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March 1st, 2024

Financial Services Regulatory Authority of Ontario ("FSRA")
25 Sheppard Avenue West, Suite 100
Toronto, ON M2N 6S6

Attention: Sreejith Lal, Relationship Manager

Dear Sreejith,

Re: Commercial Lending – FSRA guidance for consultation

DUCA Financial Services Credit Union Ltd ("DUCA" or "we") appreciates the opportunity to comment and respond to the public consultation for FSRA's Commercial Lending Guidance ("the Guidance"). FSRA's willingness to have a discussion around our concerns is helpful and we appreciate your openness for dialogue.

We support the intent and principles behind the Guidance and understand the opportunity at hand for the Guidance to further strengthen our sector. As such we are providing this feedback with the desire to assist in arriving at a final version of the Guidance that achieves the intended outcomes.

Below is a summary of **broader strategic / governance related responses** that DUCA has determined to be of particular importance. **Response on items which are more specific to commercial lending** are included in **Appendix A.**

- From a broad perspective, we ask that FSRA ensure language used in the guidance clearly distinguishes between the Board's role of governance and oversight and management's role to manage day to day operational matters and the implementation of Board level policies and frameworks. This will serve to avoid inadvertently drawing the Board into operational matters and potentially conflicting with the CUCPA's prohibition on the Board directly managing, or being involved in, the day-to-day operational management of the Credit Union.

- We have concerns about several sections of the guidance having potentially material unintended adverse consequences on sector competitiveness and ask that FSRA give due consideration to such consequences in finalizing the guidance.

- Lastly, the Guidance document recommends using technology to automate and streamline the administration, control, monitoring, reporting and underwriting of commercial lending. We agree that technology and automation should be used to improve efficiency, reduce human error and improve monitoring and reporting. However, credit union management should have discretion in the use of automation and technology considering investment, cost vs benefit, timeline of implementation, and complexity and customisation needs of products and processes involved.

As an observation, the Guidance replaces and omits various DICO guidance and advisory from 2014 and 2018. Some definitions and limits from DICO commercial lending documents may be relevant for bringing forward and updating into the FSRA Guidance – allowing for the latter's principles-based approach.

The Guidance requires changes in the broader risk management practices and in some cases may require development of new frameworks. As such we trust that credit unions will be given appropriate time to implement the changes necessary for compliance with the new Guidance.

We look forward to further discussion and would be pleased to follow up with FSRA on consultation for the Guidance in this letter.

Sincerely, RAhmad

Riz Ahmad, Chief Risk Officer

Appendix A

Principle # / Page Number / Requirement	DUCA Comments
Risk Rating 1) Principle #2 / pg. 6 / Intended outcome is that a Credit Union's management and control system and framework must allow for performing annual reviews of loans, collateral and industry sectors. 2) Principle #3 / pg. 25 / A prudent Risk Rating system considers among other things, environmental, social and governance (ESG) factors and incorporates such factors into industry risk ratings, credit concentration limits and business strategy reviews.	1) DUCA recommends that Annual Reviews are done at the borrower level which should incorporate facilities, connected exposure, collateral and industry commentary. We request the guidance be revised such that the frequency of sector reviews not be required annually but rather regularly. We believe sector reviews should occur at an appropriate regularity with the timing and frequency being determined by relevant circumstances such as economic or industry conditions that indicate a material change in risk profile. 2) We are concerned about the objectivity and practicality of using ESG factors in risk ratings of individual loans. We are unaware of available methodologies to facilitate the incorporation of such factors. Further, there continues to be evolution in appropriate ESG metrics across industry sectors which raises the inherent difficulty in the application when the "goal posts" are moving. We are also concerned about the potential for such a requirement to adversely impact Credit Union competitiveness against OSFI regulated institutions and other lenders who may not be required to incorporate such metrics to the same degree. We ask that FSRA take into consideration the reality that ESG frameworks, regulations, and stakeholder agreement on appropriate measurements are all in flux. We suggest that ESG requirements and criteria are best incorporated at the enterprise risk management policy level and introduced at a stage when commonly used ESG frameworks are more mature and stabilized. Incorporation at the enterprise risk management level allows for equivalent and holistic application of ESG criteria across all manner of lending and business activity and enables appropriate flexibility in making trade-offs across businesses to optimize overall ESG desired outcomes. We believe it is critical the introduction of ESG requirements on the sector be done in such a way that it does not compromise credit union competitiveness. We see this as an important risk of unintended consequence.
Lending Collateral 1) Principle #1 / pg. 16 / A credit union's lending and underwriting policy is to consider structuring the terms of commercial loans in such a manner that the loan to value ratio improves over the long term, particularly where the collateral's market	1) Values of collateral, particularly real estate are influenced by market forces and may fluctuate in a volatile market. At the time of origination, it is not possible to predict with full accuracy how market values will fluctuate over the term of the loan. Unless the loan is reduced by amortization or midstream by means of

value may depreciate over time or is subject to volatility.	paydowns, LTV cannot be assured to improve over the long term. We are unclear as to how a credit union would meet this criteria if the expectation involves an additional practice/procedure/methodology that isn't already employed in existing underwriting and credit adjudication practices. We are unsure as to how this requirement would add further risk management benefit over and above current practices of underwriting/credit adjudication/managing watch list accounts. We seek clarification from FSRA on this item and ask that consideration be given to potential adverse market competitiveness consequences if such a requirement is not equally applied across regulated and non-regulated entities competing for the same or similar business.
2) Principle #1 / pg. 19 / Credit union's policies are to provide for the re-evaluation of collateral upon review, renewal and/or due to early warning indicators.	2) We recommend clarifying that re-evaluation does not necessarily mean appraisal from a third party but could be an internal assessment. Obtaining an updated appraisal report upon renewal or annual review without incremental exposure, credit deterioration, or loan default is not market practice.
Stress Testing 1) Two separate sections that speak to stress testing are included: loan-level Approach to Principle #1 includes Financial Ratios and Stress Testing (pg. 15) and portfolio-level Approach to Principle #3 (pg. 25) includes Stress Testing and Sensitivity Analysis.	 1) It is our recommendation that the first section – Financial Ratios and Stress Testing – which is comprised of completing stress tests based on financial ratios is more applicable at an individual loan level and <u>not</u> portfolio level. Portfolio level references should be removed in the former

Independent Third-Party Review 1) Principle #1 / pg. 12 / The guidance document notes that as a prudent practice an independent third-party conducting a review of the Commercial Loan file will arrive at the same credit decision by replicating all aspects of the underwriting criteria.	 1) We recommend clarifying the nature and context of the third-party review test. For example, is it from the perspective of internal or external auditors who often have the benefit of hindsight when reviewing a credit file or from the perspective of a prudent credit adjudicator at the time of the request. We believe that prudent commercial credit adjudication follows risk parameters but also allows for credit discretion and judgement with some degree of subjectivity involved. Guidance on the expected frequency of independent third-party review is suggested
Pricing 1) Principle #1 / pg. 15 / The guidance document notes that Commercial Loan pricing should be implemented based on a credit risk rating model and methodology that provides a standard to measure loan risk and loan portfolio risk.	 1) Credit risk rating models typically do not risk rate entire loan portfolios. Risk rating an entire loan portfolio may not be particularly useful in pricing individual loans.