REGULATORY GUIDELINE

Residential Mortgage Underwriting

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I. INTRODUCTION

This regulatory guideline is a Regulatory Guidance Document as contemplated by the Standards of Sound Business Practice (the Standards). It supplements and expands upon section 2.1, *Financial Management* and section 3.3, *Credit Management* of the Standards and must be adhered to by Saskatchewan credit unions.

II. PURPOSE AND SCOPE OF THE GUIDELINE

The purpose of this guideline is to communicate key principles and the expectations of Credit Union Deposit Guarantee Corporation (the Corporation) with respect to residential mortgage underwriting. It complements relevant provisions of *The Credit Union Act, 1998*, the Standards, the Corporation's risk-based supervisory framework and the Government of Canada's mortgage insurance guarantee framework.[1] The Corporation expects credit unions to apply residential mortgage underwriting policies and practices that ensure the safety and soundness of individual residential mortgage loans and adequate risk management of their loan portfolios.

For the purposes of this guideline, a residential mortgage includes any loan to an individual[2] that is secured by residential property (i.e., property that will be occupied by the borrower or rented). Equity loans, HELOCs and other such products that use residential property as security are also covered by this guideline.

This guideline articulates five fundamental principles for sound residential mortgage underwriting. The first principle relates to credit union governance and the development of overarching business objectives, strategy and oversight mechanisms in respect of residential mortgage underwriting and/or the acquisition of residential mortgage loan assets.

The next three principles focus on the residential mortgage credit decision and the underwriting process, specifically the assessment of:
- the borrower's identity, background and demonstrated willingness to service their debt obligations on a timely basis (Principle 2)
- the borrower's capacity to service their debt obligations on a timely basis (Principle 3)
- the underlying property value/collateral and management process (Principle 4)

These three principles should be evaluated by lenders using a holistic, risk-based approach unless otherwise specified in this guideline. The borrower's demonstrated willingness and capacity to service their debt obligation on a timely basis should be the primary basis of a lender's credit decision. Undue reliance on collateral can pose challenges, as the process to obtain title to the underlying property security is generally difficult for the borrower and costly to the lender.

The fifth principle addresses the need for mortgage underwriting and purchasing to be supported by effective credit and counterparty risk management, including, where appropriate, mortgage insurance.

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[1] For the purpose of this guideline, "insured mortgages" refers to mortgages insured against loss caused by default on the part of a borrower under a loan secured by real property. This includes both individual transaction and portfolio insurance. It does not include separate insurance products that often accompany mortgage loans, such as: life, disability, illness, loss of employment, title, or property valuation insurance.

[2] For greater clarity, this includes an individual borrower, personal investment company, personal holding company, or personal trust. This does not include commercial loans, such as loans to entities engaged in residential real estate investments or transactions where a residential property is used in support of a commercial credit application.

The final section of the guideline summarizes disclosure and supervisory requirements.

The Corporation expects credit unions to verify that their residential mortgage operations are well supported by prudent underwriting practices, and have sound risk management and internal controls that are commensurate with their operations.

III. PRINCIPLES

PRINCIPLE 1

Credit unions that are engaged in residential mortgage underwriting and/or the acquisition of residential mortgage loan assets are expected to have a comprehensive Residential Mortgage Underwriting Policy and Practice (RMUP).[3]

Residential Mortgage Underwriting Policy and Practice (RMUP)

The board-approved risk appetite statement establishes limits regarding the level of risk that the credit union is willing to accept with respect to residential mortgages, and forms the basis for the RMUP. The RMUP should further align with the credit union's enterprise-wide strategy and be linked to the enterprise risk management framework.[4]

The RMUP should reflect the size, nature, scope and complexity of a credit union's residential mortgage business and consider factors and metrics such as:

- significant elements of the credit union's business strategy and approach to residential mortgage underwriting and the acquisition of residential loan assets
- at the portfolio level, risk management practices and processes with respect to residential mortgage loans and loan assets, including limits on relevant segments or parameters (e.g., lending, acquisition, product, borrower/property characteristics and concentration limits)
- at the individual residential mortgage loan level, acceptable underwriting and acquisition standards, criteria and limits (e.g., credit scores, loan-to-value ratios, debt service coverage, amortization period) for all residential mortgage products and loan types (e.g., conforming and non-conforming)
- the frequency of loan and collateral reviews
- identification and escalation processes for residential mortgage underwriting and/or acquisition exceptions, if any, including a process for approval and exception reporting
- limits on any exceptions to provisions contained in the RMUP for residential mortgages underwritten and/or acquired
- the roles and responsibilities for those positions charged with overseeing and implementing the RMUP

Credit unions should revisit their RMUP on a regular basis to ensure that there is strong alignment between their risk appetite statement and their actual mortgage underwriting, acquisition, and risk management policies and practices.

Board and Senior Management Roles

Senior management is responsible for the development and implementation of the RMUP and related controls. However, the board of the credit union has a critical role in providing

[3] The RMUP can be one consolidated document or a set of mortgage policy and practice documents.
[4] The principles and expectations of credit unions with respect to the risk appetite statement and enterprise risk management framework are outlined in the Corporation's regulatory guideline 2014-01, *Corporate Governance*.

high-level guidance to, and oversight of, senior management with respect to matters relating to mortgage underwriting and portfolio management.

The board of the credit union is expected to review and discuss the RMUP, or any changes to the RMUP, on a periodic basis. The board should understand the decisions, plans and policies undertaken by senior management with respect to residential mortgage underwriting and/or the acquisition of residential mortgage loan assets, and their potential impact on the credit union. It should probe, question and seek assurance from senior management that these are consistent with the board's own decisions and board-approved business and risk strategy for the credit union, and that the corresponding internal controls are sound and being implemented in an effective manner.

The board should receive timely, independent and objective reporting on the related risks of the residential mortgage business, including the procedures and controls in place to manage the risks, and the overall effectiveness of risk management processes.

The board should be aware of, and be satisfied with, the manner in which material exceptions to policies and controls related to residential mortgages are identified, approved and monitored, the nature of reporting to the board, and the consequences and processes when exceptions are identified.

Internal Controls, Monitoring and Reporting

Effective control, monitoring and reporting systems and procedures should be developed and maintained by credit unions to ensure ongoing operational compliance with the RMUP. Credit unions are expected to identify, measure, monitor and report the risks in all residential mortgage lending and acquisition operations on an ongoing basis. The credit union's residential mortgage risk appetite and tolerance profile should be understood at all relevant levels of the organization.

Credit unions are expected to have adequate processes[5] in place with respect to residential mortgages to independently and objectively:

- identify, assess and analyze the key risks
- monitor risk exposures against the board-approved risk appetite of the credit union
- ensure that risks are appropriately controlled and mitigated, and provide assurances to the board and senior management
- ensure that risk management policies, processes and limits are being adhered to, and provide assurances to the board and senior management
- provide reporting on exceptions to the RMUP, as well as the identification of patterns, trends or systemic issues within the residential mortgage portfolio that may impair loan quality or risk mitigation factors
- report on the effectiveness of models

PRINCIPLE 2

Credit unions are expected to perform reasonable due diligence to record and assess the borrower's identity, background and demonstrated willingness to service their debt obligations on a timely basis.

[5] Typically, these processes are carried out by the credit union's risk management oversight function.

Background and Credit History of Borrower

Credit unions are required to make a reasonable enquiry into the background, credit history and borrowing behaviour of a prospective residential mortgage loan borrower as a means to establish an assessment of the borrower's reliability to repay a mortgage loan.

For example, a credit score offered by the major credit bureaus is an indicator often used to support credit granting. However, a credit score should not be solely relied upon to assess borrower qualifications, as such an indicator measures past behaviour and does not immediately incorporate changes in a borrower's financial condition or demonstrated willingness to service their debt obligations in a timely manner.

Credit unions are also required to obtain appropriate borrower consent when determining the background and credit history of a borrower, and to comply with relevant provincial and federal legislation governing the use and privacy of personal information (e.g., *Personal Information Protection and Electronic Documents Act*).

Loan Documentation

Maintaining sound loan documentation is an important administrative function for lenders. It provides a clear record of the factors behind the credit granting decision, supports lenders' risk management functions, and permits independent audit by credit unions and review by the Corporation. As well, maintaining sound documentation is necessary for lenders to demonstrate compliance with mortgage insurance requirements and ensure insurance coverage remains intact.

Consequently, credit unions are expected to maintain complete documentation of the information that led to mortgage approval. This generally includes:

- a description of the purpose of the loan
- employment status and verification of income (see Principle 3)
- debt service ratio calculations, including verification documentation for key inputs (e.g., heating, taxes and other debt obligations)
- Loan-to-value (LTV) ratio, property valuation and appraisal documentation (see Principle 4)
- credit bureau reports and any other credit enquiries
- documentation verifying the source of the down payment
- purchase and sale agreements and other collateral supporting documents
- an explanation of any mitigating criteria or other elements (e.g., "soft" information) for higher credit risk factors
- property insurance agreements[6]
- the rationale for the decision (including exceptions)
- a record from the mortgage insurer validating commitment to insure the mortgage, where applicable

The above documentation should be obtained at the origination of the mortgage and for any subsequent refinancing of the mortgage. Credit unions should update the borrower and property analysis periodically using a risk-based approach in order to effectively evaluate their credit risk. In particular, credit unions should review some of the aforementioned factors if the borrower's condition or property risk changes materially.

As a general principle, an independent third-party conducting a credit assessment of a credit union mortgage loan should be in a position to replicate all aspects of the underwriting

[6] This includes a borrower's agreement to obtain property insurance, as a condition of mortgage approval, as well as proof of property insurance obtained by the credit union when the mortgage funds are disbursed.

criteria, based on the credit union's sound documentation, to arrive at the derived credit decision.

Purpose of Mortgage Loan

Credit unions should ascertain and document the purpose of a perspective loan, as it is a key consideration in assessing credit risk. This includes ascertaining the:

- intended use of the loan (e.g., purchase, refinancing), and
- type of purchase (e.g., owner-occupied primary residence, recreational or other secondary property, investment property, property that relies on rental income to service the loan), or
- type of refinancing (e.g., debt consolidation, changes to existing loan characteristics, access to home equity, renovation, etc.)

Anti-Money Laundering/Anti-Terrorist Financing

If the credit union is aware, or there are reasonable grounds to suspect that the residential mortgage loan transaction is being used for illicit purposes, the credit union must decline to make the loan and file a suspicious transaction report to the Financial Transactions Reports Analysis Centre of Canada (FINTRAC) with respect to the attempted transaction.

Credit unions are expected to ensure that residential mortgage loans are subject to the requirements of the *Proceeds of Crime (Money Laundering) and Terrorists Financing Act* (PCMLTFA) and the *Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations* (PCMLTFR) with respect to detecting and deterring the possible use of a property purchase or mortgage to launder the proceeds of crime or assist in terrorist financing.

In particular, credit unions are required to comply with the customer identification and record keeping requirements of the PCMLTFR, and ensure that they obtain sufficient information about the borrower to determine whether the customer is a higher-risk customer, as defined under the PCMLTFA and PCMLTFR.

Misrepresentation

Credit unions should maintain adequate mechanisms for the detection, prevention and reporting of all forms of fraud or misrepresentation (e.g., falsified income documents) in the mortgage underwriting process. For insured mortgage loan applications, credit unions are expected to report suspected or confirmed fraud or misrepresentation to the relevant mortgage insurer.

PRINCIPLE 3

One of the most fundamental components of prudent underwriting is an accurate assessment of the borrower's ability to repay their debt obligation. Credit unions are expected to adequately assess the borrower's capacity to service their debt obligations on a timely basis.

Income Verification

Credit unions should demonstrate rigour in the verification of a borrower's income, as income is a key factor in the assessment of the capacity to repay the mortgage loan, and verification of income helps detect and deter fraud or misrepresentation. Credit unions

should make reasonable enquiries and take reasonable steps to verify a borrower's underlying income. This includes substantiation of a borrower's:

- employment status
- income history

In regard to loan documentation that supports income verification, credit unions should undertake rigorous efforts to confirm that:

- the income amount is verified by an independent source
- the verification source is difficult to falsify
- the verification source directly addresses the amount of the declared income, and
- the income verification information/documentation does not contradict other information provided by the borrower in the underwriting process

To the extent possible, income assessments should also reflect the stability of the borrower's income, including possible negative outcomes (e.g., variability in the salary/wages of the borrower). Conversely, temporarily high incomes (e.g., overtime wages, irregular commissions and bonuses) should be suitably normalized or discounted.

For borrowers who are self-employed, credit unions should also be guided by the principles listed above. In particular, credit unions should obtain proof of income (e.g., notice of assessment and T1 General) and relevant business documentation.

Lenders should also exercise rigorous due diligence in underwriting loans that are materially dependent on income derived from the property to repay the loan (e.g., rental income derived from an investment property).

Borrowers relying on income from sources outside of Canada pose a particular challenge for income verification, and lenders should conduct thorough due diligence in this regard. Income that cannot be verified by reliable, well-documented sources should be treated cautiously when assessing the ability of a borrower to service debt obligations.

Guarantors and Co-Signers of Mortgage

Where a credit union obtains a guarantee or co-signer supporting the mortgage, it should also undertake a sufficiently rigorous credit assessment of the guarantor/co-signer. This assessment should be commensurate with the degree to which the guarantor/co-signor's support is relied upon. The guarantor/co-signer should fully understand their legal obligations.

Debt Service Coverage

A fundamental component of prudent underwriting is an accurate assessment of the adequacy of a borrower's income, taking into account the relevant mortgage payments and all debt commitments. As part of this assessment, credit unions are expected to establish debt serviceability metrics (including the method to calculate the metrics), set prudent measures for debt serviceability (articulated in the RMUP) and calculate the borrower's debt serviceability ratios for the purpose of assessing affordability.

Two ratios that are commonly used are the Gross Debt Service (GDS) ratio and the Total Debt Service (TDS) ratio. For example, for insured mortgages, the Canadian Mortgage Housing Corporation (CMHC) defines GDS and TDS ratios and sets maximum limits. Private mortgage insurers also define similar debt serviceability metrics and limits for mortgage insurance products. The Corporation expects that GDS and TDS scores will reflect a reasonable distribution across the portfolio and align with the board-approved risk appetite.

Credit unions should have clear policies with respect to the contributing factors for the calculation of GDS and TDS ratios, including, but not limited to:

- principal and interest
- primary and other sources of income
- heating costs
- property taxes
- condominium or strata fees
- payments for other credit facilities (e.g., unsecured personal loan, second mortgage loan, credit card)

GDS and TDS ratios should be calculated conservatively (i.e., appropriately stressed for varied financial and economic conditions and/or higher interests rates). As an example, for insured mortgages, the Corporation expects credit unions to meet mortgage insurers' requirements in regard to debt serviceability. For uninsured residential mortgages, credit unions should contemplate current and future conditions as they consider qualifying rates and make appropriate judgments. At a minimum, the qualifying rate for all uninsured mortgages is to be the greater of the contractual mortgage rate plus 2% or the five-year benchmark rate published by the Bank of Canada[7].

Amortization

The mortgage amortization period for the loan is an important factor in the credit lending decision as it affects the required debt service for the borrower and the growth of borrower equity in the underlying property. Credit unions should have a stated maximum amortization period for all residential mortgages that are underwritten. The Corporation expects that the average amortization period for mortgages underwritten to be less than the credit union's stated maximum, as articulated in its RMUP.

Additional Assessment Criteria

In addition to income and debt service coverage, credit unions are expected to take into consideration, as appropriate, other factors that are relevant for assessing credit risk, such as the borrower's assets[8] and liabilities (e.g., net worth), other living expenses, recurring payment obligations and alternate sources for loan repayment.

PRINCIPLE 4

Credit unions are expected to have sound collateral management and appraisal processes for the underlying mortgage properties.

General

Mortgage loans are granted primarily on the basis of the borrower's demonstrated willingness and capacity to service their debt obligations. However, to the extent that the lender would ever need to realize on the underlying property serving as security, it is important to have sound collateral practices and procedures.

Property Appraisals

A significant amount of leverage is often involved in residential mortgage lending and there is general reliance on collateral to provide adequate recourse for repayment of the debt if

[7] The benchmark rate (5-year conventional mortgage rate) is published weekly by the Bank of Canada.
[8] From an operational risk perspective, obtaining recourse to a borrower's foreign assets, in the event of default, may be more challenging for credit unions.

the borrower defaults. As such, a proper and thorough assessment of the underlying property is essential to the residential mortgage business and key to adequately mitigating risks. Credit unions are expected to have clear and transparent valuation policies and procedures in this regard.

On-Site Inspection

In general, credit unions should conduct an on-site inspection of the underlying property, to be performed by either a qualified employee or an appraiser, depending on the nature of the property or transaction. Beyond the valuation of the property, an on-site property inspection is beneficial in the process of validating the occupancy, condition, and ultimately, the existence of the property.

Third-Party Appraisal

Credit unions that use third-party appraisers should ensure that appraisals are prepared with the appropriate professional appraisal skill and diligence, and that appraisers are designated, licensed or certified, and meet qualification standards. As well, these appraisers should be independent from the mortgage acquisition, loan processing and loan decision process.

Automated Valuation Tools

Where credit unions use automated valuation tools, processes should be established to monitor their ongoing effectiveness in representing the market value of the property. Controls should also be in place to ensure that the tools are being used appropriately by lenders.

In general, credit unions should not rely on any single method for property valuation. Credit unions should maintain and implement a framework for critically reviewing and, where appropriate, effectively challenging the assumptions and methodologies underlying valuations and property appraisals. Credit unions should undertake a more comprehensive and prudent approach to collateral valuation for higher-risk transactions. Such transactions include, for example, residential mortgage loans with a relatively high LTV ratio, loans for illiquid properties and loans in markets that have experienced rapid property price increases, which generate more uncertainty about the accuracy and stability of property valuations.

Realistic, substantiated and supportable valuations are required to reflect the current price level and the property's function as collateral over the term of the mortgage. Consistent with Principle 2, comprehensive documentation in this regard should be maintained.

Credit unions are expected to ensure that the claim on collateral is legally enforceable and can be realized in a reasonable period of time or, absent that verification, ensure that the title insurance from a third party is in place. Credit unions should ensure that collateral is protected against unexpected loss through provisions within the residential mortgage loan that include, for example, fire insurance.

When extending loans to borrowers, credit unions are expected to impose contractual terms and conditions that secure their full protection under the laws applicable in the relevant jurisdiction, and seek to preserve an appropriate variety of recourses (including, where applicable, actions on personal covenant) should the borrower default. In addition, credit unions are expected to have the necessary action plans in place to determine the best course of action upon borrower default. Such action plans should cover:

- the likely recourses/options available to the credit union upon default in all relevant jurisdictions
- the identification of the parties against whom these recourses may be exercised
- a strategy for exercising these options in a manner that is prudentially sound

Loan-to-Value (LTV) Ratio

General

The commonly used LTV ratio is an evaluation of the amount of collateral value that can be used to support the loan. Past experience suggests it is highly correlated with credit risk. Residential mortgage loans with higher LTV ratios generally perform worse than those with a lower LTV ratio.

LTV Framework

Robust LTV ratio frameworks can serve to mitigate the risk of various mortgage loans (e.g., lower LTV ratio limits can help to mitigate risk by limiting loan exposure). Credit unions are expected to establish and adhere to appropriate maximum LTV ratio for various types of mortgage transactions (e.g., insured loans, conventional mortgage loans, non-conforming mortgage loans, and HELOCs). The maximum LTV ratio may be determined by law or may be established by a credit union based on risk and other considerations, including current and expected market conditions, the type of loan, as well as other risk factors that may impact a borrower's ability to service their debt and/or a lender's ability and cost to realize on their security. The Corporation expects credit union's LTV ratio frameworks to be dynamic. To this end, credit unions should have in place a robust process for regularly monitoring, reviewing and updating their LTV ratio frameworks.

The LTV ratio should be recalculated upon any refinancing, and whenever deemed prudent, given changes to a borrower's risk profile or delinquency status, using an appropriate valuation/appraisal methodology.

A credit union should not arrange (or appear to arrange) with another lender, a mortgage or combination of a mortgage and other lending products (secured by the same property) in any form that circumvents the credit union's maximum LTV ratio or other limits in its RMUP, or any requirements established by law. For greater clarity, a credit union should not engage in any transactions (e.g., co-lending, bundling a mortgage loan with various priority interests, or any funding structure involving other secured loans) with other lenders, where the combined LTV of the loan(s) secured against the property exceeds the credit union's specific LTV limits established within its LTV ratio framework.[9]

Down Payment

With respect to the borrower's down payment for both insured and uninsured mortgages, credit unions are expected to make rigorous efforts to determine if it is sourced from the borrower's own resources or savings. Where part or all of the down payment is gifted to a borrower, it should be accompanied by documentation from those providing the gift confirming no recourse. Where non-traditional sources of down payment (e.g., borrowed funds) are being used, further consideration should be given to establishing greater risk mitigation. Incentive and rebate payments (i.e., cash back) should not be considered part of the down payment.

[9] This restriction does not apply in cases where the additional secured funding is provided by a municipal, territorial, provincial or the federal government.

Property Value Used for the LTV Ratio

Credit unions should assess and adjust as appropriate, the value of the property for the purposes of calculating the LTV and determining lending thresholds within LTV limits. This includes limits for conventional mortgage loans, non-conforming mortgage loans and HELOCs (see sub-sections below), by considering relevant risk factors that make the underlying property more vulnerable to a significant house price correction or that may significantly affect the marketability of the property. These factors include, but are not limited to:

- the location, type and expected use of the property for which the loan is granted
- the property's current market price, recent price trends and housing market conditions and
- any other relevant risk that may affect the sustainability of the value of the underlying property

In markets that have experienced rapid house price increases, credit unions should use more conservative approaches to estimating the property value for LTV calculations and not assume that prices will remain stable or continue to rise.

For the purposes of incorporating property value risk and determining appropriate lending thresholds for mortgage loans, credit unions have flexibility to apply valuation adjustments to specific properties when calculating LTV, and/or by setting LTV ratio framework limits that consider and incorporate the property valuation risk factors described in this subsection.

LTV Ratio and Loan Type

Residential mortgage loans are often defined with reference to their LTV ratio. A credit union's LTV structure for underwriting loans should reflect the risk attributes of different types of mortgage loans and be consistent with the RMUP. The Corporation expects the average LTV ratios for all conforming and non-conforming residential mortgages to be less than the Corporation's stated maximums, as articulated in its RMUP, and reflect reasonable distribution across the portfolio.

Non-Conventional ("High Ratio") Mortgage Loans

Non-conventional, or "high ratio", mortgage loans have higher LTV ratios (less equity) at origination and require mortgage insurance to mitigate risk (see Principle 5). Residential mortgages underwritten for the purpose of purchasing, renovating or improving a property must be insured if their LTV ratios are greater than 80 percent.

Conventional ("Low Ratio") Mortgage Loans

Conventional, or "low ratio", mortgage loans have lower LTV ratios (more equity) at origination and do not require mortgage insurance by law since their LTV ratios are equal to or less than 80 percent.

Non-Conforming Residential Mortgages

Non-conforming mortgage loans are a subset of conventional mortgage loans and are broadly defined as having higher-risk attributes or deficiencies, relative to other conventional mortgages. The Corporation expects credit unions to develop and maintain a comprehensive and risk-based definition for non-conforming loans in their RMUPs. In general, a credit union's definition should include any of the following:

- loans with insufficient income verification (i.e., do not meet principle 3);

- loans to borrowers with low credit scores
- loans to borrowers with high debt serviceability ratios
- loans with underlying property attributes that result in elevated credit risk (e.g., illiquid properties), or
- loans that otherwise have clear deficiencies relative to other conforming mortgages

The Corporation expects credit unions to impose a maximum LTV ratio less than or equal to 65 percent for non-conforming residential mortgages. This threshold should not be used as a divide, below which sound underwriting practices and borrower due diligence do not apply. Like traditional residential mortgages, the LTV ratio for non-conforming residential mortgages should reflect a reasonable distribution across the portfolio.

In general, the maximum lending threshold for a non-conforming loan should decrease as the risk of the transaction increases (e.g., due to the presence of multiple higher-risk attributes or deficiencies in a loan application, the presence of higher-risk factors around property valuation, etc.)

Home Equity Lines of Credit (HELOCs)

A HELOC[10] is a form of non-amortizing (revolving) credit that is secured by a residential property. Unlike a traditional residential mortgage, most HELOCs are not constructed to fit a predetermined amortization, although regular, minimum periodic payments are generally required by most lenders.

HELOC products provide an alternative source of funds for customers. However, it is important to recognize that, over time, these products can also significantly add to customers' outstanding debt. While some borrowers may elect to repay their outstanding HELOC balances over a shorter period of time relative to the average amortization of a typical traditional mortgage, the revolving nature of HELOCs can also lead to greater persistence of outstanding balances and greater risk of loss to lenders. As well, it can be easier for borrowers to conceal potential financial distress by drawing on their lines of credit to make timely mortgage payments and, consequently, present a challenge for lenders to adequately assess credit risk exposure in a timely fashion.

Given the unique features of HELOCs relative to traditional residential mortgages, credit unions should ensure appropriate mitigation of the associated risks of HELOCs, including the ability to expect full repayment over time, and the need for increased monitoring of the borrower's credit quality. In addition, credit unions should review the authorized amount of a HELOC (including HELOCs that are part of a structured consolidated or linked mortgage loan product) where any material decline in the value of the underlying property has occurred and/or the borrower's financial condition has changed materially.

The Corporation expects credit unions to limit the non-amortizing HELOC component of a residential mortgage to a maximum authorized LTV ratio of less than or equal to 65 percent.[11] The Corporation expects that the average LTV ratio for all HELOCs to be less than the credit union's stated maximums, as articulated in its RMUP, and reflect a reasonable distribution across the portfolio.

For greater clarity, in determining lending thresholds for HELOCs, the Corporation expects credit unions to apply the principles set out in the sub-sections "LTV Framework" and "Property Value used of the LTV Ratio". In general, the maximum lending threshold for a

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[10] For the purpose of the guideline, all reverse mortgages, or any non-amortizing (revolving) credit products secured by residential property, are considered HELOCs.
[11] Additional mortgage credit (beyond the LTV ratio limit of 65 percent for HELOCs) can be extended to a borrower. However, the loan portion over the 65 percent LTV ratio threshold is to be amortized.

HELOC should decrease as the risk of the transaction increases (e.g., due to presence of higher-risk borrower factors, the presence of higher-risk factors around property valuation, etc.)

PRINCIPLE 5

Credit unions are expected to have effective credit and counterparty risk management practices and procedures that support residential mortgage underwriting and loan asset portfolio management, including, as appropriate, mortgage insurance.

Mortgage Insurance

Mortgage default insurance (mortgage insurance) is often used as a risk mitigation strategy. However, mortgage insurance cannot be a substitute for sound underwriting practices. It should not be considered a substitute for conducting adequate due diligence on the borrower or for using other risk mitigants.

Credit unions may obtain mortgage insurance from CMHC and/or private mortgage insurance providers. The Corporation agrees that the use of either is appropriate, provided that a credit union conduct due diligence on the mortgage insurer commensurate with its level of exposure to that insurer. When performing such an assessment, a credit union should give consideration to, among other things, the mortgage insurer's:

- claims payment record
- expected future claims obligations
- balance sheet strength
- funding sources, including the quality of its governance practices and procedures
- reinsurance arrangements and the direct and indirect impact that may have on the credit union's own arrangement with the insurer

The evaluation of each credit union's mortgage insurance counterparty should be updated throughout the life of the insurance contract. In cases where there may be material exposures incurred but not reported losses, credit union management should ensure that the evaluation continues beyond the expiration date of the contract to ensure that the credit union assesses potential insurance recoverable from expected future claims.

For insured mortgages, credit unions should meet any underwriting or valuation requirements set out by the mortgage insurer to ensure the validity of insurance on those loans.

Purchase of Mortgage Assets Originated by a Third Party

Credit unions that acquire residential mortgage loans that have been originated by a third party are expected to ensure that the underwriting standards of that third party (i.e., due diligence on the borrower, debt service coverage, collateral management, LTV ratios, etc.) are consistent with the credit union's RMUP and compliant with this guideline. Credit unions should not rely solely on the attestation of the third party. In addition to underwriting, credit unions should also consider the risks associated with other functions that may be performed by the third party in respect of acquired loans (e.g., servicing).

Model Validation and Stress Testing

Credit unions often use models to contribute to residential mortgage underwriting and/or acquisition decisions (e.g., valuation or bankruptcy models) or to make lending decisions by way of auto-adjudication.

Credit unions are expected to have an independent validation process at both inception and on a regular basis for these models. This includes the regular review and recalibration of risk parameters with respect to their mortgage portfolio. The models used should reflect the nature of the portfolio and be adapted, as appropriate, if there is substantial variation or risk within the portfolio. This could include the development of new models to capture specific risk segments.

Additionally, credit unions should have a stress testing regime that considers unlikely, but plausible, scenarios and their potential impact on the residential mortgage portfolio.[12] The results of such stress testing should be considered in the ongoing validation of any models and reflected in credit unions' Internal Capital Adequacy Assessment Process (ICAAP).[13]

Higher-Risk Asset Portfolios

Heightened Prudence

Credit unions have the flexibility to underwrite and/or acquire a wide range of residential mortgages with varying risk profiles. However, for residential mortgage loan portfolios that constitute greater credit risk (e.g., non-conforming mortgages), the Corporation expects credit unions to exercise heightened prudence through:

- greater board and senior management oversight of the asset portfolio
- increased reporting and monitoring of the residential mortgage loan asset portfolio by management
- stronger internal controls (e.g., additional substantiation of credit qualification information, enhanced credit approval processes, greater scrutiny by the risk management oversight function, etc.)
- stronger default management and collection capabilities
- increased capital levels backstopping the impact of portfolio risk

Credit unions should understand their mortgage portfolio risk dynamics, and ensure they are taken into account when refining their risk appetite.

Adequacy of Regulatory Capital

The Corporation expects credit unions to maintain adequate regulatory capital levels to properly reflect the risks being undertaken through the underwriting and/or acquisition of residential mortgages. Credit unions should reflect mortgage loan assets with inherently greater risk through risk-sensitive increases in capital identified through their ICAAP.

IV. GUIDELINE ADMINISTRATION

DISCLOSURE REQUIREMENTS

Increased disclosure leads to greater transparency, clarity and public confidence in credit union residential mortgage underwriting practices. Credit unions are expected to disclose sufficient information for members and other key stakeholders to be able to conduct an adequate evaluation of the soundness and condition of the institution's residential mortgage operations.

[12] The principles and expectations of credit unions with respect to stress testing are outlined in the Corporation's regulatory guideline 2011-01, *Stress Testing.*

[13] The principles and expectations of credit unions with respect to ICAAP are outlined in the Corporation's regulatory guideline 2010-03, *Internal Capital Adequacy Assessment Process.*

Credit union's disclosures should include:

- the amount and percentage of the total residential mortgage loans and HELOCs that are insured versus uninsured. This should include the credit union's definition of "insured".
- the percentage of residential mortgages that fall within various amortization period ranges
- the average LTV ratio for the newly originated and acquired uninsured residential mortgages and HELOCs at the end of each period
- discussion on the potential impact on residential mortgage loans and HELOCs in the event of an economic downturn

Credit unions should determine the appropriate methods of disclosure based on Generally Accepted Accounting Principles (GAAP), industry practices and ease of accessibility by stakeholders. Financial disclosures should be attached to or included in the notes of financial statements.[14]

SUPERVISION OF CREDIT UNIONS

Information for Supervisory Purposes

Enhanced transparency and sound documentation will allow the Corporation to better understand a credit union's financial position and economic impacts and risks associated with a credit union's residential mortgage underwriting and acquisition practices. A credit union is expected to promptly notify the Corporation if it becomes aware of any mortgage underwriting issues that could materially impact its financial position.

Non-Compliance with the Guideline

The Corporation supervises credit unions in order to determine whether they are in sound financial condition and to promptly advise the credit union board and senior management in the event the institution is not in sound financial condition or is not complying with supervisory requirements. Where a credit union fails to adequately account and control for the risks of underwriting or acquisition of residential mortgages, the Corporation can take, or require the credit union to take, corrective measures. The Corporation's actions can include heightened supervisory activity, including preventive or remedial intervention actions.

IMPLEMENTATION

The Corporation will look for evidence that credit unions are taking steps to evaluate and update their residential mortgage underwriting policies and practices to align with the principles, expectations and limits contained in the guideline. The Corporation expects credit unions to be in full compliance with the provisions contained in the guideline by July 1, 2019.

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[14] The principles and expectations of credit unions with respect to disclosure are outlined in the Corporation's regulatory guideline 2018-01, *Financial Reporting and Disclosure Guideline*.