Reference: Guideline for P&C

November 6, 2014

To: Federally Regulated Mortgage Insurers (FRMIs)

Subject: Final Guideline B-21 – "Residential Mortgage Insurance Underwriting Practices and Procedures" and Consequential Amendments

On April 14, 2014, OSFI published draft Guideline B-21 – Residential Mortgage Insurance Underwriting Practices and Procedures for public consultation. OSFI received 15 submissions from various stakeholders following the release of the draft. I would like to thank everyone who provided comments and suggestions.

Today, OSFI is publishing the final version of Guideline B-21. An Annex to this letter provides a summary of comments received and explanations of how the issues raised were addressed in the final Guideline.

Full implementation of Guideline B-21 by FRMIs is expected no later than June 30, 2015, with the relevant public disclosures beginning with the quarter ending September 30, 2015. The implementation deadline of June 30, 2015, allows time for FRMIs to implement any systems or process changes that may be required. In the meantime, FRMIs should conduct self-assessments of compliance with this Guideline and establish a plan to address any deficiencies before the implementation deadline. However, where possible, FRMIs should comply with the principles and expectations set out in this Guideline as of the date of this letter.

For the purposes of consistency and clarity, OSFI has made consequential amendments to Guideline B-20. The implementation deadline for revised Guideline B-20 is the same as for Guideline B-21.

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Deputy Superintendent

Annex

Guideline B-21 – Summary of Consultation Comments and OSFI Responses

Industry Comments	OSFI Response
<u>Implementation Timeline</u>: Some respondents suggested that FRMIs and other stakeholders should be provided sufficient time to make changes to internal systems, policies, processes and documentation standards before the implementation of the Guideline.	OSFI is providing stakeholders with sufficient time to make changes to their internal systems, policies, processes and documentation standards. The eight (8) month timeline for implementation will allow for a slightly longer implementation period than was provided under Guideline B-20 Residential Mortgage Underwriting Practices and Procedures, where implementation was set within approximately six (6) months following the release of the Guideline. OSFI has made consequential amendments to Guideline B-20. The implementation deadline for revised Guideline B-20 is the same as for Guideline B-21.
<u>Loan Documentation and Income Verification</u>: Some commentators noted the importance of supporting documentation and authentication in the mortgage loan underwriting and insurance underwriting process. It was noted that the veracity of loan documentation, in particular, around the verification of borrowers' incomes is important in assessing risk. At the same time, other commentators cautioned against being too rigid in outlining specific standards for income verification, given potential unintended consequences.	A borrower's income is a key factor in the assessment of the borrower's capacity to repay a mortgage loan, including for assessing debt serviceability and affordability. Verification of income also helps to detect and deter fraud. Verification of income is particularly important because borrowers' stated income may differ substantially from their actual income, with adverse impacts, as has been observed previously in other countries. OSFI expects FRMIs to specify for lenders, processes for verifying a borrower's underlying income and sources of income. This includes substantiation of employment status and the income history of the borrower. For borrowers who are self-employed, a FRMI should outline reasonable steps for lenders to obtain income verification (e.g., Notice of Assessment) and relevant business documentation. In determining the reasonableness of the documentation used to support the income, sound practice suggests 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 and documentation does not contradict other information provided by the borrower in the underwriting process. OSFI has had other consultations with members of the industry on the issue of income verification. OSFI has added language around income verification for the purposes of clarity. OSFI has made consequential amendments to the principles around income verification in Guideline B-20.
<u>Documentation Retention</u>: A respondent noted that mortgage insurers should not require lenders to retain documentation for the life of the mortgage loan.	Sound loan documentation helps a mortgage insurer assess and verify whether a mortgage loan has been underwritten in a manner that is consistent with the mortgage insurer's criteria and compliant with the mortgage insurance policy requirements. OSFI expects FRMIs to establish requirements for lenders to exercise sound loan documentation practices as a condition of mortgage insurance coverage. This includes lenders maintaining complete documentation of information obtained in the underwriting of a mortgage loan. For insured mortgage loans, relevant documentation should be maintained by the lender for the length of time that insurance coverage is in place. For greater clarity, a FRMI should specify the types of information required to be documented and retained by lenders for newly insured mortgage loans, cases where a borrower switches lenders and for insured mortgage loans that are transferred to another borrower or property.
<u>Incentive and rebate payments (i.e., "cash back")</u>: A number of respondents provided views in respect of incentive and rebate payments. Some indicated support for the principle	OSFI's view is that incentive and rebate payments (i.e., "cash back") should not be considered part of the down payment. Cash-back incentives can be used to undermine minimum down payment

that cash-back and other incentives should not be considered when calculating the down payment. Other respondents however, noted that they had not observed a high rate of arrears or default with such transactions and questioned the need to exclude such incentives from counting towards the down payment. Some respondents mentioned that the elimination of cash-back incentives might impact a small number of transactions that qualify under government funded housing affordability programs.	requirements. • The potential risks underlying such transactions may be masked in part, due to the relative property price increases that have been observed since 2000. For greater clarity, the principle does not prohibit the use of cash-back incentives and rebate payments, but rather sets out the expectation that incentives and rebate payments should not be included in the calculation of a borrower's down payment. In a small amount of mortgage insurance transactions, incentive and rebate payments are used and funded by different levels of government, for the purposes of affordable housing programs. OSFI has revised the guideline to incorporate such transactions. Incentive and rebate payments (i.e., cash-back) may be considered as part of the down payment in cases related to affordable housing programs that are funded by a municipal, territorial, provincial or the federal government. In such cases, OSFI expects a FRMI to exercise increased oversight, control, and reporting over those transactions. OSFI has also made consequential amendments to the principle around incentive and rebate payments (i.e., "cash back") in Guideline B-20.
<u>Delegated Mortgage Insurance Underwriting</u>: A commentator suggested that the restriction regarding delegated mortgage insurance underwriting may impact the umbrella agreements that are used with mortgage insurers.	While a FRMI is expected to outline its insurance underwriting criteria for lenders, and lenders typically carry out the mortgage loan underwriting function (including direct interaction with the borrower), OSFI expects that a FRMI will not outsource the responsibility for approving or denying mortgage insurance for loans.
<u>Stress Testing to inform "Operational Preparedness"</u>: A commentator noted the importance of mortgage insurers using stress-testing as a means to inform insurers' operational preparedness for dealing with claims in a stressful environment.	OSFI agrees that stress testing should be used to help inform a FRMI of its operational preparedness under various stress events, where there may be large increases in the number or value of claims. A FRMI should provide its Board and Senior Management with regular reports that cover the institution's operational preparedness for increased claims under stress.

	Such information is expected to help guide contingency planning as well as inform mortgage insurance underwriting decisions and strategies.
The Role of the Board: A commentator noted that the guideline requires a FRMI's Board of Directors to spend a greater amount of its time in the day-to-day operations of the business and that OSFI should instead rely on requirements in OSFI's Corporate Governance and other Guidelines.	OSFI's Corporate Governance Guideline (CGG) communicates OSFI's expectations with respect to corporate governance of all federally regulated financial institutions (FRFIs). Principle 1 of Guideline B-21 complements the CGG and necessarily focuses more specifically on the role of the Board in mortgage insurance underwriting. The Guideline states that Senior Management should be responsible for the development and implementation of the Residential Mortgage Insurance Underwriting Plan (RMIUP). However, the Board of the FRMI has a critical role in providing guidance to, and oversight of, Senior Management on matters pertaining to mortgage insurance underwriting. OSFI expects that the FRMI's Board should review and discuss the RMIUP or any changes to the RMIUP at least annually, or more frequently as circumstances require. The Board should understand the decisions, plans, and policies being undertaken by Senior Management with respect to residential mortgage insurance underwriting, and their potential impact on the FRMI. The Board should probe and seek assurances from Senior Management that these are consistent with the Board's own decisions and Board-approved business and risk strategy for the FRMI, and that the FRMI's internal controls are sound and being implemented in an effective manner. OSFI has not made any material changes to the language in the draft Guideline in respect of the role of the Board. OSFI has made consequential amendments to the principle around the mortgage underwriting declaration. When a deviation from Guideline B-20 has taken place, the nature and extent of the deviation, and the measures taken or proposed to correct (and mitigate the risk associated with) the deviation, should be documented and disclosed to the Board and to OSFI in full.

Debt Serviceability: Some commentators indicated that they welcomed efforts to standardize formulas and input weightings for debt servicing calculations. Others asked for greater flexibility for insurers and industry stakeholders to use their own debt serviceability definitions.	Common, standard definitions of debt serviceability will support clarity, comparability, and consistency in assessing affordability. Additionally, for government-backed mortgage insurance, the Government of Canada has established upper limits on the values of the gross debt service (GDS) and total debt service (TDS) ratios. See the Eligible Mortgage Loan Regulations. As such, for government-backed mortgage insurers, a common, standard definition supports the integrity of regulatory limits. OSFI encourages the use of an industry-wide standard for the calculation of debt service coverage ratios. The Canada Mortgage and Housing Corporation (CMHC) definitions of GDS and TDS have emerged as an industry standard. OSFI expects FRMIs to use these ratios as input for determining whether to insure residential mortgage loans. For greater clarity, this does not limit a FRMI's ability to use additional debt serviceability measures for the purposes of reducing risk.
Disclosure: Some commentators proposed technical changes to the section on mortgage insurance public disclosures. Some respondents asked for more disclosures, while others suggested less, on the basis that such information provides competitive information.	OSFI has refined the section on public disclosures, including focusing disclosures on quarterly periods and quarter over quarter changes, which is consistent with typical reporting requirements. Increased disclosure leads to greater transparency, clarity and public confidence in FRMIs' residential mortgage insurance underwriting practices. As a matter of principle, FRMIs should publicly disclose sufficient information related to their residential mortgage insurance portfolios for market participants to be able to conduct an adequate evaluation of the soundness and condition of their residential mortgage insurance operations.