Ontario

Deposit Insurance Corporation of Ontario

Société ontarienne d'assurance-dépôts

Application Guide

Securitization

March 2018

Ce document est aussi disponible en français.

Applicability

The Securitization Application Guide (Application Guide) is for use by all credit unions and applicable beginning September 1, 2018. This timing allows for the requirements outlined in this guidance note to capture the credit union's 2019 budget planning process. Reporting requirements to be submitted to DICO are effective for credit unions with a year-end of December 31, 2018 or later. It is a companion document to the Guidance Note: Securitization (Guidance Note). This document provides additional details about securitization programs, risks and further details DICO's minimum expectations for the prudent management of securitization activities and criteria that DICO will use when evaluating the effectiveness of securitization risk management practices.

This Guidance Note and accompanying Application Guide complement the information provided in, and should be read in conjunction with, other guidance notes and supporting publications available on DICO's website (www.dico.com).

Requirements for reporting of information to DICO as outlined in this guidance note are in keeping with section 226 of the Credit Unions and Caisses Populaires Act ('the Act").

Throughout this document:

- **The term "credit union" also refers to "caisse populaire" and "league".**
- The term "Board" refers to either the entire Board or a committee of the Board that has been delegated a particular element of Board oversight.
- The term "securitization" refers to any and all methods of secured wholesale funding, including the following, without limitation:
    - Government sponsored programs such as the National Housing Act Mortgage Backed Securities (NHA MBS), Canadian Mortgage Bonds (CMB)
    - Other common funding vehicles such as Asset Backed Commercial Paper (ABCP), Residential Mortgage Backed Securities (RMBS), Asset Backed Securities (ABS), Commercial Mortgage Backed Securities (CMBS);
    - Covered bonds;
    - Whole loan sales where there is an obligation to repurchase the loans or other contractual features that render the sale a method of financing in substance:
    - Any other vehicle or program, existing today or in the future, that in substance, constitutes a method of secured wholesale funding.
- Conversely, the term "securitization" excludes forms of financing that are either unsecured or non-wholesale in nature, for example:
    - Lines of credit;
    - Brokered and nominee deposits;
    - Repurchase agreements ("repos");
    - Whole loan sales where there is no material obligation to repurchase the loans; and
    - Other similar instruments.
- In the context of this guidance note for regulatory reporting purposes, the substance of any transaction will be interpreted at DICO's discretion with adequate rationale provided with respect to the interpretation made.
- All references to securitization within this document include those accounted for both on- and off-balance sheet.
- The guidance note applies to the credit union and all its subsidiaries on a consolidated basis.

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Introduction

All references to securitizations within this document include those accounted for both on- and off-balance sheet. The expectations of this guidance note apply to all securitization programs both currently in use and those that will be developed in the future.

Securitization Programs

Typical securitization structures include but are not limited to:

CMHC Government Sponsored Programs

- NHA MBS - National Housing Act Mortgage-Backed Securities
- CMB - Canada Mortgage Bond Program

Non-Government Sponsored Programs

- ABCP – Asset- Backed Commercial Paper
- ABS – Asset-Backed Securities
- RMBS – Residential Mortgage- Backed Securities
- CMBS – Commercial Mortgage-Backed Securities

CMHC Government Sponsored Programs

Canada Mortgage and Housing Corporation (CMHC) is a federal Crown corporation that provides housing loan related insurance and guarantees, enabling eligible lenders to provide financing for the purchase of owner occupied homes and rental housing. CMHC Insurance and Securitization Programs contribute to a stable housing finance system by helping eligible lenders access funds for housing loans. CMHC's programs provide small lenders, like credit unions, a reliable source of funds which allows them to compete more effectively with larger lenders. This contributes to lower funding costs for mortgages and an increase in choice and price competition for borrowers. Small lenders, like credit unions, have fewer funding options in comparison to large banks and rely to a greater relative extent on the CMHC sponsored programs to be able to fund their mortgage lending activities.

The NHA MBS and CMB programs are administered by CMHC according to the NHA MBS Guide and CMB guidelines. As a result, the structure of these securitization programs is transparent and, in comparison to non-government securitization structures, less complex and less risky.

<u>NHA Mortgage-Backed Securities</u>

An NHA MBS is a monthly pay, modified pass-through security with fixed or floating rate. The NHA MBS term to maturity is dependent on the terms of the underlying mortgages with the most common term being five years. CMHC has created 13 pool types with different characteristics. The pool type chosen by an Issuer is dependent on the nature of the underlying mortgage assets they wish to sell and the mortgage charge terms. Access to the NHA MBS program is dependent on the amount of CMHC guarantees and portfolio insurance authorized by the federal government and available to each Issuer in a given year. Liquidity for a credit union issued NHA MBS is dependent on investor demand. CMHC has the discretion to grant a credit union Issuer status and to revoke that status should a credit union be deemed in default of the Program terms and guidelines.

CMHC provides NHA MBS investors with timely payment guarantees of principal and interest on their investment. Subject to the terms and conditions set out in the NHA MBS Guide, credit unions, if approved by CMHC based on eligibility requirements as NHA MBS Issuers, may create pools of mortgages insured by CMHC or other private insurers and sell their beneficial interest in these mortgage pools to CMHC in trust for investors.

On a monthly basis, the issuer collects principal, interest and prepayment penalties from the borrowers in the underlying mortgage pool. The credit union then passes these payments through to the investor via CMHC. The notional amount of the NHA MBS investment (liability) is reduced by the same amount as the mortgage pool balance is reduced. Investors assume the risk in the variability of principal prepayments on the mortgages

Canada Mortgage Bonds

The Canada Mortgage Bond Program was introduced by CMHC in 2001 to provide the market with an alternate competitive source of mortgage funding. As a tool for managing liquidity and risk, CMBs enable credit unions to further increase the supply of low cost mortgage funds.

The CMB Program complements the NHA MBS Program. A special purpose entity (SPE) of the Government of Canada was created, called the Canada Housing Trust (CHT), to issue CMB. CHT purchases NHA MBS from Issuers as collateral for the issuance of a CMB. CHT transforms the monthly cash flows from the NHA MBS pools into non-amortizing bond cash flows. A CMB can be a fixed rate, semi-annual interest pay bond with repayment of principal at a specified maturity date or a floating rate, quarterly-pay bond. Maturity terms are primarily five years but a fixed rate 10-year term is also available. CMHC guarantees the timely payment of interest and principal to investors. CMB appeals to a much broader investor base (due to the fact that principal is repaid only at maturity) and funding can be achieved at a relatively lower cost than for NHA MBS.

The underlying assets of a CMB are NHA MBS pools issued by the many different issuers. The NHA MBS balance declines over time as the monthly mortgage payments, prepayments and interest are settled. Conversely, CMB balances do not decline over time. No principal payments are made until maturity of the CMB however, interest is settled semi-annually. Selling amortizing NHA MBS into the CHT non-amortizing bond results in the mismatch of cash flows or “Reinvestment Risk”. Credit unions selling NHA MBS to the CMB Program take on this risk and are obligated to prudently and effectively manage it on a monthly basis. At risk is what credit unions expect as a cost of funding in this program.

Non-Government Sponsored Programs

Presently, the most active asset classes for securitizing are residential mortgages, credit card receivables, auto and equipment loans and leases, and certain commercial mortgages. The market for securitized assets includes commercial paper (Asset-backed Commercial Paper) and bonds (Asset-backed Securities or Residential Mortgage-backed Securities for uninsured residential mortgages and Commercial Mortgage-backed Securities for commercial mortgages). Interest Only Strips (IO Strip) is a structured by-product of the NHA MBS Program and not considered a true securitization.

Residential Mortgage-backed Securities

Despite the federal government’s full support of the development of a private residential mortgage securitization market for uninsured mortgages, the RMBS market is still in its infancy in Canada. Investors are still not comfortable in investing in uninsured residential mortgages due to the perceived increased risk. An RMBS structure is like an NHA MBS except it contains uninsured mortgages with no government guarantee or support.

Asset-backed Commercial Paper (ABCP) and Asset-backed Securities (ABS)

ABCP and ABS are securities issued by an SPE that has been set up specifically to purchase certain assets and issue securities based on the characteristics of the underlying assets. The security may take the form of short-term commercial paper as an ABCP and term debt as an ABS. An SPE may be structured as a multi-seller or a single-seller trust. Single-seller trusts are customized for large issuers and multi-seller trusts are more suited to smaller issuers with limited volume. Credit unions can be sellers of assets in a multi-seller ABCP program.

The most common characteristics of securitizable assets in an ABCP or ABS include the stability and certainty of cash flows with predictable loan losses supported by historical default and prepayment data and fully neutralized by some form of credit enhancement mechanism. The securitization structure is split up into tranches based on the risk of credit losses from the underlying assets that are separately rated based on the amount of subordination supporting each tranche. These tranches are distributed to different parties. The largest tranche is generally rated "AAA" and is the most senior investor position meaning it receives the first of the cash distributions and is the last to absorb any losses. The smallest and most subordinate tranche at the bottom is referred to as the "first loss". The first loss position is first to absorb any credit losses from the underlying assets and the last to receive any cash distributions. There may be one or more positions in between the senior tranche and the first loss. These are referred to as mezzanine positions. Each tranche functions as an enhancement if it protects the more senior positions in the structure from loss. A credit union selling assets to an ABCP typically retains the first loss position. In ABS structures all tranches may be sold to third parties resulting in no retention of any credit risk of the underlying asset by the issuer. Credit unions generally continue to service the underlying assets.

In an ABCP structure, Global Style Liquidity forms a fundamental support mechanism because of the short-term nature of the funding for long term assets. On a monthly basis principal and interest collected from the underlying long-term asset pays down the maturing short-term ABCP debt. To ensure continued financing for the underlying assets, the manager of the SPE provides a liquidity facility. If the SPE does not have sufficient cash to redeem issued notes at maturity, the liquidity facility is drawn to provide funding to the SPE. This protects both the investor that wants to be paid back on the maturity date of the ABCP note and the seller of the assets who does not want to be forced to repay the SPE before the maturity of the underlying mortgage loans.

Unlike traditional asset securitization, lease securitization programs have an additional layer of structural complexity due to the nature of the assets. Lease programs are very data dependent. Like loans, lease deals contain default risk resulting from the lessee not having the ability to make their payment but also "residual risk" which is the contract value of the underlying asset at the end of the lease period which may be different than its fair market value. This risk materializes when the lessee does not exercise their right to purchase the asset. This residual risk is passed through to the ABCP note holders since the securitization value of the lease pool includes the residual value of the lease. SPEs are not prepared to retain any residual risk and any losses are absorbed by the seller of the assets through the first loss position.

Commercial Mortgage-Backed Securities

Commercial loans represent the least homogenous asset class securitized. The structure of a CMBS is a term transaction where the notes issued are amortizing. The risk of credit loss is split from the underlying assets into tranches with various forms of enhancements to protect investors. Each tranche of notes provides support for the higher rated notes. A "waterfall" defines the priority of cash distributions to various stakeholders with principal paid first to the highest rated tranches while losses are applied to the lowest tranches first. Credit unions prefer structures whereby the first loss or the lowest level tranche is not retained by the credit union but sold to an equity investor. This results in no retention of any credit risk of the underlying asset and the securitization transaction achieves true accounting sale treatment.

CMBS are complex structures as a result of the nature of the underlying commercial properties and loans. There is a significant amount of time and specialized expertise required to conduct analysis on CMBS deals. This limits the universe of CMBS investors and may significantly impact the economics of securitizing commercial mortgage loans.

Securitization Risks

Individual securitization structures may possess unique features, and the risks addressed in this guideline do not apply to all structures; conversely, arrangements may entail risks not summarized here. The size of a credit union's exposure to securitization and the specific structures used by the credit union will determine the degree of risk and the extent to which the credit union has identified exposures and has implemented policies and controls to manage those exposures.

Credit unions using securitization must fully understand the risks associated with each:

- securitization strategy,
- specific securitization program structure with which they are involved, and
- any counterparties supporting access to securitization programs.

For each securitization strategy and for each securitization program utilized, the credit union must fully document these risks, and their mitigants, as part of the Enterprise Risk Management (ERM) program. Tailoring of risk assessments may be in order if involvement in securitization is material relative to the size and financial strength of the credit union.

A securitization structure itself is a source of risk and these risks should be identified by the credit union. For example, program users are liable for certain losses and expenses that are in addition to any risks they may bear as asset originators.

Credit unions are encouraged to use standardized non-complex securitization program structures that are transparent and focus on the transfer of simple, homogeneous assets. An example of this is the CMHC government-sponsored programs for insured residential mortgage assets (NHA/MBS and CMB programs).

The following is a summary of the typical risks associated with the use of securitizations. Additional risks are set out in Appendix 1. These are not intended to be exhaustive lists. Each credit union is responsible for fully understanding these risks and any additional risks that may be associated with strategies and Securitization Programs with which it is involved:

INTEREST RATE RISK

The risk that changing interest rates will impact the economics of a securitization strategy and/or affect the way participants in the mortgage market behave which could affect existing and future transactions. Securitization programs should incorporate due consideration to interest rate risk hedging strategies.

Risk to Market and Borrower Behaviour:

- Due consideration should be given to possible changes in market structure and borrower behaviour;
- Increasing rates (or the belief that rates will increase) may cause borrowers to refinance early and thus result in significantly increased prepayments. Increased prepayments can mean higher costs to the credit union in the form of penalties, re-investment risk, etc.;
- Increasing rates may cause a reduction in housing demand and possibly a corresponding decline in housing values;
- Decreasing rates may continue to artificially increase housing demand and prices, and borrowers' indebtedness.

Pipeline Risks: Interest rate risk is introduced at various stages of the implementation of a securitization strategy, at the time of funding in a securitization structure and ongoing. Interest rate risk is most often experienced in active securitization programs between commitment and origination and then funding. This is referred to as pipeline risk.

Commitment Pipeline Risk: The time between when mortgage commitments and mortgage rate locks are set to when the mortgage is financed and originated on the credit union's balance sheet. The risk is two-fold:

1. the credit union does not have a commitment from the borrower to borrow, but, the credit union has committed to the borrower to lend a certain amount; and
2. a mortgage rate is locked in for between 3 and 6 months. The credit union does not know how much will be financed and the rate is locked-in regardless if interest rates increase.

Funding Pipeline Risk: The time between when the mortgage is financed and originated on the credit union's balance sheet and when it is securitized (the cost of funding determined.)

- This risk is regularly hedged to avoid unnecessary volatility in income as a result of rate variability due to the passage of time;
- The pipeline risk could be as much as 6 months, but 3 months is more common.

LIQUIDITY RISK

The inability to manage unplanned decreases or changes in funding sources.

- Liquidity risk arises from the credit union's failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value and earnings.
- The securitization of assets has significantly broadened a credit union's funding base and created a more liquid balance sheet. However, too much reliance on securitizations increases liquidity risk.
- Preparation for the possible return of securitized balances to the balance sheet as a result of either scheduled or early amortization, or a contract termination event. The primary risk is the potential that large asset pools could require balance sheet funding at unexpected or inopportune times. This exposure is heightened if there are maturity concentrations or potential long-term funding requirements.

BEST MANAGEMENT PRACTICES

Develop preventative measures:

- correlate maturities of securitized transactions with overall planned balance sheet growth;
- track the volume of securities scheduled to amortize during any particular period and any early amortization triggers;
- prepare an analysis of alternatives for obtaining substantial amounts of liquidity;
- in an off-balance sheet transaction, like an IO strip, allocate capital to the business of securitization in the event a credit union is forced to fund renewals and hold assets on its books should funding difficulties arise;
- anticipate potential problems and include in contingency planning - Plans should outline various funding alternatives, recognizing that a complete withdrawal from the securitization market or a cutback in lending could affect the credit union's viability and reputation.

OPERATIONAL RISK

Issuers face risks and are liable for certain losses, expenses and fees that are not usually the responsibility of a mortgage servicer. Issuers should be aware of these risks, losses, expenses and fees, and must make financial arrangements to ensure that they can cover them throughout the period the securitization is outstanding. Failure to comply may trigger an early amortization or termination event in a securitization structure even though the underlying assets are performing.

- In the CMHC programs: The risk that the credit union does not follow the prepayment provisions specified in the documentation such as the required prepayment penalties are not collected from the borrower and/or the NHA MBS Indemnity Factor is not calculated correctly impacting the indemnification payment to the NHA MBS investor. Failure to comply may trigger an early amortization or termination event in a securitization structure even though the underlying assets are performing.
- Process risk: This risk is a function of internal controls, information systems, employee experience and integrity, and operating processes. For most securitized asset sales, the responsibility for servicing the assets is retained by the originator. This obligation usually extends throughout the life of the issued securities. Since the fee associated with servicing the portfolio is typically fixed, the risk of inefficiency from an operational point of view is retained by the originator. This risk exposure increases when servicers do not fully understand or fulfill their responsibilities under the terms of the securitization agreement.

BEST MANAGEMENT PRACTICES

- Not waive a required unexpected prepayment penalty from the borrower and make the required indemnity payment in the securitization structure.
- Develop a thorough understanding of the securitization process and especially the associated information and technology requirements. To reduce the credit union's exposure, management should evaluate staffing, skill levels, and the capacity of systems to handle the projected type and volume of securitization transactions.

PREPAYMENT AND REINVESTMENT RISK

The risk of the underlying asset in a securitization generating cash flows that are not matched to the cash flow obligations of a securitization program. This risk may arise from the securitization structure. In the structure of the CMB program, this is the monthly ongoing risk management of the difference in the cash flow between the securitized NHA MBS and the issued CMB. The risk includes both interest rate risk and spread risk as the ongoing funding costs of the CMB are influenced by the required monthly principal reinvestment activity which is negatively impacted by rising interest rates and narrowing spreads between assets of the reinvested principal and the funding costs of the CMB. Program obligations to manage reinvestment activity of prepayments may become burdensome and render the securitization strategy uneconomical.

BEST MANAGEMENT PRACTICES

- Develop a historical prepayment curve with the assets that are being securitized, track the model against actual activity and update on a regular basis.
- The expected duration of both the underlying asset and funding should be appropriately modelled so that the credit union is not undertaking additional risks.
- Expected prepayment risk should be hedged and the hedge rebalanced regularly to the underlying asset.
- Actively hedge and rebalance the reinvestment risk with derivatives and other assets.

RENEWAL / MATURITY RISK

Credit unions are required to make funds available at maturity or termination of a securitization program. The risk that the credit union may not be able to make payment at maturity unless the refinanced asset is re-sold.

BEST MANAGEMENT PRACTICES
• Regularly model and prospectively quantify the size of predicted securitization maturities and ensure that the credit union is not put at undue risk due to upcoming maturities of securitization tranches; • Understand obligations (legal and reputational) regarding securitized assets that are maturing with bullet payments due (rollover risk); • Stagger securitization maturities and hold an amount of liquidity as determined by the credit union's liquidity models against current maturities (due in one year).
STRATEGIC RISK
The risk to earnings and capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of a credit union's strategic goals, the business strategies developed to achieve those goals, the resources deployed against those goals, and the quality of implementation. • The ability to substantially increase fee income through securitization should not lure issuers into a business line about which they do not have sufficient knowledge or resources • Credit Unions may rely on securitization as an inexpensive form of liquidity without due consideration to the long-term strategic implications of securitization programs • Boards may not have sufficient expertise in this area to govern the activities of their management teams • Credit unions may migrate into other asset classes and forms of securitization where the assets may be riskier from a credit and cash flow perspective
BEST MANAGEMENT PRACTICES
To assess a credit union's strategic risk exposure, consider: o long-term internal resource requirements, including computer systems and software to handle projected volume of securitization; o dedicated operational and treasury personnel; o how credit quality and origination decisions expose a credit union to strategic risk; o the availability of funding; o the competition. Before initiating a securitization transaction, compare the strategic and financial objectives of proposed securitization activities with the credit union's risk tolerance and resource requirements.

Securitization Process

DICO expects credit unions will adopt sound and prudent risk management practices when managing their securitization strategies and programs. When relying on expertise of a small group of individuals in order to facilitate a securitization program, credit unions should have an appropriate succession plan in place. DICO expects that the Board have the appropriate competencies and the auditing function have the appropriate skills and expertise commensurate with the complexity of the securitization products being used by the credit union.

Credit unions may assume a number of roles in a securitization program. They primarily include one or more of:

- Originator of the assets to be pooled
- Purchaser of the assets to be pooled

- Servicer of the assets to be pooled
- Pooling the assets for securitization
- Issuer of the asset-backed securities
- Servicer and administrator of the asset-backed securities
- Provider of credit enhancement in the securitization structure
- Investor in the asset-backed securities

The securitization process generally encompasses three phases, which may overlap:

- Phase 1: Pre-securitization positioning
- Phase 2: Securitization process execution
- Phase 3: Securitization monitoring/oversight

Phase I – Pre-securitization positioning

The asset securitization process generally begins with the origination or purchase of financial assets. Originators underwrite and create assets. Purchasers acquire assets originated by third parties. In the role of originator, the credit union lends money to a member borrower and creates an asset. In the role of purchaser, the credit union pays an originator for assets either in the form of a commitment to finance the assets or in the form of already financed assets.

Credit unions that assume the role of originator or purchaser should ensure that for the assets destined for securitization:

1. Credit standards are consistent with the credit union's normal course of business standards and have not been compromised in order to increase volume or realize fees:
    - underwriting of assets should be consistent with credit union's policies and procedures;
    - acquired assets from institutions with the same or better underwriting standards.
2. The assets can be pooled for securitization. Pooling requires a blend of principal and interest payments with the same frequency, there are loan size restrictions, and loans are banded by term to maturity, amortization period and interest rates. The assets are relatively homogeneous with respect to their cash flow characteristics and risk profiles, including both credit and market risks. An example of frequently pooled and securitized homogeneous assets are prime insured single family residential mortgages.
3. There is sufficient market appetite via:
    - potential investors in credit union issued "securitization paper";
    - program availability, specifically for assets destined for NHA MBS and the CMB Program where access is allocated, and for non-government backed ABS with capped facility commitments.
4. The credit union has sufficient liquidity and capital to own any assets that cannot be securitized. The credit union's credit review, funding capabilities, and approval limits should allow the credit union to purchase and hold assets that are ineligible for securitization or to hold unsold issued securities. Credit union could structure under contract with an originator or with a non-government backed ABS a "put back" option for assets that cannot be securitized.

5. Interest rate risks and price movements are managed. Interest rate risk is most often experienced between when loan rates are set at time of commitment or financing and when funding rates are set in the securitization program;
    - adequate hedging or other risk management policies are in place to limit the credit union's exposure to adverse interest rate and price movements at time of funding and may also be ongoing depending on the obligations of the securitization program.
6. Quality data and robust information management systems:

- possess quality data (integrity and completeness) on the assets to be securitized; this aspect is crucial to the success of the securitization process;
- are able to segregate and report on assets targeted to be securitized including the aging of these assets to determine continued eligibility for securitization and if there is a decline in value or pooling eligibility while the assets are in the securitization pipeline;
- adequately track the performance and condition of risk exposures arising from securitization, and monitor the credit union's compliance with internal procedures and limits;
- can analyze the impact of securitization on the remaining asset portfolio and on the adequacy of loan loss reserves and overall capital and liquidity.

Credit unions that assume the role of the servicer of the assets or outsource the role of the servicer should ensure that:

- servicing includes customer service, collection of payments from the borrowers, default management and collateral liquidation;
- when the servicer role has been outsourced, the credit union is able to periodically audit the servicer and assess the performance and reputation of the servicer. The servicer is typically compensated with a fixed servicing fee.

Phase II – Securitization process execution

Credit unions should have appropriate expertise in line with the types of assets securitized, the complexity of securitization structures and the associated risks. Credit unions are encouraged to use a simple and transparent securitization structure that is familiar to the markets in order to limit securitization risks, such as the CMHC government sponsored programs, NHA MBS and CMB programs for insured residential mortgages.

During the execution phase, pools of identified assets are sold to investors in the form of a security, such as an NHA MBS, or pools of assets are sold to a bankruptcy-remote entity, generally referred to as an SPE, which issues ABS to investors to finance the purchase.

For example, a credit union that issues NHA MBS and/or securitizes into an ABCP or ABS program should analyze the unique aspects of each structure used in the securitization process. In addition, it is important to assess the performance and reputation of each of the parties involved and the market for the securities, including:

- legal risk, by clarifying, for example, the credit union's relationship with the SPE. Documentation sets out a credit union's limits of legal liability with regard to the SPE. The credit union should rely on expert third party legal reviews and opinions;
- the characteristics and expected performance, including prepayment expectations of the underlying assets and arrears reporting. The underlying assets are used as collateral and the cash flows are used to meet the payment obligations of the SPE;
- the credit union's ability to meet all its obligations under the securitization arrangement including reporting, credit enhancement, and any risk bearing due to interest rate risk or basis risk;
- the ability of the other participants, including servicers, managers, liquidity and credit enhancement providers in the arrangement to meet their obligations;
- contingency plans to transfer responsibilities to another party in the event that those responsibilities can no longer be fulfilled, for example a credit downgrade of a credit enhancer or failure of a servicer to provide timely and accurate data;
- the evaluation of the depth of the market and determine the most appropriate period for the issuance and sale of the NHA MBS, ABCP and ABS, since the

securitized instrument is an investment that is often geared to an issuance schedule, such as the CMB, or to a specific class of investor.

Credit unions that are involved in hedging securitization risks or invest in NHA MBS, ABCP or ABS should have the appropriate risk hedging or investment expertise as securitization exposes credit unions to a number of risks, which could make this activity highly complex.

Credit union issuers are responsible for the servicing of NHA MBS, ABCP and ABS for the benefit of the Trustee of the SPE.The documentation used to issue NHA MBS is standardized and is contained in The NHA Mortgage-Backed Securities Guide published by CMHC which sets out the rights and obligations of various parties involved in the NHA MBS program. Non-government backed securitization structures rely on proprietary documentation to set out the rights and obligations of the various parties involved.

Basic responsibilities of a servicer include:

- the preparation of servicing reports including detailed data on the underlying assets on a monthly basis;
- the remittance of payments;
- the responsibility and liability for the performance of any servicer.

Phase III – Securitization monitoring/oversight

Once the securitization process is completed and the assets transferred from the credit union to investors or an SPE, the next phase is the ongoing fulfilment of obligations, the management of securitization risks and disclosure and reporting of information regarding the securitization.

With respect to securitization risk management, credit unions should:

- closely manage the credit risk associated with any retained securitization positions, such as the first loss position in non-government backed ABCP or ABS structures. This retained position is the most subordinate and carries the largest credit risk;
- consider the possibility that securitization exposures will have to be taken back on the balance sheet, even though the institution has no legal obligation to do so, in order to limit any negative impact on its reputation;
- be able to value any residual asset risks. The securitization of leases is dependent on a stream of rent related cash flow, however most structures require the credit union to assume the asset at maturity;
- take into account a credit rating downgrade of any one of the parties involved in a securitization structure in the event the party may not be able to honour its commitments. For example, the party responsible for hedging the interest rate risk in a non-government backed structure, or the servicer that is no longer capable of adequately servicing the securitized assets or the security.

Management Expertise

When considering implementing or expanding a securitization program, it is critical to consider the level of knowledge and expertise of management in place or required to effectively manage the program. The level and depth of management knowledge and documented supporting systems and processes should be commensurate with the size and complexity of the credit union's securitization program.

At a minimum, where securitization is less complex and limited to government sponsored NHA MBS programs with an aggregate liability exposure of no more that 10% of regulatory capital and deposits, management must have a demonstrable understanding of the accounting legal,

financial and risk implications of the securitization program used. Where the aggregate amount of liability exposure exceeds 10% but no more than 25% of regulatory capital and deposits, a minimum two (2) years of transactional experience is also expected.

Where aggregate securitization liability exposure is greater than 25% of regulatory capital and deposits or where it includes non-government sponsored programs, management must have demonstrable understanding of accounting, legal, financial and risk implications of all the securitization programs used, as well as a minimum of three (3) years of transactional experience. This includes a comprehensive knowledge of all securitization risk areas, best practices and market conditions for each program used. In addition, an equivalent level of experience should also be present in the internal audit or risk function within the credit union.

Complex securitization structures should only be considered where the credit union has significant relevant managerial, support staff and risk management expertise, and comprehensive supporting systems and processes.

Board Competencies

All directors are expected to have strong risk management oversight competencies as set out in the Guidance Note: Director Training and Qualifications. At a minimum, this includes having a significant understanding and expertise of risk management practices gained through a combination of education, practical work experience, previous board experience and completion of advanced director training.

As further indicated, a higher and broader level of knowledge and understanding will generally be expected for directors at larger more complex institutions, members of the audit committee and the Chair of the Board and Chair of the Audit Committee. Credit unions should add additional competencies where appropriate related to their particular circumstances and requirements, including those for any additional committees that the Board may establish. The Board should consider establishing additional securitization competency requirements as appropriate. At a minimum, the board should ensure that there is an appropriate level of director competencies in the securitization programs or products in use or planned as outlined in Table 1 of the Securitization Guidance Note.

Competency attributes should include:

- High level of understanding of securitization processes, risk management and best practices;
- Ability to interpret complex data and contribute knowledge and insight relating to securitization programs in use or contemplated;
- High level of knowledge and understanding of stress testing methodologies, tools and techniques;
- High level of knowledge and understanding of complex issues including liquidity management and contingency funding planning;
- Ability to challenge management’s assumptions and speaks out appropriately.

The level of specific director competencies is expected to increase in line with increases in the aggregate level of securitization reliance and the complexity of the credit unions securitization programs. All credit unions using securitization should implement appropriate director training plans and specialised continuing education opportunities to broaden director competencies in this area and ensure that sufficient director knowledge and expertise is achieved and maintained with training activities included as part of the By-Law No. 5 attestations. Complex securitization structures should only be considered where the credit union has significant relevant director competencies.

Audit Committee

The Audit committee is responsible to assist the board with its oversight of securitization. The committee is expected to increase its level and extent of oversight in line with increases in the size, complexity and reliance of the credit union's securitization programs.

The Board should ensure that Audit Committee competencies are commensurate with the type and level of securitization programs in use or planned as noted above.

Agenda items should be established to ensure that all key responsibilities are adequately addressed at each committee meeting as appropriate. Committee reports and director discussions should be sufficiently comprehensive to provide for a full and clear understanding of the items under review. The extent of director review and discussion should be fully documented and commensurate with the size and complexity of the securitization programs in place or planned. Where necessary, additional clarification and advice should be sought from independent expert resources.

Key Responsibilities

The key responsibilities of the Audit committee should be documented and include, but not limited to, reviewing and making recommendations to the Board on whether:

- the use of each new securitization transaction is consistent with the Board approved strategy, policies and risk appetite;
- the level and depth of management knowledge and expertise is appropriate for the size (both in terms of amount and percentage of deposits and regulatory capital), nature and structure of the securitization programs in use or contemplated;
- the business case and rationale for the use for each securitization is consistent with the current approved business plan projections and approved strategy;
- there is evidence for each securitization, that an appropriate level of risk assessment has been undertaken of the key securitization risk areas (refer Securitization Risk section);
- an appropriate level of risk has been identified and allocated under the ERM program;
- the performance and results of all existing programs in use are consistent with initial analysis and projections;
- management has developed appropriate refinancing strategies and plans for upcoming maturities;
- stress testing practices are robust and that assumptions are reasonable and prudent;
- stress testing analysis and results indicate potential issues that may require consideration of modifications to current funding strategies;
- the contingency funding plan is reasonable and achievable;
- reports from the internal auditor and external parties where required confirm that appropriate risk management practices are in place for the size and complexity of credit union's securitization programs.

Setting Limits

Policy should set out the scope of activities, including:

- individual and aggregate limits, targets and diversification of securitizations;
- the types of assets securitized and how and where these assets are originated;
- the mix of maturities and the weighted average duration of securitization deals in line with the credit union's risk tolerance.

When setting limits, credit unions should be guided by level of existing managerial expertise and board competences, supporting systems and processes. Credit unions should have appropriate expertise in line with the types of assets securitized and the complexity of securitization structures and the associated risks.

A separate comprehensive independent risk assessment addressing all relevant risks to the credit union as well as detailing the internal resource requirements to run the program is required when each of the following occurs:

- The amount of government sponsored securitization liabilities exceeds 25% of regulatory capital and deposits; and
- A new non-government sponsored securitization conduit is contemplated.

When setting limits, credit unions should monitor projected annual maturities (bullet payments) to ensure that these are not excessive and unduly concentrated.

Credit unions should be aware of the thresholds, risk levels and operational and oversight expectations set out in Table 1 in the Securitization Guidance note.

Initial Implementation

When considering implementing an initial securitization program, credit unions should consider limiting the use of securitization to well established, transparent, government sponsored programs such as the CMHC NHA MBS and CMB programs for insured residential mortgages.

CMHC has published comprehensive guidance which sets out the qualification criteria, lending criteria, documentation, processing and reporting requirements which help maintain the efficiency and effectiveness of these programs.

During the early stages of implementing securitization, credit unions should consider limiting the use of programs with assets originated by the credit union rather than relying on brokered loans or with assets or commitments originated from third parties. Initially, annual funding and aggregate limits should be set at minimum levels while management expertise, support systems and processing practices are developed. Individual limits should be established so that maturities are not concentrated. For example, credit unions may plan for two smaller securitization issues for the first year rather than one larger issue.

Sample Initial Securitization Limits

(% of regulatory capital and deposits)

Program	Individual Limit	Annual Limit	Aggregate Limit
CMHC Insured Single Family Residential Mortgages (NHA MBS/CMB)	4%	8%	15%

New Programs: Non-Government Sponsored Programs

When considering expanding securitizations and implementing more complex non-government securitization programs credit unions should be aware of the additional operational and oversight expectations set out in Table 1 in the Securitization Guidance note. These programs should only be considered where the credit union has extensive relevant risk management expertise and board competencies, along with comprehensive supporting systems and processes.

Increasing Limits

Increases in limits should not be contemplated before an annual independent review is completed and the Board is satisfied with the management of its securitization program and the results achieved to date. It is suggested that individual, annual and aggregate limits be set for each program approved by the Board. This might be based on different risk metrics (complexities) as illustrated below. The Board may also wish to consider setting separate limits on third party originations and assets purchased from third parties.

Sample Securitization Limits Based on Risk Metrics On- and Off-Balance Sheet
(% of regulatory capital and deposits)

Program/Vehicle	Risk Metric	Individual Limit	Annual Limit	Aggregate Limit
Government Sponsored Programs				
• CMHC Insured Single Family Residential Mortgages (NHA MBS/CMB)	1	10%	15%	30%
• CMHC Multi- Family Pools	2	5%	5%	5%
Non-Government Programs				
• Residential Mortgage Backed Security (RMBS)	4	5%	5%	5%
• Asset Backed Commercial Paper (ABCP)	5	Not Approved		
• Asset Backed Securities	5	Not Approved		
• Commercial Mortgage Backed Securities (CMBS)	5	Not Approved		
Total Combined Limits		**10%**	**15%**	**30%**

Monitoring and Reporting

There are minimum administrative monitoring and reporting expectations for each of the securitization programs in use as described in the Securitization Process section above. In addition, management is expected to monitor and report to the Audit Committee, the Board and DICO on the status of each of its securitization programs under a number of key metrics and stress testing conditions.

At a minimum, this will include reports and plans as set out below:

Report	Description	Frequency
Liquidity Coverage Ratio, Net Stable Funding Ratio, Net Cumulative Cash Flow Liquidity Metrics	Standard stress testing liquidity metrics as set out in Liquidity Applications Guides. Completion Guides and reporting templates available on DICO's website.	As per expectations set out in Table 1 of the Securitization Guidance Note
Risk Assessment Plan	As set out in the Securitization Guidance Note. Market conditions can change over time, impacting the cost and size of particular markets or instruments. As such, Board reporting should include an analysis of market conditions and developments, including the impact on the credit union's funding plans, as applicable, and to track and report on NHA MBS and CMB Timely Payment Guarantee room, CMB allocations, as well as Central 1's market appetite to purchase NHA MBS.	

Report	Description	Frequency
	Other exposures include access to Approved Swap Counterparties and Approved Repo Counterparties in the CMB Program.	
Internal Audit Work Plan	As set out in Securitization Guidance Note	
Financial Forecast and Variance Analysis	As set out in Securitization Guidance Note	
Program Capacity	As set out in Securitization Guidance Note	
Securitization Reporting Template	Completion guide and reporting template under development	
Financial Forecast Base Case	See below. Completion guide and reporting template under development	
Securitization Specific Stress Test	See below. Completion guide and reporting template under development	

Key Ratios

The following is a summary of key securitization ratios.

Outstanding Aggregate Securitization

This indicates the aggregate level of dependency or reliance to on- and off-balance sheet securitization.

(A) Aggregate Securitizations	$952
(B) Regulatory Capital and Deposits	$2,000
[A ÷ B]	**47%**

Annual Securitization Maturities

This indicates the cash requirements or refinancing obligations related to securitizations that fall due in the next 12 months.

(A) Total Securitization BULLET maturities < 1 year	$195
(A) Regulatory Capital and Deposits	$2,000
[A ÷ B]	**10%**

Securitization Coverage Ratio

This indicates the availability of immediate cash resources to cover short term securitization maturities. The amount of readily available cash resources should be at least equal to (100%) the amount of on- and off-balance sheet securitizations (scheduled bullet maturities amount only) that become due in the next three months.

The ratio is calculated as A ÷ B, where:

A includes: Available cash resources include cash and cash equivalents (excluding the credit union's Liquidity Reserve Deposits and any market MBS) and undrawn availability on credit facilities.

B includes: Maturing securitization obligations (on- and off-balance sheet, bullet maturity amounts only) for the next three (3) months.

SECURITIZATION LIQUIDITY COVERAGE	
Cash & Cash Equivalents	$150

MINUS: Liquidity Reserve Deposit (LRD)	$100
PLUS: Undrawn Credit Facilities (Available LOC)	$150
(A) Total Available Cash Reserves	**$200**
(B) Maturing Securitization Obligations (bullet amounts only) < 90 days	$52
[A ÷ B] = Securitization Coverage Ratio ≥100%	**385%**

Securitization Capital Buffer Ratio

This indicates the level of capital resiliency to cover off-balance sheet securitization exposure. Sufficient minimum regulatory capital should be maintained to ensure that if all off-balance sheet securitizations with scheduled maturities within the next 24 months came back onto the Balance Sheet, minimum regulatory capital (leverage ratio) coverage would be maintained.

The ratio is calculated as A ÷ [B+C], where:

A is: Regulatory Capital

B is: Net Assets

C is: The amounts of off-balance sheet securitization scheduled bullet maturities that become due within the next 24 months

SECURITIZATION CAPITAL BUFFER	
(A) Regulatory Capital ($)	$150
(B) Net Assets ($)	$2,500
Leverage Ratio = [A ÷ B]	**6.00%**
(C) Off balance sheet Maturities < 24 months	$684
[A ÷ (B+C)] Capital Buffer ratio ≥ 4.00%	**4.71%**

Stress Testing

The purpose of the securitization specific stress test is to identify the magnitude of funding gaps in the event of a stressed event and the ability of the credit union's contingency funding plan to address the funding gaps.

The following are illustrations of reporting formats setting out the minimum reporting information for each of the stress testing expectations set out in the Securitization Guidance Note.

Each credit union is expected to submit the following:

Base Case Scenario:

A six-month balance sheet statement forecast, prepared on a quarterly basis and providing monthly totals based on budget projections.

Balance Sheet: 1st Quarter

	Current (Dec 31st)	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6
Assets							
Cash & equivalents	69	71	73	75	77	79	81
LRD	219	224	230	236	242	248	254
Other investments							
Loans:							
Personal	698	698	698	699	699	699	699
Residential mtg.	1,657	1,723	1,789	1,855	1,922	1,988	2,054
Commercial	895	914	934	954	974	994	1,013
Other loans							
Total Loans	3,249	3,335	3,422	3,508	3,594	3,681	3,767
Off B/S securitized assets maturing							
Other assets	105	110	115	120	124	129	134
TOTAL	**3,642**	**3,741**	**3,840**	**3,939**	**4,038**	**4,137**	**4,236**
Liabilities & equity							
Deposits:							
Demand	870	897	924	951	979	1,006	1,033
Term	1,288	1,320	1,351	1,383	1,415	1,446	1,478
Total deposits	2,158	2,217	2,276	2,334	2,393	2,452	2,511
LOC	125	131	137	143	148	154	160
Other borrowings							
Securitizations maturing/payable	1,000	1,026	1,052	1,078	1,104	1,130	1,156
Other liabilities	97	97	96	96	95	95	95
Retained earnings	167	169	171	174	176	178	180
Other capital	96	102	108	115	121	127	134
AOCI							
Equity	262	271	279	288	297	305	314
TOTAL	**3,642**	**3,741**	**3,840**	**3,939**	**4,038**	**4,137**	**4,236**

Securitization Stress Test Scenario:

A six-month balance sheet statement forecast, prepared on a quarterly basis and providing monthly totals. incorporating the following assumptions:

1. No access to securitization markets for a 6-month period (assumes no rollover of maturities, both on- and off-balance sheet or ability to create market MBS);
2. Loan growth per base case scenario;
3. No growth (change) in deposits over the stress period.
4. Access to Credit Facilities, but no increase in availability above authorized amount;
5. No access (change) to mandatory liquidity reserve deposits (LRD) during the stress period.
6. Cash and cash equivalents do not include market MBS.
7. All other metrics as per base case.

Balance Sheet: 1st Quarter

	Current (Dec 31st)	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6
Assets							
Cash & equivalents	69	0	0	0	(1)	(110)	(219)
LRD	219	224	230	236	242	248	254
Other investments							
Loans:							
Personal	698	698	698	699	699	699	699
Residential mtg.	1,657	1,723	1,789	1,855	1,922	1,988	2,054
Commercial	895	914	934	954	974	994	1,013
Other loans							
Total Loans	3,249	3,335	3,422	3,508	3,594	3,681	3,767
Off B/S securitized assets maturing		10	10	10	10	10	10
Other assets	105	110	115	120	124	129	134
TOTAL	**3,642**	**3,680**	**3,777**	**3,874**	**3,970**	**3,958**	**3,946**
Liabilities & equity							
Deposits:							
Demand	870	870	870	870	870	870	870
Term	1,288	1,288	1,288	1,288	1,288	1,288	1,288
Total deposits	2,158	2,158	2,158	2,158	2,158	2,158	2,158
LOC	125	174	283	392	500	500	500
Other borrowings							
Securitizations maturing/payable	1,000	980	960	940	920	900	880
Other liabilities	97	97	96	96	95	95	95
Retained earnings	167	169	171	174	176	178	180
Other capital	96	102	108	115	121	127	134
AOCI							
Equity	262	271	279	288	297	305	314
TOTAL	**3,642**	**3,679**	**3,777**	**3,874**	**3,970**	**3,958**	**3,946**

Notes:

Use actual (current) balances at the start of each stress period for all categories (except #3). Then, for each month of the stress period use projected balances based on the base case scenario for all categories **accept** as noted below.

1. Cash and cash equivalents. This line represents the amount of readily available liquid resources. This is used to reflect the amount of any surplus or potential funding gap under the stress conditions. Reduce balance to zero and then use LOC to cover any funding shortfall. When LOC is fully utilized, report any remaining funding gap as a negative amount.
2. Loans. Loan balances to increase for each month of stress period based on % growth projections as per base case scenario.

3. Off balance sheet securitizations: Report projected maturing off balance sheet securitizations based on latest projections for each month of stress period.
4. Deposits: Deposit balances to remain flat for each month of stress period.
5. LOC: Use remaining authorized LOC availability (based on current authorized limit) to cover any funding gap until fully utilized.
6. On balance sheet securitizations: Report outstanding amount less any projected maturities for each month of the stress period. Assume no access to new securitizations over the stress period.

Contingency Funding Plan

In the event this stress test results in a funding shortfall at the end of the 6-month period, the credit union shall provide the following:

i) a contingency funding plan for the 6-month "stress period" (excluding access to securitizations) identifying the amount and timing of each opportunity to address the funding shortfall, including, source of funding (or cutback in lending), the costs of funds, interest rates on loans and all related assumptions.

ii) a pro-forma balance sheet and income statement that reflects the above noted contingency plan. ROAA, leverage / BIS capital, and liquidity ratios should also be included.

Contingency Funding Plan: Pro Forma Balance Sheet

	Current	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6
Assets							
Cash & equivalents							
LRD							
Other investments							
Loans:							
Personal							
Residential mtg.							
Commercial							
Other loans							
Total Loans							
Off B/S securitized assets maturing							
Other assets							
TOTAL							
Liabilities & equity							
Deposits:							
Demand							
Term							
Total deposits							
LOC							
Other borrowings							
Securitizations maturing/payable							
Other liabilities							
Retained earnings							
Other capital							
AOCI							
Equity							
TOTAL							
Leverage Ratio							
BIS Ratio							
Liquidity Ratio (Assets held for liquidity/Deposits and Borrowings)							

Contingency Funding Plan: Pro Forma Income Statement

	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6
Loan interest						
Investment income						
Loan and investment income						
Interest expense on deposits						
Interest expense of borrowings						
Other interest expense & div (incl. securitization)						
Total interest expense						
Financial margin						
Loan costs						
Other income						
Gains on Securitizations						
Total other income						
Gross margin						
Operating expenses						
Non-recurring/extraordinary						
Taxes						
Net income						
ROAA						
Avg rate on deposits						
Avg yield on loans						
Avg cost of borrowings incl. securitization						

Appendix 1.

Other typical risks associated with securitizations.

BASIS RISK
The risk of variability between two interest rates that do not reprice in line with each other. Basis risk is important because it can materially affect funding cost and spread.
BEST MANAGEMENT PRACTICES
• Identify where risk exists in each structure. • Evaluate whether or not it can be hedged • Stress test for adverse changes that cannot be reasonably hedged.
COMPLIANCE RISK
The risk arising from violations or nonconformance with seller obligations in a securitization structure, or violation of a rule or regulation that may render a party to a securitization in default. This may trigger an early amortization or termination event in a securitization structure even though the underlying assets are performing. • Credit unions may underestimate the commitment and resources required to effectively manage the securitization process. • Errors and omissions may lead to highly visible problems during the life of the transaction that could impair future access to the securitization markets as a funding source. • The result of non-compliance with obligations assumed under a securitization structure could include the credit union being replaced as a servicer of the asset, along with highly punitive monetary obligations. • Inability to meet obligations under securitization arrangements may arise from insufficient resources or from a failure of paying fees to cover associated costs.
BEST MANAGEMENT PRACTICES
• Ensure appropriate controls are in place to prepare and submit accurate data to the securitization structure's sponsoring entity • Ensure appropriate controls are in place to double-check outputs received when outsourcing complex administration of the securitization program • At the time of underwriting, ensure that assets that are insured meet all the necessary requirements of the insurer, in order to mitigate non-compliance risk and reduce the risk of denial of insurance. • Ensure staff and other parties involved in the underwriting and servicing functions comply fully with the obligations of the securitization program; • In the case of NHA MBS, fully comply with the NHA MBS Guide, and all laws and regulations; • Outsource any complex and costly administration and servicing to a supplier of these services if expertise is not available in-house; however, the credit union as issuer continues to retain the obligation and responsibilities of servicing the underlying assets and the securitization transactions.
COUNTERPARTY RISK EXPOSURE
Credit unions are exposed to various counterparties through securitization activities. This may include parties that originate and service assets on behalf of the credit union and parties that form a part of the securitization structure such as swap and REPO counterparties and liquidity providers.

The risk to the credit union is the counterparty fails to perform contractual obligations such as servicing the underlying asset to the standards required in a securitization structure or maintaining the required Credit Rating as swap or REPO counterparties or liquidity providers.

- In the case of a counterparty Credit Rating downgrade, the credit union would be required to replace the counterparty. The outsourcing agreement could contractually require the existing counterparty to establish a new counterparty in the transaction in the event of their downgrade.
- When another party involved in the securitization arrangement becomes unable to perform according to contract terms, this may be an early amortization or termination event even though the underlying assets are performing.

BEST MANAGEMENT PRACTICES

- Perform initial due diligence on all counterparties and require the counterparty to report on standards on a regular basis.
- Track the counterparty credit rating reports at least annually and if the counterparty falls to a level that risks the credit union's ongoing ability to participate in a securitization structure, the credit union must find a new counterparty.
- Include credit exposure to managing parties in a securitization transaction under a credit union's exposure limit to those parties.
- Have an Outsourcing Policy in place to govern material outsourcing such as mortgage servicing and NHA MBS servicing and administration.

CREDIT RISK

The risk of exposure to possible default of the underlying assets. The underwriting and credit quality of the underlying assets must satisfy non-deteriorating origination standards. Underwriting standards should not be less stringent than those applied to assets retained by the credit union on balance sheet.

- The risk is the credit quality of the underlying assets deteriorate below the stated obligations of the securitization and/or the cash flows are not made requiring the credit unions to make expected cash flow payments as servicer advances until legal remediation begins.
- As part of securitization, particularly securitization structures involving uninsured assets, the credit union may directly (or indirectly) retain the credit risk associated with the securitized asset. All securitized assets should be monitored from a credit perspective appropriately and included in all credit risk management reporting.

BEST MANAGEMENT PRACTICES

- Ensure appropriate procedures and controls are in place to so that all insured assets that are included in securitization vehicles, meet insurer requirements, whether recorded on or off- balance sheet.
- Ensure assets are underwritten to the credit union's underwriting standards in the ordinary course of business;
- Regularly monitor asset performance and take immediate action on any delinquencies;
- Evaluate how much potential default risk remains on balance sheet with the credit union after a securitization sale.

FINANCIAL RISK

The risk that a program loss will result in a financial impairment.

- Regulatory capital is not held against any off-balance sheet assets. In the event of a loss, or impairment in the program, there is the risk of increased loss recognition.

- Liquidity is not held against the securitized assets to be able to ensure payments can be met as obligations becomes due.

BEST MANAGEMENT PRACTICES

- Perform ongoing economic value analysis on the securitization programs to ensure there is sufficient capital to absorb any potential losses
- Stress test anticipated asset prepayments and maturities under a variety of circumstances to identify any emerging liquidity risks
- Maintain reserves against expected losses according to IFRS 9.

LEGAL RISK

Legal contracts may not be appropriately drafted reducing the protection they afford and potentially introducing unknown or unplanned risks and obligations. Credit unions may not have sufficient expertise in understanding and managing the contractual obligations in a securitization structure.

BEST MANAGEMENT PRACTICES

- Where the securitization program introduces negotiable documentation, terms and all underlying documentation should be subject to an appropriately experienced third party legal review.
- All contractual obligations should be documented and tracked to ensure the credit union is meeting its legal obligations
- Follow standardized and transparent securitization structures like the CMHC sponsored programs that have non-negotiable, industry standard documents.

MARKET RISK

The risk that the market may not be available for credit union issued NHA MBS contracts. Credit unions tend to rely on a single investing entity to provide funding for NHA MBS. This may become unsustainable. At greatest risk to the market are illiquid NHA MBS pool types like the 867 Pool type for collateral mortgages.

BEST MANAGEMENT PRACTICES

- Not issue an NHA MBS for funding without first securing a buyer for their NHA MBS.
- Seek alternative access to the market for NHA MBS. This includes becoming a seller of NHA MBS to the CMB program.

MODELLING RISK

Complex modelling is required to fully understand the cost structure and risks associated with securitization strategies and programs.

BEST MANAGEMENT PRACTICES

- Ensure that there are appropriate controls to mitigate modelling risk such as an external party review of models used, including periodic verification of modelling assumptions.

PENALTIES AND INDEMNIFICATIONS RISK

The risk that the credit union experiences higher than normal prepayments (or liquidations) on pools and are required to indemnify investors in the securities associated with the securitized assets. Credit unions may not charge penalties to the borrower of the assets in line with the charge associated with the indemnification of the asset.

BEST MANAGEMENT PRACTICES
• Ensure that prepayments and liquidations are modelled and stressed, to review possible environments that may change the overall funding cost of the securitization structure.
PROGRAM CONTINUANCE AND CAPACITY RISK
The risk that the credit union has either reduced or no access to securitization programs to fund committed originations. For the CMHC government sponsored programs, there is a risk that the overall size and credit union allocations of portfolio insurance, NHA MBS Timely-Payment Guarantees and to the CMB Program.
BEST MANAGEMENT PRACTICES
• Track program size and allocations to ensure that the credit union targets its future originations and securitization activity in anticipation of the situation that affects capacity in particular. • Evaluate and quantify the impact on the long-term structure of the balance sheet of lower funding allocations in securitization programs or inability to re-securitized assets post renewal. • Consider structure under contract arrangements or with a non-government backed ABS a “put back” option for assets that cannot be securitized
REGIONAL ECONOMIC RISKS
The sluggish economic recovery could lead to increased unemployment and may cause an increase in arrears and defaults. Properties in certain urban areas may be overvalued and suffer from corrections in housing values that negatively impact the borrowers’ loan to value ratios jeopardizing future renewals and their ability to continue to service possible payment increases.
BEST MANAGEMENT PRACTICES
• Remain knowledgeable of regional economic trends and stress test within the credit union’s ERM framework holistically the impact of lower collateral values of securitized impacts. The stress test should include (but not be limited to) the impact to credit risk, risk of losses (financial risk), liquidity risk and capital risk.
REGULATORY / POLITICAL RISK
Government may refuse to continue to support the NHA MBS/CMB program going forward (Canadian Federal government has already signalled a desire to reduce the tax payer exposure to residential mortgage debt). Non-government backed programs such as ABCP conduits may no longer provide credit union assets with funding.
BEST MANAGEMENT PRACTICES
• Require non-government backed programs to have liquidity back up provisions (Global Market Disruption Liquidity) that require the private sponsor to step in and protect ongoing funding on already securitized assets in the event of a market dislocation.
REMAINING ASSET QUALITY
Credit quality of remaining on-balance sheet assets may be at risk:

• Securitization readily lends itself to high-quality assets that provide a predictable, steady cash flow stream. • In a securitization structure, higher and more predictable net cash flows translate into lower credit enhancement fees and higher excess spread income tempting a credit union to securitize better quality assets while keeping lower quality assets on the balance sheet. • The credit union may be at risk of requiring more capital and loan loss reserves for the assets that remain on balance sheet.
BEST MANAGEMENT PRACTICES
• Securitizing assets that represent the entire portfolio of assets. • Managing credit risk with sound underwriting standards and practices remains the best overall protection against excessive credit exposure.
REPUTATIONAL RISK
This is a risk to a credit union's earnings or capital arising from negative public opinion. Reputational risk is at stake if member mortgages cannot be refinanced at maturity due to a lack of funding as a result of access to securitization. A credit union's ability to establish new relationships or services or continue servicing existing relationships may be impacted. This risk can expose the credit union to litigation, financial loss, or damage to its reputation.
BEST MANAGEMENT PRACTICES
• Establish sound business plan and a comprehensive, effective risk management and control framework that covers all aspects of securitization activities. • Maintaining the quality of underlying assets in a securitization program • Efficiency of servicing the underlying assets and the securitization program requirements.
RESIDUAL ASSET RISK
In a securitization structure for auto and equipment leases, leases are subject to residual risk. • The risk that the residual value of the asset at the end of the lease period, as stipulated in the lease contract (contract residual), will be more than fair market value resulting in a potential financial loss to the credit union seller. • The risk is only present if at the end of the lease the dealer or the customer decides not to exercise their option to purchase the vehicle. • In an ABCP securitization structure, residual risk is passed through to the ABCP note holders since the securitization value of lease pool includes the residual value of the lease. However, the credit union seller maintains the first loss position which absorbs any losses. • Term ABS investors prefer to avoid residual risk exposure and the seller retains this risk.

BEST MANAGEMENT PRACTICES
• Lower the risk of an asset carrying a higher value at maturity than the market for that asset with an assumption in the contract of a lower residual value at the

end of the lease. This would result in the lessee paying a higher lease rate over the term of the lease.

TERMINATION EVENT RISK

The risk that an event will trigger a termination of a credit union's access to a specific securitization program. This is what happens when:

- a required counterparty in the structure is downgraded below contract minimums;
- a credit union fails to meet its basic eligibility requirements under the contract which includes minimum net worth, financial stability, sound underlying asset servicing with maximum delinquency rates, and the ability to meet all reporting and data requirements.

BEST MANAGEMENT PRACTICES

- Require all securitization program obligations, constraints and triggers to be documented and reviewed at least annually

TRANSACTION RISK

Risk that an upcoming securitization does not occur as planned due to an extraordinary event. This could be a risk to liquidity and earnings if transaction spreads widen considerably, or if investor appetite for the security is no longer apparent in the marketplace.

BEST MANAGEMENT PRACTICES

- Regularly stress test the ability to manage through liquidity events where expected transactions do not move forward as planned.