



DATE November 2, 2011

TO All federally regulated financial institutions (FRFIs)

FROM Julie Dickson, Superintendent

SUBJECT FSB Principles on Mortgage Underwriting

The Financial Stability Board (FSB) has published international mortgage underwriting principles for public consultation (http://www.financialstabilityboard.org/publications/r_111026b.pdf). These principles, which will be finalized by early 2012, were designed to strengthen global residential mortgage underwriting practices. The current FSB document is materially aligned with OSFI's expectations for residential mortgage underwriting, although the consultative period could yield some amendments. Once finalized, FRFIs should deem these international principles as *minimum* criteria, and should consider them in the context of their own current mortgage lending practices.

Over the last 18 months, OSFI has conducted focused work on retail lending products, which has yielded a number of observations around industry practices in Canada. OSFI plans additional analysis in this area in the coming months to build on the international work of the FSB, where appropriate.

At this time, however, we direct your attention to the following additional points, which OSFI regards as key supplements to the FSB principles and expects FRFIs are applying to both their domestic and international mortgage lending operations.

1. **Risk Appetite and Tolerance:** Mortgage lenders are expected to have an established, Board of Directors-approved policy for mortgage underwriting that is consistent with the institution's risk appetite and tolerance, and supported through appropriate risk management practices and internal controls.
2. **Policy versus Practice:** Underwriting practices of FRFIs should comply with the established mortgage underwriting policy of that institution. Exceptions should be kept to a minimum, closely tracked and, as appropriate, approved by the Board and/or senior management to ensure adherence to the risk appetite and tolerance of the FRFI.

3. **Independence of Credit Approval:** To minimize the potential for conflicts of interest, OSFI expects that the credit approval function resides within an independent risk management group within the FRFI.
4. **Reporting and Analysis:** Comprehensive, meaningful and actionable reporting, as well as analysis, is required to appropriately measure, monitor and manage the risks in all mortgage lending operations, across all jurisdictions. This will help ensure that the FRFI's risk profile is understood at all levels of the organization and aligned with its risk appetite and tolerance.
5. **Quality Assurance:** Mortgage underwriting should include an effective quality assurance process to identify material deficiencies that may impair loan quality or ability to fully realize on other risk mitigants, including insurance.
6. **Home Equity Lending:** As referenced in the FSB document, it is expected that the principles would also apply to all home equity lending products. While these products provide an alternative source of funds for consumers, FRFIs should recognize that, over time, these products can significantly add to consumer debt loads. Lenders should ensure appropriate mitigation of the risks, including the ability to expect full repayment over time, and the need for increased monitoring of the borrowers' credit quality.
7. **Loan-to-value (LTV) ratio:** Lenders should ensure that loans are subject to an appropriate LTV, which is determined based on current and expected market conditions, as well as other risk factors that may impact borrowers' ability to service their debt and/or lenders' ability to realize on their security.
8. **Recalibration of Risk Parameters, Model Validation and Stress Testing:** Lenders are expected to have reasonable processes and controls in place for regular review and recalibration of risk parameters, model validation and stress testing with respect to their mortgage lending. The results of such stress testing should be substantially reflected in each lender's Internal Capital Adequacy Assessment Process (or "ICAAP") process.
9. **Anti-Money Laundering/Anti-Terrorist Financing:** FRFIs should ensure that they apply the prescribed risk assessment and appropriate monitoring requirements in accordance with the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* and its regulations, and OSFI's Guideline B-8, with respect to detecting and deterring the possible use of a property purchase or mortgage to launder the proceeds of crime or assist in terrorist financing.

Given the current uncertainty and volatility in global capital markets, historically low interest rates, higher Canadian borrower debt-to-income levels, and relatively strong housing price appreciation, OSFI expects FRFIs to be extra diligent in maintaining sound and prudent mortgage underwriting practices.

For additional information, please contact your OSFI relationship manager or Vlasios Melessanakis (Manager, Policy Development) at (613) 998-5478.