Guidance

☒ Interpretation ☒ Approach ☐ Information ☐ Decision

Effective Date: date TBD

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Residential Mortgage Lending

Purpose

This guidance[1] provides FSRA's:

(i) Interpretation of the requirements[2] for the management of residential mortgage lending for Ontario credit unions as required by Section 189 (2) of the *Credit Unions and Caisses Populaires Act, 1994* (the "*Act*"); and

(ii) Approach that FSRA will use to determine whether, as FSRA interprets the requirements under Section 189(2) of the *Act,* a credit union has "policies, standards and procedures that a reasonable and prudent person would apply "to the underwriting of a "residential mortgage loan" as defined in the *Act* and Ontario *Regulation* 237/09 (the "*Regulation*")*.*

The Approach section of this guidance does not prescribe compliance requirements for Ontario credit unions. Rather, it sets out what FSRA will consider when assessing a credit union's adherence to the principles listed in the Interpretation and to Section 189(2).

[1] The guidance is being published as an Interpretation and Approach under FSRA's Guidance Framework. Each different component is labelled for clarity.

[2] Section 189(2) of the *Act* requires that for residential mortgages, a credit union have "policies, standards and procedures that a reasonable and prudent person would apply".

FSRA considers proportionality in the application of this Interpretation and Approach guidance. Proportionality includes the nature, size, complexity and risk profile of a credit union, and the potential consequences of the credit union's failure, including systemic impact.

Scope

This Interpretation and Approach guidance affects the following entities regulated or registered by FSRA:

- credit unions, caisses populaires and leagues incorporated under the *Act.*

Rationale and Background

Residential mortgage lending is the most significant activity of Ontario credit unions. The activity comprises the largest asset portfolio on credit unions' balance sheets. The health of this portfolio is instrumental to the financial well-being of credit unions and the credit union sector, the protection of its depositors and the ongoing ability of credit unions to serve their members.

Residential lending is a major financial relationship between the credit union and its members. This relationship requires a careful balancing between:

- providing members with sufficient financial accommodation so they can purchase a residence to meet their needs;
- earning a return for other members; and
- ensuring the credit union, its depositors and members, and the mortgagor member, are not put at unnecessary risk due to such credit granting.

Given the co-operative nature of credit unions, their high levels of customer knowledge and their obligations to serve their members by prudently granting credit, credit unions are well motivated and uniquely positioned to balance these competing objectives.

As such, while FSRA's statutory objects require it to protect depositors and contribute to the stability of the credit union sector, this Interpretation and Approach guidance is premised on the principles that:

- credit union members elect their boards and are ultimately responsible for using member-controlled governance to decide how to balance these competing objectives;

- credit union boards, management and employees are accountable for successfully balancing these competing objectives in residential lending activities, and for transparently reporting on this to their members and to FSRA; and

- FSRA's supervision of such activities should allow credit unions to compete effectively and take reasonable risks, intervening only when FSRA is concerned about the financial viability of a credit union, whether members' interests are being well-served, and whether there may be a potential adverse impact on credit union depositors or the stability of the credit union sector.

The Interpretation section of this guidance outlines FSRA's principles for sound residential mortgage risk management including underwriting practices and risk controls and oversight practices at Ontario credit unions. This guidance supplements other FSRA by-laws, rules and guidance, and should be read and interpreted in conjunction with other FSRA guidance, rules and applicable provisions of the *Act* and the *Regulation*. To meet the requirements of Section 189(2), credit union boards, management and employees should apply the principles set forth in this Interpretation guidance.

The Approach section of this guidance describes how FSRA will determine whether a credit union has "policies, standards and procedures that a reasonable and prudent person would apply", as required under Section 189 (2) of the *Act*. It is the responsibility of the Board and Senior Management of each credit union to obtain the necessary internal or external assistance or expertise (legal, financial, risk management, etc.) in the creation and maintenance of prudent residential lending policies and procedures for the underwriting, monitoring, and management of their residential lending portfolios.

Throughout this Interpretation and Approach guidance:

- The term "credit union" also refers to "caisse populaire" and "league".

- The term "Board" refers to either the entire Board of the credit union or a committee of the Board that has been delegated an element of Board oversight.

- The term "Senior Management" refers to the senior management of a credit union consisting of the Chief Executive Officer, the Chief Financial Officer, the Chief Risk Officer and any other member of the senior management team.

Interpretation

FSRA has identified the following four principles to determine whether the requirements under Section 189(2) of the *Act,* for a credit union to have "policies, standards and procedures that a reasonable and prudent person would apply", are satisfied for the purposes of residential mortgage lending activities:

1. **Framework:** The credit union, through its Board and Senior Management, must develop and maintain an efficient and effective framework for residential mortgage risk management ("Framework").

   The Framework should be risk-based and integrated with the credit union's overall lending risk management approach including the Board approved risk tolerance and "risk appetite" statement. The Framework should also align with the credit union's enterprise-wide strategy and, in turn, be linked to the enterprise risk management framework ("ERM").

   The Framework should be commensurate with the nature, size, complexity and risk profile of the credit union's mortgage activities.

2. **Underwriting Policy**: The credit union, through its Board and senior management, should develop, regularly review and approve a comprehensive residential mortgage underwriting policy or set of policies ("Underwriting Policy").

   The Underwriting Policy is an integral component of the Framework and includes process, criteria and documentation standards, assessing the affordability of the loan, collateral management and assuring compliance with all applicable laws, regulations and guidelines (AML, consumer protection, funding, etc.).

3. **Portfolio Management:** The credit union, through its Board and Senior Management, should implement appropriate processes and systems for the effective on-going administration, control and oversight of its residential mortgage portfolio.

   This includes maintaining effective credit and counterparty risk management infrastructure (e.g., people, processes, systems, organization structure) and management information systems (MIS) that support the underwriting, acquisition and monitoring of the credit union's residential mortgage risk.

4. **Risk Management:** The Framework, Underwriting Policy and portfolio management activities should fully integrate with the credit union's overall strategic planning, enterprise risk management, capital management and liquidity management activities.

   This includes maintaining adequate regulatory capital and liquidity levels that sufficiently support the risks undertaken through the underwriting, acquisition or securitization of residential mortgages.

The Board and Senior Management are accountable for ensuring that a credit union conducts its residential mortgage activities in accordance with these Principles and for successfully balancing the competing objectives discussed above. In particular:

- Management is responsible for the creation and effective implementation of a residential lending Framework and Underwriting Policy, for effective residential mortgage risk management (including controls and information) and for reporting to the Board and FSRA on such Framework, portfolio and activities, including whether residential mortgage activities and portfolio are performing in accordance with business plans and risk parameters.

- The Board is responsible for overall governance of residential mortgage activities and for oversight and supervision of management in its duties, including approval and periodic review of the Framework, Underwriting Policy, portfolio administration and risk management activities, monitoring deviations and exceptions and providing effective challenge to management (both directly and through specialized expertise such as internal auditors).

- Board and management are responsible for ensuring the credit union has the necessary assistance, expertise (legal, financial, risk management, etc.) and resources (human and technology) to create an effective Framework and Underwriting Policy and to ensure effective residential mortgage portfolio management and risk management activities.

This Interpretation guidance sets out FSRA's view of requirements under the *Act* and the *Regulation* concerning residential mortgages. Non-adherence can lead to enforcement or supervisory action by FSRA, including requiring remediation and reporting, making capital or liquidity orders and placing a credit union under supervision or administration.

FSRA will monitor adherence to the applicable principles and requirements as part of its supervisory approach, as outlined in the Approach section below.

FSRA's supervision, and if required enforcement activities, will be carried out under any relevant provisions of the *Act* and the *Regulations* and its general authority under the *FSRA Act*.

Approach

This Approach defines standards and practices that FSRA will use in its supervisory approach when assessing a credit union's adherence with the requirements of Section 189(2) of the *Act* and the principles established in FSRA's Interpretation set out in this guidance.

1. Does the credit union have efficient and effective corporate governance of its residential mortgage activities?

Overall residential mortgage risk management controls and oversight

Have the Board and Senior Management:

a) established an adequate residential mortgage credit risk management function and defined a framework for residential mortgage credit approvals, including: the credit union's residential mortgage credit risk appetite within its overall risk appetite framework (RAF), the credit approval process including any internal structures or requirements for credit granting, monitoring and decision-making, and effective oversight of credit risk quality and provisioning;

b) ensured that its credit policy setting the risk tolerance for residential mortgage lending is documented out in a manner that is clear and useful to credit union employees and is readily presented upon request by FSRA;

c) approved the credit union's residential mortgage credit risk strategy to ensure that it is in line with the RAF, capital and liquidity planning, and the Internal Capital Adequacy Assessment Process (ICAAP), where relevant;

d) ensured that all staff involved in managing, monitoring, controlling and taking residential mortgage credit risk are adequately skilled, resourced and experienced; and

e) included the credit union's core values and expectations in its residential mortgage credit risk culture, consistent with the overall corporate culture of the credit union?

Board

Has the Board of the credit union:

a) reviewed and approved the Framework and the Underwriting Policy, and any changes that pertain to residential mortgage lending, at least annually;

b) understood the decisions, plans and policies of Senior Management with respect to residential mortgage underwriting and the administration and acquisition of residential mortgage loan assets;

c) provided effective challenge to Senior Management to ensure these are consistent with the Board's decisions, and Board-approved business and risk strategy/ RAF for the credit union, and that the corresponding internal controls are sound (i.e. separation of origination and adjudication);

d) monitored exceptions to policies and controls established in the Framework and Underwriting Policy;

e) received accurate, independent, and objective reporting on the related risks, controls and oversight processes for the residential mortgage business, including from the second line (risk) and third line (internal audit) of defence; and

f) reviewed such reports in respect of the Framework and Underwriting Policy and ensured that a plan of action is created and implemented to rectify, in a timely manner, any issues identified in the risk management of the residential mortgage portfolio?

Senior Management

Has Senior Management developed and implemented the Framework, Underwriting Policy and associated controls and oversight policies and procedures by ensuring that:

a) mortgage credit policy requirements are followed (e.g., residential mortgage loans do not exceed the established level of risk tolerance; compliance with the Act and other legal requirements, such as anti-money-laundering and anti-terrorist financing);

b) exceptions to the credit policy are identified, approved and noted in exception reporting to the Board or Audit Committee;

c) portfolio concentration levels are within the credit policy limits;

d) risk management functions are working properly, including separation between residential mortgage origination and adjudication functions;

e) controls, monitoring and reporting is completed as per the credit policy, including appropriate portfolio and risk metrics and controls to manage risks and achieve diversification;

f) knowledgeable and qualified staff are performing appropriate functions and meet or exceed standards and expectations;

g) the Board receives timely reporting on the residential mortgage portfolio at regular intervals, including reports from Senior Management on concentrations, volumes, performance, residential mortgages that do not conform to the Underwriting Policy ("non-conforming residential mortgages"), delinquency and impaired allowances, watch list accounts and aggregate exceptions to policy;

h) the Board receives all necessary information about issues and/or potential risks to the Mortgage portfolio; and

i) questions from the Board are addressed in a timely manner?

2. Does the credit union have comprehensive and well-documented policies and procedures governing its residential mortgage activities?

Credit Risk Policies and Procedures

a) Are the policies and procedures comprehensive enough for the credit union's residential mortgage activities?

b) Has the credit union documented its policies and procedures?

c) Is there a review procedure that clearly identifies the functions and employees tasked with maintaining up-to-date specific policies and procedures?

Data Infrastructure

a) Does the credit union have appropriate data infrastructure and information to support monitoring the credit granting and risk management process throughout the life cycle of a residential mortgage?

b) Does the credit union record and aggregate specific data from each residential mortgage loan at origination, and update as available, through its data infrastructure for all relevant information, including:

- Purpose of Loan
- Amortization (initial and remaining)
- Credit Bureau Score
- GDSR/TDSR
- LTV
- Location of collateral
- Approved amount
- Unique Member Identifier
- Insured/uninsured
- Appraised Value
- Exception to policy
- Number of days delinquent
- Origination date
- Product type
- Outstanding balance
- Connected party loans and/or total exposure

3. Does the credit union have efficient and effective control and oversight of its residential mortgage activities, risks and portfolio?

Credit Decision-Making

Has the credit union established a clear and well-documented credit decision-making process for residential mortgage activities that sets out a clear and sound structure for the credit decision-making responsibilities in the credit union, including structures and procedures of credit committees and delegated credit decision-making bodies?

Independence in Credit Decision-Making

Is the process for residential mortgage credit decision-making established using the principle of independence and minimisation of conflict of interest?

Exception and Escalation Procedures

Has the credit union established a risk-based framework and policies for dealing with exceptions to and deviations from residential mortgage credit policies and procedures and their monitoring, recording and reporting?

Credit Risk Management and Internal Controls

Does the credit union have risk management and internal control frameworks for residential mortgage activities that include robust, comprehensive and integrated credit risk management and internal controls, respecting the principles of accountability, segregation and independence of functions and responsibilities, challenge and assurance of outcomes? In particular,

a) Does the credit union maintain quality data, including risk data, and information on individual residential mortgages and the residential mortgage portfolio?

Incentives & Remuneration

Does the credit union have remuneration policies and practices that are consistent with the approach to residential mortgage risk management and reflect residential mortgage risk appetite and strategies? In particular,

a) Does its approach to residential mortgage credit administration and monitoring promote prudent residential mortgage credit growth and appropriate risk-taking behaviour and not encourage excessive risk taking?

b) Do the credit union's remuneration policies and practices ensure that:

- **(i)** variable remuneration of the staff involved in residential mortgage credit granting should be linked, among others, to the long-term quality of residential mortgage credit exposures;
- **(ii)** variable remuneration of the staff involved in residential mortgage credit granting that is linked to performance objectives/targets should include residential mortgage credit quality metrics and be in line with mortgage credit risk appetite; and
- **(iii)** all remuneration policies and practices related to Senior Management and employee activities should take into account the rights and interests of consumers and should not incentivise any poor selling practices?

Collection of Information and Documentation

Does the credit union collect, verify, document and store a sufficient level of accurate and up-to-date information and data necessary to assess the borrower's (and any guarantor's) creditworthiness before concluding a residential mortgage agreement, or significantly increasing the residential mortgage amount?

Does the credit union periodically update the borrower, guarantor and property analysis to re-evaluate the residential mortgage credit risk at renewal, renegotiation/amendment or any other material change?

Is an independent third-party conducting a review of the residential mortgage loan file able to replicate all aspects of the underwriting criteria based on the existing documentation and arrive at the same credit decision?

Purchase of Residential Mortgage Assets Originated by a Third Party Including Mortgage Brokers

If the credit union acquires residential mortgages that have been originated by a third party, does it ensure that the underwriting standards of that third party – including due diligence on the borrower, debt service coverage, collateral management, LTV ratios, etc., are consistent with the credit union's residential mortgage credit policies and adhere to this Approach guidance?

In such case, does the credit union evaluate, monitor and test that the residential mortgages underwritten by the third party are meeting the underwriting standards of the credit union and do not include any risk that the credit union would not normally take on if the credit union originated the residential mortgages itself.

Assessment of Creditworthiness (borrower soundness and ability to repay)

Borrowers and Co-Borrowers

When granting a residential mortgage, does the credit union assess the borrower's income, wealth, history of repayment, and the affordability of the loan, to ensure there is no undue debt burden to the borrower and to minimize risk of default to the credit union and financial stress to the borrower?

Acceptable Income Sources

Does the credit union take reasonable steps to verify the borrowers' capacity to service his/her debt obligations, such as obtaining include written and independent confirmation of employment status, duration, type and history?

Debt Servicing Ratios Methodology and Stress Testing

Does the credit union set prudent policy limits for each debt service ratio including maximum limits for stress-tested ratios?

Does the credit union have clear policies that set out prudent maximum values for, and contributing factors in calculating, Gross Debt Service Ratios (GDSR) and Total Debt Service Ratios (TDSR)? In particular,

a) Are GDSR and TDSR calculations conservative with appropriate stress tests for varied financial and economic conditions and/or higher interest rates, particularly considering those factors relevant to the borrower?

b) For individuals with a residential mortgage and HELOC, are the GDSR and TDSR calculations using a conventional blended mortgage payment that considers both the residential mortgage and the HELOC?

c) Does the required qualifying payment of principal and interest include the terms of the HELOC and is it appropriately stress tested at the qualifying interest rate?

Does the credit union's Underwriting Policy require ratio analysis to assess a residential mortgage applicant's risk of default, such as: percentage of unsecured debt to income; and Loan to Income Ratio (LTI)?

Credit Decision and Loan Agreement

Does the credit union have a properly functioning residential mortgage approval process that includes the following?

a) A pre-established loan processing flow, which sets out the proper movement of residential mortgage applications within the credit union;

b) Documentation of borrower information and credit analysis against established credit underwriting criteria in the credit policies and procedures;

c) Residential mortgage loan decisions are made and approved by employees with the appropriate authorization and accountability;

d) Prior to disbursement, approved residential mortgage loans are reviewed by an individual other than the approved lender, to ensure that:

- Documentation is accurate;
- There are no exceptions to policy that require approval;
- Proper and adequate security has been valuated and pledged; and
- All conditions have been met and all supporting documentation and signatures have been obtained as required;

e) Residential mortgage funds are disbursed to the solicitor (in trust) or according to title insurance requirements, as applicable.

Amortization and Mortgage Insurance

Does the credit unions set prudent maximum amortization periods based on the risk associated with the credit product and type of dwelling?

If mortgage insurance is required or otherwise obtained (to manage risk or to facilitate funding): Does the credit union have polices, procedures and practices in place to ensure that such mortgage will qualify for insurance, that insurance will be confirmed and documented reliably and that the credit union will be able to satisfy all documentary, policy and audit requirements of the insurer?

Model Validation and Stress Testing of Auto-Adjudication Models

If applicable, does the credit unions have an independent validation process at both inception and on a regular basis for auto-adjudication or other models including the regular review of risk parameters for their residential mortgage portfolio, and does this process use portfolio stress testing results in the validation?

Residential Mortgage Products

Does a credit union's residential mortgage credit policy contain a comprehensive, risk based description and definition of what constitutes a non-conforming residential mortgage, including reverse mortgage lines of credit, (eg. any loan that breaches the stated risk appetite/tolerance, criteria, limits or guidelines contained in its credit policy)?

Does the policy include determining its risk tolerance (appetite) for, and a process for dealing with, "non-conforming" loans?

Is the average Loan to Value (LTV) ratios for all conforming and non-conforming residential mortgages less than the credit union's stated maximums as outlined in its residential mortgage credit policy and does it reflect a reasonable distribution across the portfolio?

Pricing Framework

Has the credit union developed, documented and implemented a comprehensive framework, including cost allocations, for the risk-based pricing of residential mortgages based on the borrower, collateral and product characteristics and market, funding, margin and matching requirements, and for the effective communication and control of mortgage rates offered to members/potential borrowers?

Lending Security

Does the credit union's Underwriting Policy clearly state the types of properties that are acceptable to the credit union as security for a residential mortgage loan, including that they conform to those permitted as security for residential mortgage loans under section 55 of the Regulation?

Valuation at the Point of Origination

Does the credit union limit financing for conforming residential mortgages to a specified percentage of value and does that percentage vary to reflect increased risks (e.g. size of mortgage; insured vs not insured; HELOC vs conventional mortgage)?

Assessing Appraisers or Valuers

Does the credit union have clear and transparent property valuation policies and procedures that produce realistic, substantiated and supportable valuations reflecting the current value of the property as collateral for the residential mortgage?

Does the credit union include a requirement for an independent, professional, current and reliable valuation for mortgages (by an individual or a validated and reliable automated valuation model) where the risk is highly dependent on the collateral value, and which show how the credit union ensures reasonable reliance on such valuation?

Collateral Management and Re-valuation

Does the credit union have a process that identifies the underlying factors that would require a revaluation of a property due to evidence of increasing risk and a procedure for dealing with a mortgage where such increased risk arises (which may vary depending on the circumstances – e.g. renewal vs continuation)?

Credit risk monitoring framework

Has the credit union implemented and maintained a robust, effective and documented residential mortgage credit risk monitoring framework, practices and data infrastructure that considers key attributes for the borrower, guarantors, the mortgaged property and other risk mitigation (e.g. the existence of adequate insurance coverage and the absence of tax or other liens)?

Monitoring of Credit Exposures and Borrowers

Does the credit union continuously monitor and assess the quality of credit exposures and financial situation of residential lending borrowers (from internal and external sources) to ensure that subsequent changes in underlying individual and portfolio residential mortgage credit risk can be identified and quantified?

Stress Testing and Sensitivity Analysis

Does the credit unions conduct regular stress testing and sensitivity analyses of their residential lending portfolios and activities to assess risks (eg. borrower, collateral, funding, interest rate, non-renewal), update its strategy, Framework and Underwriting Policies and incorporate this in its Internal Capital Adequacy Assessment Process and other risk management processes?

Use of Key Risk Indicators and Early Warning Indicators

Has the credit union identified and actively monitored key residential mortgage risk drivers and quantitative and qualitative early warning indicators (EWIs) and triggers for action?

Watch-List

Has the credit union established policies and procedures for identifying, monitoring, managing and independently assessing residential lending exposures with increased risk, including those identified though the monitoring of EWI?

4. Has the credit union effectively integrated its Framework into its overall business model?

Integration of the Framework

Is there integration of the Framework with all relevant aspects of the credit union’s business and activities?

This includes:

a) aligning the Framework with the strategy, objectives and culture of the credit union;

b) communicating residential mortgage risk management activities and outcomes across the organization;

c) providing sufficient information to facilitate residential mortgage risk oversight and decision-making;

d) building inclusiveness and ownership among those affected by risk;

e) involving different areas of expertise in the Framework process and considering different views in defining risk criteria and evaluating risks;

f) incorporating the results of residential mortgage risk management in the credit union's performance management, measurement and reporting activities;

g) continually monitoring the Framework and, if it no longer supports corporate objectives, adapting it as necessary; and

h) improving the suitability, adequacy and effectiveness of the Framework.

Effective Date and Future Review

The effective date of this Interpretation and Approach guidance – *Residential Mortgage Lending*, is [TBD].

As at its effective date, this Interpretation and Approach guidance replaces:

- DICO - Lending Advisory #3, May 2012, Mortgage Lending Practices And Potential Real Estate Market Correction.
- DICO - Lending Advisory #4, January 2017, Mortgage Lending Practices.
- DICO - Lending Advisory #5, November 2017, Mortgage Lending Practices.

The latest date for FSRA to initiate a review of this Interpretation and Approach guidance is [TBD].

About this Guidance

Interpretation guidance sets out FSRA's view of requirements under its legislative mandate (i.e. legislation, regulations and rules) so that non-compliance can lead to enforcement or supervisory action.

Approach guidance describes FSRA's internal principles, processes and practices for supervisory work, action and application of CEO discretion.

Visit FSRA's Guidance Framework to learn more:
https://www.fsrao.ca/regulation/guidance/fsra-guidance-framework