Deposit Insurance Corporation of Ontario
Société ontarienne d'assurance-dépôts

LENDING ADVISORY #3 **May 2012**

MORTGAGE LENDING PRACTICES AND POTENTIAL REAL ESTATE MARKET CORRECTION

Insured institutions should exercise additional prudence in the wake of uncertainty surrounding a potential real estate market correction

Background

Recently there has been considerable media coverage regarding the risks associated with the housing sector in Canada. This Advisory sets out DICO's expectations with respect to actions that insured institutions should undertake to confirm that policies, procedures and risk appetite remain appropriate under current market conditions.

Recent articles and media reports have provided mixed views on whether a market correction will occur and, if it does, the timing and magnitude. Those reports cite factors such as:

- The real estate correction and depressed market values experienced over the past few years in the US;
- Recent change in oversight of the Canada Mortgage and Housing Corporation and approaching legislative insurance cap; and
- Repeated warnings from Mark Carney, Governor of the Bank of Canada, regarding rising, unprecedented levels of household debt in Canada.

The current environment in Canada is distinctly different from the events that led to the U.S. real estate market value correction. However, the rise in house prices is highly correlated to the continuation of certain supportive economic factors such as a low interest rate environment, steady employment, and demographic life-cycle trends, particularly those of baby boomers. In certain areas, such as the major urban downtown condo and suburban real estate markets, values are further driven by the level of immigration and foreign investment. A significant negative trend in any of these factors, either alone or in combination, has the potential to cause a correction in real estate property value. Also, the Ontario economy continues to be sensitive to shocks such as recurring episodes in the European financial crisis and political and social instability in the Middle East. This has resulted in continued unusual economic uncertainty.

Risk Implications for Insured Institutions

As a result, some insured institutions may be exposed to potential mortgage defaults and losses if a significant real estate market correction takes place.

DICO's Expectations

In addition to those policies, processes and practices already implemented by insured institutions as required under By-law 5 – Sound Business and Financial Practices, and in light of this uncertainty and potential exposure, insured institutions should undertake the following to confirm that credit risk management policy and practices and risk levels remain prudent:

- Review of the credit risk management policy to ensure it incorporates consideration of the current economic environment and that the credit union's risk appetite remains prudent, particularly surrounding limits on exceptions, including portfolio sub-limits on higher-risk residential mortgage business;
- Measure, monitor and report risk exposures including concentration risk from both a geographic and aggregate risk perspective, against Board-approved risk appetite;
- Ensure underwriting practices are appropriate including investigation, income verification and GDS/TDS calculations, fully supported appraisal valuations, and loan-to-value ratios, particularly with respect to Home Equity Lines of Credit (HELOCs);
- To avoid issues regarding repayment ability on renewal, institutions should consider qualifying borrower's using higher rates and / or shorter amortization periods where appropriate in order to minimize the potential for future default;
- Other aspects of the mortgage lending facility at the credit union should also be reviewed (process, lending staff), as should the usual risk factors associated with mortgage lending; and
- Regular monitoring in the geographic areas served by the insured institution of real estate market and socio-economic trends for emerging issues or buying and investment patterns which may affect consumer demand, consumer confidence in the real estate market or property values.

Insured institutions are referred to Guideline B-20 Residential Mortgage Underwriting Practices and Procedures published by the Office of the Superintendent of Financial Institutions of Canada (OSFI) and available at http://www.osfi-bsif.gc.ca/eng/fi-if/rg-ro/gdn-ort/gl-ld/pages/b20.aspx for consideration of further risk mitigation activities. The OSFI Guideline is based on principles articulated by the Financial Stability Board (FSB) in its recently published guidance. DICO will be incorporating certain elements of OSFI's Guideline in our Guidance Note on Lending later this year.

DICO recognizes institutions continue to operate in a highly competitive market and face challenges to maintain profitability levels. The above expectations are in no way meant to suggest insured institutions should either curtail or cease lending. However, growing uncertainty surrounding the real estate market should be taken into account by confirming that existing risk appetite and practices remain appropriate.

Should you have any questions regarding this matter, please contact us.