Office of the Superintendent
of Financial Institutions Canada

Bureau du surintendant
des institutions financières Canada

255 Albert Street
Ottawa, Canada
K1A 0H2

255, rue Albert
Ottawa, Canada
K1A 0H2

www.osfi-bsif.gc.ca

Guideline

Subject: **Accounting for NHA Mortgage-backed Securities**

Category: **Accounting**

No: **D-3** **Date:** **July 1992**
October 2002 (Revised)

Status

In 2001, the Accounting Standards Board of the Canadian Institute of Chartered Accountants (CICA) issued Accounting Guideline AcG-12, "Transfers of Receivables." AcG-12 took effect on or after July 1, 2001 but applied at a transferor's option to transfers of receivables occurring on or after April 1, 2001. It superseded this OSFI Guideline for all but certain transactions for which the accounting was grandfathered. OSFI has issued a new guideline, D-8, "Transfers of Receivables Including Securitizations" that addresses the application of AcG-12.

Scope

This OSFI Guideline continues to apply to the accounting and servicing of each transfer of NHA mortgage-backed securities (NHA-MBS) that occurred before the date AcG-12 was first applied.

Introduction

This guideline, which applies to all federally regulated financial institutions (FRFIs), outlines the accounting requirements for an issuer-servicer of NHA-MBS. It also provides guidance on the amounts that a purchaser is to record as assets on acquiring mortgage servicing rights and the net interest spread from the issuer-servicer of an issue of NHA-MBS.

The guideline does not need to be applied by those financial institutions whose NHA-MBS activities are immaterial. The criteria for determining materiality would be the same as those used in determining the applicability of recommendations in the Handbook of the Canadian Institute of Chartered Accountants (CICA).

Table of Contents

Descriptions

The NHA Mortgage-backed Securities Program

The Government of Canada sponsors a program through the Canada Mortgage and Housing Corporation (CMHC) whereby privately issued mortgages insured under the National Housing Act (NHA) and by private insurers are pooled, securitized and issued to the investing public as NHA-MBS. Interest is paid to the investors at the coupon rate stated on the securities. The MBS securities issued represent undivided ownership rights in the cash flows of the underlying mortgage pool that are guaranteed by CMHC. The CMHC guarantees the investors timely payment of both principal and interest provided for in the privately issued NHA-MBS. To obtain this guarantee, the issuer-servicer of the securities pays a lump-sum fee to the CMHC prior to the issue and sale of the securities.

In the event CMHC takes over the servicing of securities backed by mortgage pools that carry either no prepayment or limited prepayment terms from a defaulting NHA-MBS issuer-servicer, CMHC will pay the issuer an amount equal to the present valued net interest spread of the pools reflected in the related receivable balance. This CMHC commitment to pay applies to all NHA-MBS pools except for those that permit unrestricted prepayments without prepayment penalty.

In a situation where CMHC causes the servicing rights to be sold by a defaulting issuer, or the servicing rights are sold by a receiver-liquidator in control of the issuer's assets, CMHC will ensure that the issuer receives the same return as if CMHC had taken over the servicing directly.

For the CMHC commitment to pay, the present valued net interest spread calculation for each qualifying pool will be based on:

- the principal amount of the mortgages outstanding at the time CMHC declares the issuer in default, or the issuer is taken over by a receiver (date of default);

- the interest rate difference between the weighted average mortgage rate and the MBS coupon rate, less an allowance for normal servicing fee. The servicing fee rate, which may be changed from time to time by CMHC based on its periodic review of the market, will initially be 25 basis points for homeowner and mixed mortgage pools, and 15 basis points for multiple family and social housing mortgage pools;

- the UPP rate used for accounting purposes by the issuer; and as verified by the issuer's auditor in the period immediately preceding the date of default; and

- a discount rate equal to the original yield to maturity of the MBS pool at the date of issue.

Mortgage Pools

Under the NHA-MBS program, pooled mortgages are designated as homeowner, multiple family and social housing loans. Homeowner and multiple family mortgages have various prepayment terms, while no prepayment is allowed for social housing mortgages. For purposes of this guideline, pooled mortgages are distinguished by their prepayment terms. They are categorized as (1) closed pools, (2) partially open pools, and (3) fully open pools.

1. Closed pools have no prepayment rights.

2. Partially open pools allow restricted unscheduled prepayments, with or without prepayment penalty.

3. Fully open pools permit unrestricted prepayments at any time without prepayment penalty.

Interest Spread

The interest spread is an estimate of the future cash flows resulting from the application of the interest rate spread to the estimated outstanding principal mortgage balances over the life of the respective securities.

The interest rate spread is the difference between the stated interest rate on the mortgages in the pool and the stated rate (coupon rate) of interest on the MBS certificates. Under the NHA-MBS program this interest rate spread cannot be less than 50 basis points for any mortgage in the pool.

The cash flows from the interest spread represent two separate forms of compensation to the issuer-servicer:

- a fee to service the pool of mortgages on behalf of the holders of the mortgage-backed securities (the normal servicing fee); and

- part of the consideration (sales proceeds) received from the sale of the mortgage-backed securities to investors (the net interest spread).

Normal Servicing Fee

The normal servicing fee represents a reasonable estimate of a market-based fee to service the pool of underlying mortgages over the life of the mortgage-backed securities. The normal servicing fee rate should not be less than the market-based rates established by CMHC from time to time. Currently these rates are 25 basis points for homeowner and mixed (generally homeowner and multiple family) mortgage pools, and 15 basis points for multiple family and social housing mortgage pools.

Net Interest Spread

The net interest spread is that portion of the estimated interest spread that remains after provision has been made for the normal servicing fee.

The present value of the net interest spread is carried as a receivable balance on the balance sheet of the vendor (issuer) and drawn down as mortgage payments are received over the life of the securities.

Calculation of Present Value of Net Interest Spread

Present value of:			
	estimated mortgage interest from mortgagors		xxx
less sum of:			
	estimated interest paid to investors	xxx	
	estimated normal servicing fee	xxx	xxx
			xxx

For partially open mortgage pools, the future cash flows constituting the net interest spread are reduced by estimated unscheduled principal prepayments. To calculate the prepayment estimates related to such pools, OSFI has established unscheduled principal prepayment rates, which are described below.

Unscheduled Principal Prepayment (UPP) Rates

New Pools

Each issuer is required to establish, at the beginning of each fiscal quarter, an estimated UPP rate to be applied to all new partially open pools ("pools") issued during the quarter. For purposes of this section, all pools issued in a quarter will be referred to as a "group." Where the term or other characteristics of the pools issued during the quarter vary considerably from pool to pool, separate groups should be created that are made up of pools of roughly similar characteristics, with each group having an appropriate estimated UPP rate. The estimated rate is to be the highest of:

- the rate that, in the judgement of the issuer, is unlikely to be exceeded over the life of the pools, taking into account current and likely future mortgage interest rates, the prepayment features of the mortgages, past UPP experience of the issuer, and other factors likely to affect future UPP experience;

- 1.1 times the weighted average UPP rate since inception ("historic UPP") for all remaining partially open pools;

- the most recent six months weighted average UPP rate for all remaining partially open pools; and

- 7.0 per cent per annum (of the original principal outstanding).

Pools Issued in Prior Quarters

For groups issued in prior quarters, the estimated UPP is to be revised up, or may be revised down, as follows:

- The estimated UPP rate for the group is to be adjusted upward as and when necessary to ensure that at any time the estimated UPP rate is not less than the higher of 1.1 times the historic UPP for that group, and 7.0 per cent per annum.

- The estimated UPP rate for the group may be revised downward when the most recent six-month weighted average UPP rate for that group has been below the historic UPP (for the same group) for a period of not less than six consecutive months. When these conditions are met, the estimated UPP rate for the group may be revised downward to a rate not less than the rate being applied to new pools at that time.

In determining UPP rates, new issuers are to follow the procedures for new pools using published industry data.

An issuer is required to have on file and available for review by OSFI examiners its calculations of estimated UPP consistent with these requirements. OSFI may require the issuer's external auditor to express an opinion on the correctness of the calculation.

Discount Rate

The interest or discount rate that is used to determine the present value of the net interest spread is to be equivalent to the original yield to maturity of the MBS at the date of issue.

Direct Issuance Costs

Direct issuance costs are the costs incurred in assembling and selling the securities and include:

a) commissions to third parties;
b) commissions to third parties on MBS sales;
c) application fees paid to CMHC;
d) Central Payor and Transfer Agent fees incurred at issue;
e) CMHC guarantee fees;
f) printing costs associated with the new securities; and
g) legal costs associated with the new securities.

Method of Accounting

The issuer-servicer of NHA-MBS should account for the transaction as follows:

- where the underlying mortgages are fully open pools, transfers of the securities are to be accounted for as collateralized loans and not be given sales treatment; any discount or direct issuance cost incurred is to be amortized over the life of the collateralized loan;

- transfers of securities backed by mortgage pools that are closed or partially open are to be accounted for as sales by the issuer-servicer of the pools;

- the sales price of the securities backed by closed or partially open pools are to be adjusted, for purposes of determining the gain or loss on the sale of the securities, to recognize a normal servicing fee in each year of the securities;

- to determine the gain or loss at the date of sale, the proceeds from the sale of the securities include the present value of the net interest spread as defined above, and direct issuance costs constitute part of the costs deducted from the proceeds;

- at the end of each reporting period, the amount receivable, representing the present value of the remaining net interest spread, is to be recalculated taking into account factors such as early repayments of principal made by mortgagors and revised estimates, if applicable, for future unscheduled principal prepayments over the remaining term of the mortgage-backed securities;

- the change in the present-valued amount receivable between the beginning and the end of the reporting period in respect of each mortgage pool is to be charged or credited to income;

- in cases where the estimated servicing costs at the date of sale or at the end of a subsequent reporting period are expected to exceed the normal servicing fee over the term or remaining term of the mortgage-backed securities, the expected loss on servicing is to be accrued and charged to income in that period;

- estimated penalty interest payments to be retained by the issuer and interest (float interest) expected to be earned on the amounts received monthly from the mortgagors and temporarily invested in the period between the date of receipt and the date of payment to the investors are not to be present valued and capitalized at the date of sale. These amounts are to be recognized in income at the time they are received by the issuer-servicer.

Disclosure

The following items are to be disclosed in a note to the annual financial statements (or in the OSFI annual return for institutions that do not produce annual financial statements) of an issuer-servicer with respect to NHA-MBS:

- the accounting policy with respect to such transactions, including the income recognition policy regarding the accounting for the net interest spread receivable by the issuer-servicer under the terms of the transaction, the estimated UPP rates, the normal servicing fee, and the issuance and servicing costs;

- a description of the NHA-MBS program and of the risks and rewards relating to the pool of mortgages that are retained by the issuer-servicer and the obligations to purchasers of the securities that are assumed by the issuer-servicer. This description is to state that in the event an issuer-servicer defaults on any provision in its servicing contract, the CMHC is empowered to enter into an agreement with another qualifying issuer to assume all or any part of the servicing duties;

- the balance of the retained interests representing the present value of the net interest spread of the outstanding issues of mortgage-backed securities at the end of the year;

- for all securitized mortgage-backed securities sold, the outstanding principal amounts at the end of the year; and

- the amount at the end of the year by which the total recourse exceeds the sum of the expected losses under recourse provisions and the gain on sale, if any.

Mortgage Servicing Rights

Purchase of Mortgage Servicing Rights

When a purchaser acquires the mortgage servicing rights from the issuer-servicer, the purchaser is to set up as an asset the amount paid for the intangible asset subject to the following limitation:

- the amount recorded is not to exceed the amount by which the present value of the estimated future normal servicing fee revenue exceeds the present value of the expected future servicing costs.

The intangible asset is to be amortized over the period of the estimated servicing income.

The intangible asset is to be deducted when determining the capital of the institution for the purpose of assessing capital adequacy.

Purchase of Net Interest Spread and Mortgage Servicing Rights

When a purchaser acquires the net interest spread and the mortgage servicing rights from the issuer-servicer, the purchaser is to set up these items as an asset in the amount paid, subject to the following limitation:

- the amount recorded is not to exceed the present value of the future mortgage interest income less the present value of (1) the future interest payable to the investors in the mortgage-backed securities, and (2) the expected future servicing costs.

The asset acquired is to be reported on the balance sheet as two separate assets -- a receivable representing the net interest spread, and an intangible representing the mortgage servicing rights.

The intangible asset is to be amortized over the period of the estimated servicing income. The intangible asset is to be deducted when determining the capital of the institution for the purpose of assessing capital adequacy.

- END -