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**AUTORITÉ
DES MARCHÉS
FINANCIERS**

RESIDENTIAL HYPOTHECARY LENDING GUIDELINE

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Preamble

The *Autorité des marchés financiers* (“AMF”) has established this guideline setting out its expectations with respect to financial institutions’ legal requirement to follow sound and prudent management practices. The guideline therefore covers the interpretation, execution and application of this requirement.

The AMF favours a principles-based approach rather than a specific rules-based approach. As such, guidelines provide financial institutions with the necessary latitude to determine the requisite strategies, policies and procedures for implementation of such principles and to apply them based on the nature, size and complexity of their activities. In this respect, a guideline provides guidance on how to comply with the principles set out therein.

The AMF considers governance, integrated risk management and compliance (GRC) as the foundation stones for sound and prudent management practices and, consequently, as the basis for the prudential framework provided by the AMF.

This guideline is part of this approach and sets out the AMF’s expectations regarding sound and prudent residential hypothecary lending management practices.

Introduction

Poor residential hypothecary (mortgage) lending practices may, particularly through the securitization of such loans, give rise to a systemic risk that threatens financial market stability and investor and borrower protection.

In order to limit the risks the hypothecary market poses to market stability, improve investor protection, avoid consumer over-indebtedness and reduce the risk of real estate bubbles, in April 2012 the *Financial Stability Board* (the “FSB”) published principles¹ applicable to any loan to an individual that is secured by a hypothec on residential property.² They also apply to home equity lines of credit, term loans and other similar products secured by residential property.³ These principles will also allow regulators to monitor lending practices more effectively and detect or prevent any deficiencies.

The document published by the FSB therefore calls on regulators in all jurisdictions to ensure that financial institutions that originate such loans or intend to own the resulting risk adhere to these principles, including entities involved in outsourcing⁴ of residential hypothecary lending operations.

It is important that the AMF support this initiative and ensure that oversight of institutions active in its jurisdiction satisfies the assessment criteria “recognized” by the international financial community. This approach will foster the competitiveness of financial institutions with hypothecary lending operations in Québec, particularly when they seek to securitize their residential hypothec⁵ or turn to hypothec insurance.⁶

In this context and pursuant to the authority⁷ conferred upon the AMF under the various sectorial statutes it administers, it is issuing this guideline to set out its expectations arising from financial institutions’ legal requirement to follow sound and prudent residential hypothecary lending management practices.

¹ Financial Stability Board, FSB, Principles for Sound Residential Mortgage Underwriting Practices, April 2012.

² Residential hypothecary loan on a property with one to four unit dwellings.

³ Some or all of the principles will not apply to certain types of financing, such as reverse hypothecs and bridge financing which are to be repaid from the proceeds of sale of the property.

⁴ *Autorité des marchés financiers, Outsourcing Risk Management Guideline*, Revised, December 2010.

⁵ *Autorité des marchés financiers, Securitization Risk Management Guideline*, April 2009.

⁶ Type of insurance where the lender is compensated for the loss caused by the default of the borrower under a loan secured by a residential property.

⁷ *An Act respecting insurance*, R.S.Q., c. A-32, ss. 325.0.1 and 325.0.2;
An Act respecting financial services cooperatives, R.S.Q., c. C-67.3, s. 565;
An Act respecting trust companies and savings companies, R.S.Q., c. S-29.01, s. 314.1.

Scope

This guideline is intended for insurers of persons (life and health), damage insurers, portfolio management companies controlled by an insurer, mutual insurance associations, financial services cooperatives as well as trust and savings companies, which are governed by the following Acts:

- *An Act respecting insurance*, R.S.Q., c. A-32
- *An Act respecting financial services cooperatives*, R.S.Q., c. C-67.3
- *An Act respecting trust companies and savings companies*, R.S.Q., c. S-29.01.

This guideline applies to financial institutions operating independently as well as to financial institutions operating as part of a financial group.⁸

In the case of financial services cooperatives and mutual damage insurance associations that are members of a federation, the standards or policies adopted by the federation should be consistent with—and even converge on—the principles of sound and prudent management detailed in this guideline.

The generic terms “financial institution” and “institution” refer to all financial entities covered by the scope of this guideline.

⁸ For purposes of this guideline, “financial group” refers to any group of legal persons composed of a parent company (financial institution or holding company) and legal persons affiliated therewith.

Coming into effect and updating

This residential hypothecary lending guideline will come into effect on month xx, 20XX.

With respect to the legal requirement of institutions to follow sound and prudent management practices, the AMF expects each institution to develop strategies, policies and procedures based on its nature, size, complexity and risk profile, to ensure the adoption of the principles underlying this guideline by month XX, 20XX. Where an institution has already implemented such a framework, the AMF may verify whether it enables the institution to satisfy the requirements prescribed by law.

This guideline will be updated based on changes in residential hypothecary lending industry practices, developments in risk management and in light of the AMF's observations in the course of its supervision of financial institutions.

Governance of residential hypothecary lending or acquisition operations

1. Roles and responsibilities of the board of directors and senior management

The AMF expects residential hypothecary lending or acquisition operations to be supported by effective and efficient governance.

In light of the respective roles and responsibilities incumbent upon them under the Governance Guideline,⁹ senior management is responsible, among other things, for developing, implementing and ensuring compliance with the residential hypothecary lending policy, and the board of directors is responsible for reviewing and approving the policy and providing guidance to, and oversight of, senior management with respect to matters relating to residential hypothecary lending and management of the related portfolio.

In particular, the AMF expects the institution's board of directors to:

- Review and understand all changes to policies established with respect to residential hypothecary lending or the acquisition of residential hypothecary loan assets, and their potential impact on the institution;
- Question senior management in order to obtain reasonable assurances that orientations, decisions, plans and policies are consistent with the board's own decisions and board-approved business and risk management strategies;
- Be aware of, and be satisfied with, the method used to identify, approve and monitor material exceptions to policies and controls related to such loans. Furthermore, it should be kept informed of the consequences and remedial measures implemented when exceptions are identified; and
- Require timely, accurate, independent and objective reporting on risks in all residential hypothecary lending and acquisition operations, across all jurisdictions in which the institution operates (e.g., trends and systemic issues within the residential hypothecary portfolio that may impair loan quality, risk mitigation factors or effectiveness of models).

⁹ *Autorité des marchés financiers, Governance Guideline, April 2009.*

2. Residential hypothecary lending policy

The AMF expects a financial institution that originates residential hypothecs and/or acquires residential hypothecary loan assets to comply with a board-approved policy.¹⁰

The board of directors and senior management have the primary responsibility for developing a risk management framework to address the various types of risks to which an institution is exposed.¹¹ With respect to institution-wide risk management strategies, risk appetite and risk tolerance, the AMF expects the residential hypothecary lending policy to take various elements into account, including:

- The roles and responsibilities of individuals charged with overseeing and implementing the policy;
- Significant elements of the strategy and approach to residential hypothecary lending or the acquisition of residential hypothecary loan assets (e.g., products, markets);
- At the portfolio level, risk management practices and processes with respect to residential hypothecary loans and loan assets, including limits on lending, the securities acquired, the types of products, and geographic zones;
- At the individual loan level, financing standards, lending or acquisition eligibility limits and criteria for all residential hypothecary products (e.g., borrower's credit score, loan-to-value ratio, debt service coverage ratio, amortization period);
- Limits on any residential hypothecary lending or acquisition exceptions; and
- Identification and reporting processes for such exceptions, including a process for the approval and communication of exceptions.

¹⁰ The policy can be set out in a single document or in a set of strategic documents governing residential hypothecs or it can be included in a general credit policy.

¹¹ *Autorité des marchés financiers, Integrated Risk Management Guideline, April 2009.*

Residential hypothecary lending process and procedures

When assessing a residential hypothecary application, the principal criteria an institution should take into consideration are the identity of the borrower, the purpose of the loan, the borrower's credit history, financial situation and ability to repay the loan, as well as the quality, adequacy and appropriateness of guarantees.

These criteria should be evaluated by the institution using a holistic approach designed to identify actual and potential risks in accordance with the parameters of its policy. However, guarantees, including a suretyship or reliance on hypothec insurance, should not replace the borrower's demonstrated willingness and capacity to service debt obligations on a timely basis or a poor credit history as the primary basis for the institution's decision.

The process should also contain requirements as to the analysis and validation of information obtained about the borrower before the residential hypothec is granted. The same applies to the evaluation of guarantees.

3. Collection and validation of information about the borrower

The AMF expects the financial institution to collect and, where necessary, validate all information about the borrower necessary for its decision.

3.1 Identity of the borrower and purpose of the loan

As part of the institution's assessment, it should obtain sufficient information about the borrower, namely, elements such as integrity, reputation, career profile, employment stability, residential stability and evidence of proper administrative and financial management. The institution should also remain vigilant so as to detect whether the loan is liable to be used for illicit purposes or if there are reasonable grounds to suspect such use.¹²

3.2 Background and credit history of the borrower

The institution should make reasonable enquiry into the background, credit history, and consumption patterns of a prospective borrower in order to assess the borrower's willingness to service debt obligations on a timely basis.

¹² Autorité des marchés financiers, *Financial Crime Risk Management Guideline*, June 2012.

In this respect, institutions routinely refer to credit bureau scores. A credit score should be required particularly where the prospective borrower has no credit references, has been on the labour market a short time or seems to have high spending habits or where there is a doubt as to the validity of the information provided by the borrower.

However, a credit score given to a borrower by one of the major credit bureaus should not be the sole criterion relied upon to assess the borrower's qualification. Such an indicator only measures past behaviour and does not necessarily take into account the most recent changes in the borrower's financial condition nor the borrower's willingness to service debt obligations in a timely manner.

3.3 *Income verification*

A borrower's income is a key factor in the assessment of the borrower's capacity to repay the residential hypothec. The institution should take reasonable steps to verify the borrower's income, particularly by confirming the borrower's employment status and prior income. These steps should be adapted according to the categories of borrowers.

The borrower's income history should be sufficient to allow the institution to identify any income fluctuations.

3.4 *Joint borrowers or sureties*

Where an institution obtains a suretyship or a joint borrower supports the loan application, the institution should also verify the surety's or joint borrower's situation, including income and net worth, and satisfy itself that the surety or joint borrower fully understands his or her legal obligations.

3.5 *Borrower's consent*

The institution should obtain the consent of the borrower (the surety or the joint borrower, as applicable) before assessing the borrower's situation, and it should comply with the requirements of *An Act respecting the protection of personal information in the private sector*,¹³ particularly when communicating personal information to third parties.

¹³ R.S.Q., c. P-39.1.

4. Assessment of borrower's capacity to repay the loan

The AMF expects the financial institution to adequately assess the borrower's capacity to service debt obligations on a timely basis without this placing an excessive burden on the borrower.

4.1 Debt service coverage ratio

A fundamental component for minimizing the risk of default or loss is an accurate assessment of the borrower's financial capacity to repay the residential hypothec sought and all other indebtedness, whether or not secured, the borrower has with a financial institution or other lender.

The institution should calculate the borrower's repayment capacity by applying the most commonly used ratios, namely the gross debt service ("GDS") ratio and the total debt service ("TDS") ratio. The factors used to compute these ratios (including the method to calculate these factors) and the institution's maximums for these two ratios should be set out in its policy and be reviewed, as necessary, to reflect varied financial and economic conditions.

Where the institution decides to use hypothec insurance, it should satisfy itself that the parameters set by it for the GDS and TDS ratios satisfy those of the Government of Canada's hypothec insurance guarantee framework. For example, this guarantee framework requires that for all variable interest rate hypothecs, regardless of the term, and fixed rate hypothec with a term less than the standard five-year term, institutions use the greater of the contractual hypothec rate or the five-year benchmark rate published by the Bank of Canada.

The AMF expects the average GDS and TDS scores for all residential hypothec originated or acquired by an institution to be less than the maximums stated in the institution's policy and reflect a reasonable distribution across the portfolio.

4.2 Other assessment criteria

In addition to income and debt service coverage, the institution should take into consideration other factors that are not ordinarily captured by debt amortization parameters. These include recurring payment obligations (e.g., electricity, condominium fees), property costs (municipal and school taxes) for the residential property used as collateral and current and expected living expenses based on the composition of the household.

Temporarily high income should not be taken into consideration. Moreover, if the borrower will reach the usual age of retirement during the term of the loan, the institution should satisfy itself that the borrower's income during retirement will allow the borrower to pay his or her debts.

4.2.1 Down payment

A down payment should come from the borrower's own funds. It should not affect the borrower's payment capacity. If all or part of the down payment originates from a gift to the borrower, it should be accompanied by a letter from the donor confirming no recourse. Incentive and rebates payments (i.e., "cash back") should not be considered part of the down payment.

4.3 Amortization period

The hypothecary amortization period has a significant impact on principal and interest payments. It affects the borrower's repayment capacity, the speed of repayment of the loan and the growth of equity in the borrower's property.

The AMF expects the average amortization period for the institution's residential hypothecary loans to be less than the maximum stated in its policy.

5. Appraisal of the residential property and management of collateral

<p>The AMF expects a financial institution to have sound processes for appraising the residential property and managing the collateral.</p>

5.1 Appraisal of the residential property

An objective appraisal of the value of the residential property should allow the institution to confirm that it will be able to collect any unpaid balance on its loan if the borrower defaults and give the borrower some assurance as to the quality of his or her investment.

The appraisal process should be based on clear and transparent valuation policies and procedures. In addition, it should be structured and efficient and provide for an appraisal that is independent of the lending decision itself, particularly for higher-risk loans or loans with a relatively high loan-to-value ratio.

In assessing the value of a residential property given as collateral, the institution should therefore adopt a combination of valuation tools and processes (property appraisal, automated valuation tools, on-site visits, appraisal by an outside chartered appraiser) it can use depending on the level of risk assumed.

5.1.1 Property appraisal

Where the institution is relying on a property appraisal¹⁴ to establish the value of the residential property, it should conduct an on-site inspection by using a qualified employee (e.g., building technician, architect, engineer, appraiser) to report on the quality of the construction, the property's condition and its occupancy rate, where appropriate, with substantiating photographs. The employee should be independent from the hypothec acquisition, loan processing and loan decision processes.

Moreover, the institution should assess, and adjust if appropriate, the value of the property by taking into account relevant risk factors that make the property more vulnerable to a significant house price correction or that may affect the marketability of the property. These factors include the location of the property, the type of property and its use.

5.1.2 Automated valuation tools

Where the institution has decided to rely on an in-house appraisal using an automated valuation tool, the valuation should also be supported by an on-site visit.

Furthermore, the institution should establish processes to monitor the on-going effectiveness of the automated valuation tools in representing the market value of the residential properties accepted as collateral. Controls should also be put into place to ensure that the tools are being used appropriately by the institution's staff.

5.1.3 Appraisal by a chartered appraiser

Where the loan involves greater risks (refinancing, major renovation, high loan-to-value ratio), the institution should require an evaluation report prepared in a reliable, diligent and impartial manner by an outside appraiser with the necessary professional appraisal skills. The appraiser should hold a licence in good standing from a recognized professional regulatory and oversight organization¹⁵ and be governed by professional standards of practice and a code of ethics.

5.2 Management of collateral

The institution should ensure that the right to exercise its collateral is legally enforceable and can be realized in a reasonable period of time or, absent that verification, ensure that title insurance from a third party is in place.

¹⁴ In Québec, the value entered on the property assessment roll established under *An Act respecting municipal taxation*, R.S.Q., c. F-2.1.

¹⁵ In Québec, the *Ordre des évaluateurs agréés*. In Canada, the Appraisal Institute of Canada.

The institution should impose contractual terms that ensure full protection for its collateral under the laws applicable in the jurisdictions in which it operates, and seek to preserve an appropriate variety of recourses (including, where applicable, actions on personal undertakings) should the borrower default. In addition, the institution should have the necessary action plans in place to determine the best course of action should the borrower default. Such action plans should cover:

- The recourses/options available in the event of default in all the jurisdictions in which it operates;
- The identification of the parties against whom these recourses may be exercised; and
- A prudentially sound strategy for exercising these options.

6. Loan-to-value ratio

The institution should determine a maximum loan-to-value (“LTV”) ratio for various types of loans (e.g., traditional residential mortgages, home equity lines of credit). These LTV ratios should be set out in its policy and be reviewed, as necessary, to reflect varied financial and economic conditions.

At the individual loan level, other risk factors, such as the prospective borrower’s repayment capacity, potential difficulties envisaged when repossessing the property or repossession costs, can also affect the LTV ratio.

6.1 *Traditional residential mortgages*

The AMF expects the institution to require mortgage insurance when a traditional mortgage loan¹⁶ to be granted for the purchase and/or renovation of a residential property has a LTV ratio greater than 80%.

Moreover, the AMF believes the institution should impose a lower maximum LTV ratio for residential mortgages that do not conform to its policy, or those where the attributes of the property or the risk profile of the borrower present a higher-than-average credit risk.

The AMF expects the average LTV ratios for all residential mortgages originated or acquired by an institution to be less than the maximum LTV ratios stated in the institution’s policy and reflect a reasonable distribution across the portfolio.

¹⁶ Including loans with a specified amortization period that are secured with a second mortgage (i.e. second-ranking mortgage).

6.2 Home equity lines of credit

A home equity line of credit¹⁷ (“HELOC”) is a form of non-amortizing (revolving) credit that is secured by a residential property. It does not have a pre-determined amortization period, although minimum periodic payments are generally required by most institutions.

HELOC products provide a source of funds for consumers. Over time, these products can significantly add to their debt loads. Moreover, their revolving nature can also lead to greater persistence of outstanding balances and greater risk to institutions. As well, borrowers may conceal potential financial distress by drawing on their lines of credit to make timely hypothecary payments and, consequently, present a challenge for institutions to accurately assess credit risk exposure.

Given these attributes, the AMF expects the institution to limit the non-amortizing HELOC component of a residential hypothec to a maximum LTV ratio of 65%.

The AMF expects the average LTV ratios for all HELOCs to be less than the maximum LTV ratios stated in the institution’s policy and reflect a reasonable distribution across the portfolio.

7. Hypothec Insurance

The AMF expects a financial institution to have effective credit and counterparty risk management practices and procedures that support residential hypothecary lending and loan asset portfolio management, including, as appropriate, hypothec insurance.

Hypothec insurance is often used as a risk mitigation strategy. However, this type of insurance should not be a substitute for the institution’s sound lending practices as set out in this guideline.

Moreover, the institution should act with due diligence when it decides to obtain hypothec insurance from a public or private insurer, by establishing and abiding by its level of exposure to that insurer. When analyzing the hypothec insurers it may use and establishing its level of exposure to each, the institution should take the following into account:

- Claims payment record;
- Expected claims obligations;
- Financial soundness;

¹⁷ For purposes of the loan-to-value ratio, reverse hypothecs and other non-amortizing (revolving) products secured by residential property are considered to be home equity lines of credit.

- Funding sources, including the level of, and access to capital, and form, amount and sources of liquidity;
- Management, including the quality of its governance; and
- Reinsurance arrangements and the direct and indirect impact they may have on the institution's own arrangements with the insurer.

This evaluation should be updated throughout the life of the insurance contract. In cases where there may be material exposures in respect of losses sustained but not reported, the institution's management should continue the evaluation beyond the expiration date of the contract to ensure that the institution establishes potential insurance recoverable from expected future claims.

8. Loan documentation

The AMF expects the institution to maintain loan documentation that will allow an independent third party to confirm the application of, and compliance with the institution's hypothecary lending policy, including established control procedures.

Maintaining sound loan documentation is an important administrative function for institutions. It provides a clear record of the factors behind the credit granting decision, supports the institution's risk management functions, permits independent review by the institution and allows staff in charge of granting credit to make sound and informed decisions. It substantiates the credit review and granting process. It shows whether or not the loan was properly administered and monitored. It clarifies the collateral valuation and loan disbursement processes. It also allows the institution to categorize loans based on its portfolio classification system.

As well, the institution should maintain such documentation to demonstrate compliance with hypothec insurance requirements and ensure insurance coverage remains intact.

The documentation should include:

- Identity of the borrower and description of the purpose of the loan (e.g., purchase, refinancing, renovation, debt consolidation) (see principle 3);
- Background and credit history of the borrower (see principle 3);
- Analysis of the borrower's financial condition, including income verification (see principle 3) and assessment of the borrower's capacity to repay the loan (see principle 4);
- Description of the collateral, the basis for assessing its value and evidence of its marketability and condition (see principle 5);

- Description of material risks and mitigating factors;
- Rationale for the decision, including rationale for any exceptions to the policy and established standards;
- Required signatures of authorized individuals;
- Documentation used to analyze the loan application and collateral;
- Documentation evidencing validation of information (title search, review of tax accounts, bank verifications, credit check, etc.);
- Documentation evidencing the down payment (as applicable) or use of the sums as authorized; and
- A record from the hypothec insurer validating approval of the hypothec insurance where there is an exception to the lending policy.

Other factors

9. Model validation and stress testing¹⁸

Institutions often use models to help make residential hypothecary lending or acquisition decisions.

Institutions should apply an independent validation process for these models both at inception and on a regular basis. The process should include the regular review and updating of risk parameters with respect to their hypothecary portfolio. The models used should reflect the nature of the portfolio and, as appropriate, be adapted if there is substantial variation of risk within the portfolio. This approach could include the development of new models to capture specific risk segments.

Moreover, the institution's stress testing program should consider unlikely, but plausible, scenarios and their potential impact on the residential hypothecary portfolio. The results of such stress testing should also be considered in the on-going validation of models and be reflected in the institution's internal capital adequacy assessment process.

10. Provisions relating to financial disclosure

Financial disclosure about institutional hypothecary portfolios bolsters public confidence and improves market discipline. It allows market participants, including institutions that are considering owning the risk resulting from loans originated by another institution, to perform reasonable due diligence with respect to the other institution's operations in that sector.

Financial disclosure related to residential hypothecs should include quarterly publication by institutions that originate or acquire residential hypothecs, in a format and location that fosters availability to and understanding by the public, of the following:

- The amount and percentage of the total residential hypothecary loans and HELOCs that are insured versus uninsured. This should include the definition of "insured." A geographic breakdown for the amount and percentage of the total residential hypothecary loans and HELOCs that are insured versus uninsured;
- The percentage of residential hypothecs that fall within various amortization period ranges significant for the institution (e.g., 20-24 years, 25-29 years, 30-34 years, 35 years and greater);
- The average LTV ratio for newly originated and acquired uninsured residential hypothecs and HELOCs at the end of each period. A geographic breakdown for the average LTV ratio for newly originated and acquired uninsured residential hypothecary loans and HELOCs at the end of each period; and
- A discussion of the potential impact on residential hypothecs and HELOCs in the event of an economic downturn.

In order to meet financial disclosure requirements, the presentation of foreign operations should be grouped into a separate category, such as "other jurisdictions."

¹⁸ *Autorité des marchés financiers, Stress Testing Guideline, June 2012.*

Supervision of sound and prudent management practices

To foster the establishment of sound and prudent management practices within financial institutions, the AMF, acting within the scope of its supervisory activities, intends to assess the degree of compliance with the principles set forth in this guideline in light of the specific attributes of each institution. Consequently, it will examine the effectiveness and relevance of the strategies, policies and procedures adopted by financial institutions as well as the quality of oversight and control exercised by their board of directors and senior management.

Residential hypothecary lending risk management practices are constantly evolving. The AMF therefore expects decision makers at financial institutions to remain current with best practices and to adopt such practices, to the extent that they address their needs.