exceeded due to member error or funds mismanagement. Whenever these situations occur, lending personnel should immediately investigate the underlying causes. Where there is insufficient security, however, it is recommended that the item causing the credit excess be returned.

Security for a Commercial Mortgage

With respect to evaluating and establishing security for commercial mortgages on income generating properties, the following recommendations apply:

- Obtain a qualified appraisal report on the value of the commercial property. Ensure that a certified commercial appraiser is employed (for a list of accredit appraisers, refer to Section 5508).
- Determine the annual rental revenue of the property by obtaining an up-to-date rental schedule on the building. Determine the number and length in years of remaining leases. What is the outlook for further rental increases? What is the industry vacancy rate, at present and in the future?
- Review the appraisal report to assess the reasonableness of the property value, in light of property income.
- Calculate the property's Debt Service Ratio. This is the ratio of annual principal and interest repayments (including proposed new debt) divided by total operating funds. The debt servicing ratio should not exceed 1.0 before approval of a commercial mortgage is granted, assuming no additional security is being taken.
- Compare the appraised value of the property to the proposed amount of mortgage principal; the principal should not exceed 75 per cent of the value of the property when the loan is made (where the value is the lessor of the appraised value or the purchase price); it is generally prudent to limit this ratio to lesser percentages, such as 60 per cent, for commercial mortgages.
- For income properties, an assignment of leases should be taken and a pledge of fire insurance must be obtained.

Where a commercial property does not generate rental income or does not have sufficient income to support the commercial mortgage, an assessment of other sources of cashflow and security from the borrower is required. Credit and security investigation must be broadened to consider the operations and assets of the entire business, although the requirement that the mortgage principal not exceed 75 per cent of property value continues to apply.

Security for Agricultural Loans

Security investigations for agricultural loans should include a complete appraisal of the farm property. A complete property appraisal should provide an indication of the:

- soil type;
- number of acres of each variety of crop;
- age of plantings, if applicable;
- condition of plantings and/or land;
- drainage;
- value per acre of each variety of crop;
- cold storage facilities or other facilities as required, depending on farm product.

Farm mortgages, including any prior encumbrances, must never exceed 75 per cent of the value of the farm property; a maximum amortization period of 25 years is recommended.

Where farm equipment is being financed, it is recommended that the loan principal not exceed 75 per cent of the market value of equipment which is new, and that lesser percentages apply for equipment which is used. The maximum recommended term for an equipment loan is 10 years, or less depending on the life expectancy of the equipment. A chattel mortgage is recommended as security for farm equipment that is removable. Additional collateral or insurance should be considered when securing farm loans include the following:

- General Security Agreement
- Assignment of Crop Proceeds
- Assignment of Crop or Livestock Insurance
- Key Man Life Insurance
- Collateral Mortgage
- Personal Guarantees
- Farm-Plus (20 per cent guarantee from provincial government at no cost subject to terms and conditions)
- Farm Improvement Loan Act (up to $250,000 guarantee subject to terms and conditions)

While security in the form of an assignment of quota payments can and should be registered with the appropriate marketing board, it may not always be relied upon. The conditions of an operating line of credit for a farm business should always include monthly reporting requirements of aged payables, and where applicable, monthly product shipment volumes (e.g. eggs, milk) and aged receivables.

Loan Renewals

Where a personal or commercial term loan is up for renewal, or a commercial line of credit is being re-extended, it is recommended that the same level of credit authorization and the same type of credit analysis that was originally conducted on either the personal or commercial loan, be repeated to determine whether credit risk remains acceptable. This type of analysis should also be applied to other types of loans where loan payments were repeatedly late. Financial information and credit investigation reports should be updated with the current year's data and retained on file. Where security is registered under the PPSA, a review should be conducted to ensure that the PPSA registration period is long enough to cover the renewal period, or whether it has to be extended.

A loan renewal should not be confused with annual and interim loan reviews, part of the loan monitoring process, and which are covered in the previous section of this Reference Manual.

Mortgage Renewals

Generally, residential mortgages that have operated satisfactorily to date do not require a loan review process before extending renewed credit. The credit union should send a confirmation of all its mortgage renewals, and request the signature(s) of the applicable borrower(s) and guarantor(s), along with proof of up to date property tax payments (where the member is responsible for directly paying property taxes). However, in high risk circumstances (e.g. commercial mortgages, volatile real estate markets, borrowers not meeting the terms and conditions of their mortgage), a review of the mortgage is required.

Each month the credit union should prepare a list of all forthcoming mortgage renewals. This list should be reviewed carefully by the credit manager to identify problem accounts (e.g. delinquent mortgages or slow payers) in addition to real estate mortgages on properties which have reduced substantially in value. As stated above, these mortgages should be subject to further documented analysis, possibly including: mortgage reappraisals, investigations of tax arrears, sub-searches for subsequent registrations or reconfirmation of a borrower's financial status. Alternatively, residential mortgages that have operated satisfactorily to date would not require such a detailed review process before extending renewed credit.

Mortgage Reappraisals

For real estate mortgages on properties which have declined significantly in value, mortgage reappraisals can be useful to measure the exact amount of credit exposure. However, reappraisals are not always useful in reducing credit risk. They are generally not required where the mortgages concerned are in good standing, or the properties are owner occupied. Where reappraisals are not commissioned, management should increase the non-specific loan provision for increased market risk and place these loans on a watchlist to ensure they remain in good standing. Factors for granting mortgage renewals should always be well documented.

Where a reappraisal is conducted and reveals that available equity has fallen below 25 per cent of the value of the property, it may become difficult for a member to refinance elsewhere. A member's knowledge of decreased equity in the home may reduce his/her financial commitment to the property. In this case the lender must proceed with caution. However, if the loan is impaired and the borrower's commitment to the property is in doubt, reappraisals would constitute the first important step in the loan collection process. The cost of reappraisals are generally borne by the credit union, and cannot be forced onto the member.

In the case of delinquent mortgages, reappraisals are recommended to determine likely proceeds from a possible power of sale; in fact, multiple property reappraisals should be commissioned and compared in a declining real estate market before establishing a sales price for the property to avoid subsequent legal liability. In the case of continually slow payers, a credit check on the borrower and a mortgage reappraisal may be useful in alerting the credit union of a deteriorating financial situation. This may necessitate referring the member to another financial institution, or a restructuring of the terms of the mortgage to better accommodate the member's needs.

Collection of Delinquent Loans

Calling of Delinquent Loans

Where possible, it is recommended a credit union establish a loan collection department with staff who have been appropriately trained to deal with loan liquidations. The policies and procedures of the collection department should be clearly documented. All collection activities should be documented in the file of each impaired loan.

It is recommended that the following alternative collection strategies be considered when terminating delinquent loans:

- Request member to refinance the loan through another financial institution or through an equity injection.
- File wage assignment with employer by registered mail.
- Exercise the right of deposit set-off.
- Repossess security or appoint a Receiver.
- Agree to accept partial repayment of principal or to forgive interest.
- Pursue other methods of legal recourse (e.g. use collection agencies, sue borrower, petition borrower into bankruptcy).

The first three strategies are recommended where the borrower has the ability to repay but is unwilling to repay. The fourth strategy, is recommended where the borrower has insufficient cashflow to repay the loan, but where security has some liquidation value, and has been legally perfected. The final strategies should be considered only as a last resort.

In all cases of loan collections, a notice letter demanding payment should be forwarded by registered mail to the last known address of the borrower, and any co-signer or guarantor, specifying a reasonable deadline by which the borrower must comply. The amount of time which should be permitted a borrower to repay a delinquent loan should vary depending on the circumstances of the case. Even where an obligation is payable on demand, and demand has been made, the courts have ruled that a debtor must be given a "reasonable time to pay".

Generally, if there is virtually no prospect of the debtor making payment, the notice period can be fairly short (e.g. more than seven but less than 30 days). On the other hand, if a debtor appears to have the resources to make payment, a longer time frame would be required, assuming this time does not deteriorate the secured position of the credit union. The courts have deemed that the following factors should be considered when assessing what is a reasonable length of time:

- Size of the loan: the larger the debt, the longer the notice period.
- Length of the relationship between debtor and creditor: the more substantial the relationship, the longer the notice period.
- Character and reputation of the debtor: the better the credit history, the longer the notice period.
- Possibilities for quick refinancing: the greater the potential for quick refinancing, the shorter the notice period.
- Risk of loan loss or devalued security: the greater the risk of loan loss or security devaluation, the shorter the notice period.

Where the final factor exists, the credit union should move as quickly as possible to realize its security.

Right of Set-Off

The right of set-off is an effective collection tool, to be employed once a loan becomes impaired. By statute, if a credit union depositor owes a debt to the credit union, then the credit union and the member owe mutual debts to each other and these debts can be set-off against each other, by the credit union without prior notice. The right of set-off cannot legally be exercised on a member's RRSP deposits, deposits held in trust for a designated beneficiary or deposits held jointly with another member. The following steps are recommended when exercising set-off:

- The credit union must ensure that a member has been appropriately advised that the member has indeed defaulted on his/her loan and be given an opportunity to make the loan current. For example, if a member owes money under a demand loan, that member must be given a reasonable period of time to repay the loan following the credit union's demand for repayment. During this time, however, it would be prudent for the credit union to freeze the member's account.
- Notice must be given by the credit union to a member immediately after setting off his/her deposit account. Prompt notice of the set off of a member's account is necessary to prevent the member from continuing to issue cheques on the account and to give the member an opportunity to correct any possible misunderstanding over the status of the loan.

Security Repossession

Every credit union must formulate clear procedures on the process of security repossession. Refer to Schedule 5.27 for a summary of required steps for security repossessions. A letter of intent to enforce security repossession must be sent by registered mail to a borrower before seized collateral is liquidated. (Credit unions can contact their league for a sample notice). Where security registered under the PPSA has been repossessed, legislation requires that at least 15 days written notice of security repossession of non-perishable goods be made prior to the sale of the collateral. Notification must be provided to the secured party, any person having a registered security interest in the collateral and any other person known by the lender to have an interest in the collateral (e.g. guarantor). If no objections are received within the designated time periods, the credit union may act on the security. Where objections are received or where the credit union has limited experience with repossessions, it should consider consulting its lawyer for further legal advice.

Failure to give statutory notice of collateral liquidation may:

- result in the credit union not obtaining the collateral free from the interests of the debtor and subordinate security interests;
- preclude the right of the creditor to claim against the debtor for any shortfall;
- give rise to claims by the debtor or subordinate secured parties who may have had the right, but were not given an opportunity to redeem the collateral.

Schedule 5.27   ***RECOMMENDED STEPS FOR AN INVOLUNTARY REPOSSESSION OF SECURITY***
• Prior to seizure, complete a security search to ensure that the security agreement is properly registered and there are no prior encumbrances. • Contact a bailiff to perform the actual repossession. • Once the security is in the credit union's possession, ensure it is located in proper storage to prevent damage or theft. Log the condition of the collateral and monitor the collateral in storage. • Arrange for insurance coverage of repossessed security. • A "Notice of Repossession and Intent to Sell" is to be sent to the member, guarantor or co-signer generally allowing at least 15 days to redeem the security by paying the loan in full. • On expiry of the waiting period, appraise the value of the security and obtain at least three written bids for purchase. Sell to the highest, reasonable bidder. Keep the written bids on file. To avoid the appearance of a conflict of interest, collateral should not be sold to staff or board members or their related or connected parties.

Collection Through Receivership

Where a credit union has taken back a debenture or a general security agreement for a commercial loan, it should specify the right to appoint a receiver in the event of borrower default in its security agreement. Appointment of a receiver is appropriate where a large collateral pool or a going concern business exists which needs to be realized. The function of a receiver is to liquidate the business or parts of the business as a going concern in order to satisfy the borrower's debts. In order to maximize the security payout to secured creditors, the receiver may elect to foreclose on the debtor's assets, thereby allowing the secured creditors to become the owners of such assets until these appreciate in value. Generally, foreclosure is not recommended due to the uncertainty of future asset values and the costs of continuing ownership.

In the event that the right to appoint a receiver or receiver-manager is not contained in a security agreement, the credit union may go to court to obtain a court appointed receiver or receiver-manager. In that case, the court will determine the rights and duties of the receiver or receiver-manager. A privately appointed receiver, pursuant to the provision of a security agreement, will offer the secured party greater flexibility in dealing with the debtor's assets than would a court appointed receiver and would also expedite the realization process.

Where a receiver is appointed by the credit union, an independent party (e.g. a representative from an accounting firm) must be selected in order to avoid legal liability relating to impartiality. Under both the Ontario and the Canada Business Corporations Acts, the receiver must look after the interests of all persons with a financial interest in the business including the shareholders.

Obtaining and enforcing security in accordance with the covenants contained in a security agreement does not permit the credit union to do anything unlawful. If a debtor is not co-operative (e.g. does not allow the secured creditor access to the collateral to repossess the same or to commence realization proceedings) a security agreement does not entitle a secured creditor to commit acts of unlawful entry, trespass, assault or theft. In this case, the secured party will be required to apply to the courts to obtain an order which will require the debtor to perform and honour the covenants in the security agreement with respect to realization.

Other Methods of Legal Recourse

Where a credit union does not have sufficient security which may be seized to redeem a delinquent loan, or the cost of appointing a receiver is prohibitive relative to loan size, it should consider other methods of legal recourse. These methods generally include: the hiring of a collection agency or the initiation of a law suit through small claims court (for amounts up to $6,000 through the Ontario court - general division). Finally, there is the option of petitioning a creditor into bankruptcy. In choosing a method of legal recourse, all transaction costs should be estimated and compared to the likely proceeds collected. The alternative with the highest likely payback should then be pursued.

Where a collection agency is employed, it is recommended that the agency be given a maximum term of six to nine months to collect the delinquent loans. After the expiry of this term, any uncollected loans should be returned to the credit union for alternative collection strategies.

Where a collection agency is unsuccessful or where a court action will likely recoup a higher portion of the delinquent loan than a collection agency, legal action should be pursued, particularly where it is possible to use a small claims court. Should the court rule in favour of the credit union, the court judgment should be filed as an execution and attached immediately to property of the debtor (e.g. securities, other chattel, residence) and enforced by a local bailiff. A common legal remedy which should be investigated (particularly in instances where insufficient loan security has been taken) is to determine whether the borrower on his/her loan application declared he/she had disclosed all of his/her debts; borrower misrepresentations in this regard will often result in court judgments against the debtor.

Alternatively, where loan collection can be more speedily obtained through the petitioning of a creditor into bankruptcy, this option should be considered. Refer to Schedule 5.28 for the common events which constitute an act of bankruptcy, which must be proven in a court of law by the credit union. Some of these acts are not necessarily a result of financial insolvency.

Schedule 5.28 ***COMMON ACTS OF BANKRUPTCY***
• Voluntary assignment of assets by borrower to a trustee. • Failure to meet obligations as they fall due. • Fraudulent transfer of assets to a third party other than a trustee. • Fraudulent preference; e.g. a payment to one but not all debtors. • An attempt by the debtor to abscond. • An attempt to remove or hide property. • Failure to redeem goods seized under a creditor order of execution which will benefit one creditor to the disadvantage of another. • Failure to meet liabilities generally as they become due.

Consumer Proposal Under the Bankruptcy and Insolvency Act (BIA)

Where financial insolvency is the cause of borrower delinquency, the credit union might suggest the debtor attempt a consumer proposal to settle his/her debts as a means of staying expensive potential lawsuits as well as avoiding the stigma and long term credit consequences of declaring bankruptcy. The Bankruptcy and Insolvency Act (BIA), as amended November 30, 1992, allows an insolvent individual (i.e. a person whose liabilities exceed their assets) with debts under $75,000 to propose to his/her creditors settlement of these debts by paying less than the full amount or paying debts over a longer term. A consumer proposal is started when the consumer debtor obtains the assistance of an administrator, generally a licensed trustee in bankruptcy.

Commercial Reorganizations Under the BIA

The BIA allows an insolvent commercial debtor to stay all creditor proceedings (including realization of security) for a period of time up to 5 months, during which creditors are requested to assess the viability of a business reorganization plan. The process is initiated by the debtor filing a notice of intention through a trustee to its creditors for a reorganization proposal. Within 10 days after filing a notice of intention, the debtor must provide its creditors with a projected cashflow report and a report from a trustee assessing its reasonable-ness. Secured creditors who would be materially prejudiced by the stay can apply to the court for exemption from the stay.

Once a proposal is made, a creditor's meeting must be called within 21 days and the creditors must vote on the proposal by class. A proposal is not binding on secured creditors of a particular class who reject the proposal. Secured creditors in such a class may proceed to realize their security subject to specific notice requirements for security realization. If a proposal is rejected by the unsecured creditors or the court, the debtor is automatically deemed bankrupt; secured creditors are free to realize on their security (provided it is properly registered and perfected) and the trustee shall distribute residual assets to the unsecured creditors.

The amended BIA permits an insolvent debtor the opportunity to negotiate with lenders for loan repayment concessions that will net higher loan recoveries through the continuation of the business than what would otherwise be realized through a business liquidation.

Use of Real Estate Appraisers

In order to comply with the requirements of section 57 of Regulation 76/95 which stipulates that a conventional mortgage not exceed 75 per cent of the value of a property, reliance on professional real estate appraisers is recommended. A procedure on appraisals should require that all properties with financing in excess of 50 per cent of their market value as well as mortgages involving commercial/agricultural properties must be given a full appraisal. For loans that do not meet these criteria, alternative practices should be specified by policy. For example, a letter of opinion (i.e. not a full scale appraisal) or drive-by by a qualified employee should apply.

It is recommended that a qualified professional with an accredited designation be employed for real estate appraisals. Accredited Appraisers of the Canadian Institute (AACI) are appraisers with the broadest qualifications for real estate valuations, including both residential and commercial property. Alternatively, a Canadian Residential Appraiser (CRA) may appraise individual residential lots and residential dwellings containing not more than three self-contained housing units. A Market Value Appraiser-Residential (MVA), may similarly appraise undeveloped residential lots and residential dwellings, comprised of a maximum of two self-contained housing units.

Reliance on other, more accessible appraisal services is acceptable given the credit union confirms that the appraiser meets the following criteria:

- The appraiser can provide documented evidence that he/she is experienced, trained and knowledgeable regarding the real estate market within the area to which the appraisal relates and the type of real estate being appraised (i.e. commercial, residential, agricultural).
- The appraiser uses one or more recognized appraisal techniques such as the sales comparison approach (based on consideration of similar property), the replacement cost approach, and the income capitalization and discounted cashflow approach (for income producing properties).
- The appraiser is independent of the real estate being appraised or of the person whom the institution is dealing with respect to the real estate-related transaction.
- The appraiser is covered by comprehensive "errors and omissions" insurance for appraisal services, with a minimum coverage of $500,000 per incident.

Directors or officers of a credit union should not act as real estate appraisers or be affiliated with organizations that perform appraisals for the credit union in order to avoid conflict of interest situations described in sections 146 and 149 of the Act. Rather, the credit union should formulate a policy which states who the approved qualified appraisers are, and engage the services of these appraisers exclusively. In establishing the approved list, the board should confirm the desired quality and expertise level of designated appraisers and their coverage by errors and omissions insurance.

Use of Mortgage Reappraisals

The need for mortgage reappraisals should be considered whenever mortgages are renewed in an area where general economic and real estate market conditions have significantly declined, where applications for additional credit are received, or where credit problems arise. Generally, residential mortgages that are operating within the terms and conditions of their credit agreements should not require reappraisals at the time of their term renewals.

Use of Lawyers for Mortgage Transactions

The quality of real estate lawyers is particularly important when relying on them to verify and assess mortgage security. Credit union policy should require independent expert lawyers to conduct the necessary legal opinions, tax, title and security searches, and to both prepare and register the mortgage document. Section 149 of the Act prohibits any businesses which are financially associated with directors from providing legal services to the credit union for a fee.

A credit union should develop an approved list of lawyers for corporate use. Periodically, the status of the lawyers on this list should be confirmed by contacting the leagues or alternatively the Membership Records Department of the Law Society of Upper Canada. Additionally, where lawyers are relied upon for large transactions (e.g. over $1 million) confirmation of their practice insurance should be obtained. A similar check should be made when adding a new lawyer to the list, or when a lawyer's qualifications are in issue.

It is recommended that operational procedures designate the lawyers who may be used for mortgage loans. Mortgage funds should always be advanced to a borrower in trust to his/her real estate lawyer. Before funds are advanced, a draft mortgage and title opinion should be requested from the lawyer and reviewed so that when the final mortgage is signed in the lawyer's office, and later registered, it reflects accurately the desired terms of the mortgage and other encumbrances on title are satisfactory. General knowledge of mortgage documentation is required by lending personnel, in order to review and evaluate the lawyer's letter of final report. It is not a recommended business practice for credit unions to register real estate collateral directly without the use of a licensed and properly insured lawyer.