



Reference: Banks/BHC/T&L/MI

December 11, 2015

To: Banks
Bank Holding Companies
Federally Regulated Trust and Loan Companies
Federally Regulated Mortgage Insurance Companies

Subject: Updating capital requirements for residential mortgages

OSFI is planning to update the regulatory capital requirements for loans secured by residential real estate properties (i.e. residential mortgages).¹ Risks in the Canadian mortgage market continue to evolve. Household debt continues to grow faster than income and housing prices in some markets continue to rise rapidly. The planned changes to the regulatory capital framework will ensure that capital requirements keep pace with those developments and reflect underlying risks.

As per our usual practice, OSFI will consult with federally regulated financial institutions and other stakeholders before making any changes, initially through a directed consultation with industry in the new year, followed by broader public consultation later in 2016. We expect to have final rules in place no later than 2017. The anticipated changes will impact the regulatory capital requirements for those deposit-taking institutions using internal models for mortgage default risk² and the standardized capital requirements for Canada's private mortgage insurers.³

The purpose of OSFI's regulatory capital framework is to ensure, as much as possible, that federally regulated financial institutions can absorb severe but plausible losses. The potential severity of loss scenarios in the residential mortgage market depends crucially on price developments. In particular, potential losses become more severe during extended periods where house prices have recently risen rapidly and/or are high relative to borrower incomes. As a result, the potential severity of losses may vary across Canada.

¹ Loans secured by residential real estate properties include residential mortgages and home equity lines of credit secured by residential real estate properties. For purposes of this letter, the term residential mortgages encompasses both forms of lending.

² At present, these are the Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, HSBC Canada, National Bank of Canada, Royal Bank of Canada, and Toronto-Dominion Bank.

³ At present, these are Canada Guaranty Mortgage Insurance Company and Genworth Financial Mortgage Insurance Company Canada.



Accordingly, for banks using internal models, OSFI will propose a risk-sensitive floor for one of the model inputs (losses in the event of default) that will be tied to increases in local property prices and/or to house prices that are high relative to borrower incomes. This will ensure a level of consistency and conservatism in the protection provided to depositors and unsecured creditors.

For federally regulated private mortgage insurers, we will introduce a new standardized approach that updates the capital requirements for mortgage guarantee insurance risk. It will require more capital when house prices are high relative to borrower incomes. This will ensure a level of conservatism in the protection provided to policyholders and unsecured creditors.

At present, federally regulated deposit-taking institutions benefit from very low capital requirements on mortgages that are insured against default, in recognition of the government backstop on that insurance. OSFI is also considering additional criteria for recognizing the capital benefits of mortgage insurance in light of recent observations related to mortgage loan documentation. The risk mitigation benefits of mortgage insurance for regulatory capital purposes should, in principle, be reduced in circumstances where there may be material concerns around compliance with the terms of the insurance policy. This is consistent with OSFI Guidelines B-20 and B-21, which emphasize the importance of monitoring lender compliance with the terms of insurance contracts.⁴

Current capital requirements for banks and private mortgage insurers already contain an appreciable degree of conservatism regarding residential mortgages. These proposed updates to regulatory capital requirements reflect a measured and forward looking response to changing risks in the Canadian mortgage market. They will be applied on a go-forward basis to new mortgage loans.

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⁴ See Principle 4 of OSFI Guideline B-21 - Residential Mortgage Insurance Underwriting Practices and Procedures