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

LENDING ADVISORY #4 **JANUARY 2017**

MORTGAGE LENDING PRACTICES

Credit unions should exercise additional prudence in the wake of continued rising house prices and changes to CMHC's mortgage insurance program

This Advisory reinforces DICO's expectations for credit unions to continue to enhance their mortgage lending practices in response to the elevated financial risks and associated vulnerabilities in the Ontario housing market and in light of changes to CHMC's mortgage insurance program.

Background

In May 2012, DICO issued Lending Advisory #3: Mortgage Lending Practices and Potential Real Estate Market Correction that sets out expectations surrounding actions credit unions should take to confirm credit risk management policies and practices and risk levels remain prudent. At that time, credit unions were advised to review the Advisory and ensure that they had implemented appropriate and prudent policies and practices to meet those expectations.

DICO recognizes credit unions continue to operate in a highly competitive market. However, there continues to be considerable concern regarding a possible real estate market correction, most notably in the Toronto and surrounding areas, including the Golden Horseshoe given the following conditions:

- Increasing house prices
- Sustained low interest rates
- Record levels of household indebtedness
- Local sensitivity to global economic instability

Demand for residential real estate is correlated to economic and demographic factors. The sustained low interest rate environment coupled with stable employment has contributed to a dramatic increase in demand for real estate resulting in higher prices in larger urban areas over the past number of years. In areas such as downtown condominium and suburban real estate markets in major cities, values may be further driven by higher levels of immigration and foreign investment which can increase vulnerability in these local housing markets. A significant negative trend in any of these factors, either alone or in combination, has the potential to cause a material correction in real estate property values. As a result, some credit unions may have an increased exposure to potential mortgage defaults and losses if a real estate market correction takes place.

Repeated concerns have been raised by the Bank of Canada, regarding rising, unprecedented levels of household debt in Canada resulting in the tightening of mortgage insurance rules six times since 2008.

The latest round of changes (http://www.fin.gc.ca/n16/data/16-117_2-eng.asp), announced in September 2016, were targeted to further subdue mortgage demand and reduce the risk and impact of a housing market correction as well as stem further increases in household debt. These changes have the potential to impact residential mortgage lending activities at credit unions.

With the continuing increase in house prices, organizations such as Equifax have noted a sharp increase in the number of suspected fraudulent mortgage applications by their reporting institutions. At the same time other regulators have observed a trend towards more relaxed credit standards being applied for mortgages with lower loan to value ratios. DICO expects mortgage lenders to verify that their mortgage operations are well supported by prudent underwriting practices, as well as sound risk management and internal controls that are commensurate with the risk. Mortgage underwriting standards at the credit union should reflect the evolving risk profile of the market and be adhered to on a consistent basis. The following elements remain key to the sound underwriting of mortgages in Ontario:

- Rigorous verification of borrower's income
- Consistent application of appropriate mortgage underwriting standards regardless of the loan to value ratio
- Debt Service Ratios that are appropriately stressed with both the current, and a potentially severe but plausible, market event
- Use of conservative appraisal values and approaches
- Strong alignment between the credit union's stated risk appetite and the actual mortgage underwriting and risk management practices
- Enhanced monitoring and analysis of the performance of the mortgage portfolio under normal and stressed situations

Implications to Credit Unions

Credit union boards and management should review DICO's published guidance and advisories pertaining to residential mortgage lending, industry best practices (such as OSFI`s B20) and the changes to the CMHC mortgage insurance program and determine the impact on their existing policies, practices and portfolios to confirm they have implemented a robust set of policies and practices to prudently manage the risk in this area.

Credit unions are also expected to take into account market developments as well as any potential vulnerabilities in their local housing market when developing business and risk management strategies. Credit union boards should be aware of any unique exposure their credit union may have to the residential mortgage market in their geographic location and ensure that stress testing of correlated stress factors is conducted on the residential mortgage portfolio to assess the impact of a housing market correction.

DICO expects credit unions to verify that their mortgage operations are well supported by prudent underwriting practices, and have sound risk management and internal controls that are commensurate with the size and complexity of their residential mortgage lending operations. Where the credit union is deemed not to be acting prudently or not complying with DICO's expectations, DICO may consider the credit union to be in non-compliance with By-law No. 5 – Standards of Sound Business and Financial Practices, and require the credit union to take corrective measures.