Ontario

Deposit Insurance
Corporation of Ontario
Société ontarienne
d'assurance-dépôts

MARKET RISK ADVISORY # 2 **August 2014**

INVESTMENTS IN PORTFOLIOS OF INDIVIDUAL MORTGAGES AND MORTGAGE POOLS

Legislative limitations and DICO's expectations regarding investments in portfolios of individual mortgages and mortgage pools by credit unions as permitted under the Credit Unions and Caisses Populaires Act

BACKGROUND

The current legislative framework permits credit unions to invest in mortgages other than by way of originating loans to its own members. This Advisory outlines the legislative limits required to be applied to these investments and provides DICO's expectations regarding key steps and considerations that a credit union should bear in mind before making investments in a portfolio of individual mortgages or mortgage pools that have been originated by another credit union, caisse populaire or financial institution. This advisory does not apply to securitization transactions including the National Housing Association mortgage backed securities (NHA MBS) and Canada Mortgage Bond (CMB) programs which will be addressed in a separate advisory.

Appendices set out the supporting legislative authority, due diligence considerations, examples of various investment transactions and an extract of DICO's Guidance Note: Investments.

Investment in a Portfolio of Individual Mortgages

DICO expects that a credit union purchasing an investment in a portfolio of individual mortgages will do so through a mortgage loan sale and administration agreement ("MLSA"). The MLSA includes an assignment of individual mortgage loans, related securities and the right of the purchaser to receive all payments owing on the loans including any prepayment penalties with no obligation of the seller to repurchase defaulted loans. This arrangement allows the seller to treat the transaction as a whole loan sale and to transfer the repayment risk to the purchaser. As a result, the purchasing credit union will be exposed to the possibility of delayed principal and interest payments, delinquent loans, potential default situations and resulting collection processes.

A common feature of a MLSA includes a provision whereby the seller will take action on behalf of the purchaser to collect delinquent loans as appropriate. Also, the seller has "right of first refusal" to repurchase a loan that has become delinquent. While not obligated, this provides some level of comfort that the seller will take the necessary steps to minimize any loss to the purchasing credit union. In addition, while there is usually no initial registration of the assignment in any Land Titles Office the seller is required to provide an assignment of the mortgage loan and related security to the purchasing credit union in order to dispose of any security where this becomes necessary.

DICO Expectations

DICO expects that the purchasing credit union will ensure that the seller has a comprehensive and robust accounting, audit and compliance infrastructure to adequately segregate, administer, monitor and report on the underlying mortgages to minimize risk and maintain expected cash flows to the purchaser(s). DICO would define these institutions as those who have been approved by CMHC as MBS issuers. All investment transactions should be fully addressed and authorized in policy. The credit union's policy should specify the purpose and conditions for each investment, establish prudent single and transaction investment limits by issuer, aggregate investment limits, investment criteria, board oversight and reporting requirements. It is important that the policy also require an independent legal opinion to be obtained to confirm the validity and enforceability of the MLSA in the event of default especially in the case of investments outside of Ontario.

Purchasing and selling credit unions must be in full compliance with all regulatory requirements and should be in adherence with DICO By-law #5 where applicable. Purchasing credit unions should also conduct appropriate due diligence as outlined in Appendix 2.

- *Where an investment is made and an assignment of the individual mortgages within a portfolio has not been registered, the investment will be treated as one investment, and the single investment limit will apply to the total amount of the portfolio and in aggregate for investments issued by the same selling institution.*

- *In view of the additional risks on realizing on security outside of Ontario, credit unions should strongly consider the benefits of limiting investments in individual mortgages that originate in other provinces to those that are CMHC insured.*

- *Where an agreement in a jurisdiction other than Ontario is not enforceable, the investment should be considered unsecured and weighted accordingly when calculating and reporting the risk weighted capital ratio.*

Investments in Mortgage Pools

Mortgage pools are typically originated and administered by a third party mortgage service provider (e.g. MCAP) that is highly rated by a credit rating agency (e.g. Standard & Poor's). Investments are made by way of an "investment subscription agreement" (ISA). Each participant in the investment subscription owns a share of the net cash flows of the underlying mortgages including any pre-payment penalties and any losses that may arise. Usually there is a minimum investment requirement. Unlike investments in an MLSA there is no assignment of individual mortgages or underlying securities and the purchasing credit union must rely solely on the selling institution for repayment in accordance of the terms of the investment. Although mitigated to a certain degree by the composition and structure of the mortgage pools, the purchasing credit union can still be exposed to the effects of delayed principal and interest payments, delinquent loans, potential default situations and resulting collection processes and the insolvency of the third party mortgage service provider.

DICO Expectations

DICO expects that the purchasing credit union will ensure that the seller of the mortgage pool has a comprehensive and robust accounting, audit and compliance infrastructure to adequately segregate, administer, monitor and report on the underlying mortgages to minimize risk and maintain expected cash flows to the purchaser(s). DICO would define these institutions as those who have been approved by CMHC as MBS issuers. All investment transactions should be fully addressed and authorized in policy. The policy should specify the purpose and conditions for each investment, establish prudent single and transaction investments limits by issuer, aggregate investment limits, investment criteria, board oversight and reporting requirements. The policy should also include the requirement for an independent legal opinion to confirm the validity and understanding of the arrangement. Purchasing credit unions should conduct appropriate due diligence on the underlying securities based on the considerations outlined in Appendix 2 as applicable.

- *Where an investment is made in a pool of mortgages, the investment will be treated as one investment, and the single investment limit will apply to the total amount of the portfolio and in aggregate for investments of the same selling institution.*

SUMMARY

A summary of limitations and legislative references is set out in Table 1.

Table 1: Investment Limits and Legislative References

<table>
<tr><th>Investment</th><th>Individual Mortgage</th><th>Aggregate value of all investments from same issuer</th><th>Aggregate value of all investments*</th></tr>
<tr><td>CMHC Insured Mortgages</td><td>No limit</td><td>No limit</td><td rowspan="4">100% of regulatory capital</td></tr>
<tr><td>Other Insured Mortgages</td><td rowspan="2">25% of regulatory capital</td><td rowspan="3">25% of regulatory capital</td></tr>
<tr><td>Uninsured Mortgages</td></tr>
<tr><td>Mortgage Pools</td><td>Not applicable</td></tr>
<tr><td>Legislative References</td><td></td><td></td><td></td></tr>
<tr><td>CU/CP Act</td><td>S.199</td><td>S.198</td><td>S.198</td></tr>
<tr><td>Regulation 237/09</td><td>S.65</td><td>S.65</td><td>S.60
S.61
S.62
S.63</td></tr>
</table>

The aggregate amount of all investments in improved real estate includes investments in mortgages and purchases of improved real estate for the credit union's own use.

Guidance

Where a credit union has entered into an MLSA or ISA with another financial institution where the investments do not meet statutory requirements or exceed the limits identified above, it should contact its Relationship Manager to discuss plans to address any deficiencies or achieve compliance. Credit unions should also ensure that they comply with the requirements outlined in other applicable Acts and that provincial reciprocity agreements are in place if applicable.

DICO Examination Process

DICO's examination process will include a review of these types of investments to confirm that all legislative and sound business practices are satisfied, including considerations set out in Appendix 2. If you have any questions, please contact your Relationship Manager at DICO.

Appendix 1

Legislative References

The Caisses Populaires and Credit Union Act, 1994

Eligible investments
198. A credit union shall invest only in such types of securities or property and on such conditions as are prescribed for its class. 2007, c. 7, Sched. 7, s. 106.

Exception to restriction re single investment
199. (1) A credit union may directly or indirectly invest, by way of purchase from or loans to a single person or to two or more connected persons, more than the amount prescribed for its class only if,

- (a) the investment is in the form of deposits with or loans to,
  - (i) a financial institution that is not a credit union or a securities dealer,
  - (ii) the Corporation, or
  - (iii) a prescribed person or entity; or
- (b) the investment is in securities issued or guaranteed by the Government of Canada, including mortgages insured under the *National Housing Act* (Canada), by the government of any province of Canada or by any municipality in Canada.

Ontario Regulation 237/09

Eligible investments for class 1 credit unions
60. (4) The total book value of all investments by a class 1 credit union and its subsidiaries in improved real estate in Canada must not exceed 100 per cent of the credit union's regulatory capital.

Eligible investments for class 2 credit unions
61. (5) The total book value of all investments by a class 2 credit union and its subsidiaries in improved real estate in Canada must not exceed 100 per cent of the credit union's regulatory capital.

Prescribed conditions re improved real estate
62. (1) For the purposes of section 198 of the Act, the following are prescribed conditions that must be satisfied if a credit union invests in improved real estate, either by purchasing it or by way of a loan secured by a mortgage on it:

1. The amount advanced on a mortgage plus all outstanding mortgages with an equal or prior claim against the real estate must not exceed the lending value of the real estate.
2. Despite paragraph 1, the amount may exceed the lending value of the real estate if the loan secured by the mortgage is approved or insured under the *National Housing Act* (Canada).
3. Despite paragraph 1, the amount may exceed the lending value of the real estate,
   - i. if the excess amount is guaranteed or insured through an agency of the Government of Canada or of the government of a province or territory of Canada, or
   - ii. if the excess amount is insured by an insurer licensed to undertake mortgage insurance.

Definition
63. For the purposes of sections 60, 61 and 62, "improved real estate" means real estate,

(a) on which there exists a building capable of being used for residential, financial, commercial, industrial, educational, professional, institutional, religious, charitable or recreational purposes,

(b) on which such a building is being built or is about to be built,

(c) on which farming operations are being conducted, or

(d) that is vacant land restricted by law to being used for commercial, industrial or residential purposes. O. Reg. 237/09, s. 63.

Restriction re single investments
65. For the purposes of section 198 of the Act, a credit union shall not directly or indirectly invest, by way of purchases from or loans to one person or more than one person that, to its knowledge, are connected persons, more than 25 per cent of the credit union's regulatory capital.

Appendix 2
<u>Due Diligence Considerations</u>

Prior to making an investment in a portfolio of individual mortgages or a mortgage pool, the credit union should conduct appropriate due diligence as applicable. Specifically the credit union should confirm:

- That the proposed investment meets the criteria and limits established in policy;
- The financial health of seller is sound;
- Legal counsel is retained to act on its behalf that is familiar with the laws governing the said contract;
- The credit union is legally entitled to register and act on the assignment of the mortgages if the mortgages are in another province, or the MLSA contains default provisions that require the reassignment of the defaulted mortgage to the selling institution in consideration for which the selling institution will enforce the security and remit the net proceeds of realization to the purchasing credit union;
- The investment is in compliance with all applicable legislation;
- The seller's credit policy and practices align with the policies of the purchasing credit union;
- The seller is in compliance with applicable legislation in its jurisdiction;
- Each of the mortgage loans has been underwritten in accordance with the seller's documented lending policies and procedures and include:
    a. Appropriate background and credit history of the borrower
    b. Complete loan documentation
    c. Verification of employment status and income.
    d. Nationally recognized credit bureau report.
    e. Appropriate Gross Debt Service (GDS) and Total Debt Service (TDS) ratios with supporting documentation of inputs and calculation
    f. Maximum loan amortization
    g. Compliance with the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* and Regulations
    h. Confirmation of current appraisals with consideration given to potential environmental issues and associated impacts;
- Mortgage documents are properly registered on secured properties
- Policy and procedures are established to address delinquent mortgages in the event it elects or must take over a file;
- Copies of the applications and mortgages will be provided by the Seller in the event of default in cases where the credit union has the legal right to enforce the security and assume collection efforts;
- The timing and nature of reporting with regards to outstanding balances, delinquencies, renewal of annual insurance, confirmation of payment of property taxes, etc.

Appendix 3
<u>Examples</u>

INVESTMENT IN A PORTFOLIO OF INDIVIDUAL MORTGAGES

Example 1

Credit Union A is an approved MBS issuer and sells a portfolio of individual mortgages to Credit Union B by way of a MLSA. Credit Union A continues to service the mortgages and provide detailed reports to the purchaser on all transactions for each mortgage. Credit union B conducts appropriate due diligence on the loan portfolio and confirms that the investment meets its investment policy criteria.

Example 2

Credit Union A is not an approved MBS issuer but sells a portfolio of individual mortgages to Central 1 by way of an MLSA. Central 1 (an approved MBS issuer) conducts appropriate due diligence. Credit Union A continues to service the mortgages and provide detailed reports to Central 1.

Central 1 is an approved MBS issuer and sells a portfolio of mortgages containing some or all of these mortgages to Credit Union B by way of a MLSA. Central 1 provides detailed reports to the Credit unions B on all transactions for each mortgage.

Credit union B conducts appropriate due diligence on the loan portfolio purchased from Central 1 and confirms that the investment meets its investment policy criteria.

INVESTMENTS IN MORTGAGE POOLS

Example 3

Credit Union A makes an investment in a pool of mortgages offered by Concentra Financial. The amount invested represents a percentage of the aggregate amount of mortgages within the pool. The pool typically includes mortgages that originate in different provinces.

Credit Union A receives its share of monthly repayments of interest and principal less administration fees and any expenses or losses related to Concentra Financial enforcing its security.

Appendix 4

Market Risk Management- DICO Guidance Note: Investments (relevant excerpt)

Policy

Section 61 of the Regulations prescribes that a Class 2 credit union may hold any investments authorized in its investment policies, other than a prohibited investment, subject to any conditions, limitations or exceptions outlined in the Act and Regulations.

These policies should take into account the:

- knowledge and expertise of the credit union’s management and staff;
- business environment in which the credit union operates;
- credit union’s risk tolerance; and
- level of the credit union’s capital (ability to absorb losses).

At a minimum, credit unions are expected to establish an investment policy that addresses:

- authorized types, limits and concentration of investments;
- defined and prudent levels of delegated decision making authority;
- documented criteria for making investment decisions;
- monitoring the value and investment returns of the investments;
- identifying, measuring and establishing appropriate accounting provisions for market impairments; and
- frequency, form and content of reports to the board.

Procedures

Each credit union is required to have written internal procedures outlining how investment policies will be implemented, monitored and reported to the board. Credit unions should ensure that the policies are implemented by employees who have the appropriate level of expertise.

Authorized types, quality, limits and concentration of investments

Credit unions are expected to identify all authorized investments in policy and establish limits on the volume and quality of investments by category. To be considered prudent, credit unions are expected to establish lower limits for higher risk investments such as equity investments, mutual funds and commercial paper, compared to lower risk investments such as government bonds and bankers’ acceptances. Credit unions are encouraged to establish aggregate limits on investments by category and risk. In order to mitigate risk, credit unions are also encouraged to establish portfolio limits for higher risk categories of investments.