July 7, 2016

To: Federally Regulated Financial Institutions (FRFIs)

Subject: Reinforcing Prudent Residential Mortgage Risk Management

The purpose of this letter is to update OSFI's expectations for residential mortgage underwriting. OSFI has identified areas for improvement and aims to reinforce the principles of OSFI Guideline B-20 — *Residential Mortgage Underwriting Practices and Procedures* and, where applicable, OSFI Guideline B-21 — *Residential Mortgage Insurance Underwriting Practices and Procedures*. As well, this letter provides an update on OSFI's plans to strengthen capital requirements for mortgage underwriting and mortgage insurance first announced in its December 2015 letter.

While OSFI will tighten its supervisory expectations in this area, it will also be reviewing OSFI Guideline B-20 more broadly to ensure it is aligned with prudent industry practice and Canadian housing market realities.

Given the current economic environment in Canada, with record levels of household indebtedness and growing risks and vulnerabilities in some housing markets, OSFI's supervisory scrutiny in the area of mortgage underwriting will continue. Moving forward, OSFI will place an even greater emphasis on confirming that financial institutions conduct prudent mortgage underwriting, and that their internal controls and risk management practices are sound and take into account market developments.

Rising Risks and Vulnerabilities Associated with Household Lending

The current macroeconomic environment in Canada is characterized by elevated financial risks and associated vulnerabilities for Canadian financial institutions. Persistently low interest rates, record levels of household indebtedness, and rapid increases in house prices in certain areas of Canada (such as Greater Vancouver and Toronto), could generate significant loan losses if economic conditions deteriorate. Financial institutions can sustain losses both through the potential inability of borrowers to meet their debt obligations, as well as through declining values of the real estate properties pledged as collateral in mortgage loans.

Enhancing Risk Management Expectations

OSFI Guideline B-20 sets out OSFI's expectations for prudent residential mortgage underwriting. Lenders are aware that they need to have processes and controls in place to ensure ongoing compliance with all aspects of OSFI Guideline B-20, and OSFI expects all lenders to fully embrace the principles underpinning that guideline. Lenders should not view adherence to the guideline as a compliance exercise, nor should they treat the examples it contains as safe harbours.

As a consequence of the unsettled economic environment, OSFI has identified several areas related to OSFI Guideline B-20 where it will be enhancing its supervisory scrutiny. These include:

Income Verification

OSFI expects all financial institutions to exhibit rigour in the verification of a borrower's income as it is a critical element in the residential mortgage underwriting process. Inadequate income verification can adversely affect the assessment of credit risk, anti-money laundering and counter terrorist-financing (AML/CTF) compliance, capital requirements, and mortgage insurability.

OSFI is aware of incidents where financial institutions have encountered misrepresentation of income and/or employment. Institutions should have adequate processes and controls in place to mitigate this type of risk. OSFI will continue collecting information from institutions to monitor this activity and will assess the adequacy of their associated risk management controls.

Borrowers relying on income from sources outside of Canada pose a particular challenge for income verification and lenders should conduct thorough borrower 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.

Lenders should not rely on collateral values as a replacement for income verification, especially in areas of Canada where house prices have been rising rapidly.

Non-Conforming Loans

OSFI Guideline B-20 establishes an upper limit of 65 percent loan-to-value (LTV) for loans that are considered to be "non-conforming." OSFI has observed that underwriting practices for residential mortgages at or below the non-conforming threshold of 65 percent LTV are often not as strong as those for conforming mortgages, especially in regard to income verification.

The 65 percent LTV threshold used in OSFI Guideline B-20 should not be used as a demarcation point below which sound underwriting practices and borrower due diligence do not apply. The mortgage underwriting principles of OSFI Guideline B-20 apply equally to conforming and non-conforming loans. Moreover, an assessment of a borrower's character and capacity to service the loan should always take precedence over the value of the collateral when underwriting mortgage loans and mortgage insurance.

Mortgage lenders should establish their own clear limits on the amount of non-conforming mortgages they are willing to undertake (including loans where income is difficult to verify), and should ensure that controls are in place so that these limits are not exceeded.

Debt Service Ratios

Prudent mortgage underwriting requires a full assessment of a borrower's ability to withstand plausible financial and economic shocks. Key elements used in debt service calculations for qualifying eligible borrowers should be appropriately stressed with both the current, and a potentially severe but plausible, economic environment in mind.

A borrower's income should be calculated conservatively and its resilience appropriately questioned. In particular, the resilience of rental income from the underlying property, or other potentially variable income in the event of borrower stress amidst declining property values, should be carefully assessed.

Relying on the prevailing posted five-year mortgage rate to test a borrower's ability to service its obligations in a rising interest rate environment does not represent a sufficiently conservative stress test. Given current exceptionally low interest rates, mortgage lenders should ensure the qualifying interest rate appropriately accounts for the possibility that interest rates could be significantly higher at renewal, and over the full mortgage amortization period.

Certain mortgages inherently carry greater credit risk regardless of LTV. These include, for example, mortgages for properties purchased for investment purposes, or properties that are partly reliant on income from the property to service the loans. Institutions should identify residential mortgages exhibiting higher risk characteristics and adequately mitigate those risks through greater due diligence of the borrower and stronger internal controls.

Appraisals and LTV Calculation

Rapid house price increases create more uncertainty about the reliability of property appraisals. Lenders and mortgage insurers should have processes in place that challenge property valuation appraisals and, in particular, the assumptions made, or concerns raised, about the appraised property. Institutions should use appraisal values and approaches that provide for a conservative LTV calculation, and not assume that housing prices will remain stable or continue to rise.

Risk Appetite and Portfolio Risk Management

OSFI's supervisory work indicates that the risk profile of newer mortgage loans is generally on the rise. Lenders and mortgage insurers should understand these mortgage portfolio risk dynamics, and ensure they are taken into account when refining their risk appetite expectations.

It is important that lenders and mortgage insurers revisit their Residential Mortgage Underwriting Policy (RMUP) and Residential Mortgage Insurance Underwriting Plan (RMIUP), respectively, on a regular basis to ensure that there is strong alignment between their stated risk appetite (as approved by their Board of Directors) and their actual mortgage/mortgage insurance underwriting and risk management practices.

OSFI expects lenders and mortgage insurers to verify that their mortgage operations are well supported by prudent underwriting practices, and have sound risk management and internal controls that are commensurate with these operations.

Strengthening Capital Adequacy

OSFI issued a letter in December 2015 announcing an initiative to strengthen the measurement of capital held by the major banks and mortgage insurers, to better position them to withstand potential losses stemming from their residential mortgage underwriting and mortgage insurance operations. These measures for banks and mortgage insurers are targeted for implementation in November 2016 and January 2017, respectively. In addition, the Basel Committee on Banking Supervision (BCBS) is proposing revisions to the standardized approach for credit risk.

These various capital policy initiatives include, more specifically:

Risk Sensitive Floors

For banks that have been approved by OSFI to use the Internal Ratings-Based (IRB) approach for credit risk, a risk-sensitive floor on the modelled estimates of Loss Given Default (LGD) will be implemented in a way that is sensitive to local housing market conditions. This floor will be tied to the behaviour of property prices, both in terms of housing price trends over the previous three years, and the behaviour of housing prices relative to household incomes. As well, these banks will be expected to take into account periods where the value of properties pledged as collateral become less certain.

Capital Requirements for Mortgage Insurers

The new regulatory capital framework that is currently being developed for federally regulated mortgage insurers will require additional capital when house prices are high relative to borrower income. This will ensure a level of conservatism in regulatory capital calculations and, ultimately, ensure that policyholders and unsecured creditors are properly protected.

BCBS Revisions to the Standardized Approach for Credit Risk

Lenders subject to the standardized approach for credit risk are also reminded that OSFI is working with its international counterparts at the BCBS to make standardized approaches for loans secured by residential real estate more risk-sensitive. The current proposals scale capital requirements to the LTV of individual residential mortgage loans. This is an improvement on a flat risk weight, as the loan risk weight increases as the equity cushion shrinks.

In addition, a separate higher schedule of capital requirements has been proposed for loans that are materially dependent on income from the property to repay the loan. Once finalized, OSFI will begin consultations on the calibration and implementation of the new rules to the Canadian market.

OSFI expects lenders and mortgage insurers to take into account the above changes and proposed revisions to the capital rules for mortgage underwriting and mortgage insurance when considering capital allocation and other capital planning activities.

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