

OSFI Issues New Draft Guideline On Residential Mortgage Insurance

Introduction

On April 14 2014 the Office of the Superintendent of Financial Institutions Canada (OSFI) released for consultation Draft Guideline B-21 Residential Mortgage Insurance Underwriting Practices and Procedures. Once finalised, the draft guideline will apply to all federally regulated insurers that are governed by the Insurance Companies Act and provide insurance for residential mortgage loans in Canada, and/or reinsurance for such insured loans.¹ The draft guideline sets out OSFI's prudential expectations for residential mortgage insurance underwriting and related activities in the form of six fundamental principles; it also outlines increased disclosure obligations on insurers issuing such insurance.

Six fundamental principles

The draft guideline articulates six fundamental principles for sound residential mortgage insurance underwriting.

Residential mortgage insurance underwriting plan

Under the draft guideline, insurers engaged in residential mortgage insurance underwriting should have a comprehensive residential mortgage insurance underwriting plan. The plan should be developed and implemented by the insurer's senior management and should contain the insurer's key mortgage insurance underwriting policies, including its:

¹ Any reference to 'mortgage insurance' in this update also includes mortgage loan reinsurance. The remainder of this update makes reference only to mortgage insurance, unless the distinction is required.

- business objectives;
- risk management policies;
- complete set of mortgage insurance products, requirements and conditions for lenders for mortgage insurance coverage; and
- policies for assessing lenders' underwriting and compliance with their mortgage insurance agreements.

The insurer's board is expected to provide guidance to, and oversee senior management's role in, implementing the plan.

Establishing standards for initial assessment and qualification of mortgage lenders

The draft guideline requires insurers to establish sound standards for initially assessing and qualifying mortgage lenders for mortgage insurance coverage. To carry out an initial assessment of a mortgage lender, the insurer is expected to establish sound qualification standards by considering the particular lender's:

- financial soundness;
- mortgage loan underwriting experience;
- ability to provide timely and accurate information on the performance of mortgage loans; and
- delinquency, foreclosure and claims management processes.

Mortgage insurance criteria and insurance coverage requirements for lenders

An insurer issuing residential mortgage insurance should establish prudent underwriting criteria which specify the characteristics and parameters of insurable mortgage loans for lenders. At a minimum, the criteria for mortgage loans for each mortgage insurance product and insurance type should cover certain components, such as:

- mortgage loan parameters;

- the borrower's background and the borrower's willingness and capacity to service debt; and
- underlying mortgage property/mortgage insurance premiums.

To help control risk, the draft guideline also requires insurers to promote sound mortgage underwriting and loan management practices consistent with the insurer's interests. In order to do so, the insurer must outline requirements, conditions and any other obligations to be adhered to by residential mortgage lenders, including elements such as:

- a description of the mortgage insurance coverage;
- a condition for lenders to provide complete, accurate and timely information; and
- requirements for lenders to exercise documentation retention.

Periodic assessments of lenders' underwriting practices

In order to measure, track and control risk, the draft guideline expects insurers to review lenders' underwriting policies on a periodic basis, and to assess and verify the degree to which the insurer's stated criteria and insurance policies are being followed by lenders. Insurers should establish clear policies on the types, methods and frequency of reviews and remedial action to be taken in order to address inadequate underwriting practices by lenders.

Assessment and validation of underwriting systems, models and underwriters' processes

Under the draft guideline, insurers engaged in residential mortgage insurance underwriting should periodically assess and validate their insurance underwriting systems and models to ensure compliance with the residential mortgage insurance underwriting plan. For automated underwriting systems, the insurer should establish programmes to monitor continuously and audit the information received on mortgage loans, and take immediate remedial action to address any identified weaknesses. Insurers should:

- train their underwriting personnel appropriately;

- ensure that underwriters' decisions are well documented; and
- develop appropriate underwriting processes and practices which are regularly monitored and evaluated to assess compliance and consistency in decision making.

Effective portfolio risk management and other risk mitigation

Insurers should have effective portfolio risk management practices, including a stress-testing regime that considers "exceptional, but plausible" events and scenarios and the corresponding impact on asset and liability-side portfolios. Based on the assessment of risk, insurers are expected to adjust their mortgage insurance underwriting criteria and premium schedules appropriately to align with the objectives outlined in their residential mortgage insurance underwriting plan. For higher-risk insured mortgage loans, insurers should exercise heightened caution through:

- greater board and senior management oversight;
- increased reporting to and monitoring by senior management and the board;
- clear internal time limits consistent with the residential mortgage insurance underwriting plan;
- stronger internal controls; and
- increased oversight of higher-risk mortgage lenders.

Increased disclosure requirements

The draft guideline also imposes increased and somewhat onerous disclosure requirements on insurers, although it is not clear exactly how such disclosure should be made, except that it should be "publicly disclosed" to "market participants". The disclosure requirements in the draft guideline include publishing quarterly information relating to residential insurance portfolios and discussions of the potential impact of an economic downturn on insured mortgage loans. The draft guideline requires insurers to provide a breakdown of mortgage loans insured during the past 12 months, as well as the total stock of insured mortgage loans

divided by mortgage insurance type and further categorised by volume, loan to value, amortisation, geography and delinquencies.

Supervisory requirements

The draft guideline not only requires an insurer to maintain and provide to OSFI, on request, its residential mortgage insurance underwriting plan and associated management reports, but also expects an insurer to inform OSFI promptly of any mortgage insurance underwriting issues that could materially affect the insurer's financial condition. The draft guideline gives OSFI the power to take, or require the board and/or senior management to take, necessary corrective measures to deal with issues of financial soundness.

Comment

Through the draft guideline, OSFI has proposed tightening mortgage insurance and lending practices. OSFI is initiating a public consultation on the draft guideline, for which comments are due by May 23 2014. OSFI plans to review and consider all comments before finalising the draft guideline later in 2014, at which time it will provide further guidance on implementation issues, such as the required time for insurers and other stakeholders to adjust their internal systems, policies and processes. A summary of stakeholder comments and OSFI's associated responses will be provided when the final guideline is released.

The draft guideline is consistent with various recent OSFI initiatives requiring insurers to identify, monitor and report on the risks undertaken in their underwriting activities. Once finalised, the requirements of the draft guideline will need to be incorporated into the insurer's risk appetite framework and ultimately dealt with as part of the insurer's own regulatory solvency assessment.

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[a cautionary note](#)

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