Guideline

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I. Purpose and Scope of the Guideline

Mortgage (default) insurance is a financial product offered by a mortgage insurer that protects a lender against losses caused by a borrower's default on a mortgage loan. Given the exposure to potential losses, a mortgage insurer's safety and soundness is strongly influenced by its mortgage insurance underwriting policies, practices, and risk management.

This Guideline sets out the Office of the Superintendent of Financial Institutions' (OSFI's) expectations for prudent residential mortgage insurance underwriting and related activities. This Guideline is applicable to all federally-regulated mortgage insurers (FRMIs) to which the *Insurance Companies Act* applies and that provide mortgage insurance for residential mortgage loans in Canada, and/or reinsurance for such insured loans. [1], [2]

This Guideline complements OSFI's *Supervisory Framework* and *Assessment Criteria* and other Guidelines (see Section IV), as well as the Government of Canada's mortgage insurance guarantee framework. [3]

Section II of this Guideline articulates *six fundamental principles* for sound residential mortgage insurance underwriting:

Principle 1 relates to a FRMI's governance and the development of business objectives, strategies and oversight mechanisms in respect of residential mortgage insurance underwriting.

Principles 2 to 4 focus on a FRMI's interaction with lenders as part of the mortgage insurance underwriting process. This includes:

- The FRMI's establishment of standards, and the initial assessment of lenders against those standards, for "qualified / approved" lender status (Principle 2);
- The FRMI's loan underwriting criteria for lenders (i.e., the characteristics defining insurable mortgage loans [4]), as well as requirements for lenders, for initial and continuing mortgage insurance coverage (Principle 3); and

- The FRMI's ongoing due diligence into lenders' underwriting practices (Principle 4).

Principles 5 and 6 relate to a FRMI's internal underwriting operations and risk management. This includes:

- The assessment and validation of the mortgage insurer's internal underwriting systems, models, and underwriters' processes (Principle 5); and
- The use of effective portfolio risk management, including stress testing and risk mitigation such as reinsurance (Principle 6).

The final section of the Guideline outlines disclosure and supervisory requirements.

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

II. Principles

Principle 1: Residential Mortgage Insurance Underwriting Plan

A FRMI that is engaged in residential mortgage insurance underwriting should have a comprehensive Residential Mortgage Insurance Underwriting Plan (RMIUP). The FRMI's insurance underwriting practices and procedures should comply with its established RMIUP.

Residential Mortgage Insurance Underwriting Plan (RMIUP)

The RMIUP is a document (or set of documents) that consolidates the FRMI's key mortgage insurance underwriting policies. It includes a description of a FRMI's business objectives, risk appetite, and risk management policies. The RMIUP also contains other key elements that relate to, or support, mortgage insurance underwriting.

The RMIUP should include the insurer's complete set of mortgage insurance products (and baseline underwriting criteria for each product [5]), the requirements and conditions for lenders for mortgage insurance coverage [6], and policies for assessing lenders' underwriting and compliance with its mortgage insurance agreements [7].

The RMIUP should describe the FRMI's delegated authorities for approving mortgage insurance applications, including its approach for approving any exceptions to the baseline underwriting criteria. Additionally, the RMIUP should outline the FRMI's policies for detecting and addressing fraud.

FRMIs should revisit their RMIUP on a regular basis to ensure that there is strong alignment between their risk appetite statement and their actual mortgage insurance underwriting policies and practices.

Role of Senior Management – Development and Oversight of RMIUP

Senior Management should be responsible for oversight of the development and implementation of the RMIUP.

The FRMI's Senior Management should review, discuss and approve the RMIUP or any changes to the RMIUP at least annually, or more frequently as circumstances require. Senior Management should consider how the decisions, plans, and policies they make with respect to residential mortgage insurance underwriting will potentially impact the FRMI. Senior Management should also ensure that the RMIUP is consistent with the overall business and risk strategy for the FRMI, and that the FRMI's internal controls are sound and being implemented in an effective manner.

> Please refer to OSFI's *Corporate Governance Guideline* for OSFI's expectations of FRMI Boards of Directors in regards to operational, business, risk and crisis management policies.

Internal Controls, Monitoring and Reporting

Effective controls, monitoring and reporting systems and procedures should be developed and maintained by FRMIs to ensure ongoing operational compliance with the RMIUP. This includes processes for monitoring and testing compliance with established mortgage insurance underwriting policies by the FRMI's staff, mortgage lenders, and third parties (e.g., property appraisers).

A FRMI should identify, measure, monitor, and report to the Senior Management on all relevant risks (e.g., strategic, operational, and financial, including credit, market, and liquidity risks) in its residential mortgage insurance operations, on an ongoing basis. To support operational compliance, the FRMI's residential mortgage insurance risk appetite, risk limit profile, and risk management policies should be understood at all relevant levels of the FRMI.

A FRMI should have adequate processes in place with respect to residential mortgage insurance to independently and objectively:

- Identify, assess and analyze key risks and monitor risk exposures against the FRMI's Risk Appetite Framework; [8]
- Ensure that risks are appropriately controlled and mitigated, and provide assurances to Senior Management;
- Ensure that risk management policies, processes and limits are being adhered to, and provide assurances to Senior Management;
- Provide Senior Management with regular reporting that covers:
  - Insurance underwriting exceptions, including the identification of any patterns, trends or systemic issues within the residential mortgage insurance portfolio that may impair insurance quality or risk mitigation factors;
  - Quality assurance processes in relation to lenders' practices and compliance with the FRMI's mortgage insurance criteria and mortgage insurance coverage requirements;
  - Claims settlement and claims exceptions, as well as operational preparedness for increased claims under stress events; and
  - Effectiveness of underwriting systems and key underwriting-related models (e.g., property valuation).

Principle 2: Establishing Standards for the Initial Assessment and Qualification of Mortgage Lenders

A FRMI should establish sound standards for the purpose of initially assessing and qualifying mortgage lenders for mortgage insurance coverage.

A FRMI should ensure that a lender applying for mortgage insurance coverage is adequately qualified to offer and service mortgage loans and that it has adequate processes in place to comply with the FRMI's mortgage insurance coverage requirements, before providing mortgage insurance coverage to that lender.

To carry out an initial assessment of a mortgage lender, a FRMI should establish sound qualification standards. Factors that should be considered include, but are not limited to:

- Financial soundness of the lender;
- Mortgage loan underwriting experience, practices and procedures;
- Ability of the lender to provide timely and accurate information on the performance of its mortgage loans; and
- Delinquency, foreclosure and, where applicable, claims management processes.

Lenders should meet the FRMI's established standards on an ongoing basis, and this should be periodically reviewed and verified by the FRMI. The nature of the assessment and designation should reflect the lender's regulatory status, [9] current or proposed business model and the specific approvals being sought by the lender. The FRMI's standards for qualifying and designating lenders should be consistent with any applicable federal laws and regulations (e.g., PRHMIA and its associated Regulations).

Principle 3: Mortgage Insurance Criteria and Insurance Coverage Requirements for Lenders

A FRMI should establish prudent underwriting criteria, which specify the characteristics and parameters of insurable mortgage loans for lenders. In addition, for the purpose of controlling risk, a FRMI should promote sound mortgage underwriting and loan management practices by mortgage lenders by establishing prudent requirements in its insurance policies (e.g., Master Policy Agreements).

Important factors that influence the overall risk borne by a FRMI from its mortgage insurance business include, among others, the underlying risk of the mortgage loans it has insured, as well as the effectiveness of lenders' mortgage underwriting practices and management of those loans.

To help manage credit risk and to promote prudent mortgage underwriting, proper loan management, and timely reporting of relevant information by lenders, a FRMI should outline the specific characteristics and parameters that define the types of mortgage loans the FRMI is normally willing to insure (i.e., “criteria for mortgage loans”). A FRMI should also establish requirements for lenders (usually contained in a Master Policy Agreement), as a condition for initial and continuing mortgage insurance coverage.

Criteria for Mortgage Loans

A FRMI’s *criteria for mortgage loans* [10] outline the baseline characteristics and parameter values (e.g., specific debt service coverage ratios, credit scores, etc.) for mortgage loans that the mortgage insurer will normally insure. These criteria are central to the FRMI’s underwriting process and should be sound and prudently set and consistent with the objectives and risk appetite established by the FRMI in its RMIUP [11]. While a FRMI is expected to outline its insurance underwriting criteria for lenders, and lenders typically carry out the mortgage loan underwriting function, the FRMI is expected to retain responsibility for approving or denying mortgage insurance for loans.

At minimum, the criteria for mortgage loans should cover the following components, for each mortgage insurance product and insurance type (i.e., transactional or portfolio insurance).

(i) Mortgage Loan Parameters:

- Allowable loan purpose;
- Allowable loan security position;
- Maximum mortgage loan size and, if applicable, maximum exposure to any one borrower and/or related parties;
- Maximum loan-to-value (“LTV”) ratio; and
- Maximum allowable loan term and amortization length.

(ii) Borrower’s Background and Willingness and Capacity to Service Debt:

As part of the insurance underwriting process, a FRMI should ensure that lenders have a process for undertaking a reasonable inquiry into a borrower’s background and demonstrated willingness and capacity to service debt. As part of its criteria for mortgage loans, a FRMI should establish and outline prudent underwriting criteria for the assessment of the borrower, which should include, but is not limited to:

- **Background and Credit History**: A FRMI should outline acceptable methods for lenders to assess the financial background of prospective borrowers, including the use of credit history checks and credit bureau reports. The mortgage loan criteria should outline the FRMI's minimum credit bureau score requirements.
- **Down Payment**: A FRMI should establish minimum down payments, as well as acceptable sources of down payment in its criteria. In particular, the FRMI should specify where traditional sources of down payment (e.g., borrower's own equity) are required and cases where non-traditional sources for the down payment (e.g., borrowed funds) may be used. Where non-traditional sources of down payment are being used, further consideration should be given to establishing greater risk mitigation and/or additional premiums to compensate for increased risk. Incentive and rebate payments (i.e., "cash back") should not be considered part of the down payment [12].
- **Income and Employment Verification**: A FRMI should specify processes for lenders to rigorously verify a borrower's underlying income and sources of income. This includes substantiation of a borrower's employment status and income history. In regard to loan documentation that supports income verification, the FRMI should specify that lenders make 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 and documentation does not contradict other information provided by the borrower in the underwriting process.

  FRMIs should specify in their criteria that, 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, FRMIs should specify that temporarily high incomes (e.g., overtime wages, irregular commissions and bonuses) should be suitably normalized or discounted.

  For borrowers who are self-employed, FRMIs should also be guided by the principles listed above. In particular, FRMIs should outline steps for lenders to obtain income verification (e.g., Notice of Assessment and T1 General) and relevant business documentation.

FRMIs should specify that lenders are required to exercise rigorous due diligence in underwriting mortgage insurance for 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 may pose a particular challenge for income verification, and FRMIs should expect lenders to 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.

- **Debt Service Coverage**: A FRMI should outline quantitative limits on debt service coverage ratios, using measures such as the total debt service (TDS) and gross debt service (GDS) ratios, as a means to assess affordability. In general, debt service coverage ratios should be calculated conservatively. To reduce ambiguity, a FRMI should have clear policies with respect to the contributing factors for the calculation of debt service coverage ratios. [13] A FRMI should clearly outline the formulae to be used by lenders to calculate debt service coverage and describe how key inputs (e.g., income, mortgage loan interest and principal repayment, other debt obligations, etc.) should be treated. This includes specifying any "qualification" parameters that should be used in calculating debt serviceability (e.g., interest rates) for the purpose of reducing risk. [14]
- **Loan Recourse and Additional Assessment Criteria**: A FRMI's decision to insure a mortgage loan (or require higher risk mitigation) should consider the effectiveness of recourse against the borrower in the event of borrower default. To the extent possible, a FRMI should also consider factors that would not ordinarily be captured by income and debt serviceability metrics, such as the borrower's assets (e.g., savings).

(iii) Underlying Mortgage Property:

Conducting a thorough assessment of the underlying property, prior to mortgage insurance approval, helps to reduce risk in the residential mortgage insurance business. As part of the FRMI's criteria for mortgage loans, a FRMI should outline clear and transparent policies in respect of the property acting as collateral, including:

- **Insurable Property Types**: The FRMI should outline insurable and non-insurable property types, dwelling types, and tenure.
- **Responsibility for Property Valuation**: A FRMI should retain responsibility for carrying out property valuation for transactional mortgage insurance. In the case of portfolio insurance (where insurance is applied to a pool of uninsured mortgage loans), a FRMI should conduct its own updated property valuation for the underlying mortgage loans, using a risk-based approach.
- **Property Valuation Assessment**: In assessing the value of a property (or requiring a third party to carry out the assessment [15]), a FRMI should take a risk-based approach, and consider a combination of valuation tools and appraisal processes appropriate to the underlying risk being undertaken (e.g., automated valuation model, review of comparable properties, on-site inspections, drive-by appraisals, progress inspection reports, and/or a full appraisal).
    - In general, a FRMI should not rely exclusively on any single method for property valuation. A FRMI should maintain and implement a framework for critically reviewing and, where appropriate, effectively challenging the assumptions and methodologies underlying valuations and property appraisals. A FRMI should undertake a more comprehensive and prudent approach to collateral valuation for applications with higher overall risk (e.g., less liquid properties, higher risk borrowers), as well as loan applications in markets that have experienced rapid property price changes or higher volatility, which generate more uncertainty about the accuracy and stability of property valuations.
    - For the purposes of risk management, a FRMI's risk assessment should also consider 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.
- **General Property Requirements**: A description of any additional property requirements or restrictions on use of the property.

(iv) Mortgage Insurance Premiums:

A FRMI should establish actuarially-sound premium rates for the risks it incurs, taking into consideration the overall risk of insuring mortgage loans and the potential that economic and market conditions and/or borrower characteristics can unexpectedly change. A FRMI should review its mortgage insurance premiums periodically, but at least annually.

Insurance Coverage – Conditions and Requirements for Lenders

To promote prudent mortgage loan underwriting and loan management consistent with the FRMI's interests and to help control risk, a FRMI should outline (e.g., in a Master Policy Agreement or other insurance policy documents) requirements, conditions, and any other obligations to be adhered to, or carried out, by lenders for initial and continuing mortgage insurance coverage. The elements covered should include, but are not limited to, the following:

- **Description of Mortgage Insurance Coverage**: A FRMI should provide a description of the mortgage insurance coverage (and any relevant coverage exclusions), as well as the events and conditions for the calculation and payment of claims.
- **Complete, Accurate and Timely Information**: As a condition for mortgage insurance coverage, a FRMI should require that lenders provide complete, accurate, and timely information when submitting applications for mortgage loan insurance and throughout the life of an insured mortgage loan.
- **Documentation Retention**: A FRMI should 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.
- **Access to Information**: Rights conferred on the lender to share information with the FRMI so that the FRMI may access underwriting information and conduct due diligence in respect of a prospective or insured

mortgage loan or borrower. A FRMI should ensure that it obtains appropriate borrower consent to access both the borrower's information as well as the lender's underwriting documentation involving borrower information. A FRMI should also ensure it complies with relevant laws governing the use and privacy of personal information (e.g., see the *Personal Information Protection and Electronic Documents Act*).

- **Updated Information**: A FRMI should establish requirements and standards for lenders to provide the insurer with accurate, timely and updated information on insured mortgage loans. This includes reporting of relevant credit risk information (e.g., outstanding loan balances, level of arrears) around "events," such as insured mortgage loan delinquencies and defaults. Updated information should also be provided for any specified loan modification, restructuring or transfer of an insured mortgage loan to an alternate borrower, property or lender. To allow for a current assessment of its overall mortgage insurance exposures, a FRMI should obtain an updated outstanding mortgage loan balance for each insured mortgage loan, on a periodic basis, but at least quarterly. The updated loan information obtained from lenders should be sufficient in detail to facilitate the FRMI's reconciliation to its own records.
- **Property Valuation**: Rights conferred on the FRMI, by the borrower, and through the lender's documentation, to permit and allow use of specific methods of property and land valuation (e.g., appraisals), as needed, on a case-by-case basis.
- **Property Condition**: To the extent that a FRMI may need to realize on the underlying property serving as security, it is important to have put in place sound collateral practices and procedures, at the point of origination, which cover the property throughout the life of the insurance policy. For the purposes of controlling insurance risk, a FRMI should establish requirements for lenders for managing distressed properties. A FRMI should clearly outline the responsibility for arranging appropriate insurance coverage against physical damage, as well as the responsibility for costs related to any uninsured physical damage to properties (i.e., property damage beyond normal wear and tear) when settling claims on defaulted loans.
- **Lenders' Management of Delinquent and Defaulted Loans**: A FRMI should establish standards for lenders' management of delinquent and defaulted loans that reasonably mitigate the frequency and severity of claims to the insurer. This includes outlining options for loan workouts and permissible claims settlement methods (e.g., deficiency basis or "property take-backs"), as justified. A FRMI should also ensure the inclusion of appropriate contractual terms and conditions that secure the FRMI's full protection under the laws applicable

in the relevant jurisdiction, and that seek to preserve an appropriate variety of recourses (including, where applicable, actions on personal covenant) should the borrower default.

- **Conditions for the Sale or Transfer of Mortgage Loans and/or Servicing Rights**: The sale or transfer of an insured mortgage loan or the servicing rights may impact the overall risk borne by a FRMI. As a condition of insurance, a FRMI should outline any requirements or obligations for lenders when seeking to transfer or sell an insured mortgage loan, servicing rights, or both, including where lenders require the FRMI's prior consent to carry out such transactions.
- **Conditions for Mortgage Insurance Exceptions**: A FRMI should outline any conditions which must be satisfied in the case of exceptions to criteria for insurable mortgage loans or for exceptions to requirements in any insurance policy agreement. The FRMI should provide the lender with a record or policy certificate validating the FRMI's approval to insure the mortgage loan, along with any specific conditions that apply. The rationale and approval of underwriting exceptions should be appropriately documented and maintained by the FRMI. Such records help reduce the potential for disputes by providing clear recognition where exceptions have been approved or conditions have been attached to the insurance policies.
- **Fraud Detection and Reporting**: Requirements for lenders to maintain adequate mechanisms for the detection and prevention of fraud or misrepresentation (e.g., falsified income documents) in the mortgage underwriting process. In addition, FRMIs should require lenders to inform and report cases to them of suspected or verified fraud or misrepresentation, in respect of a mortgage insurance application or an insured mortgage loan.
- **Termination of Insurance Policy**: The conditions or circumstances where policy coverage may be terminated or rescinded, or where claims can be expected to be denied or reduced (e.g., misrepresentation or fraud on the part of the lender, specific types of loan modifications by the lender without the insurer's pre-approval, unrepaired physical damage to a property, etc.).

To achieve clarity and certainty in respect of mortgage insurance coverage, the insurance agreements between a FRMI and mortgage lenders should be clear, comprehensive and unambiguous. A FRMI should ensure that its insurance policy coverage requirements, obligations, and any other terms and conditions are binding and enforceable. Complete and final agreement of all components of the mortgage insurance contract should be executed between a FRMI and a lender prior to or upon the effective date of committing any mortgage insurance coverage.

In general, a FRMI's maintenance of insurance coverage and payment of claims should be made conditional on the lender satisfying all policy coverage obligations and other requirements in the FRMI's insurance agreements. Any claims exceptions should be defined in the FRMI's RMIUP, tracked, and reported to Senior Management.

As part of a FRMI's sound practice, the FRMI should review the requirements, conditions, and obligations established in its insurance coverage agreements, at least annually, or more frequently as needed. Such reviews ensure the agreements remain current and consistent with the decisions made by the FRMI's Senior Management, as outlined in the FRMI's RMIUP.

Principle 4: FRMI's Periodic Assessments of Lenders' Underwriting Practices

A FRMI should exercise reasonable due diligence regarding lenders' underwriting practices, on a periodic basis, in order to assess consistency with the FRMI's criteria for insuring mortgage loans and compliance with the requirements contained in the FRMI's policy coverage documents. A FRMI should establish clear policies for identifying, escalating, and as needed, addressing weak or non-compliant lender practices.

As part of the mortgage insurance underwriting process, a FRMI typically obtains information from a lender's initial assessment of a prospective borrower. The overall prudence and rigour employed by a mortgage lender in the loan underwriting process is a factor that can influence the risk being transferred to the FRMI.

Given that the underlying motivations for funding a mortgage loan can differ from those for insuring a mortgage loan, and that underwriting discipline among market participants can change over time, it is important that a FRMI assess and verify the degree to which its stated criteria and insurance policies are being followed by mortgage lenders (or other servicing companies), as a means to measure, track, and control risk. Assessing lenders' practices can also help to identify changing trends or emerging industry practices that may require greater attention, remedial action, or changes to insurance underwriting criteria.

OSFI expects that a FRMI will undertake reasonable inquiries and reviews, on a risk-based and periodic basis, into lenders' underwriting practices. This may include, but is not limited to, reviews for assessing accuracy of insured mortgage loan information in applications, reviews that are triggered and focused on specific events (e.g., review of insurance claims), in-depth lender-specific assessments (e.g., to assess a lender's underwriting and control functions), and/or cross-sectional reviews of underwriting criteria across a group of lenders.

In general, a FRMI's assessment of an individual lender's practices, and the frequency of those assessments, should be commensurate with the FRMI's level or concentration of risk to that lender (i.e., a risk-based approach). OSFI expects a FRMI to exercise a relatively higher level of examination and scrutiny in respect of underperforming lenders (e.g., those with proportionately higher levels of delinquencies and claims, on a risk-adjusted basis) or whose practices have been found unsatisfactory or inconsistent with the insurer's criteria or conditions established in the mortgage insurance policies (e.g., poor loan documentation, inconsistent reporting, evidence of misrepresentation, forms of negligence, etc.).

The review process can include various methods, including automated reviews, desk-reviews, as well as on-site inspections involving a team of reviewers. [16] In general, a FRMI should not rely on any one method or approach and should establish clear policies for determining the types, methods, and frequency of reviews it will undertake. [17]

Lender reviews should be undertaken by an independent function within or outside the FRMI (either an internal or external group, or combination of both). [18] Reviewers should have the appropriate skills and expertise to conduct such reviews and are expected to maintain adequate records and appropriate reporting to Senior Management.

In general, the results of such reviews should be considered in the insurance underwriting decision-making process (i.e., part of the assessment of risk factors), including to help a FRMI determine whether to insure various mortgage loans by specific lenders or consider changes to underwriting standards. A FRMI should have a policy for determining the relative weight placed on its lender assessments and their contribution to the underwriting decision-making process.

OSFI expects that a FRMI will put in place clear policies to identify, escalate, and undertake remedial action, as part of its review and quality assurance processes, to address materially weak or inadequate underwriting practices or procedures by lenders. In cases where the FRMI identifies significant inadequacies, the FRMI should consider appropriate responsive actions (e.g., depending on the circumstances, corrective measures, applying more stringent underwriting standards, or where remedial action is ineffective to effect change, declining to insure mortgage loans by a specific lender, etc.).

Principle 5: Assessment and Validation of Underwriting Systems, Models, and Underwriters' Processes

A FRMI that is engaged in residential mortgage insurance underwriting should periodically assess and validate its insurance underwriting systems, models, and underwriters' processes, to ensure sound insurance underwriting outcomes and consistency with the FRMI's RMIUP.

Mortgage insurers often rely upon proprietary automated underwriting systems and other models to provide timely and comprehensive information for decision-making into the mortgage insurance underwriting process. In the case of mortgage loans that do not meet standard underwriting characteristics or that are flagged for a closer review, mortgage insurers typically rely on individual underwriters to manually re-examine specific details of such loans before providing a recommendation as to whether to extend mortgage insurance.

Ensuring that such systems, models, and underwriters' processes are robust and produce outcomes that are consistent with the objectives and risk appetite outlined in a FRMI's RMIUP is central to sound mortgage insurance underwriting and risk mitigation.

Automated Underwriting Systems and Models

Automated underwriting systems and other models are commonly used to help an insurer efficiently assess the risk of insuring a mortgage loan (or a group of mortgage loans). Given the importance of underwriting systems and other models to mortgage insurance underwriting, a FRMI should establish an appropriate governance framework for models that outlines the standards and criteria related to the adoption and use of models, data inputs, initial and ongoing validation, and the treatment of model redevelopment and recalibration.

As part of that framework, a FRMI should have an independent validation process for models at initial implementation, and on a periodic basis, to ensure ongoing performance and suitability. As needed, mortgage insurers should recalibrate associated parameters with respect to their models, based on findings of file reviews (e.g., performance of comparable tools for property assessments).

For automated underwriting systems, a FRMI should maintain adequate mechanisms for detecting and preventing fraud or misrepresentation. A FRMI should also put in place programs to continuously monitor and audit the information received on mortgage loans to reduce the potential for inaccuracies and to help detect fraud or "gaming." This includes the use of back-testing processes. A FRMI should take immediate remedial action to address identified weaknesses in its automated underwriting systems.

Mortgage Insurance Underwriters' Processes

Mortgage insurers often depend on underwriters to assess the risks underlying mortgage loans that generally do not meet standard underwriting characteristics or which are otherwise flagged by automated systems. Underwriters are normally required to assess the degree to which such loans are deficient in meeting baseline characteristics and judge the value of compensating factors (e.g., risk mitigating factors, such as a borrower's assets), prior to approving a mortgage loan for insurance.

A FRMI should ensure that its underwriting personnel have the appropriate skills, experience and training to carry out their function. To support consistency of outcomes with a FRMI's RMIUP, a FRMI should document and maintain standard operating procedures for all personnel involved in the underwriting of mortgage insurance. Underwriters' decisions should be well-documented and sufficient to facilitate third-party replication of the approval decision. A specific underwriting authority and escalation process should be established and applied according to the level of underwriting risk, as well as for review and approval of policy exceptions.

A FRMI should have in place processes, conducted by an independent oversight function, for regularly monitoring and evaluating the overall quality of underwriters' practices and for assessing the performance of individual underwriters and compliance with established procedures. This includes internal underwriting audits as a means to assess compliance and consistency in decision-making.

Principle 6: Effective Portfolio Risk Management and other Risk Mitigation

FRMIs should have effective portfolio risk management practices, including the use of stress testing and, as appropriate, the use of reinsurance. Given the objectives and risk appetite established in the RMIUP, a FRMI should consider the outcome of stress-testing and risk mitigation in appropriately setting or adjusting its mortgage insurance underwriting criteria.

Portfolio Risk Management and Stress Testing

A mortgage insurer commonly holds a portfolio of invested insurance premiums on the asset-side of its balance sheet. It also holds insured mortgage loan liabilities (i.e., the “insurance in-force” portfolio). Variability in the returns on its invested assets, as well as uncertainty in the number and value of insurance claims pose risk to a mortgage insurer in achieving its business objectives, and may necessitate changes to underwriting criteria.

To support an assessment of risk, a FRMI should have in place a stress-testing regime that considers “exceptional, but plausible” events and scenarios and their impact on the asset- and liability-side portfolios. [19] Based on the assessment of risk, OSFI expects that a FRMI will consider appropriate adjustments to its mortgage insurance underwriting criteria (e.g., re-calibrating its criteria for mortgage loans) and premium schedules, as necessary, to align the FRMI’s underwriting activities and overall portfolio risk, with the aim of achieving its objectives, as outlined it its RMIUP. Stress testing should also 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.

To support portfolio risk management, stress testing activities, and overall assessment of risks, a FRMI should rely on accurate, updated information on its insured mortgage loans (e.g., current outstanding insured mortgage loan balances and other current, relevant information judged necessary by the FRMI).

Reinsurance

Reinsurance is often used as a risk mitigation strategy by insurers. However, reinsurance by a mortgage insurer (i.e., ceding risk to a reinsurer) should not be used as a substitute for sound mortgage insurance underwriting and for conducting adequate, ongoing due diligence on lenders and borrowers. A FRMI that seeks to reinsure the risks under its mortgage insurance policies should ensure compliance and consistency with applicable laws, regulations and relevant guidelines. [20]

Higher-Risk Insured Mortgage Loans

FRMIs have the flexibility to insure a wide range of residential mortgage loans with varying risk profiles. However, for a FRMI's insured residential mortgage loan portfolios that constitute greater risks (as defined by the FRMI), OSFI expects a FRMI to exercise heightened prudence through:

- Greater Senior Management oversight of higher-risk insured loans;
- Increased reporting to and monitoring of higher-risk insured loans by Senior Management;
- Clear, internally-set limits on the insurance of higher-risk mortgage loans consistent with the RMIUP;
- Stronger internal controls (e.g., additional substantiation of credit qualification information, enhanced credit approval processes, increased scrutiny by the risk management oversight function, etc.); and
- Increased oversight of lenders with originations concentrated in higher risk mortgages.

III. Guideline Administration

Disclosure 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.

FRMIs are expected to make public disclosures related to residential mortgage insurance. Such disclosures should be carried out on a quarterly basis, in a readily understandable format, and in a location generally available to the public.

The disclosures should include, but are not limited to, a breakdown of information for residential mortgage loans insured during the quarter [21], as well as the total stock of insured mortgage loans (except where noted), with further separation by mortgage insurance type (i.e., transactional- vs. portfolio-insured loans), for the following categories:

- **Volume**: The number and outstanding balance of insured mortgage loans;
- **Loan-to-Value**: A breakdown of insured mortgage loans according to LTV buckets of 5% increments (both estimated current LTV [22] and LTV at origination);
- **Amortization**: Amortization period ranges (e.g., 15 – 19.9 years, 20 – 24.9 years, ≥ 25 years, etc.) at origination and remaining amortization;
- **Geography**: Geographic breakdown by province and territory; and
- **Delinquencies**: Breakdown of the level of insured mortgage loan delinquencies (as a proportion for the total stock of insured mortgage loans, as at the end of the period).

FRMIs should also provide a discussion of the potential impact an economic downturn may have on insured residential mortgage loans.

Supervision of FRMIs

Information for Supervisory Purposes

Enhanced transparency and sound documentation will allow OSFI to better understand the FRMI's financial position and economic impacts and risks associated with a FRMI's residential mortgage insurance underwriting practices and procedures. A FRMI should maintain and provide to OSFI, upon request, its RMIUP and associated management reports. A FRMI should promptly inform OSFI if it becomes aware of any mortgage insurance underwriting issues that could materially impact its financial condition.

Non-compliance with the Guideline

OSFI supervises FRMIs in order to determine whether they are in sound financial condition and to promptly advise the FRMI Board and Senior Management in the event that the institution is judged not to be in sound financial condition or is not complying with supervisory requirements. OSFI is required to take, or will require the Board and/or Senior Management to take, necessary corrective measures to deal with prudential soundness issues in an expeditious manner and to promote the adoption of policies and procedures designed to control and manage risk by Senior Management and Boards.

Where a FRMI fails to adequately account and control for the risks of underwriting insurance for residential mortgage loans, on a case-by-case basis, OSFI can take, or require the FRMI to take, corrective measures. OSFI's actions can include heightened supervisory activity and/or discretionary authority to require the FRMI to adjust its capital, commensurate with the risks being undertaken by the FRMI.

IV. Other Guidance

This Guideline is complementary to, and should be read in conjunction with, other relevant OSFI guidance and the Government of Canada's mortgage insurance guarantee framework, including but not limited to:

- Corporate Governance Guideline;
- Guideline B-1 Prudent Person Approach;
- Guideline B-3 Sound Reinsurance Practices and Procedures;
- Guideline E-18 Stress Testing;
- Guideline E-19 Own Risk and Solvency Assessment; and
- *Protection of Residential Mortgage or Hypothecary Insurance Act*
    - *Eligible Mortgage Loan Regulations*
    - *Protection of Residential Mortgage or Hypothecary Insurance Regulations*.

Footnotes

1 For the purpose of this Guideline, an "insured residential mortgage loan" refers to a mortgage loan that is insured against loss caused by default on the part of a borrower, under a loan secured by real property (i.e., one- to four-unit dwellings) or chattel, or for a property that is on-reserve. 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 the purpose of this Guideline, "mortgage insurance" also includes mortgage loan *reinsurance*. The remainder of this Guideline makes reference only to "mortgage insurance," unless the distinction is required.

3 See the *Protection of Residential Mortgage or Hypothecary Insurance Act* (PRMHIA), the *National Housing Act* (NHA), and each of their associated Regulations, which outline the framework.

4 As part of the mortgage insurance guarantee framework, the Government of Canada sets limits on certain mortgage insurance underwriting parameters (e.g., loan-to-value, debt service ratios, credit scores, etc.), as well as other requirements for loans that are eligible for government-backed mortgage insurance.

5 The FRMI should separately outline the underwriting criteria and filtering process for insuring mortgage loans on a transactional and portfolio basis.

6 A FRMI's requirements for lenders for mortgage insurance coverage are often outlined in a mortgage insurance Master Policy Agreement.

7 The FRMI's insurance coverage documents should separately outline the requirements and conditions for lenders that originate loans and for companies (or lenders) that service loans. The remainder of this Guideline makes reference only to "lenders" unless the distinction is required.

8 Refer to OSFI's Corporate Governance Guideline for additional guidance in this area.

9 OSFI expects a higher level of due diligence by a FRMI in respect of the assessment of any lenders that are not prudentially regulated.

10 A FRMI's "criteria for mortgage loans" are often referred to by industry participants as "underwriting guidelines".

11 In all cases, the criteria must be consistent with applicable laws and regulations, such as those established by the Government of Canada for insured mortgages made under the PRMHIA. For example, see the *Eligible Mortgage Loan Regulations* under the *Protection of Residential Mortgage or Hypothecary Insurance Act*.

12 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. OSFI expects a FRMI to exercise increased oversight, control, and reporting in respect of such transactions.

13 OSFI encourages the use of an industry-wide standard for the calculation of debt service coverage ratios. The CMHC definitions of GDS and TDS have emerged as an industry standard. Thus OSFI expects FRMIs to use these ratios as input for determining whether to insure residential mortgage loans. This does not limit a FRMI's ability to use additional debt serviceability measures for the purposes of reducing risk.

14 For the purposes of calculating debt serviceability, OSFI expects that the minimum qualifying interest rate used should satisfy the requirements set out in the Government of Canada's mortgage insurance guarantee framework. For example, see the subsections on Debt Service Ratio Calculations contained in the *Eligible Mortgage Loan Regulations* of the *Protection of Residential Mortgage or Hypothecary Insurance Act*.

15 Where third-party appraisers are used for valuation, FRMIs should ensure that appraisals are prepared with 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.

16 On-site reviews may be particularly useful in helping a FRMI determine whether a mortgage lender's underwriting practices simply meet the "letter" of the insurance contract, or whether the practices are robust, comprehensive, and fully meet the *intent* of the insurer's criteria and requirements.

17 While the expectations established in this section relate to reviews of qualified lenders, FRMIs should also have in place similar processes for any activities outsourced to third parties, on a repeat basis (e.g., property appraisers).

18 In particular, reviews should be undertaken by a group that is separate from the FRMI's underwriters.

19 See OSFI Guideline E-18 Stress Testing for further background.

20 The PRMHIA and its associated Regulations outline reinsurance restrictions and exceptions applicable to "approved mortgage insurers". See section 4 of the PRMHIA Regulations. OSFI Guideline B-3 Sound Reinsurance Practices and Procedures also outlines sound reinsurance practices and procedures.

21 At a minimum, a FRMI should disclose insured mortgage loan information for the most recent quarter (MRQ), the quarter previous to the MRQ, and for the same period as the MRQ, in the prior year.

22 A FRMI should provide a description of how "estimated current LTV" is calculated as part of its disclosures. This includes the methods used to estimate the value of the properties underlying outstanding mortgage loans.