

DRAFT



**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. However, this guideline differs ~~from those published previously~~ in that it places more emphasis on the execution of the legal obligation ~~and~~ **than on** its interpretation, in order to ensure harmonization with rules developed across ~~the country~~ **Canada**.

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

Residential hypothecary (mortgage) lending constitutes an important activity for many financial institutions. Hypothec markets play a predominant role in the economy. Poor residential hypothecary lending practices may have serious consequences for institutions and give rise to a systemic risk that threatens financial market stability.

In this regard, in April 2012 the *Financial Stability Board* (the “FSB”) published principles¹ applicable to any consumer loan that is secured by a hypothec on residential property.² These principles also apply to home equity lines of credit, term loans and other similar products secured by residential property.³

Pursuant to the authority⁴ conferred upon it under the various sectorial statutes it administers, the AMF 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.

The AMF expects financial institutions that originate such loans or intend to own the resulting risk to adhere to these principles, including entities involved in outsourcing⁵ of residential hypothecary lending operations. This will facilitate some of their operations, including when deciding to use hypothec insurance⁶ for their residential hypothecary loans or to securitize⁷ their residential hypothecary loans in order to generate liquidities.

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

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

³ — Some of the principles will not apply to certain types of financing. For example, the principle relating to the assessment of the borrower’s capacity to repay the loan does not apply to reverse hypothecs and bridge financing since they are to be repaid from the proceeds of sale of the property.

⁴ — *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.

⁵ — *Autorité des marchés financiers*, *Outsourcing Risk Management Guideline*, Revised, December 2010.

⁶ — Type of insurance whereby the insurer undertakes to indemnify an insured creditor against loss resulting from failure on the part of a debtor to repay a loan secured by a movable or immovable hypothec.

⁷ — *Autorité des marchés financiers*, *Securitization Risk Management Guideline*, April 2009.

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~~ statutes:

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

This guideline applies to financial institutions operating independently as well as ~~to financial institutions~~ those 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.⁹

The generic terms “financial institution” and “institution” refer to all financial entities covered by the scope of this guideline. ~~The generic term “consumer” is used in this guideline and refers to consumers of products and financial services.~~

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 with it.

⁹ Mutual insurance associations are damage insurers covered by this guideline.

Coming into effect and updating

~~This residential hypothecary lending guideline will come~~ The *Residential Hypothecary Lending Guideline* came into effect on January 1, 2013.

With respect to the legal requirement of institutions to follow sound and prudent management practices, the AMF expects each institution that originates or acquires residential hypothecs to ~~develop~~ adopt the principles of the initial version of the guideline in developing strategies, policies and procedures based on its nature, size, complexity and risk profile, and to ~~ensure the adoption of the principles underlying this guideline no later than June 30,~~ have been applying them since June 30, 2013. ~~Where an institution has already implemented such a framework, the AMF may verify whether it enables to satisfy the requirements prescribed by law.~~

~~This guideline will be~~ To reflect the evolution of hypothecary markets and the principles of sound and prudent management, this guideline has been updated ~~based on~~ to come into effect in March 2018. If an institution has already set up such a framework, the AMF may verify whether it complies with the legal requirements.

As mentioned in the initial version of this guideline, changes in ~~residential hypothecary lending~~ industry practices practice regarding the granting of residential hypothecary loans or insurance on these loans, developments in risk management and ~~in light of~~ the AMF's observations in the course of its supervision could lead to other changes to this guideline.

Introduction

of

Residential hypothecary (mortgage) lending constitutes an important activity for many financial institutions and this market plays a key role in the economy. Poor lending practices could cause serious consequences for institutions and give rise to a systemic risk that threatens financial market stability.

In this context the AMF is issuing this guideline to set out its expectations regarding the granting of residential hypothecary loans stemming from the legal requirement to follow sound and prudent management practices.¹⁰ The goal is to control the risks posed by this activity and better protect borrowers and investors.

For the purpose of this guideline, a “residential hypothecary loan” or “residential mortgage” includes any loan to an individual¹¹ that is secured by residential property (i.e., one to four-unit dwellings). This guideline also covers home equity lines of credit, term loans and other similar products secured by residential property.

The AMF expects financial institutions that originate such loans or

¹⁰ *Act respecting insurance*, CQLR, c. A-32, sections 325.0.1 and 325.0.2;
Act respecting financial services cooperatives, CQLR, c. C-67.3, section 565;
Act respecting trust companies and savings companies, CQLR, c. S-29.01, s. 314.1.

¹¹ This includes an individual borrower, personal investment company, personal holding company or personal trust. It does not include commercial loans, including loans to entities investing in residential properties or transactions in connection with which a residential property is used to support a commercial loan application.

1. — acquire assets related to such loans to adhere to these principles. This will facilitate some of their operations, including when deciding to use hypothec insurance for their residential hypothecary loans or to securitize their residential hypothecary loans in order to generate liquidities.

1. Governance of residential hypothecary lending or acquisition operations

1.1 ~~Principle 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.~~

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

The board of directors and senior management have ~~the~~ primary responsibility for developing ~~a risk~~ the integrated management framework ~~to address~~ for the ~~various types of~~ risks to which ~~an~~ the institution ~~is~~ may be exposed. In this sense, the board of directors ~~actively participates in the choice, review~~ reviews and ~~approval of~~ approves the integrated risk management strategies developed by senior management.

More specifically, concerning residential hypothecary lending or acquisition operations, the AMF expects the board of directors to:

- ~~Question~~ question senior management in order to obtain ~~reasonable assurances~~ assurance that orientations, decisions, ~~business~~ plans and policies are consistent with the ~~board's~~ decisions and ~~board-approved~~ business and risk management strategies; ~~approved by the board~~;
- ~~Analyze~~ analyze the policy and understand any change made to it and its potential impact on the institution;
- ~~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~~ receive timely, accurate, ~~timely~~ and independent reporting on ~~risks in all residential hypothecary lending~~ risks, across all jurisdictions in which the institution operates (~~e.g. such as trends and systemic issues within the residential hypothecary portfolio that may impair loan quality, risk mitigation factors or effectiveness of models for decision-making~~ models used), including the effectiveness of control mechanisms in place to manage risk and ensure the overall effectiveness of the management processes;

- ~~Principle 2 — Residential~~ be aware of and satisfied with the method used to identify, approve and monitor material exceptions to policy and controls applied to such loans;
- be aware of the practices, procedures and controls for the granting or acquisition of residential hypothecary loans and be satisfied that they comply with the appropriate laws, regulations and guidelines.

1.2 Policy respecting residential hypothecary lending ~~policy~~ or acquisition.

The AMF expects a financial institution that originates residential hypothecs or acquires residential hypothecary loan assets to comply with a policy implemented in accordance with this guideline.

The policy may take the form of a single document or a set of ~~strategic~~ documents governing residential hypothecary lending.

The AMF expects the ~~residential hypothecary lending~~ policy to ~~result from institution-wide risk management strategies and~~ take various elements into account, including:

- ~~The~~ the roles and responsibilities of individuals charged with implementing and overseeing the policy;
- ~~Significant~~ significant elements of the institution's strategy and approach to residential hypothecary lending or the acquisition of residential hypothecary loan assets (~~e.g.~~ products, markets), etc.);
- ~~Risk management practices and processes, including limits on lending, the securities acquired, types of products and geographic concentration.~~
- ~~At~~ at the individual loan level, financing standards, acceptable lending or acquisition limits and criteria for all residential hypothecary products (~~e.g.~~ and all types of loans, whether conforming or non-conforming (such as borrower's credit score, loan-to-value ratio, debt service coverage ratio, and amortization period));¹²
- ~~Limits on any residential hypothecary lending or acquisition exceptions; and~~
- ~~Identification~~ at the portfolio level, risk management practices and internal control mechanisms, including limits (with respect to lending, acquisition, products and geographic concentration, etc.) and other relevant parameters such as borrower/property characteristics;

¹² Non-conforming mortgage loans generally have higher-risk attributes or deficiencies relative to other mortgages. In general, the expression "non-conforming," as defined by the institution in its residential hypothecary lending policy, should focus on risk and could include loans where income was not sufficiently verified, loans with a low credit rating or high debt servicing rates, hypothecary loans with increased credit risk due to the attributes of the property and any other loan with obvious deficiencies compared with conforming residential hypothecary loans.

- the processes for identifying and reporting ~~processes for its~~ exceptions to management, including a process for the approval and communication of exceptions;
- limits on any residential hypothecary lending or acquisition exceptions.

2. Residential hypothecary lending procedures

When assessing a residential hypothecary loan application, the principal criteria an institution should consider are the subject property, identity of the borrower and the borrower's credit history, income, financial condition and capacityability to repay the loan. The quality, adequacy and appropriateness of guarantees should also be taken into consideration.

The institution should evaluate these criteria using a holistic approach designed to identify and mitigate 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 as the primary basis for the institution's decision.

The procedures 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.

2.1 Principle 3—Collection and validation of information about the borrower

The AMF expects the financial institution to show reasonable diligence in collecting and validating information about the borrower which-supports to support its decision.

2.1.1 3.1—Identity of the borrower

The institution should obtain sufficient information about the borrower notably in order to determine whether he or she presents there is a risk of financial crime¹³, among other things.¹⁴

2.1.2 3.2—Credit history check of the borrower

The institution should make reasonable inquiry into a borrower's credit history in order to assess the likelihood of the borrower repaying the residential hypothec sought.applied for.

In this respect, institutions routinely refer to credit bureau scores to complete their analyses. 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 ability to service debt obligations in a timely manner.

¹³ — Autorité des marchés financiers, *Financial Crime Risk Management Guideline*, June 2012.

¹⁴ — AUTORITÉ DES MARCHÉS FINANCIERS, *Financial Crime Risk Management Guideline*, June 2012.

3.3 — Income verification**2.1.3 Verifying borrower's income and financial condition**

A borrower's income is a key factor in the assessment of the borrower's capacity to repay the residential hypothec. ~~Verification of income helps prevent and detect fraud~~The institution should thoroughly verify a borrower's income with reliable, well-documented sources to help detect and deter fraud or misrepresentations. Income that cannot be verified should be treated with caution when assessing a borrower's ability to repay the loan.

The ~~institution should take reasonable steps to verify the borrower's income. These steps (e.g. taken and documents obtained~~ (confirmation of the borrower's employment status and income, notice of assessment), etc.) should be adapted according to the category of borrower (e.g.:such as employee, self-employed worker, ~~permanent worker,~~ or seasonal worker) and the nature of the income (e.g.:such as salary, commissions, ~~bonuses, independent income, or investment income, net income from a real estate portfolio~~).

Income stability should also be taken into account in calculating a borrower's ability to repay the loan. ~~Conversely, temporarily~~Temporarily high income should be normalized or discounted. ~~The borrower's income history should be sufficient to allow the institution to identify any income fluctuations.~~

3.4—The analysis of the borrower's financial condition should corroborate the borrower's ability not only to repay debts on time but also to make other recurring payments and pay living expenses.

2.1.4 Down payment

The information gathered by the institution should allow it to determine the source of the borrower's ~~funds~~down payment, which should come from the borrower's own resources or savings, not from another source of credit, so ~~that~~ the borrower has an appropriate financial interest in the property to be given as collateral. ~~Where part or all of the down payment is gifted to a borrower, it should be accompanied by a letter from the person providing the gift waiving any recourse against the borrower.~~

~~Incentive~~Cash rebates and ~~rebate payments (i.e., "cash back")~~other incentives should not be considered part of the down payment.¹⁵

2.1.5 3.5 — Joint borrowers or sureties

Where an institution obtains a suretyship or where there is a joint borrower, the institution should perform ~~reasonable~~a thorough due diligence in verifying the surety's or joint borrower's credit history, income and financial condition, and satisfy itself that the surety fully understands his or her legal obligations.

¹⁵ Cash rebates and other incentives may be considered part of the down payment in cases related to affordable housing programs that are funded by a municipal, territorial, provincial or the federal government.

~~Principle 4~~**2.2 Assessment of borrower's capacity to repay the loan¹⁶**

The AMF expects the financial institution to adequately assess the borrower's capacity to service his or her debt obligations on a timely basis.

2.2.1 ~~4.1~~ Debt service coverage ratio

A fundamental component for minimizing the risk of default or loss is an adequate assessment of the borrower's financial capacity to repay the residential hypothec ~~sought~~ applied for 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 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 reviewed, as necessary, to reflect various financial and economic conditions, including changing interest rates. The calculation of these ratios should include, among other things, principal and interest, minimum periodic payments to be made based on the expected average use of revolving credit (e.g.: such as lines of credit, and credit cards) and recurring payments directly related to the hypothecated property (e.g.: such as heating costs, condominium fees and property taxes).

~~Where~~ For insured residential hypothecs, the institution ~~decides to use hypothec insurance, it~~ should satisfy itself that meet mortgage insurers' requirements regarding debt serviceability.

For uninsured residential hypothecs, the ~~parameters set by it for the GDS~~ institution should take into account economic conditions and ~~TDS~~, in calculating the debt service ratios ~~satisfy those of the hypothec insurance guarantee frameworks set up by the various mortgage insurance programs. Furthermore, to prevent the impact of a potential, use an interest rate increase on borrowers' ability to repay the loan, the interest rate used in calculating these ratios should be, for all variable interest rate hypothecs, regardless of the term, and fixed rate hypothecs with a term less than the standard five-year term, whether secured or not, at least equal to~~ the greater of the contractual hypothec rate plus 2% or the five-year benchmark rate published by the Bank of Canada.

The AMF expects the average GDS and TDS results for all residential hypothecs 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.

¹⁶ This section will not apply to certain types of financing, such as reverse hypothecs and bridge financing that are to be repaid from the proceeds of the sale of the property.

2.2.2 4.2—OtherAdditional assessment criteria

The institution should also take into consideration, *as appropriate*, other criteria that are not ordinarily included in debt service parameters (~~e.g. such as other~~ recurring payment obligations ~~such as condominium fees, alimony or student loan payments~~), and other living expenses).

2.2.3 4.3—Amortization period

The hypothecary amortization period is a significant element of the decision to grant credit. ~~It~~ affects the borrower's debt service, the speed of repayment of the loan and the growth of net 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.

~~Principle 5~~**2.3 Appraisal of residential property ~~value~~ and protection of collateral rights**

The AMF expects a financial institution to ~~lend~~ extend loans based on an adequate appraisal of the residential property and to protect its collateral rights.

2.3.1 ~~5.1~~ Appraisal of ~~value of~~ residential property

An adequate appraisal ~~of the value~~ of the residential property should allow the institution to ensure that it will be able to collect any unpaid balance on its loan if the borrower defaults. ~~It is one of the main tools the financial institution uses to control the level of risk it is willing to accept in its real estate portfolio.~~

The appraisal should be based on risk as well as clear and transparent valuation ~~polici~~ policies and procedures. ~~It should be supported by several valuation methods and tools (In determining the value of a residential property appraisal, the institution should adopt a combination of valuation tools and methods (such as property appraisal, automated valuation tools, on-site inspections, appraisal by chartered services of an outside appraiser) the institution can use and on-site visits) depending on the risks-level of risk assumed or inherent concerns regarding related to the financing or the property. It should critically review and, where appropriate, question the assumptions and methods underlying property appraisals.~~

~~Where circumstances warrant (e.g.:~~ Where the risks related to the loan (such as a high loan-to-value ratio and a debt service ratio close to the maximum) or the residential building (such as market-related risk ~~or~~, a relatively high loan-to-value ratio), ~~certain or the environment) are higher, the institution should use a broader and more cautious appraisal method. It could opt for an appraisal methods (e.g.:~~ by an outside appraiser using several valuation techniques. Other valuation methods such as property appraisal or an automated valuation tool) ~~should~~ can be combined with an on-site inspection to validate factors or physical features which could affect the value of the property ~~(e.g.: the quality of its location, its condition, occupancy rate and, ultimately, the existence of the property).~~

2.3.2 ~~5.1.1~~ Property appraisal Appraisals

Where the institution is relying on a property appraisal¹⁷ to establish the value of the residential property, it should adjust it if appropriate, ~~the value of the property by~~ taking into account relevant risk factors (such as the quality of its location, its condition, occupancy rate, zoning change, collapse of or rapid changes to the real estate market, deterioration of the neighbourhood, and the presence of hazardous materials) likely to make the property more vulnerable to a significant ~~house~~ housing price correction or affect its marketability.

¹⁷ - In Québec, the value entered on the property assessment roll established under ~~the~~ Act respecting municipal taxation, ~~R.S.Q., CQLR~~, c. F-2.1.

2.3.3 ~~5.1.2~~ Automated valuation tools

Where the institution has decided to rely on automated valuation tools, it should establish controls to ensure their ~~on-going~~ongoing effectiveness 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.

2.3.4 ~~5.1.3~~ Appraisal by an outside appraiser

Where the institution chooses to require an evaluation report by an outside appraiser, it should ensure that the person has the necessary professional skills and acts in a reliable, diligent and impartial manner. The appraiser should hold a valid licence from a recognized professional regulatory and oversight organization and be subject to professional standards of practice and a code of ethics.

2.3.5 ~~5.1.4~~ On-site inspection

In addition to the above-mentioned methods, if the institution conducts an on-site inspection, it should be performed by a qualified employee, depending on the nature of the property or the financing. The employee should be independent from the transaction related to the property and the loan decision process.

2.3.6 ~~5.2~~ Protection of collateral rights

The institution should ensure that its collateral rights are legally enforceable and can be realized in a reasonable period of time.

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~~range 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 provide in particular for the identification of the parties against whom these recourses may be exercised and a prudentially sound strategy for exercising these options.

~~Principle 6~~**2.4 Loan-to-value ratio**

The AMF expects financial institutions to limit their default risk exposure for loans secured by a residential property.

The institution should ~~determine a~~establish maximum loan-to-value (“LTV”) ratio limits for ~~all~~various types of hypothec transactions (such as conventional residential hypothecary ~~lending products~~loans, non-conforming hypothecary loans and home equity lines of credit). These maximum LTV ratios should be set out in the ~~lending~~ policy and reviewed, as necessary, to reflect financial and economic conditions or other risk factors which could affect ~~borrowers’ repayment capacity~~.a borrower’s ability to repay the loan. Potential difficulties envisaged by institutions when repossessing properties and repossession costs can also affect the maximum LTV ratio.

The LTV ratio should be ~~re-calculated~~recalculated upon any refinancing, and whenever deemed prudent, given changes to a borrower’s risk profile or delinquency status, using an appropriate valuation/appraisal methodology.

6.1 Traditional residential hypothecs

~~The AMF expects the institution to require hypothec insurance when a traditional hypothecary loan¹⁸ to be granted has a LTV ratio greater than 80%.~~

~~Moreover, the AMF believes the institution’s internal policies should provide for a maximum LTV ratio of 65% for eligible residential hypothecs that are non-compliant with its policy.¹⁹~~

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

6.2—The institution should not arrange (or appear to arrange) with another lender a hypothec or combination of a hypothec and other lending products (secured by the same property) in any form that circumvents its maximum LTV ratio or other limits in its policy. For greater clarity, an institution should not engage in any transactions (such as co-lending, bundling a mortgage loan with various priority interests, or any funding structure involving other secured loans) with other lenders where the combined LTV of the loans

¹⁸—~~Including loans with a specified amortization period that are secured with a second hypothec (i.e. second-ranking hypothec).~~

¹⁹—~~In general, the expression “non-compliant,” as defined by the institution, could include eligible non-performing loans, loans with a low credit rating or high debt servicing rates, hypothecary loans with increased credit risk due to the attributes of the property and any other loan with obvious deficiencies compared with compliant residential hypothecary loans.~~

secured against the property exceeds the institution's specific LTV limits established in its policy.

2.4.1 Conventional residential hypothecs

The AMF expects the institution to require hypothec insurance where a conventional hypothecary loan²⁰ to be granted has a LTV ratio greater than 80%.

2.4.2 Home equity lines of credit

A home equity line of credit²¹ ("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~~ HELOCs provide a source of funds for consumers. ~~Over time, these products can significantly add to the borrower and their debt loads. Moreover, their use can become a source of indebtedness. Their revolving nature can also lead to maintaining~~ continued outstanding balances and greater risk to institutions.

Given these attributes, the institution should ensure appropriate mitigation of the associated risks of HELOCs. It should exercise increased monitoring of borrowers' credit quality and grant this type of financing to borrowers who demonstrate proper administrative and financial management. ~~The institution should also revise downward the authorized amount of a HELOC where any material decline in the value of the underlying property has occurred or the borrower's financial condition presents higher risks.~~

The AMF expects the institution to limit the non-amortizing HELOC component of a residential hypothec to a maximum LTV ratio of 65%. ~~It 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.~~

²⁰ Including loans with a specified amortization period that are secured with a second hypothec (i.e. second-ranking hypothec).

²¹ 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.

~~Principle 7~~**2.4.3 Non-conforming loans**

The AMF expects the institution to impose a maximum LTV ratio of 65% for non-conforming residential mortgages. This threshold should not be used as a demarcation point below which sound lending practices and borrower due diligence do not apply.

In general, the maximum lending threshold for a non-conforming loan should decrease as the risk of the transaction increases (due to the presence of multiple higher-risk attributes or deficiencies in a loan application, the presence of higher risk factors related to property valuation, etc.).

2.5 Hypothec ~~Insurance~~ insurance

The AMF expects an institution's counterparty risk management practices and procedures to apply to hypothec insurance.

Although hypothec insurance may be used as a risk mitigation strategy, this type of insurance does not release the institution from its sound lending practices obligations 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 commensurate with~~ 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 future claims obligations;
- Financial soundness;
- Funding sources, including the level of and access to capital, as well as the 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.

The evaluation of each institution's hypothec insurance counterparty 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 ~~losses-claims~~.

For insured hypothecs, the institution should meet any ~~underwriting or valuation~~ requirements set out by the mortgage insurer to ensure the validity of insurance on ~~thesesuch~~ loans-

~~Principle 8~~; in particular with respect to credit granting and valuation. It should also report suspected or confirmed fraud or misrepresentation to the relevant mortgage insurer.

2.6 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 complete and relevant loan documentation is an important administrative function for institutions. It sets out the factors behind the credit granting decision, supports the institution's risk management functions, permits independent review by the institution and ~~allows~~helps staff in charge of granting credit to make sound decisions. It substantiates the credit review and granting process, ~~shows whether or not the loan was properly administered and monitored, clarifies the collateral valuation and loan disbursement practice and~~. As well, it demonstrates an adequate administration and monitoring of credit risk through periodic updating of borrower and property analysis, and clarifies evaluation practices related to guarantees and disbursements. 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 valid.

The documentation should include:

- A description of the purpose of the loan (~~e.g., purchase of a principal or secondary residence, refinancing, renovation, debt consolidation~~); etc.);
- Analysis and validation of information about the borrower required for decision-making (~~e.g., such as credit record, bank verifications, credit inquiries, confirmation of employment status and verification of income, personal balance sheet, and documentation verifying the source of the down payment~~) (~~see principle 3~~);
- Assessment of the borrower's capacity to repay the loan, including verification of the main factors (~~e.g., heating, tax bills~~ such as property taxes and other debts) (~~see principle 4~~);
- Appraisal of the property, ~~the documentation supporting it~~ (~~see principle 5~~) documents and the establishment of the loan-to-value ratio (~~see principle 6~~);
- 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;
- Purchase and sale agreements and other collateral ~~supporting~~ documents (~~e.g., such as title search, and certificate of location~~); ~~and~~
- Documentation evidencing the use of funds as authorized, where applicable;

- Proof of property insurance;²²
- A record from the ~~hypothec~~mortgage insurer validating ~~approval of the hypothec insurance where there is an exception~~commitment to insure the ~~underwriting or valuation requirements set out by the hypothecary insurer~~mortgage, where applicable.

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²² This includes a borrower's agreement to obtain property insurance as a condition of mortgage approval as well as proof of property insurance obtained by the financial institution when the mortgage funds are disbursed.

3. Other factors

3.1 Purchase of mortgage assets originated by a third party

An institution that acquires residential hypothecary loans that were originated by a third party should ensure that the third party's underwriting standards, including due diligence on the borrower, debt service coverage, collateral management and LTV ratios, are consistent with its policy and compliant with this guideline. The institution should not rely solely on the attestation of the third party. In addition to underwriting, the institution should consider the risks associated with other functions that may be performed by the third party in respect of acquired loans.

3.2 Model validation and stress testing²³

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 exceptional, 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~~ongoing validation of models and be reflected in the institution's internal capital assessment process (for deposit institutions) or internal target capital ratio (for insurers).

3.3 Provisions relating to financial disclosure

The purpose of financial disclosure about institutional hypothecary portfolios is to bolster public confidence and improve 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~~hypothecary lending 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

²³ - AUTORITÉ DES MARCHÉS FINANCIERS, *Stress Testing Guideline*, June 2012.

“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 that are significant for the institution (e.g. such as 20-24 years, 25-29 years, 30-34 years, 35 years and greater); or more);
- 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 statement discussion regarding the potential impact on residential hypothecs and profits margins in the event of an economic downturn or any other adverse situation.

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

4. 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.