Residential Mortgage Underwriting Guideline

BC CREDIT UNIONS

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INTRODUCTION

The Residential Mortgage Underwriting Guideline (guideline) outlines the Financial Institutions Commission's[1] (FICOM) expectations for sound residential mortgage[2] underwriting and risk management practices at British Columbia credit unions.

FICOM expects credit unions to apply residential mortgage underwriting practices that ensure the safety and soundness of residential mortgage loans and adequate risk management of loan portfolios. This guideline outlines supervisory standards for residential mortgage underwriting and portfolio management, reporting, and risk management. The principles and standards outlined in this guideline are applied to the direct underwriting of mortgages, mortgages acquired from brokers and other outsourced loan originators, and mortgages acquired as part of a portfolio.

THE ROLE OF THE BOARD

The board of directors is responsible for establishing and overseeing a residential mortgage underwriting policy[3]. The residential mortgage underwriting policy aligns with the credit union's risk governance framework, its risk tolerances[4] and limits, and its overall risk appetite and strategy.[5] The policy articulates the credit union's business strategy and approach to residential mortgage underwriting, including the acquisition of residential mortgage loan assets, and is reviewed by the board annually.

The board seeks assurance from the credit union's oversight functions[6] that individual residential mortgage transactions comply with the underwriting policy and the risk tolerances and limits. Regular reporting on the loan portfolio enables the board to properly monitor and evaluate lending policies and procedures, risks, and the effectiveness of oversight functions. It is important to validate the loan portfolio's composition and performance to ensure it reflects the credit union's plans and pricing of its residential mortgage products. The board receives clear reports on risks and trends in the loan portfolio from management to the level that the board can adequately perform its oversight function. At a minimum, the board should expect semi-annual reports on the credit union's residential mortgage loan portfolio including reporting on concentrations and aggregate exceptions to policy.

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[1] References to FICOM may include the staff, the Superintendent and/or the Commission.

[2] A residential mortgage includes any loan to an individual(s) that is secured by residential property (i.e., one to four unit dwellings) as well as home equity lines of credit (HELOCs), equity loans and other such products and assets that use residential property as security.

[3] A residential mortgage underwriting policy can be a separate stand-alone document, part of an investment and lending or credit policy or within any other board-approved policy document.

[4] Tolerance refers to the specific maximum risk and degree of variability a credit union is willing to take regarding each relevant risk.

[5] Refer to FICOM's *Governance Guideline for Credit Unions* for more information on the role of the board in defining a credit union's risk governance framework and risk appetite.

[6] For example, internal audit or other risk management oversight functions.

RESIDENTIAL MORTGAGE UNDERWRITING POLICY

A credit union's residential mortgage underwriting policy ensures that its mortgage portfolio is aligned with its risk appetite and strategy, and that its products meet the needs of its borrowers without introducing undue risk to the credit union or over-indebtedness to its borrowers by:

- *granting residential mortgage loans on the evidence of safety and soundness;*
- *maintaining complete documentation;*
- *maintaining quality data; and*
- *ensuring adequate oversight and regular reporting of residential mortgage underwriting risks.*

The residential mortgage underwriting policy establishes limits to the level of risk the credit union is willing to accept in its mortgage portfolio. The policy takes into account the credit union's risk appetite, strategy, oversight capabilities, and the product needs of its borrowers. As well as minimizing defaults and losses to the credit union, the policy ensures that the likelihood of borrower over-indebtedness is reduced through sound underwriting practices during the underwriting process.

A residential mortgage underwriting policy documents:

- residential mortgage product offerings;
- acceptable underwriting and acquisition standards, criteria and limits for all residential mortgage products[7] (such as credit scores, loan-to-value (LTV) ratios, amortization, and debt service ratios);
- risk management practices and processes;
- clearly defined roles and responsibilities for those administrating the policy;
- any loan above a policy limit as an exception to policy with clear direction on how the exception to policy is approved, monitored and reported;
- acceptable portfolio concentration limits;
- frequency of loan and collateral reviews; and
- frequency of reports to oversight functions including the board.

As part of implementation, the credit union ensures that effective control and reporting systems are developed and maintained. Identification, measurement, monitoring and reporting of risks in the mortgage loan portfolio occur on an ongoing basis.

[7] Residential mortgage products include home equity lines of credit, non-income qualifying loans and reverse mortgages; appropriate standards, criteria and limits are set for each type of mortgage product. See page 5.

PRUDENT UNDERWRITING PRACTICES

In granting a residential mortgage loan, the credit union assesses the borrower's income, history of repayment, and the affordability of the loan to ensure there is no undue debt burden to the borrower and to minimize risk of default to the credit union.

A residential mortgage loan is considered safe if the risk of loss is minimal or immaterial in the event of a payment default. The soundness of a residential mortgage loan is determined through a thorough evaluation of the borrower's ability to repay the loan. Both safety and soundness are equally important to the underwriting process.

<u>Income Verification</u>

A credit union verifies the borrower's income including substantiation of the borrower's employment status and income history. The borrower's underlying income should be verified through an employment letter or another reliable and documented source, and reliable and documented income history. This includes:

- verification through independent means from a source that is difficult to falsify;
- documentation that does not contradict other information provided during the underwriting process; and
- documentation that matches the amount of income used by the credit union in its assessment of the borrower's debt service capacity.

Inconsistent incomes should be appropriately valued and, if necessary, suitably discounted. Sound practice includes undertaking additional due diligence through third-party verification of historical income in the case of self-employed or borrowers with irregular sources of income. For rental income, documentation is provided to substantiate income, such as a lease/tenant agreement, rent roll and/or tax assessment.

<u>History of Repayment</u>

The assessment of a borrower's reliability to repay considers repayment history and the borrower's stage in his/her financial lifecycle.

- A credit union obtains a borrower's credit bureau score as one indicator of the borrower's reliability of repayment; the credit bureau score should not be the sole assessment tool used to determine reliability as it indicates past, not future behaviour, or the borrower's current financial condition.
- A borrower's financial lifecycle indicates the borrower's current and future stage of financial life. By considering the stage of the borrower's financial lifecycle, a lender assesses whether the residential mortgage fits the current and future financial conditions of the borrower, and the probability of repayment; doing so assists the lender in assessing an appropriate amortization period when determining the conditions of the loan.

Affordability

A credit union determines the borrower's capacity to repay in order to minimize defaults and losses to the credit union and to minimize the likelihood of borrower over-indebtedness. The credit union and the borrower have a clear understanding that the residential mortgage meets the needs and financial circumstances of the borrower. Where a loan is offered to a borrower on an exception to policy basis, the borrower should be made aware.

In determining a borrower's capacity, a credit union:

- determines the borrower's debt service ratios.
    - the debt service calculations consider any existing and ongoing financial commitments (shelter costs, debt repayments, marital and family contractual obligations). The calculations should not rely on long term access to discounted introductory rates; and
    - ensures that appropriate buffers and adjustments are in place to account for potential changes in interest rates, increases in the borrower's living expenses and/or decreases in the borrower's income available to service the debt. Interest rate buffers should be regularly reviewed to ensure the current buffer is appropriate.
- calculates the LTV ratio[8] with an appropriate level of down payment sourced from the borrower's own resources and identifies any other resources available as a secondary source of recovery;
- undertakes appropriate due diligence on the guarantor or co-signor, where there is a guarantor or co-signor supporting the residential mortgage;
- determines an amortization relative to LTV ratio such that the principal portion of the monthly payments is reasonably reducing the credit union's exposure to the underlying collateral security; and
- documents any amortization beyond 30 years as an exception to policy that is approved, monitored, and reported in accordance with the requirements within the credit union's residential mortgage underwriting policy.

COLLATERAL MANAGEMENT

In assessing the value of a property, a credit union takes a risk-based approach using various tools and processes, to protect against unexpected loss, and undertakes ongoing monitoring of the collateral.

Sound collateral management and appraisal practices are essential for risk management. A combination of valuation tools and appraisal processes includes:

[8] Where the collateral mortgage is dispersed through multiple advances, the LTV should reflect the aggregate exposure.

- third party appraisal by a certified professional appraiser that is independent from the residential mortgage originator, and the underwriting process;
- automated valuation tools that monitor the ongoing market value of the property;
- property tax assessments; and
- on-site inspection by a qualified employee or appraiser that determines existence, occupancy, and condition of the property.

Collateral is protected against unexpected loss through provisions within the residential mortgage loan that include fire and/or earthquake insurance[9], where required, against risk of collateral damage repairs and replacement.

Processes are established to monitor the ongoing effectiveness of any tool used to assess the market value of the property. Controls are in place to ensure that the tools are being used appropriately by lending officers and that risk factors[10] that can lead to significant price corrections are continually monitored.

It is important that loan securities documents are complete in order to substantiate a borrower's commitment to the residential mortgage loan and to register a claim against the collateral property. Loan securities documentation deficiencies can lead to unexpected losses. A credit union is expected to establish policies and procedures to ensure loan securities documents are kept safe and enforceable.

OTHER RESIDENTIAL MORTGAGE PRODUCTS

Home Equity Line of Credit (HELOC)

HELOC products provide an alternative source of funds for borrowers; however, over time, they can also significantly add to consumer debt loads. The revolving nature of HELOCs can lead to greater persistence of outstanding balances, and greater risk of loss to lenders. As well, it can be easier for a borrower to conceal potential financial distress by drawing on his/her lines of credit to make timely residential mortgage payments and, consequently, present a challenge for lenders to adequately assess credit risk exposure.

- A credit union should ensure the financial conditions of the borrower and the economic conditions are appropriate when considering a HELOC application; individual transaction LTV thresholds and a maximum portfolio concentration limit should be stated within the residential mortgage underwriting policy.
- Credit unions are expected to limit the non-amortizing HELOC component of a residential mortgage to a maximum LTV ratio of less than or equal to 65 per cent.

[9] Collateral in certain regions of BC has increased earthquake risk exposure; credit unions understand the location of the mortgage collateral and how earthquake risk exposure could impact both uninsured and insured mortgages.
[10] Examples include the collateral's location, its expected use, its remaining economic life, its type and its current market price.

Additional mortgage credit beyond the LTV ratio limit of 65 per cent is documented as an exception to policy that is approved, monitored and reported in accordance with the requirements within the credit union's residential mortgage underwriting policy.

Non Income Qualifying (NIQ) and Equity Mortgages
A credit union should ensure the financial conditions of the borrower and the economic conditions are appropriate when considering a NIQ or Equity Mortgage application; individual transaction LTV thresholds and a maximum portfolio concentration limit should be stated within the residential mortgage underwriting policy.

Reverse Mortgages
A credit union should ensure the financial conditions of the borrower and the economic conditions are appropriate when considering a reverse mortgage application; individual transaction LTV thresholds and a maximum portfolio concentration limit should be stated within the residential mortgage underwriting policy.

DOCUMENTATION

The residential mortgage underwriting policy of a credit union, together with complete documentation that supports a credit-granting decision, should enable an independent third party conducting a credit assessment to replicate all aspects of the underwriting criteria to arrive at the same credit decision.

Maintaining prudent loan documentation is an important administrative function for lenders, it provides a clear record of the reasons for a credit-granting decision, supports compliance with a credit union's residential mortgage underwriting policies, and permits independent audit and/or review by a credit union's risk oversight functions. Documentation is also necessary to demonstrate compliance with mortgage insurance requirements.

Complete documentation of a residential mortgage approval includes:

- a description of the purpose of the loan;
- verification of the source of down payment;
- verification of income and employment status;
- debt service ratio calculations, including verification documents;
- LTV ratio and confirmation that the LTV is confirmed as the aggregate lending exposure to one collateral security;
- property valuation and appraisal;
- credit bureau reports and any other credit enquiries;
- purchase and sale agreements, and other collateral supporting documents;
- an explanation of any mitigating criteria for higher credit risk factors;

- a clearly stated rationale for the decision (including exceptions);
- a record of approval for an exception; and
- where required, a record from the mortgage insurer validating approval to insure the residential mortgage.

RISK MANAGEMENT

A credit union ensures that risk management policies and practices are in place enabling operational staff and oversight functions to:

- *identify, assess and analyze risks;*
- *ensure that the residential mortgage underwriting policy and its limits are being followed, particularly on exceptions to policy;*
- *monitor risk exposures against the credit union's risk appetite;*
- *ensure that risks are properly controlled and mitigated, and provide assurance to the board and senior management;*
- *provide regular risk reporting; and*
- *report on the effectiveness and performance of underwriting practices.*

Risk management requires a continuous process of identifying risks that are sometimes subject to quick and volatile changes. The identification of risks can result in opportunities for portfolio growth or mitigate unacceptable exposures to the credit union. In order to properly assess its risks, a credit union maintains quality data and information on the residential mortgage loan portfolio. FICOM recognizes that risk management practices will vary according to the size, scope, and complexity of the credit union.

Credit unions are expected to record and aggregate the following data from each residential mortgage loan at origination, and update as available, through its management information systems:

Amortization (initial and remaining)	Credit Bureau Score
GDS/TDS	LTV
Location of collateral	Approved Amount
Insured/Uninsured	Exception to Policy
Number of Days Delinquent	Origination Date
Product Type[11]	Outstanding Balance
Unique Member Identifier	Purpose

To manage credit risk, credit unions should focus on the oversight of individual residential loans and the loan portfolio, particularly in balancing the risk of the loan or portfolio in

[11] Identification of mortgage product type, for example, residential mortgage, HELOC, NIQ or other.

five key risk areas:

- LTV;
- credit bureau score;
- GDS/TDS;
- amortization; and
- exceptions to policy.

For example, in a residential mortgage transaction, any two of the four combinations of a low credit bureau score, high TDS, high LTV, and maximum amortization period increase the risk of loss given default. The data collected should provide the credit union with insight into the loan portfolio's attributes, including exposure (dollar value of loans), distribution (percentage) and the number of loans in each risk area.

Concentration Risk

The composition and level of risk in the loan portfolio should reflect the risk appetite and limits, strategy, and policies set by the board. A high volume of loans, near or at policy limits in key risk areas, generates concentration risk to the portfolio. It is expected that credit unions perform concentration analysis, at a minimum segmenting the residential mortgage loan portfolio amongst the key credit risk areas of LTV, credit bureau score, GDS/TDS, amortization, and exceptions to policy in order to identify concentration risk.

Each area of concentration risk should be evaluated individually and as part of the whole portfolio. For example, where a portfolio is found to have concentrations of loans with high LTV and therefore increasing market risk in the event of a real estate market correction, management may seek ways to minimize the increasing risk by underwriting loans with lower levels of risk in other key risk areas. With ongoing monitoring of segments of the loan portfolio, active loan portfolio management rebalances the level of risk and helps contain exposure to unexpected events.

In particular, a credit union should continuously assess whether there is sufficient capital to support any concentration of risk in the portfolio and that adequate controls are in place to properly monitor concentration risk exposure. As part of its risk management practices, a credit union should periodically stress test the loan portfolio's capital and capacity to absorb expected and unexpected losses.

Exceptions to Policy

Tracking the aggregate level of exceptions to policy can identify shifts in the credit risk characteristics of the loan portfolio. Where a high volume of exceptions is identified, the board needs to review its risk limits and residential mortgage underwriting policy and either revise the credit union's strategy or place new limits in its policy; when aggregated, even well-mitigated exceptions can increase portfolio risk significantly.

As part of its residential mortgage underwriting policy, a credit union documents any loan above a policy limit as an exception to policy with clear direction on how the exception to policy is approved, monitored and reported. An appropriate exception to policy portfolio concentration tolerance is documented in the residential mortgage underwriting policy with the board receiving semi-annual reporting on this segment of the loan portfolio.

Counterparty Risk

Effective counterparty risk management policies and procedures support sound residential mortgage underwriting. This includes appropriate use of mortgage insurance[12] as a risk management tool; however, mortgage insurance should not be a substitute for sound underwriting practices.

The evaluation of counterparty risk should be updated throughout the life of the mortgage insurance contract and continue beyond the expiration date of the contract to ensure the credit union assesses potential insurance recoverables from expected future claims, where applicable. Additionally, a credit union should meet any underwriting or valuation requirements set out by the mortgage insurer to guarantee the validity of insurance on any insured loans.

Outsourcing

Where a credit union outsources any part of the residential mortgage underwriting process, it remains responsible for ensuring that the underwriting standards of the third party are consistent with the policies and procedures of the credit union and this guideline. A credit union that acquires residential mortgage loans that have been originated by a third party is responsible for ensuring that the underwriting standards of that third party are consistent with this guideline; a credit union should not rely solely on the attestation of the third party. In the case of borrower default, the credit union has procedures in place to determine the best course of action, identifying the parties for recourse and plans for pursuing recourse.

Reporting

The frequency of reporting on the loan portfolio is written into the credit union's residential mortgage underwriting policy; the portfolio should be reviewed monthly by senior management and semi-annually by the board.

Semi-annual reporting to the board includes, at a minimum:

- portfolio concentration of levels of LTV, debt service ratios, amortization, credit bureau score, and exceptions to policy;
- layered analysis of portfolio concentrations of levels of LTV and amortization, and LTV, TDS and amortization; and
- any other combinations deemed appropriate in identifying risk.

[12] Mortgage insurance can include mortgage default insurance or mortgage life insurance.

FICOM'S APPROACH TO ASSESSING RESIDENTIAL MORTGAGE UNDERWRITING PRACTICES

When assessing the quality of residential mortgage underwriting practices and loan portfolios, credit unions are expected to demonstrate that;

- the appropriate due diligence is performed;
- credit decisions are sound; and
- adequate oversight and controls are in place.

FICOM assesses loan portfolio reporting to senior management and the board of directors and other risk management reports. This includes reviewing board packages and internal auditors' or compliance reports for the effectiveness of risk oversight and controls.

Additionally, FICOM may undertake certain reviews, such as asset quality reviews, to evaluate underwriting practices, compliance with the residential mortgage underwriting policy, loan administration, and financial and collateral documentation, and the effectiveness of loan control functions. Process reviews are used to evaluate aspects of loan portfolio management, including methodologies, responsibility designations, controls, and the quality of management information systems.

Senior management and the board of directors will be expected to demonstrate a broad understanding of the residential mortgage underwriting policy and the potential impact on underwriting practices as a result of any changes in the credit union's risk appetite, strategy, and/or business model.

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