AUTORITÉ DES MARCHÉS FINANCIERS

Residential Hypothecary Lending Guideline

March 2024

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Introduction

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.[1] 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 individual[2] 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 acquire assets related to such loans to adhere to the principles set out in this guideline. 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 *Insurers Act*, CQLR, c. A-32.1, s. 463;
Act respecting financial services cooperatives, CQLR, c. C-67.3, s. 565.1;
Deposit Institutions and Deposit Protection Act, CQLR, c. I-13.2.2, s. 42.2;
Trust Companies and Savings Companies Act, CQLR, c. S-29.02, s. 254.

2 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. Governance of residential hypothecary lending or acquisition operations

1.1 Roles and responsibilities of the board of directors and senior management

The AMF expects residential hypothecary lending or the acquisition of residential hypothecary loan assets to be supported by effective and efficient governance.

Specifically, in connection with residential hypothecary lending or acquisition operations, the AMF expects the board of directors to:

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

The AMF expects the policy to take various elements into account, including:

- the roles and responsibilities of individuals charged with implementing and overseeing the policy;
- significant elements of the institution’s strategy and approach to residential hypothecary lending or the acquisition of residential hypothecary loan assets (products, markets, etc.);

- at the individual residential hypothecary loan level (including loans with shared equity features, reverse hypothecary loans and combined loan plans) financing standards, acceptable lending or acquisition limits and criteria[3] for all residential hypothecary products and all types of loans, whether conforming or non-conforming[4];
- 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;
- the processes for identifying and reporting exceptions to management, including a process for the approval and communication of exceptions;
- limits on any residential hypothecary lending or acquisition exceptions.

[3] For example, the borrower's credit score, the loan-to-value ratio, the debt service coverage ratio or the amortization period.

[4] Non-conforming mortgage loans generally have higher-risk attributes or deficiencies relative to other loans. 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.

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 ability 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.

The institution should obtain the borrower's consent before assessing his or her situation and comply with the provisions of the *Act respecting the protection of personal information in the private sector*.[5]

2.1 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 to support its decision.

2.1.1 Identity of the borrower

The institution should obtain sufficient information about the borrower in order to determine whether there is a risk of financial crime, among other things.[6]

2.1.2 Credit history check

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 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 or the borrower's ability to service debt obligations in a timely manner.

5 Act respecting the protection of personal information in the private sector, CQLR, c. P-39.1.

6 AUTORITÉ DES MARCHÉS FINANCIERS, Financial Crime Risk Management Guideline.

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. 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 steps 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 (such as employee, self-employed worker or seasonal worker) and the nature of the income (such as salary, commissions, investment income or income from sources outside Canada).

Income stability should also be taken into account in calculating a borrower's ability to repay the loan. Temporarily high income should be normalized or discounted.

The analysis of the borrower's financial condition, including his or her net worth, 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 down payment, which should come from the borrower's own resources or savings, not from another source of credit, so 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.

Cash rebates and other incentives should not be considered part of the down payment.[7]

2.1.5 Hypothecary loans with shared equity features

An institution that supplies financing for an uninsured hypothecary loan with shared equity features should ensure that it is in the first hypothec position and that the investment provider's contribution is an equity investment that is not a loan and is made on terms that are *pari passu* with the borrower's equity. The institution must be informed about the shared equity agreement.

2.1.6 Joint borrowers or sureties

Where an institution obtains a suretyship or where there is a joint borrower, the institution should perform a thorough due diligence in verifying the surety's or joint

[7] 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.

borrower's credit history, income and financial condition, and satisfy itself that the surety fully understands his or her legal obligations.

2.2 Assessment of borrower's capacity to repay the loan

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 Debt service coverage

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 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 (such as lines of credit and credit cards) and recurring payments directly related to the hypothecated property (such as heating costs, condominium fees and property taxes).

For insured residential hypothecs, the institution should meet mortgage insurers' requirements regarding debt serviceability.

For uninsured residential hypothecs, the institution should take into account factors that could cause the borrower's financial condition to deteriorate, while considering the qualifying rate[8] and making qualitative judgments as to the appropriateness of the assumptions used.

The qualifying rate for all uninsured hypothecs should be the greater of the contractual hypothec rate plus a buffer or the floor rate. These rates are listed in the appendix to this guideline.[9]

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.

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[8] The qualifying rate is the rate used for the stress test. The financial institution should stress-test borrowers to ensure that they will be able to continue to make their mortgage payments should interest rates rise.

[9] The AMF will review the calibration of the qualifying rate (both the buffer and the floor) at least annually, in December, and will amend the appendix accordingly.

2.2.2 Additional assessment criteria

The institution should also take into consideration, as appropriate, other criteria that are not ordinarily included in debt service parameters (such as other recurring payment obligations and other living expenses).

2.2.3 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.

2.3 Appraisal of residential property and protection of collateral rights

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

2.3.1 Appraisal of residential property

An adequate appraisal 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.

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

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, a relatively high loan-to-value ratio or the environment) are higher, the institution should use a broader and more cautious appraisal method. It could opt for an appraisal by an outside appraiser using several valuation techniques. Other valuation methods such as property appraisal or an automated valuation tool can be combined with an on-site inspection to validate factors or physical features which could affect the value of the property.

2.3.2 Property appraisals

Where the institution is relying on a property appraisal[10] to establish the value of the residential property, it should adjust it if appropriate, 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 housing price correction or affect its marketability.

2.3.3 Automated valuation tools

Where the institution has decided to rely on automated valuation tools, it should establish controls to ensure their 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 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 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 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 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.

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[10] In Québec, the value entered on the property assessment roll established under the *Act respecting municipal taxation*, CQLR, c. F-2.1.

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 establish maximum loan-to-value (LTV) ratio limits for various types of hypothec transactions (such as conventional residential hypothecary loans, non-conforming hypothecary loans and home equity lines of credit). These maximum LTV ratios should be set out in its policy and reviewed, as necessary, to reflect financial and economic conditions or other risk factors which could affect 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 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 (see section 2.4.1).

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.

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

2.4.1 Property value used to calculate the LTV ratio

The following guidance is intended to underscore the fundamentals of sound management of the risks associated with hypothecary loans. Consequently, the AMF expects financial institutions' LTV ratio frameworks to be dynamic. To this end, financial institutions should have in place a robust process for monitoring, reviewing and updating their LTV ratio frameworks.

Furthermore, the financial institution should update the value of the residential property as necessary for the purposes of calculating the LTV ratio and determining lending thresholds within LTV limits, including limits for conventional hypothecary loans, home equity lines of credit and non-conforming hypothecary loans (as described in the sub-sections below), by considering relevant risk factors that make the residential property more vulnerable to a significant housing price correction or that significantly affect its marketability. These factors include, but are not limited to:

- The location, type and expected use of the residential property for which the loan is granted;
- The residential property's market price, recent price trends and housing market conditions; and
- Any other relevant risk that may affect the sustainability of the value of the residential property for which the loan is granted.

The financial institution should reassess its risk appetite by considering market price increases. Consequently, it should use more conservative approaches to estimating the property value for LTV calculations and not assume that prices will remain stable or continue to rise.

For the purposes of incorporating property value risk and determining appropriate lending thresholds for hypothecary loans, the financial institution has flexibility to apply valuation adjustments to specific properties when calculating LTV and/or by setting LTV limits that consider and incorporate residential property valuation risk factors described in this section on the loan-to-value ratio.

2.4.2 Conventional residential hypothecs

The AMF expects the institution to require hypothec insurance where a conventional hypothecary loan[11] to be granted has a LTV ratio greater than 80%.

2.4.3 Combined loan plans

A combined loan plan ("CLP") is defined as a loan:

- Where a set of loan products is secured by the same residential property; and
- That has authorized borrowing limits that are dependent on the balances of the other loans and are underwritten on a combined basis as a single loan under one overall limit;

The AMF expects that any and all portions of a CLP above 65% LTV be both amortizing and non-readvanceable. Principal payments should be matched by a reduction in the overall authorized limit until this overall CLP authorized limit reduces to 65% LTV for all products, on a combined basis.

2.4.4 Home equity lines of credit

A home equity line of credit ("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.

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

HELOCs provide a source of funds for the borrower and their use can become a source of indebtedness. Their revolving nature can also lead to 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%.

2.4.5 Reverse hypothecary loans

Reverse hypothecary loans do not typically require principal or interest repayment until the property is sold. Accrued interest is added to the loan balance. The borrower's age should also be an important lending consideration and introduces longevity risk.

Given these attributes, the AMF expects the institution to demonstrate heightened due diligence and ongoing risk management in respect of residential property accepted as collateral and to establish a maximum LTV limit of 65% at origination of the loan.

2.4.6 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

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 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 claims.

For insured hypothecs, the institution should meet any requirements set out by the mortgage insurer to ensure the validity of insurance on such loans; 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 helps staff in charge of granting credit to make sound decisions. It substantiates the credit review and granting process. 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 (purchase of a principal or secondary residence, refinancing, etc.);
- Analysis and validation of information about the borrower required for decision-making (such as credit record, confirmation of employment status and verification of income, personal balance sheet and documentation verifying the source of the down payment);
- Assessment of the borrower's capacity to repay the loan, including verification of the main factors (such as property taxes and other debts);
- Appraisal of the property, supporting documents and the establishment of the loan-to-value ratio;
- 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 documents (such as title search and certificate of location);
- Documentation evidencing the use of funds as authorized, where applicable;
- Proof of property insurance;[12]
- A record from the mortgage insurer validating commitment to insure the mortgage, where applicable.

[12] 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 testing[13]

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 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 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 "insured." A geographic breakdown for the amount and percentage of the total residential hypothecary loans and HELOCs that are insured versus uninsured;

[13] AUTORITÉ DES MARCHÉS FINANCIERS, *Stress Testing Guideline,* June 2012.

- The percentage of residential hypothecs that fall within various amortization period ranges that are significant for the institution (such as 20-24 years, 25-29 years, 30-34 years, 35 years 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 discussion regarding the potential impact on residential hypothecs and 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, for instance "other jurisdictions."

Appendix: Qualifying rate for uninsured hypothecary loans

The rate to be used to calculate debt service ratios for uninsured hypothecary loans is equivalent to the greater of the following:

- the contractual hypothec rate plus 2% or
- a fixed floor set at 5.25%.