First Nation Housing Loan Fund

Best Practices Guide
2017

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Written by Pieter van Gils, Headwater Capital Consulting and Dominique Collin, Waterstone Strategies.

Report design by Hypsypops Design Co.

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1. Introduction

1.1 Origin and intent of this document

Housing Loan Funds have made a deep and lasting contribution to improving First Nations housing: going where banks cannot go, creating strong loan discipline, making private home-ownership possible.

They have empowered communities to transition from offering free or subsidized housing that was often inadequately tailored to the need and financial capacity of each member, to offering a continuum of housing solutions that better reflected both need and financial capacity.

The more successful Housing Loan Funds operate on sound business principles and have succeeded in creating local housing markets where homes are not just shelters but actually build family equity. Because they are local, grass-root solutions, reflecting local needs and circumstances, Housing Loan Funds have been able to lend on the basis of their borrowers' reputation, credit strength and the value of their homes, with no need for ministerial or band guarantees, freeing up First Nation budgets to focus on maintenance, infrastructure and economic development. Local knowledge, moral suasion and good lending practices have allowed them to keep losses under control and to keep their capital revolving, in some cases for over 40 years.

In 2015, the Aboriginal Savings Corporation of Canada (ABSCAN) and Housing as a Business (HaaB) held The First Nation Housing Loan Funds Symposium. The purpose of the symposium was to share experiences between housing loan funds; to discover best practices; to network; to find ways to work cohesively; and to pool resources. At the close of the symposium, participants identified a number of initiatives that can strengthen Housing Loan Funds. Publishing a best practices guide was one of those initiatives; ‘Na̱mg̱is First Nation volunteered to take on that task.

1.2 Methodology

The authors of this best practices guide examined the policies and procedures of a number of First Nation housing loan funds across Canada; interviewed their staff; and visited their communities to see the results on the ground of operations over the last 40 years. They extend their thanks to the housing staff of the Mohawks of Kahnawa:ke, Six Nations of the Grand River, le Fonds d'habitation de la Nation Huronne Wendat, the Aboriginal Savings Corporation of Canada (ABSCAN), 'Namgis First Nation, and iHousing.

1.3 'Na̱mg̱is First Nation

'Na̱mg̱is oral history details the origin and existence of five namima who have occupied the Nimpkish River watershed for thousands of years. When European ships arrived in Johnstone Strait in 1792, 'Na̱mg̱is people were occupying the village of Xwalkw at the mouth of the Nimpkish River. At this time, 'Na̱mg̱is village sites existed along the entire length of the Nimpkish River and its major tributaries.

Through ancient protocols with neighboring Nations of similar cultural traditions, 'Na̱mg̱is continue to have shared rights to resources throughout the Broughton Archipelago, along the coastal region, and up several of the region's coastal fjords. The 'Na̱mg̱is are ocean and river people, making use of all available resources on land and water.

Soon after contact, the rich resources of 'Na̱mg̱is lands attracted new developments. The new colonial and provincial governments caused large changes to traditional aboriginal ways. With a spirit born of thousands of years of survival, the 'Na̱mg̱is First Nation greatly evolved the range and quality of social services it offered to its members and beyond, becoming the new engine of Cormorant Island employment and economic activity.

'Na̱mg̱is started its own housing loan fund in 1969. It has provided assistance to many 'Na̱mg̱is members and in 2016 it financed the house that graces the cover of this guide. Yet however much of a help the loan fund has provided, its resources have not been adequate to satisfy demand. 'Na̱mg̱is wants to improve the policies and procedures that govern the fund and then invest more capital in the fund. We will be implementing changes throughout the next few years, based on the lessons this guide offers, as well as deliberations from Council and the community at large. We will document the effectiveness of these changes and we will continue to share our learnings with the community of housing loan fund practitioners across Canada.

1.4 CMHC

CMHC works closely with First Nations communities, other federal partners, provinces and territories and Aboriginal organizations to address housing needs in First Nation communities.

CMHC's funding supports the construction of new rental housing; the renovation of existing homes; ongoing subsidies for existing rental social housing; and investments in capacity building for First Nations people living on-reserve. CHMC provided funding for this guide, which represents the collective wisdom and experience of First Nations that pioneered, and persevered in, the creation of locally-designed housing solutions.

2. Raison d'être and Typology of Housing Loan Funds

2.1 Situating housing loan funds in a continuum of approaches to First Nation housing needs

Housing finance provided by conventional financial institutions is based on **the borrowing capacity of individuals** and on **the realizable value of assets taken as collateral**.

These two components rely on a series of ancillary services and tools that one could group into a third component: **the legal and information support system for lending**. This system includes: information sources to assess credit strength and asset home value; the registration of titles and liens; and the network of tools and institutions needed to realize on security.

In First Nations, each of these three components presents difficulties:

- Absence of sufficiently high, stable sources of personal income, as well as a lack of saving tools, limit the ability to make loan payments and to make a down payment. However, the number of creditworthy individuals with the savings and the employment income to support mortgages is rapidly increasing in every First Nation.
- Absence of a legal framework for land and property, as well as of conventional mechanisms for collateral and its seizure are usually identified as the main obstacle to mortgage lending. To this must be added the absence of a structured resale market, which limits the market value of the assets even if they could be taken as collateral.
- The conventional mechanisms for asset valuation and for the analysis of borrower risk rely increasingly on electronic databases and tailored software programs that exclude groups outside the mainstream. The unconventional security arrangements on reserve make it even more difficult to fit in the risk tolerance limits imposed by regulatory authorities and international agreements, so that even commercial lenders that have a relationship with First Nations and know how to do business with them are finding it difficult to finance homes without risk-free First Nation guarantees or Ministerial Loan Guarantees.

For close to two generations now, some First Nations have found ways to overcome all three of these hurdles, within the current legal framework. Some of the solutions are based on financial windfall or exceptional geography, but the ones that have had the deepest transformative impact are also the ones with the highest replication potential. Following is a description of three of these solutions.

A first approach involves local, conventional and regulated deposit-taking financial institutions, such as credit unions, that have the capacity to make loans on the basis of their local deposit base. Their mix of local knowledge, understanding of on-reserve lending, feet-on-the-ground, and good lending practices and systems has enabled several of them, the Kahnawake credit union for example, to build an important home finance portfolio without the guarantees required by other conventional lenders. This is made possible by innovative security instruments such as the "trust deed" arrangement in Kahnawake, or the tri-partite agreements used in many communities by conventional lenders where First Nation governments play an intermediary role to enable the exercise of security arrangements. (See section 4.4 for more details on these security arrangements).

The second approach involves First Nation guarantees for loans made by conventional financial institutions with, in the best cases, a strong measure of Nation-enforced loan discipline to control their financial exposure.

The third approach, the one with the deepest impact and highest potential for replication, involves the creation of Housing Loan Funds that provide direct loans to First Nation members. Most of the funds on the ground now are operated and capitalized by First Nations through the redirection of housing subsidies or with community assets. Some, such as ABSCAN, are independently incorporated, at a distance from community politics, and operate with leveraged funds.

All three of these solutions have proven their transformative value and their capacity to energize local housing markets with a continuum of housing solutions. Strong and stable loan management discipline is the common ingredient for all of them.

2.2 Loan fund typology

Housing Loan Funds are local, unregulated financial institutions. Their objectives, policies, impact and viability vary Nation to Nation. Because they are not required to apply the conventional risk measures imposed on commercial financial institutions with deposit insurance, they can design their own risk management and lending criteria on the basis of their members' reputations, stability and credit profile. The collateral relies on non-standard security, including certificates of possession or customary titles, achievable through mechanisms developed by each Nation, and based ultimately on the Nation's legal ability to seize the land title and dispose of the assets, either through resale or by integrating the property into its rental activity.

Housing loan funds are solutions to housing needs that can be implemented to achieve different goals in response to local circumstances.

This guide identifies three broad sets of goals that housing loan funds pursue: development, growth and market goals.

Funds with development goals prioritize the transition from highly subsidized rental housing to private homeownership. Because there is a significant increase in the housing cost that falls to an individual member if he or she makes the transition from highly subsidized rental housing to carrying the market cost of private homeownership, most housing loan funds starts operations with development goals and attendant concessionary lending policies. These policies usually involve a mix of subsidies, below-market interest rates, low equity requirements, and a high tolerance for risk. In some cases programs are designed to help loan applicants gain employment and accumulate savings for equity. Some Nations have used interest-free loans to create a private home-ownership culture or to wean members away from dependency on subsidies and contributions.

Funds with growth goals prioritize expansion of private housing stock and the creation of market discipline. The fund takes a lower risk of incurring losses by applying eligibility criteria that emphasize the borrower's ability to repay the loan, and the fund charges interest rates that help grow the capital base.

Funds with market goals aim to attract capital from the market; they do no rely only on grants and internally generated revenues. They function with tight loan discipline. Not only is the risk of losses minimized, the operations of the loan fund are run at break-even or better. This goal requires policies and procedures adjusted to on-reserve lending constraints, but designed to meet conventional lending performance on arrears, write-offs and income. An example of a fund pursuing market goals is the Aboriginal Savings Corporation of Canada (ABSCAN), which has been providing housing loans to individuals and capital for a housing loan fund in Quebec since 2005 with no arrears or losses, on the basis of capital raised from First Nation savings.

Several housing loan funds pursue a combination of goals. Kahnawake, for example, offers loans to increase and diversify its private housing stock and employs eligibility criteria and interest rates that ensure the capital of its fund is protected and grows. At the same time it dedicates a portion of its fund to loan products that are targeted to members who do not have enough money saved for a down payment. Wendake, one of the early funds with growth goals, has been borrowing external capital through a commercial bank and through ABSCAN to meet demand for housing loans from its members.

There are housing loan funds that attempt to reach a combination of development and growth objectives with a single suite of programs and policies that combines features appropriate to one and the other, and with the same financial reporting system. The result is a mixed track-record that blends results from higher risk development loans and low-risk growth loans. It is advisable for funds to segregate the developmental, growth and market segments of their portfolios and report on each separately. This allows the funds to build a solid track record for the fund's performance with respect to each category and, with respect to market goals, to increase investor confidence that funds borrowed by the Nation for housing can be repaid from housing loan payments.

2.3 Relationship between Council and loan fund

FUNDS WITH DEVELOPMENT AND GROWTH GOALS

Funds with development and growth goals typically operate under Council's supervision and form part of the Nation's administrative structures. In other words, housing loan operations are run by staff in the housing and accounting or finance departments. The housing loan fund has no separate accounting.

Effectively, the housing loan fund is a budget allocation in terms of the capital made available for housing loans and the staff dedicated to managing it. Most often, housing loan eligibility is reviewed by housing staff; housing loans are awarded by a housing committee; and loan payments are processed by accounting staff.

This structure has the advantage of shared staff costs, with their knowledge of housing issues, integrating seamlessly the use of capital with other programs that aim to provide housing for the members of a Nation.

A housing committee often has Council representation, and sometimes community representation, to whom reports are made concerning the performance of the loan fund: how many applications are made to the fund, how much money is available for loans, whose loan applications have been accepted, how existing loans are performing, what actions have been taken to deal with delinquencies, what actions are proposed with regard to problem loans. Housing staff make recommendations with regard to policy changes. Policy changes may be suggested because the housing situation in the community changes over time, or because certain aspects of the fund seem not to be functioning optimally – perhaps eligibility requirements need to be adjusted, or the fund's actions once a loan is delinquent. The most successful housing loan funds have staff that bring a great measure of innovation and adaptation to changing circumstances.

Council's direct responsibility for the loan fund does leave the loan fund vulnerable to short-term, political decisions. For example, Council might want to use capital that was dedicated to the housing fund for other purposes. Council might also want to stay actions that the housing department wishes to pursue to deal with problem loans – actions like evictions. Communities with successful loan funds, where the capital base remains intact and continues to be recycled, are those where the membership regards the fund as an important instrument that needs to be kept in good working order. Council is thus discouraged by public opinion from diverting funds or refusing approval for evictions.

FUNDS WITH MARKET GOALS

To raise external market capital by issuing bonds, housing loan funds needs to meet stringent provincial requirements. The funds need to be independently incorporated to offer assurance that there can be no political interference from Chief and Council when it comes to applying eligibility criteria or instigating recovery action when loans are in default. Furthermore, there are detailed financial reporting requirements that go beyond the usual audited financial statements of a First Nation. At present, ABSCAN is the only housing loan fund in Canada operating as a market fund and it is structured as an independent corporation.

There are two sources of market capital for housing loan funds that do not require an independent housing loan fund structure: commercial bank loans and First Nations Finance Authority loans.

Transferring First Nation housing loan funds with market goal ambitions to a local or regional housing authority, with loan management services tendered out to Aboriginal financial institutions, may be a cost-effective strategy to build the track record and the independent structure needed to pursue market goals. A number of off-reserve Aboriginal housing authorities with a critical mass of assets and expertise are currently examining the prospects of raising external capital to accelerate their housing development.

2.4 Lending culture and housing loan fund staffing

2.4.1 Lending culture

When a First Nation takes on the job of extending credit to its members - whether directly under the responsibility of Council or indirectly under the responsibility of a Board in a separate organization – it takes on a grave responsibility. A housing loan is almost always a large loan that takes decades to repay. When a loan is in trouble, it can be a source of great stress to borrower and lender alike. The loan fund needs its capital preserved or else the fund will fail. Borrowers have their lives anchored by their homes; the threat of losing one's home due to financial difficulties is heavy to bear.

To navigate successfully between the requirements of a financially sound loan fund and the housing needs of members, the lending operation must be focused on discipline and responsibility. There must be an organizational focus on the management of risks that are inherent in lending. And lending staff need to be properly equipped with the relevant skills. This may sound self-evident, but it is not easily accomplished or maintained. The world-wide financial crisis of 2008 was brought on in part by large portfolios of shaky mortgages.

DISCIPLINED, RESPONSIBLE LENDING

Discipline in lending means that the lender consistently ensures that loan eligibility requirements are met and that all the rules that govern loan approval and loan monitoring are followed.

Responsible lending means that loan fund staff must understand a community member's financial capabilities. They should always ask: "Does this credit decision make sense for the member and for our loan fund?" And in answering that question, they need to use common sense and conservative assumptions. **Loan funds cannot sacrifice credit quality for a short-term focus on meeting a community member's housing need.**

Loan funds that are successful over the long term have three rules that guide their lending practices:

- The pricing of loans should reflect risk.
- The community member needs to clearly understand the obligations he or she takes on.

» Lending staff need to exercise due diligence to determine that community members have the ability to repay a loan.

It should be viewed as contrary to the internal culture of a loan fund to try to provide community members with loans when it is not appropriate for them. In the long run, that leads to great personal stress.

RISK MANAGEMENT

Risk management for a housing loan fund primarily centres on the following:

Monitor performance indicators and share the results

In the section on financial reporting, there is a list of reports that a housing loan fund should generate every month or quarter. It's important to then share those reports so that everyone responsible for the fund can see how the fund is doing and progressing. The reports then require decisions: what is working well and what needs improving?

Have a rigorous, independent review process

Have an internal auditor or credit reviewer who reports directly to Council or the board. It's important to find problems early while they can still be fixed. "Never fool yourself" was the maxim of one housing manager. See section 4.15 for more detail on independently conducted loan reviews.

2.4.2 Competent lending staff

A loan officer's job is comprised of the following duties:

» Evaluate loan applications and documentation by confirming credit worthiness.

» Improve loan applications and documentation by informing applicant of additional requirements.

» Reject loan applications by explaining deficiencies to applicants.

» Forward complete applications to a loan manager or loan committee.

» Complete loan agreements by explaining provisions to borrower; obtain signatures and notarizations; collect fees.

» Help community members by answering questions; respond to requests.

» Follow up on delinquent loans

» Maintain borrowers' confidence by keeping loan information confidential.

To be successful in these duties, a loan officer needs the following skills:

» Interpersonal communications skills - preferably including command of the First Nation's language and culture. These skills are a key to successfully handling loan application interviews when loan officers are expected to counsel and advise community members. Loan officers may contend with high stress situations when applications cannot be accepted, when borrowers need to be reminded of their obligations, or when default remedies need to be exercised when all else fails.

» Analytical skills. The ability to focus on the details and apply critical thinking techniques is a critical part of the loan officer's job, especially when it comes time to shift gears from being understanding of the community member's situation to being a pragmatist with respect to evaluating the lending risk. There is little room for uncertainty when it comes down to reviewing the numbers. All figures must be verified and documented and management's judgements of loan requests need to be realistically anticipated.

» Organizational and planning skills. Because loan officers manage files, relationships, resources, time, people, and expectations, it is important that they have strong organizational skills, as well as a good aptitude for financial planning.

It must be emphasized that housing managers and loan officers have very different jobs and require different skills. The practice, in many housing loan funds, of splitting the fund's management and reporting responsibility between housing program managers and accounting or finance staff is a reasonable option for a fund pursuing mainly developmental goals, but falls short of the HR requirements for funds pursuing growth or market goals.

2.5 Financial systems and reporting

2.5.1 Loan management systems

It is possible to customize database programs, or use accounting programs already deployed by the Nation's administration to manage a loan portfolio; however, loan management systems specifically designed for the purpose of administering a loan portfolio greatly facilitate efficient record keeping, payment calculations and generation of reports necessary to managing a portfolio of housing loans.

Loan management systems offer the following features:

- Has a contact management system to manage interactions with applicants and borrowers
- Easily modifies and restructures loans, can track changes
- Accommodates amortized payments, interest-only, principal-only, percentage- and fixed-principal reductions, interest-only beginning periods, step payments, and custom payment schedules
- Handles fixed, variable, step-by-amount, step-by-days, post-maturity and default rates and deferred interest
- Generates statements, late notices and payoff notices
- Supports unlimited commenting, document generation and storage of all correspondence including invoices
- Has a robust reporting system allows sorting and grouping information by type, status, risk rating and much more. Output can be in PDF or Excel file format.

2.5.2 Loan fund reporting

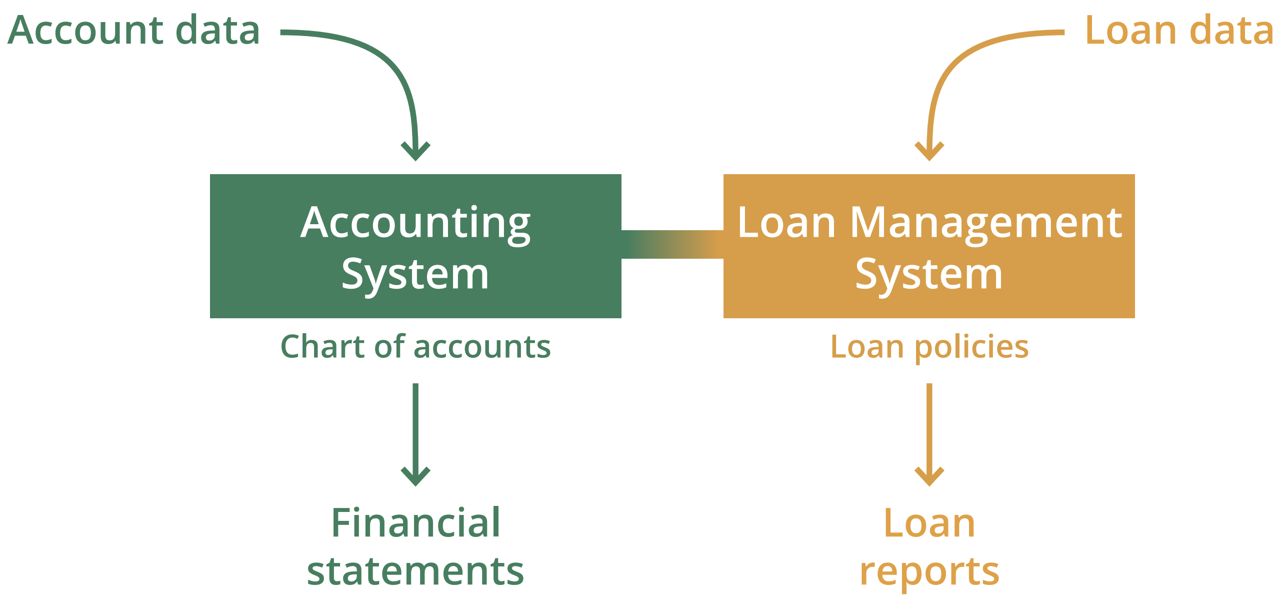
For loan funds that form part of Council's operations, financial reporting forms part of the annual audited statements. **For the sake of transparency for the community and for an adequate understanding on the part of Council and management, it is recommended to keep separate line items related to the housing loan fund.** These line items and their notes should include:

- Housing loans receivable

- The basis for the valuation of these loans
- At what point housing loans are considered impaired
- What the allowance for doubtful debts is on the outstanding housing loans
- The amount of cash that is held in reserve for the loan fund
- The interest rates charged on outstanding loans

For internal management of the portfolio, the following reports should be produced and reviewed monthly:

- Loans outstanding
- Watch list loans: loans whose payments go past due
- Problem loans: loans where there is a significant deterioration in the borrower's financial circumstances
- Delinquent loans: loans with missed payments. Delinquency reports need to be "aged", that is, show loans that are delinquent 30, 60, 90, and 90+ days. To understand the lending environment, it is helpful to review, every month, the delinquency trend over 12 months. If delinquencies are becoming more frequent over time, something is going on. Is it the loss of a major employer near the community? Or does the increase in delinquencies coincide with a change in housing loan fund staff? Is there generalized dissatisfaction with Council's handling of the housing file? Delinquency reports need to include the actions undertaken for and proposed next steps.
- Loan write-offs



The accounting system and the loan management system need to be in accordance, as illustrated above. For example, the loans receivable number needs to be the same in both systems, as does the number for loans written off.

Above: *The link between the loan fund system and the accounting system. Both systems need to operate in tandem.*

Data passes through each program according to its underlying framework: loan policies for the Loan Management System, and the chart of accounts for the Accounting System. Statements report the outcomes of these systems.

FUNDS WITH MARKET GOALS

Funds with market goals prepare a full set of audited financial statements that allow the governing body, the community and investors to track performance of the fund over time. As the loan fund is set up independently of operations, it will have a profit and loss statement that will feature line items that feature the performance of the loans as well as the net cost or net profit of administering the loans. Investors not only look at the performance of the loans and the reserves that are set aside to cover potential loan losses, but also whether the fund can sustain its operating costs.

3. Housing Loan Fund and Housing Policy

The establishment of a sound housing policy allows a community to develop overall parameters for the management, administration and operations of a First Nations housing portfolio.

It puts the community on a path where it develops comprehensive capacity to deliver culturally-relevant policies and programs; offers affordable and appropriate housing solutions; ensures an equitable allocation and distribution of resources; and engages the community regularly in an assessment and analysis of conditions and needs.

The purpose of a housing loan fund is to facilitate private home ownership in First Nations communities. Therefore, **communities that operate a loan fund need to have a housing loan policy that addresses private ownership.** Specifically, there need to be sections that deal with the following headings:

- Zoning, land management, land servicing, distribution or sale of land parcels
- Property titles , their registration and privileges attached
- Mechanisms to enable property title or leases to be used as security; and
- Fund and First Nation roles and responsibilities in the event of repossession in case of default.

The best practices options related to land title and possession are too complex and numerous to be reviewed here. A variety of policies can be applied to serve the goal of enabling the operation of a housing loan fund. For example: customary land ownership recognition managed locally; Certificates of Possession registered with AANDC in Ottawa; sophisticated regimes such as leasehold titles that meet conventional lender requirements on designated land; or so-called A-to- A leases developed in land codes under the FNLMA.

An important consideration is that the collateral value of land title depends on the quality of its registration system and the privileges and restrictions attached to them (such as resale or occupation limited to members only).

Where housing loan funds are not stand-alone structures but part of Council's operations, the housing policy should include most of the headings under section 4 (Policies and Procedures for housing loans) to clarify how the Nation deals with the loans it extends for the purpose of buying a house.

Once the core housing policy document has been completed, it should be communicated to all community members and ratified by the consensus of those members to ensure an adequate understanding of what the policy is intended to do, how it will be implemented, and the variety of roles and responsibilities of those involved.

4. Policies and Procedures for Housing Loans

4.1 Eligibility

FUNDS WITH DEVELOPMENT GOALS

Funds with development goals have eligibility policies that focus on need. There are not always criteria related to employment or income. These funds often maintain a waiting list for loans (and, in some instances, a waiting list for land distribution) that is open to all members of the Nation who meet certain criteria (age; residency; in some communities, building plans and equity; in others, possession of a parcel of land). It is not uncommon for members to register on the waiting list at the earliest allowable moment given multiple-year wait times.

Waiting lists are sometimes used in parallel with priority access policies, enabling housing loan fund managers to bypass the waiting list in specific cases (e.g. a large family whose residence was destroyed by fire). Housing loan applications are accepted on the basis of priority status and waiting list order.

This approach allocates housing resources on the basis of need and membership rights with minimal constraints tied to income - an important consideration in many communities where employment is irregular. However, **unless strong loan discipline is exercised, this approach perpetuates the sense of housing as a community service, and of housing debt as a lesser priority than car- or business-debt**, where failure to pay brings immediate consequences.

Finding the right balance between eligibility based on the community service objectives of the fund and eligibility based on its financial sustainability objectives is the single biggest challenge of funds with development goals. Funds that have succeeded attribute success to fair but no-nonsense policies, as well as avenues of recourse that are well understood and accepted in the community. Continuity in the application of policies is important, as is a general understanding of the benefits of the fund to the community, and local political support for eviction and repossession in the case where it is needed.

FUNDS WITH GROWTH GOALS

Funds with growth goals have eligibility criteria that focus more on the borrower's credit strengths than needs or rights, although criteria such as membership, residence and age are part of the qualification process. Eligibility criteria stipulate that a borrower must be employed; must have an income high enough to require less than 30% of it to make loan payments; cannot have total monthly debt payments exceeding 40% of net income; and must have a good credit score.

Some funds have a cut-off number, e.g. 600; refuse loans for R3 notes or above; require an R9 to be cleared off – see the glossary at the end of this report for definitions and further explanation of the credit scoring system). Many communities are now considering the benefits of financial literacy clinics that include an emphasis on personal management of credit scores: recent research has shown that First Nation members in general tend to have lower credit scores than comparable Canadians as a result of a lower number of credit lines reported and failure to clear off negative information.

These criteria can also be used be to decide whether a Nation will provide a guarantee for a housing loan from a financial institution. See section 6.

Some growth funds specify that loans are for new construction only. They can then ensure, through regular inspection, that the house is well-built (see the section on construction risk management). Borrowers must demonstrate that they have possession of a serviced lot. This restriction puts a crimp in the development of a housing market on reserve as it limits access to capital for resale. In other words, the resale value of a house is depressed by community members' limited access to capital. We therefore recommend funds do not employ this criterion.

FUNDS WITH MARKET GOALS

In addition to the criteria related to employment, income and debt servicing, market funds also require statements of net worth. These are used as an indicator of a borrower's ability to earn and save over his or her life time.

An independently incorporated housing loan fund like ABSCAN, which operates in more than one community, does have community service objectives - in fact this is part of the moral suasion that enables it to operate on the ground. Its structure frees it of administrative and political pressure for credit decisions; however, eligibility requirements tied to service priorities and membership requirements are negotiated with local governments.

4.2 Loan application process and analysis of credit risk

The loan application process consists of members submitting to housing staff the information required to ensure that they meet the eligibility criteria. It is helpful to members if loan fund staff go through the criteria with applicants and explain, if required, where they fall short and what they need to do to become eligible.

If a member does not qualify for a housing loan, staff can review their eligibility for financial assistance (see section 4.9)

The loan fund policy should stipulate who is responsible for making final decisions regarding eligibility. To enhance consistent application of eligibility criteria it is advisable to entrust this responsibility to the manager of the housing department, or a housing committee, rather than Council, and where possible to provide for checks and balances. **The Huron-Wendat Housing Fund in Wendake, for example, has implemented a dual approval process for this purpose whereby the housing loan fund manager makes a recommendation that requires independent review and approval from the housing and the finance departments.**

The information that is submitted to the loan fund needs to be validated and subsequently analyzed to determine whether the loan can be made with acceptable risk.

- Analysis of loan amount – is it sufficient to complete the project? The information required to come to a determination includes the purchase contract, construction plans and quotes and inspector's reports.
- Analysis of the ability to repay and the borrower's credit history – does the borrower have a stable income that covers loan payments adequately? Does the borrower show he or she has a track record of meeting debt obligations? Has the borrower consistently met rental payment and other financial obligations towards the First Nation?

» Analysis of the net worth of the borrower – does it show the borrower has managed to earn and save over his or her lifetime?

4.3 Interest rates

FUNDS WITH DEVELOPMENT GOALS

Some development funds charge no interest because they want to keep access to housing as affordable as possible. **Borrowers pay back the construction cost of the house, including the subsidy that was received for the house from AANDC. The repaid subsidy capitalizes the loan fund.** A Nation may consider this the maximum financial effort it can ask of its members.

The advantages of a zero interest rate is keeping the housing cost low and in reach of more members than might be the case than if interest were charged. The disadvantage is that the fund's ability to pay for construction of new housing erodes over time, due to inflation. If construction costs go up every year by 3%, then, over a period of 25 years, they double. If a loan of $100,000 is paid off over 25 years and it costs $200,000 to build a new house by the time the loan is paid off, the fund's capacity to construct new housing is halved.

If the aim is to keep borrowing in reach for members who could not afford to make their payments, housing loan funds can target these members specifically (see section 4.9 on financial assistance). The fund should consider charging an interest rate that at least keeps pace with inflation. If some or all of the funds are borrowed, then, in addition, the borrowing cost needs to be passed on. For example, a fund of $2 million that pays 3% in interest per year on half its funds under administration would lose $30,000 annually if it does not pass on that cost. However, if it charges a rate of 1.5% interest on $2 million of outstanding loans, it recovers its borrowing costs. In sum, if construction costs increase annually by 3% and the fund needs to charge 1.5% to recover interest costs, then the rate it needs to charge to keep constant its ability to finance new housing construction is 4.5%.

Funds with development goals frequently adopt a fixed, simple interest rate with a loan term that spans the period of amortization. In other words, the rate remains unchanged for the entire period of amortization, and interest is only charged on the principal outstanding, not on interest outstanding (see glossary for further explanation). Fixed rates over 25 years have the advantage of predictability for members. However, it is advisable for the fund to build in a review of the interest rate annually so the fund can respond to changes in the inflation rate. To enable the fund to change interest rates, the terms of housing loans need to be restricted to increments of a maximum of five years, so that the change in interest rates can be applied to the outstanding mortgages as their terms mature.

FUNDS WITH GROWTH GOALS

Interest rates set by funds with growth goals tend also to be set as simple, fixed rates. They are typically set between 7% and 8% for the length of the term. This allows the loan fund's capital base to grow – provided the Fund's cost of capital is zero. If there is a borrowing cost for some of the capital under management, the fund needs to be able to adjust rates as the borrowing cost changes – otherwise the Fund can run significant deficits, year after year.

There are funds that charge interest rates that follow the posted mortgage rate of banks and credit unions. Whereas this makes sense to the membership, who see these rates advertised every day in the papers, and whereas, in an era of unprecedented low rates, there is pressure from members to match these rates, it should be noted that the market rates are quoted for the financing of property off reserve and that the off- and on-reserve environments require separate approaches. Another way of putting this: **there is no market rate for housing on reserve, as the market, in the form of conventional financial institutions, does not operate on reserve.** Conventional financial institutions only make loans with guarantees from the Nation. The Nation should charge the borrower at least the difference between its Housing Loan Fund rate and the market rate, thereby ensuring that the risk to which the Nation is exposed due to its guarantee is at least partially covered (proceeds could be used to build a reserve), while also ensuring that the Housing Loan Fund is not undercut by competition from institutions benefiting from a subsidy provided by the Nation. (See also section 6.)

FUNDS WITH MARKET GOALS

A market fund sets interest rates based on the fund's cost of capital and the borrower's credit risk.

The fund's cost of capital is the average of the interest rates it pays over its total capital.

The credit risk posed by a borrower is the risk of financial loss resulting from the borrower not being able to pay back all of his or her loan. That risk is therefore composed of the risk of default and the risk of not being able to recover the outstanding balance through the sale of the house. The risk of default is subject to a number of variables, such as: loss of employment or reduction of income; increase in the borrower's debt load; change in family circumstances (birth of a child, separation, etc.). The inability to recover the outstanding balance of a loan may result from a drop in the value of the house, for example due to the construction of a neighbouring property that produces noise or pollution, or following the shutting down of a major employer in a remote community.

4.4 Security

All housing loan funds use variations of the same security mechanism: the Nation - or individuals acting in a Trustee capacity - either holds or guarantees access to the title of the financed property until the loan is paid off. The title is only issued after repayment of the housing loan (the borrower effectively enters into a lease agreement with the Nation for the length of the amortization period) or the title is turned over to the Nation for the duration of the loan. In other cases, a tripartite agreement between lender, borrower and the Nation ensures access to the security for the lender. Funds with market goals may require additional security in the form of a co-signor or guarantor.

Housing Funds are advised to seek legal advice to confirm the validity of their approach to security.

4.5 Down payment

FUNDS WITH DEVELOPMENT GOALS

To allow more people to gain access to the fund and purchase a house, funds with development goals tend not to ask for a down payment from borrowers. These funds lend the member the full cost of construction.

The ability to make a down payment is usually a good gauge of a borrower's ability to repay. It shows the borrower has earned and saved. Furthermore, reducing the loan amount relative to the value of the house provides a cushion to the loan fund should the borrower default and the loan fund need to sell the house to recover its loan. The records show that housing loan funds that do not ask for a down payment increase the likelihood of suffering losses over time.

Some loan funds recognize so-called 'sweat equity': the effort a borrower has made, or the expenses incurred, in preparing a lot for construction. Where it regards expenses incurred, these can properly be considered a down payment if they were financed from savings. With respect to non-cash related efforts: these are interpreted as a demonstration of commitment to repay the loan when that member does not have cash to put down. This corresponds to the development goal of maximizing access to home ownership. However, if a loan fund wants to avoid losses, it is advisable to provide assistance by helping members find employment and save towards an equity contribution and thus ensuring they are ready to borrow.

FUNDS WITH GROWTH GOALS

Funds with growth goals ask for a down payment, ranging from 5% to 10%. They may offer financial assistance to those who do not have sufficient savings.

FUNDS WITH MARKET GOALS

Funds with market goals tend to ask for larger down payments: usually 15% or higher.

4.6 Loan amount

FUNDS WITH DEVELOPMENT GOALS

Maximum loan amounts are set to distribute funds fairly and equally over a fund's borrowing members and to limit the loan losses a fund could suffer.

Loan funds that are in their earliest stages usually do not have sufficient capital to finance more than a few houses. They may accordingly set loan maxima below the cost of construction and engage in a partnership with a local financial institution. One housing loan fund, in its first 30 years of operation, lent two-thirds of the required construction cost and the local credit union lent one-third. The credit union took a second position on the security for the loan and held control of loan approvals. It did not ask for band guarantees. This was a very productive partnership that gave the loan fund a significant boost in its ability to meet loan demand.

Loan funds with development goals do not always stipulate a maximum loan amount. Instead, they may control the cost of construction by instructing the general contractor. Money does not change hands between the housing loan fund and the borrowing member. Rather, the housing loan fund pays for construction directly. The Nation has standard designs for one-, two- and three-bedroom houses. It consults the borrowing member and allows for small variations, as long as these do not add to the cost of construction, or the member is asked to contribute the difference. The maximum loan amount is then the prevailing cost of building a house.

FUNDS WITH GROWTH GOALS

Maximum loan amounts are set and revised on a periodic basis to ensure they take into account the amount of capital in the fund and the cost of construction. Current loan fund maxima range between $175,000 and $210,000. Note that, where housing loan funds allow borrowing for existing houses (some loan funds only lend for new construction), the resale value of a house increases as the maximum loan amount increases – the corollary to including existing houses as eligible for financing. As a result, every home owner's equity increases over time.

FUNDS WITH MARKET GOALS

Market funds may adjust the maximum loan amount according to the property being financed. For example, a new single family dwelling may be financed up to 85% of its assessed value; an existing single family dwelling may be financed up to 75% of its assessed value; and a multiple family dwelling, new or existing, may also be financed up to 75%. The remainder of the purchase price is furnished by the buyer, as equity. This approach provides more protection for the loan fund. Assessment of value is difficult in small and slow moving markets, especially in the absence of conventional assessment instruments (registry of sales, property valuation for tax purposes) and accredited evaluators.

4.7 Amortization and loan term

Amortization is similar for all three types of loan funds: 25 to 30 years. However, the terms vary:

FUNDS WITH DEVELOPMENT GOALS

Development funds typically offer 25- to 30-year terms where the interest rate and other conditions are held steady. The borrower is allowed to prepay any amount of the loan. This approach offers maximum security to the borrower (no uncertainty about the interest rate). The prepayment option is unlikely to be taken advantage of if the fund charges no interest. The financial incentive for the borrower is to spread payments out over as long a period as possible. With capital tied up in loans for the maximum of the amortization period, fewer members have access to loans – and that works against the goal of serving as many members as possible.

FUNDS WITH GROWTH GOALS

Funds with growth goals offer a variety of terms, from 1 to 3 to 5 years all the way to a 30-year term. Offering shorter terms is preferable for a loan fund so that it can apply changes in interest rates.

FUNDS WITH MARKET GOALS

Market funds limit their terms to 5 years, which reflects how they finance their lending capital.

4.8 Insurance

Loan funds need to ensure that the property they finance is insured against damage or destruction. This requires the housing loan fund to maintain records with regard to borrowers' home insurance and follow up when insurance expires. It is prudent for funds to take out mortgage impairment insurance. A mortgage impairment policy should be considered contingent coverage. The policy protects insured mortgagees against losses on properties in their portfolio that were believed to have valid primary insurance at the time the house was financed but were found to have no valid insurance, or the amount or type of valid insurance was insufficient to cover the mortgagee's interest.

Alternatively, loan funds may take out policies against loss on behalf of the home owner and pass on the cost of the premium.

Note: loan funds should ensure they are included as mortgagee on the policy (and not as "additional insured").

4.9 Financial assistance

A housing loan program presupposes that members who borrow from the fund can repay the loan. As discussed in section 4.1 (Eligibility), it is therefore prudent to put in place eligibility criteria that focus not only on need but also on ability to repay. Those eligibility criteria will screen out people who cannot come up with the required equity contribution or do not have the required income to make the monthly mortgage payments. A Nation may wish to offer these people financial assistance. That assistance would be targeted, that is, made available only to people who need it, rather than to everyone. In other words, **the best way to offer assistance is not to water down the eligibility criteria for every borrower (equity contribution lowered, or ability to repay redefined) but offer assistance to people who have qualified for participation in a financial assistance program.**

As examples of targeted financial assistance, here are two programs offered by the Mohawk Council of Kahnawake.

4.10 Loan documentation

It is the Loan Fund's responsibility to insure that all agreements are carefully documented for the fund's records. All loans need to be supported and documented with standard loan agreements and all documents related to security. Documentation of unusual conditions and covenants should be reviewed and approved by a Nation's legal counsel.

Typically loan documentation includes:

INFORMATION PROVIDED BY BORROWER

Employment and income verification

» Current employment and amount of income, such as pay slips, evidence of recent pay deposited electronically

- Previous employment (if required)
- Additional income sources (if any)

Basic financials

- A list of current assets and liabilities
- Bank account and transit number for payments

Confirmation of down payment

- Saving or investment statement from within the last 90 days
- Sale of an existing property – a copy of the sale agreement
- Gift letter

Property details

- Property's full legal address
- Approved building plans
- A copy of accepted purchase and sale agreement, if applicable
- Well and septic certificates, if appropriate

INFORMATION GENERATED BY LOAN FUND

Loan Agreement

- Borrowers need to sign a loan agreement. The loan agreement outlines the specific terms and conditions of the loan. For example, the loan agreement will describe the interest rate, term, payment information and whether the loan is open or closed to prepayment. These terms and conditions are the written version of what was agreed during the application process.

Collateral Charge

- Once the loan agreement is signed by the borrower, the Collateral Charge will be signed. The Collateral Charge is the security that the housing loan fund takes in exchange for lending the money set out in the loan agreement. Off-reserve it is registered as a mortgage against the property that is bought or constructed; depending on the property title regime in use in a First Nation, registration systems may not be available or may not register priorities. Legal advice is important in the choice of instrument for this purpose.

Repayment Letter

- After the borrower has received the funds, a housing loan fund may choose to send the borrower a repayment Letter. This letter contains a summary of the loan details, such as the principal amount, payment amount and important dates. It will also the borrower with any changes that may have as the loan agreement and collateral charge documents were finalized.

4.11 Loan closing

Loan closings represent the end of an approval process and the beginning of a relationship that involves repayment by the borrower and monitoring by the loan fund.

Loan closings give the housing loan fund staff an opportunity to express formally the fund's expectations with regard to borrower performance and to make sure that a borrower fully understands the content of the loan agreement. A borrower should know precisely how the loan is structured; how the loan fund intends to monitor the loan; and how it will enforce the terms and conditions of the contract. Also, under the terms of the loan agreement, the borrower acknowledges his or her contractual responsibility to promptly advise the loan fund about any inability to repay and also of any material changes in circumstances which could give rise to an event of default in an agreement.

When a loan is modified (see 4.13), a loan agreement amendment requires loan closings also.

4.12 Managing construction risk

Construction loans should only be granted to borrowers who demonstrate the expertise and capability to complete the proposed construction within the stated period at the planned cost. Most housing loan funds offer their borrowers help in this regard, because delays and cost overruns very negatively impact the ability to complete the project.

The loan fund needs to analyze the construction project and establish identifiable points of completion when agreed upon amounts of the loan will be funded to continue the construction. This requires the loan fund to be presented with a full set of final architectural and engineering plans, specifications for materials and construction, and a full cost budget, including all "hard costs" (labour, materials and subcontract work) and "soft costs" (architect, engineering fees, costs of permits), including a provision for contingencies. The loan fund analyzes these materials, or may require the review of an expert of its choice to determine that the materials and costs presented are reasonable to complete the project.

The loan structure should require use of the borrower's own funds as equity to initiate the project and carry it through its early stages before any loan funds are advanced. The borrower should be required to provide verification that all subcontractors and labourers have been paid for their work to date as a pre-condition to funding of subsequent loan advances. Upon request of the borrower for more loan funds, the loan fund needs to inspect the construction to ensure that the project has reached the next planned stage of completion. This inspection should also make sure that the quality of the construction is acceptable. This process should be explained in detail to the borrower to ensure he or she completely understands the funding mechanism.

4.13 Loan modifications

On occasion, a member may wish to amend originally approved credit terms. Changes may be necessitated by changes in the borrower's economic circumstances or in the cost of construction.

Determining if a borrower is experiencing financial difficulties requires a significant amount of professional judgment. Two situations may arise:

- The borrower has defaulted on his or her housing loan, or other debt obligations.
- The housing loan fund may conclude that a borrower is experiencing financial difficulties despite the absence of a payment default: the borrower's cash flow is insufficient to make loan payments to the housing loan fund and to his or her other debtors.

All loan modification requests must be made in writing and submitted to the same body that governs loan approval. The analysis undertaken for loan modification should be the same as for the original approval.

Loan modifications should only be considered if there is a realistic chance that the borrower will stay current as a result of the change in terms. Loan modifications should rarely be made more than once for a particular borrower. Internal control systems are needed to effectively identify and manage the risks associated with loan modification. An important control function is an internal loan review (see section 4.8). An effective loan review will report on compliance with established policies and procedures, assist in the identification of loan modifications and attest to the appropriateness of the modification.

If a Nation has the capacity to conduct an internal audit, then these are helpful in verifying that appropriate reporting procedures are in place and reporting is accurate. They ensure that loan modifications are included within the allowance for loan loss analysis and that the impairment measurement is correct.

4.14 Problem loans

All institutions that provide loans rely on trust. A housing loan fund makes loans trusting that borrowing members will make their loan payments. In the words of one housing loan fund manager: "My father borrowed from this loan fund; so did my sister; so did I. We all know this is the community's money. We pay our loans so others may benefit as we did and be able to buy a house". A culture of trust and an understanding of shared benefits are the most important ingredients to a successful, sustainable loan fund.

Not all housing loan funds have spelled out how they will deal with arrears: what are the steps that the fund will take? What are the consequences if borrowers cannot or will not pay?

It is important for the housing loan fund to know how it will deal with problem loans. Aside from the risk of loan losses, there are many other, hidden costs: the time spent by staff collecting past-due receivables; the time taken away from management in addressing delinquency issues; the potential domino effect, when other borrowers lose motivation to pay on time; and perhaps most damagingly, the loss of the housing loan fund's reputation.

Well-performing housing loan funds have well-articulated policies that deal with loans that are in arrears. Typically there are interventions at 30-day, 60-day, 90-day, and 120 days of arrears. After the first missed payment date, a borrower will be sent a late payment notice and contacted by phone. An inquiry will be made as to why the payment was late, and a new date will be set by which the payment must be made – usually within 30 days of the original due date.

The most common reasons why a borrower does not make his or her loan payments are:

- Borrower has cash flow problems
- Borrower is under pressure from other creditors – for example, if car payments are not made, the car will be repossessed.
- Borrower perceives the housing loan fund as his or her "partner" – the loan fund is expected to be understanding and forgiving.

The only way to figure out what is going on is to be hands-on. The person responsible for collecting the loan payments needs to visit the borrower and dig through a borrower's financials data, such as bank statements and bill payments, review recent credit scores, check financial statements if the borrower runs a business and check pay stubs if the borrower is employed.

In one Nation, the person contacting the borrower is a Case Manager, who will sit down with the borrower to look in detail at the borrower's finances. The Case Manager and the borrower will then agree on how spending patterns may be changed – and may propose together to modify the loan and change the monthly payment. This is sometimes referred to as a "workout agreement".

As long as the borrower is cooperating and showing he or she is committed to keeping current, the loan will not be considered in default. This approach provides a measure of intelligence and control for the loan fund and allows borrowers to ride out any adverse changes in their financial health. When this approach is not successful – if a borrower will not pay - fines are levied. For example, one growth fund charges fees for late payment that range from a $100 penalty for 60 days late, to a penalty of half the mortgage payment for 90 days late, to a penalty of twice the mortgage payment for a payment that is 120 days late.

Funds should stop accruing interest after 90 or 120 days. The housing loan fund manager will make a recommendation to Council to evict the borrower from the property (there is no repossession of the property as the property was already held by the Nation).

Most funds that have successfully pursued growth goals report having had to use evictions as measures of last resort. These were rare because they sent a strong signal that the fund would move to repossess, causing defaulting borrowers to make arrangements less painful to them. Fairness to all borrowers and sustainability of the fund as a community resource requires establishing a strong sense of discipline from the start.

4.15 Loan review

A loan review provides an assessment of the overall quality of a loan portfolio. Specifically, a loan review:

- » Assesses individual loans, including repayment risks.
- » Determines compliance with lending procedures and policies.
- » Identifies lapses in documentation.
- » Provides risk management findings: are there systemic problems in the loan portfolio that have increased the risk of losses being incurred?
- » Recommends practices and procedures to address findings.

A loan review should include all delinquent and modified loans and at least a statistically significant sample of all performing loans.

A loan review is not an assessment of the adequacy of the loan loss reserve unless the review reveals that a large percentage (greater than 10%) of the loans reviewed are at risk of not getting repaid.

A loan review checklist contains the sections listed below.

- » **Credit Initiation:** Review of initial loan documentation
- » **Loan Structuring:** Evaluation of loan terms against the borrower's ability to repay
- » **Loan Approval Procedures:** Review of written approval procedures and policies
- » **Credit File Documentation:** Verification of all relevant initial and ongoing documentation. Review of post-closing procedures for outstanding items.
- » **Normal Loan Monitoring:** Verification of ongoing monitoring, as appropriate.
- » **Problem Loan Management:** Evaluation of problem loan management including reporting to senior management.
- » **Loan Workout Management:** Review of action plans and workout agreements for seriously delinquent loans.

Following the file review, the loan review team will issue a formal report summarizing its findings, conclusions and recommendations. An initial draft report will be issued solely to the housing loan fund management for its response. Upon receipt of management's response, a final report will be issued to the governing body of the loan fund. The final report will include management's response.

DESCRIPTION OF A LOAN REVIEW REPORT

The main sections of the written loan review report are as follows

Summary Results: This section presents the findings grouped by priority level. High priority findings are defined as violations in policy that could result in loss of principal. Moderate priority findings are those that are not in line with the housing loan fund's policies or practices. Low priority findings offer suggestions towards adhering to industry-wide best practices. The majority of the findings will be reflective of systemic issues within a loan portfolio.

Risk Management: This section presents the findings and recommendations by loan review checklist category (from credit initiation to loan workout management).

Financial or Documentation Exceptions: This section is a list that outlines any specific documents that are missing from the files.

A First Nation's internal audit department, or a team of external consultants, can complete a loan review. **The most important feature of any review team is independence.** Therefore, anyone who is currently involved in the lending process, including the people charged with approving the housing loans, should not be on the team.

A First Nation may have staff with appropriate experience but they may not have completed a loan review before. A consultant can lead a first loan review, select the sample, develop the loan review checklist template, and complete the loan review with the First Nation's administrative personnel working along-side so they receive the training and oversight that give them the capacity to confidently and competently complete the next loan review.

The length of time spent on a loan review depends on the size of the loan portfolio. On average, however, the review process should take 30-45 days.

In theory, a housing loan fund would have annual loan reviews. However, the cost of conducting a review may be prohibitive. Therefore, medium and small housing loans funds may consider bi-annual reviews if the loan review reports do not indicate that there are any significant issues within the loan portfolio. A loan review with a number of medium and high priority findings may indicate heightened credit risk and warrant a follow up loan review within 12 or fewer months.

MOST COMMON DEFICIENCIES FOUND IN HOUSING LOAN FUND REVIEWS

Credit Initiation and Loan Structuring

- Over-reliance on projected income instead of historical income.
- Lack of documentation regarding physical inspection of the house.

Loan Approval Procedures

- Lack of evidence of approval in file.

Credit Documentation

- Lack of follow-up process after loan closing to ensure receipt of all loan documentation.
- No evidence of insurance in place (expired insurance certificate in file).
- Incorrect naming of housing loan fund's role on insurance certificate (i.e., "additional insured" instead of "mortgagee").
- Lack of system to confirm renewal of insurance policies.

Normal Loan Monitoring

- Lack of documentation (phone calls/visits) of loan monitoring by loan officer.

Problem Loan Management

- Lack of documentation of agreement with borrower.
- Unrealistic action plan.
- Lack of evaluation of possible losses.

4.16 Problem portfolios

A number of possible events may lead the governing body of a housing loan fund to conclude that the housing loan fund has a problem portfolio:

When management reports that the number of delinquent loans is growing alarmingly. This is the preferred way of finding out there is a problem: it means that management is doing its job, monitoring the portfolio and reporting signs that concern is appropriate. The governing body of the loan fund can then work with management to find out what the cause of the problem might be. Is it external? For example, a significant downturn in the local economy due to the shutdown of a large employer. Is it internal to the community? For example, a growing dissatisfaction with the community's governance may have influenced borrowers' attitudes towards their obligations. Is it internal to the administration of the loan fund? For example, is it the result of a change in staff (the collections officer or the bookkeeper)?

When a loan review indicates that there are a significant number of loan policy violations. The governing body of the loan fund may then conclude that administration of the loan fund has been deficient to the degree that their confidence in the people charged with management of the loan fund is shaken. In that case, loan fund management needs to be strengthened through training, addition of experienced lending personnel; or there needs to be a change of personnel.

When the external auditor's view of the likelihood of recovering loan principal is significantly more sober than management's reports indicated and the auditor asks that significant loan losses be recognized and loans written off. In that case, the governing body of the housing loan fund should bring in an independent party who can conduct a loan review that will help establish the cause of the discrepancy in the perceived likelihood of loan losses.

First Nation housing loan funds have been in existence for over 40 years and all of them have gone through periods where a hard look at the quality of the portfolio and subsequent changes in policies, systems or management, were necessary. Indeed, all credit institutions periodically find themselves in that position.

The primary concern with problem portfolios is catching them as early as possible: the earlier one acts on a problem portfolio, the less costly the problems will be. Knowing the loan fund has problems is far preferable to being in the dark while problems grow. The governing body of the loan fund needs to ensure it receives regular, comprehensive reports from management regarding the status of the loan portfolio. And it should not skimp on external reviews: there is no other way to know that the reports it reviews are accurate.

4.17 Problem portfolio repair

Problem portfolio repair is, in most cases, a prolonged exercise that involves making hard decisions. People administering the loan fund may need to be replaced and borrowers – members of the community – need to either catch up on their loan payments or lose their homes.

If there is a pervasive non-payment problem, then the community likely needs more than a tightening up of loan fund management. Repairing the portfolio successfully requires efforts that tend to be broad and address a number of issues:

- Community members need to be given a chance to become "literate" in homeownership. The community needs to probe the mentalities that drive what members know, think, believe and expect when it comes to housing.
- The roles and responsibilities of governments, lenders, builders and individual members need to be clarified.
- Housing policies need to be revisited. In particular, it is important to review the incentive structure that drives individuals' decisions and behaviour with regard to housing, from rent payments to undertaking maintenance to becoming a home owner.
- The regulatory framework of the community around land management and ownership titles may need adjustment to create the proper conditions for an internal housing market where homes have financial value and where homeownership is a way for families to accrue equity.
- The economic circumstances of the Nation may play a role: a decline in steady, well-paying employment opportunities will naturally have ramifications for the health of a portfolio.

Initiatives that successfully address these issues tend to be incremental rather than all-or-nothing. They involve steps: informing the community; letting ideas percolate; empowering early adopters of new ideas. They tend to rely more on local examples than on best practices from somewhere else. The initiatives are most likely to succeed if they are driven by a group of local champions involving a combination of elected representatives, administrators and members at large.

An important point is to make allowance for the fact that some people cannot and some will not change, so that resistance will remain. Often that means the community must find tolerance for uncooperative behavior, such as persistent refusal to meet with loan officers or refusal to catch up on loan payments in arrears. What is effective is to exert growing pressure to conform to the agreements that were entered into, as well as conform to the expectations of the community at large, through the narrowing of choices and benefits for those who hold out. For example, one Nation-run Housing Fund has a policy of not evicting elders who refuse to make loan payments; however, they are made aware that they are foregoing the possibility of passing on their house to their children at death, at which time Council will repossess. Another Nation excludes uncooperative borrowers with significant arrears from any services provided by the Nation that require a financial contribution from the recipients.

The main feature of successful change is to ensure at every step in the process that any increase in personal responsibility required by changes in housing programs corresponds to a combination of self-interest (tangible increase in benefits) and community interest (the member is contributing to the overall well-being of the community).

5. Policies and Procedures for Housing Loan Guarantees

Housing loans funds tend to have clear and documented decision criteria and processes, with dedicated lending staff, financial reporting, default mechanisms and periodic review, all of which are (or should be) reflected in policies and procedure. Guarantees, on the other hand, are often managed without specialized lending staff analysis and without corresponding recourses.

Given the rapidly increasing volume of private homeownership loans backstopped by First Nations and the contingent liabilities they create, there is an urgent need to develop and implement appropriate expertise, recourse, policies and procedures. This is especially critical for those Nations that do not have direct loan fund administrations, and, as a result, no access to local lending expertise.

This section reviews the most important considerations for Nations offering guarantees to financial institutions for housing loans.

TYPES OF GUARANTEES

- A **Ministerial Loan Guarantee (MLG)** secures on-reserve housing loans made by a financial institution for the purpose of construction, acquisition, or renovation of on-reserve housing projects. In the event a borrower fails to make loan payments as stipulated in the Loan Agreement, the financial institution informs the borrower, the First Nation and AANDC of the default. The First Nation or AANDC may make loan payments, including the arrears, to the lender. Any loan payments made on behalf of the borrower by AANDC will be recovered from the First Nation.

  The first recourse by AANDC must be to recover acceptable security pledged by the First Nation. A repayment agreement can only be established if all reasonable efforts have been made by the Minister to recover acceptable security pledged by the First Nation. If the acceptable security or repayment agreement cannot be recovered, the Minister must set off against payments made by Canada to the First Nation pursuant to its Funding Agreement with AANDC (or other applicable funding agreement in the case of Self-governing or Comprehensive Land Claim First Nations).

- Most financial institutions will also enter into **guarantee arrangements** directly with First Nations that have sufficient assets or discretionary revenues. The financial institution establishes a cap on the guarantees it will accept from a First Nation, based on its analysis of the First Nation's financial statements. Individual members of the First Nation can then approach the financial institution. Member loans need to be approved on their merit by the financial institution, and the specific guarantee by the First Nation.
- The **First Nations Market Housing Fund (FNMHF)** extends the guarantee capacity of First Nations with an additional backstop and a certification process that confirms the Nation's financial health.

For the First Nation, any of these three guarantee arrangements means that the Nation incurs a so-called contingent liability: if a member defaults on a loan, payment must be made by the First Nation. It is therefore important that the Nation be as diligent in its scrutiny of members who take out loans with the Nation's guarantee as it is with members who take out loans from a Housing Loan Fund.

5.1 Eligibility

A financial institution will apply criteria of eligibility – and a First Nations should put in place its own criteria. After all, it is the First Nation government that will lose money if the borrower cannot repay the loan, not the financial institution. As with housing loan funds that aim to protect their capital, eligibility criteria for guarantees allow assessment of the borrower's ability to make loan payments. These criteria should stipulate that a borrower must be employed or have an alternate source of income; must have an income high enough to require less than 30% of it to make loan payments; cannot have total monthly debt payments exceeding 40% of net income; and must have a good credit score.

5.2 Guarantee application process and analysis of credit risk

The guarantee application process consists of members submitting to housing staff the information required to ensure that they meet the eligibility criteria. It is helpful to members if staff go through the criteria with applicants and explain, if required, where they fall short and what they need to do to become eligible.

The Nation's housing policy should stipulate who is responsible for making final decisions regarding eligibility. To enhance consistent application of eligibility criteria it is advisable to entrust this responsibility to the manager of the housing department, or a housing committee.

The information that is submitted to the manager or committee needs to be validated and subsequently analyzed to determine whether the guarantee can be made with acceptable risk.

» **Analysis of loan amount that is guaranteed** – is it sufficient to complete the project? The information required to come to a determination includes the purchase contract, construction plans and quotes and inspector's reports.

» **Analysis of the ability to repay and the borrower's credit history** – does the borrower have a stable income that covers loan payments adequately? Does the borrower show he or she has a track record of meeting debt obligations?

» **Analysis of the net worth of the borrower** – does it show the borrower has managed to earn and save over his or her life time?

5.3 Interest rates

The Nation's guarantee should come with a cost to the member in the form of an interest rate. That rate should reflect the risk incurred by the Nation. The interest collected should be set aside to build a reserve for payments the Nation is called on to make when a borrower defaults.

The interest rate should at minimum bring into line the interest rate paid to the financial institution by the borrower and the rate he or she would have paid to the Nation's housing loan fund, if it operates

one. For example, if a financial institution charges a 4.5% rate for a mortgage with a guarantee, and the Nation's housing loan fund charges 7%, then the rate charged by the Nation to the borrower for the use of the Nation's guarantee should be at least 2.5%. Without that rate, the Nation would be subsidizing the financial institution and the member, while undercutting the competitiveness of its own housing loan fund. If the Nation offers total guarantees of $5 million and it collects 2.5% in interest from those guarantees, then it receives $125,000 per year that it can use to retain qualified credit risk expertise and contribute to a reserve fund. If the loss rate from the guarantees is higher than $125,000 per year, then the Nation will want to review its eligibility criteria and guarantee approval process; it may also decide to increase the rate is charges for the guarantees.

5.4 Security

The Nation should take out a second mortgage on the property that is financed. The Nation should also have the borrower sign an agreement that obliges him or her to repay the Nation for any payments the Nation was compelled to make by force of its guarantee.

5.5 Loan amount

The Nation should decide on a maximum loan amount it is willing to guarantee for every eligible member. This may be less than the financial institution is willing to lend. For example, due to the strength of the Nation's guarantee, the lender may be willing to lend up to $200,000 with an equity contribution of 5%. The Nation may decide that it will only guarantee $175,000 per borrower. This means borrowers would need to come up with more equity or reduce their total construction or acquisition cost.

6. Glossary

Amortization period

Number of years over which the repayment of your mortgage is calculated. Usually from 25 to 35 years.

Assets

Value of property, investments, and items owned by the borrower

Closing date

Date on which the sale of the property becomes final and the new owner takes possession. All costs and charges to close the deal are now payable.

Credit Score

Your credit score is a judgment about your financial health, at a specific point in time. It indicates the risk you represent for lenders, compared with other consumers.

There are many different ways to work out credit scores. The credit-reporting agencies Equifax and TransUnion use a scale from 300 to 900. High scores on this scale are good. The higher your score, the lower the risk for the lender. Lenders may also have their own ways of arriving at credit scores. In addition, lenders must decide on the lowest score you can have and still borrow money from them. They can also use your score to set the interest rate you will pay.

Some credit-reporting agencies report the lenders' rating of each of your credit history items on a scale of 1 to 9. A rating of "1" means you pay your bills within 30 days of the due date. A rating of "9" means that you never pay your bills at all or that you have made a consumer debt repayment proposal to the lender. A letter will also appear in front of the number: for example, I2, O2, R2. The letter stands for the type of the credit you are using.

The most common ratings are "R" ratings. These are known as North American Standard Account Ratings and are the most frequently used. The "R" indicates that the item being described involves revolving credit. If you always pay on time, it will be coded an R1. If an amount was written off because you never paid it back, it is coded

R9. The R ratings are a coding system that translates “on time”, “one month late”, “two months late”, etc., into two-digit codes:

- **R0:** Too new to rate; approved but not used.
- **R1:** Pays (or paid) within 30 days of payment due date or not over one payment past due.
- **R2:** Pays (or paid) in more than 30 days from payment due date, but not more than 60 days, or not more than two payments past due.
- **R3:** Pays (or paid) in more than 60 days from payment due date, but not more than 90 days, or not more than three payments past due.
- **R4:** Pays (or paid) in more than 90 days from payment due date, but not more than 120 days, or four payments past due.
- **R5:** Account is at least 120 days overdue, but is not yet rated “9.”
- **R6:** This rating does not exist.
- **R7:** Making regular payments through a special arrangement to settle your debts.
- **R8:** Repossession (voluntary or involuntary return of merchandise).
- **R9:** Bad debt; placed for collection; moved without giving a new address or bankruptcy.

Down payment

The amount of money put forward by the buyer toward the purchase price of a home.

Equity

Monetary value or interest in a property in excess of claims or liens against it.

Foreclosure

Court action taken by the lender to take possession of a property when the owner has failed to make payment. Once foreclosure is final, the lender then has the right to resell the property and recover the balance of the loan. The owner stands to lose any equity in the property.

Interest rate

Simple interest rate: When payments are made on a simple interest loan, the payment first goes toward that month’s interest, and the remainder goes toward the principal. Each month’s interest is paid in full so it never accrues. If a loan is paid late, more of the payment goes toward interest than if it was paid on time. Almost all non-commercial loan funds (housing loan funds, Community Futures loan funds, aboriginal capital corporations, etc.) charge simple interest.

Compound interest: When payments are made on a compound interest loan, some of the monthly interest is added back onto the loan;

in each succeeding month, new interest is charged on the old interest. The rate at which compound interest accrues depends on the frequency of compounding; the higher the number of compounding periods, the greater the compound interest. Almost all commercial lenders charge compound interest, with interest compounded semi-annually.

Loan term

The term of a loan is the length of time covered by the loan agreement. During that time, borrowers make payments according to the terms and conditions of that agreement. The terms can include the interest, the payment frequency, and the amortization (total debt repayment period).

Mortgage

A registered charge on property held as security for a loan. It is removed once the loan has been completely repaid to the lender.

Open mortgage: Borrower has the option of paying any or all of the balance owing on the mortgage at any time, without penalty.

Fixed mortgage: Borrower has the option of paying off any or all of the balance owing on the mortgage at any time, but with an interest penalty. Generally offered at a lower rate than an open mortgage.

Prepayment penalty

A penalty on an amount paid during the term of a mortgage, which is more than what was in the original mortgage agreement.

Principal

Amount of money borrowed under the mortgage, not including the interest.

Term

Period of time, a few months to several years, over which the mortgage agreement has been written. Mortgage terms are renewed or extended at the end of each term over the course of the amortization period.

Title

The legal evidence of ownership to a property.

Total debt service (TDS) ratio

Percentage of a borrower's gross (before tax) monthly income needed to cover payments for housing costs, including principal, interest, taxes, heating costs and condominium fees (if applicable), and all other debts and obligations, such as loans, credit cards and car payments. The total should not be more than 40% of gross monthly income.

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