CREDIT UNION CENTRAL OF CANADA

SYSTEM BRIEF

IMPLICATIONS OF RECENT FEDERAL POLICY CHANGES FOR CANADA'S CREDIT UNIONS

OCTOBER 2012

"…Over-and-above narrowing the gap between federal and provincial financial sector policy, the new federal policy direction also appears to be moving towards increasing regulatory oversight. This new direction could be construed as furthering the commoditization of loan products and undermining long-standing credit union practices of lending based at least in part on character, membership in a community, or other intangible or "soft" information."

Credit Union Central of Canada

Prepared by:

Marc-André Pigeon
Director, Financial Sector Policy
Credit Union Central of Canada
(613) 232-1262 ext. 350
pigeonm@cucentral.com

Sabrina Kellenberger
Senior Manager, Regulatory Policy
Credit Union Central of Canada
(416) 232-3415 ext.3415
kellenbergers@cucentral.com

Credit Union Central of Canada

TABLE OF CONTENTS

INTRODUCTION

It has been five years since the beginning of the financial crisis. Some things have improved – in Canada and in the United States (but not Europe), unemployment rates have fallen, albeit slowly and modestly. Volatility is diminished, most of the time. North America's economy is growing, albeit tepidly.

In many ways however, the financial crisis lives on. Europe's economy teeters on the brink of recession, with some countries already in the midst of a second severe downturn. Questions remain about the sustainability of the European currency union, with each new round of worry leading to a return to volatility reminiscent of the early years of the crisis. China's economy appears to be slowing. The financial sector continues to reel from revelations of incompetent and fraudulent behaviour, including most recently the Libor scandal, but also failures and fraud at hedge funds like MF Global and Peregrine Financial. Meanwhile, more than 450 U.S. bank failed from 2008 through to 2012.[1]

As a result, the financial crisis is very much alive in the minds of federal policymakers, many of whom vividly remember the scramble – the long hours, the panic, the uncertainty and the criticism – to salvage the financial system and the economy from collapse in 2008-09. To make sense of that period, federal policymakers have crafted a story to describe the federal government's response to the crisis. This story filters policy discussions and says that Canada was saved by a combination of strong regulations and enforcement, judicious use of fiscal and monetary policy, a more, rather than less, concentrated banking system, and perhaps some amount of luck because it was late to the deregulation wave that swept the U.S. and many European countries. In many ways, the federal government has leveraged this story by branding Canada as home to "sound banking" and "strong regulation." This "brand" translates however into a policy eagerness to conform to internationally-driven regulatory efforts, a pattern we document below.[2]

All is not perfect of course: policymakers fret that part of Canada's economic resilience can be attributed to strong, perhaps unsustainable growth in the residential real estate market coupled with historically high levels of household indebtedness, two factors that are believed to have been at the heart of the financial crisis in other countries. These concerns have, if anything, reinforced the Ottawa policy narrative and have helped frame a new policy direction that consists of unwinding deregulation measures introduced before the crisis (see Appendix A for a complete list of measures), introducing new capital and liquidity norms flowing out of the Basel III framework, creating a new legislative framework for federal credit

[1] Author's calculation based on U.S. Federal Deposit Insurance Corporation, "Failed Bank List," available at: http://www.fdic.gov/bank/individual/failed/banklist.html.
[2] Bank of Canada Governor Mark Carney's role as chair of the Financial Stability Board undoubtedly reinforces this tendency.

unions, revising governance guidelines,[3] expanding the reach of federal power and, implementing a host of measures that work through the Office of the Superintendent of Financial Institutions (OSFI), the Canada Mortgage and Housing Corporation (CMHC), the Canada Deposit Insurance Corporation (CDIC) and the Financial Consumer Agency of Canada (FCAC).

Finally, it is important to recognize that unlike many other policy areas where silo-like thinking often precludes coherent policy responses, the federal government has institutional mechanisms to co-ordinate financial sector policy changes. Specifically, the federal government coordinates its financial sector policy through two committees: the Financial Institutions Supervisory Committee (FISC), which is a statutory committee that meets quarterly and is chaired by the head of OSFI,[4] and the Senior Advisory Committee (SAC), which is a more ad hoc group chaired by the Deputy Minister of Finance and responsible for reviewing financial sector policy issues, including legislation and regulation.[5] The membership in both committees is limited to officials from the Department of Finance, OSFI, CDIC and the Bank of Canada.

[3] This guideline is not discussed in this note. Interested readers can consult a draft version of the guideline at: http://www.osfibsif.gc.ca/osfi/index_e.aspx?ArticleID=5051.

[4] In a report issued after the financial crisis, the Auditor General noted however that "during the recent financial turmoil, it met more frequently to address issues as they arose. We found that, through FISC, the Department of Finance Canada, OSFI, and CDIC shared relevant information to guide decision making." See Auditor General of Canada, 2010 Fall Report, Chapter 5, available at: http://www.oag-bvg.gc.ca/internet/English/parl_oag_201010_05_e_34288.html.

[5] In the same 2010 Auditor General report, the Office noted that the SAC "usually meets three or four times a year. We found that the discussions of issues that take place at these meetings influence policy changes."

Section 1: NARROWING THE GAP BETWEEN FEDERAL AND PROVINCIAL FINANCIAL POLICY

Credit union readers may be forgiven for wondering what this new policy framework has to do with them. After all, credit unions have long been regulated provincially from a prudential and consumer perspective, operate largely within provincial boundaries, and are regional almost by definition. While it is important to keep this context in mind, it is also important to recognize just how much direct influence the federal government has on the day-to-day operations of provincially-regulated credit unions. Above and beyond its ability to set rules around privacy, money laundering and terrorist financing, communications and inter-provincial trade (not to mention a range of federal programs designed to assist lending to small businesses), the federal government also has a direct channel into the credit union system through its power to set the terms and conditions related to mortgage insurance provided by CMHC and its private-sector counterparts. The federal government has made significant changes to these terms and conditions since the crisis and they have a direct and immediate impact on Canadian credit unions, regardless of jurisdiction.

Credit unions should also understand the new federal policy framework because there is reason to believe that the policy distance between the two jurisdictions, insofar as it concerns financial sector matters, is likely to narrow substantially in the future. There are three major reasons to support this conjecture. First, the federal government has clearly signaled that it will do what it takes to ensure a stable financial system, including reaching into provincial jurisdiction. The recently-introduced federal credit union legislation is, itself, some evidence for this proposition because it gives federal policymakers a window into the credit union system that they did not have before. Moreover, the mere fact of having this new legislative responsibility means that the Department of Finance now devotes staff time to monitoring the health of the credit union system. It also means that the Department has been courting credit unions to jump to the federal level, engaging in direct talks with some credit unions, but also querying provincial government officials about other potential candidates.

Further evidence of the federal government's all-consuming drive towards financial stability comes from changes in 2009 to the *Financial Administration Act*, referred to colloquially in Ottawa circles as the "spiderman" changes because they potentially extend the federal financial sector web deep into provincial jurisdiction.[6] Paradoxically, we also understand, from discussions with a senior official at the provincial level

[6] Specifically, these changes enacted in 2009 in Part IV.1 of the Financial Administration Act enable the federal government to enter into "any contract that in the Minister's opinion is necessary to promote the stability or maintain the efficiency of the financial system in Canada, including such a contract to (*a*) purchase, acquire, hold, lend or sell or otherwise dispose of securities of an entity; (*b*) create a charge on, or right or interest in, securities of an entity held by the Minister; (*c*) make a loan to an entity; (*d*) provide a line of credit to an entity; (*e*) guarantee any debt, obligation or financial asset of an entity; or (*f*) provide loan insurance or credit insurance for the benefit of an entity in respect of any debt, obligation or financial asset of the entity.

and from public comments by a senior regulator in a different province, that the federal government has made it clear to provincial governments that it will not backstop them in the event of a crisis at a major provincially-regulated financial institution. These calls may have been motivated by a recent report by the International Association of Deposit Insurers (IADI) which singled-out the "moral hazard" presumed to exist in the four Western provinces that offer unlimited deposit insurance.[7] They may also be motivated in part by a desire to lever discussions about a need for a banking union – with a single deposit insurer – in the European Union. Either way, the calls suggest that the federal government is intent on protecting the Canadian brand as a leader in financial services regulation.

At a minimum, these two policy activities amount to a rather strange juxtaposition of seemingly conflicting objectives. The Spiderman changes suggest that, on the one hand, the federal government wants the power to interfere in order to salvage the financial system even if that means stepping into provincial jurisdiction. At the same time, the phone calls suggest it wants to minimize the expectation that it will do anything of the sort. Notwithstanding the seeming contradiction, the effect could be to prod the provinces – because of fear about some future liability – into at least contemplating changes that would make it easier – or more interesting – for credit unions to obtain a federal charter. Over and above these activities, the federal government has also laid the groundwork for resolving insolvent federally-regulated financial institutions – including future federal credit unions – while minimizing the risk of having government absorb related costs. It has done this by granting the CDIC the right to own shares in its member institutions and establish a "bridge institution" to preserve critical functions of one of its member institutions in the event of a crisis.[8]

The second reason to think there could be a narrowing gap between federal and provincial regulation is that the historical migration of trust and insurance company regulation to federal oversight suggests that in some circumstances, provincial governments and their regulators *are* willing to countenance just such a move. Specifically, in the current context, this uploading of responsibility might gain salience if (a) challenging fiscal circumstances cause provincial governments to re-examine the costs associated with regulating the sector, including the contingent financial risks arising from deposit insurance; (b) politicians grow increasingly concerned about the inherent *political* risks of having responsibility for a sector that can be part of significant systemic problems; or (c) the federal government does something – like place "moral suasion" phone calls – that increase the incentives of shifting regulatory responsibility up the line. Given these forces, some provincial governments may eventually come to believe that it is in their interest to harmonize their rules with those of the federal government to make the move to federal jurisdiction as compelling as possible.

[7] International Association of Deposit Insurers (IADI), "Core Principles for Effective Deposit Insurance Systems," available at: http://www.iadi.org/aboutiadi.aspx?id=105.
[8] Amendments introduced to the *Canada Deposit Insurance Corporation Act* as a result of the 2009 Budget Implementation Act.

Third and finally, there is already evidence that some provincial regulators are taking their cue from federal policy changes including at least two provincial regulators – the Deposit Insurance Corporation of Ontario (DICO) and the Financial Institutions Commission in British Columbia (FICOM)[9] – that have asked member institutions to closely follow the recently introduced OSFI guidelines around residential mortgage lending, which we discuss below.

To be sure, it is of course important to recognize that there is still a major gap between most federal financial sector policy and its application to provincially-chartered credit unions. Any narrowing of this gap will take time, if it happens at all, and will be subject to the vagaries of political calculations and changes, different historical trajectories and antipathies towards Ottawa, and of course the larger federal-provincial relationship.

With that in mind, we focus the rest of our discussion on five key categories of policy changes. The first two of these have an immediate impact on credit unions while the other three affect credit unions only indirectly and in the future. The policy changes with a direct and immediate impact include: (1) changes to terms and conditions related to CMHC mortgage insurance, including portfolio insurance and (2) changes to CMHC approved lender criteria. The policy changes with indirect and future implications for credit unions include: (3) recently introduced residential mortgage lending guidelines; (4) a new covered-bond legislative framework; and (5) anticipated changes to capital and liquidity requirements for federally-regulated financial institutions.

To forecast our discussion, we can summarize by saying that over-and-above narrowing the gap between federal and provincial financial sector policy, the new federal policy direction also appears to be moving towards increasing regulatory oversight. This new direction could be construed as furthering the commoditization of loan products and undermining long-standing credit union practices of lending based at least in part on character, membership in a community, or other intangible or “soft” information.

Commoditization – or “factory lending” as some refer to it – serves two broad policy purposes. First, it allows regulators to easily monitor and exert some control over the financial services sector from the comfort of their desks, an important consideration in an era of fiscal restraint and ongoing human resource challenges at regulatory bodies such as OSFI. In short, commoditization allows for quantification and it is often said that you cannot control what you cannot measure.

Second, and surprisingly, the new emphasis on regulatory tightening facilitates a turn to a specific type of market-based financial sector policy that involves the federal government shedding responsibility for insuring mortgages, a little understood outcome that recently received some attention after federal finance Minister Jim

[9] This information is based on discussions with chief executive officers at two large credit unions in each province as well as a conversation with a senior provincial official.

Flaherty mused publicly about the possibility.[10] We elaborate on this theme later in the text and in our concluding comments. Ultimately, and regardless of the policy intent, the federal government's policy direction poses a risk to the credit union system to the extent that it favours factory lending and therefore the kind of scale found at larger banks.

[10] Tara Perkins, "Flaherty Eyes Privatization of CMHC," *Globe and Mail*, October 22, 2012, accessed on October 25th and available at: http://www.theglobeandmail.com/report-on-business/economy/housing/flaherty-eyes-privatization-of-cmhc/article4627593/

Section 2: CHANGES RELATED TO MORTGAGE INSURANCE

The federal government exerts tremendous influence over credit union residential mortgage underwriting practices by means of its control over the terms and conditions related to mortgage insurance provided by CMHC and its private-sector counterparts. Since the crisis, the federal government has introduced a large number of measures that effectively unwind prior deregulation efforts in an effort to dampen what it perceives as speculative activity in some parts of the housing market caused by a very low interest rate environment.

While these measures are detailed in Appendix A, they can be summarized as follows: since the crisis, the federal government has reduced the maximum amortization period for mortgage insurance to 25 years from 40, increased the minimum down payment to 5 per cent from zero, required borrowers to qualify for a five-year fixed-rate mortgage before qualifying for a variable rate mortgage, reduced the maximum refinancing rate to 85 per cent from 95 per cent of value, imposed minimum down payments of 20 per cent on the purchase of “speculative” properties, and banned the sale of mortgage insurance on home-equity lines of credit (HELOCs).

The federal government also imposed a limit on the sale of CMHC mortgage portfolio insurance, which is a *purely optional product* that “provides lenders with the ability to purchase insurance on pools of previously uninsured low ratio mortgages.”[11] The cap, which has been distributed based on historical usage, was imposed to ensure that CMHC could comfortably meet demand for traditional mortgage insurance (on individual purchases) given an overall legislative limit of $600 billion on the *combined* issuance of both types of insurance (as of 30 June 2012, insurance in force was $576 billion).

Credit Union Implications

These measures are not in and of themselves necessarily negative for the credit union system because they apply to insured loans issued by all lenders, regardless of size, jurisdictions or other consideration. In other words, they create a “level playing field.”[12] At the same time, the measures could limit the range of possibilities available to credit unions that might want to lend to nonconforming and marginalized borrowers such as first nations people, immigrants or low income individuals, many of whom may struggle to meet the new CMHC terms.

---

[11] CMHC, “CMHC Statement on Portfolio Insurance,” available at: http://www.cmhc-schl.gc.ca/en/corp/nero/nero_019.cfm. Mortgage insurance is used by financial institution to help securitize mortgages. Note that the bank pays the insurance charge, not the consumer as in traditional individualized mortgage insurance. The insurance applies to individual mortgages within the pool.

[12] As discussed in a joint CUCC/Filene sponsored publication, the “level playing field” metaphor sometimes works against credit union interests. In this case, however, the metaphor is appropriate and constructive from a credit union perspective. The publication is available at: http://filene.org/publications/detail/Competitive_Balance.

Paradoxically, they could also impinge on the ability of credit unions to lend to anyone who is asset rich and income poor, but otherwise represents a very low default risk. These "asset rich, income poor" individuals include many wealthy seniors, high-income recently divorced couples whose income and assets are tied up in legal proceedings and the temporary startup costs of operating two households instead of one, and small business owners who are able to legally shelter much or all of their income from a tax perspective but who nevertheless are perfectly able to service substantial home mortgage loans.[13]

In limiting the ability of credit unions to exercise judgment and discretion based on what they know about individuals and their circumstances, the regulatory changes again effectively standardize or commoditize residential mortgages and facilitate securitization, two outcomes that favour large-scaled institutions with fewer branches at the expense of smaller, more local institutions with a greater branch presence.

Interestingly, the Bank of Canada has produced research that shows how these outcomes could also, increase default (and hence systemic) risk.[14] In the study, the authors find that Canadian banks which rely on hard information – essentially quantifiable metrics such as credit scores, gross debt service ratios and total debt service ratios – at the expense of soft information (assessments of character, family, community) tend to incur higher default rates than those that use more soft information. In fact, the study shows that a (standard deviation) greater reliance on hard information is associated with a 10 per cent increase in bankruptcies. These are important findings that should be understood by all policymakers before they reflexively increase regulatory burden, effectively commoditize lending products and indirectly undermine what has traditionally been an important credit union advantage.

On the other hand, the hard cap on mortgage portfolio insurance could work against this commodification tendency in the sense that it limits the extent to which credit unions can purchase the product and package their mortgages. While this might seem like a good thing from the perspective of a concern about commodification, it is important to remember that portfolio insurance is only available for pools of mortgages that have low loan-to-value measures (under 80 per cent) and hence effectively exclude most non-conforming mortgages. In other words, if there is a mortgage product that can and should be commoditized, these kinds of very safe, plain-vanilla mortgages are probably it.

[13] To illustrate, any of these individuals could easily fall offside CMHC's new gross debt and total debt service ratio requirements because they report low or zero notice of assessment (NOA) income.

[14] Jason Allen, H. Evren Damar, and David Martinez-Miera, "Consumer Bankruptcy and Information," Bank of Canada Working Paper No. 2012-18, available at: http://www.bankofcanada.ca/2012/07/publications/research/working-paper-2012-18/.

Section 3: APPROVED LENDER REQUIREMENTS

Credit unions interested in selling and administering CMHC insured mortgages must qualify as "approved lenders." There has been some indication that CMHC is reviewing these criteria.[15] Currently, the qualification criteria include:

- Membership in a Regional Central – Centrals support the activities of their members with respect to CMHC approved lender criteria and provide related administrative and intermediary services;
- Evidence that the credit union is financially sound (CMHC evaluates financial statements);
- "Sound" underwriting and loan administration policies which meet established CMHC policies;
- Evidence that the percentage of monthly arrears is "satisfactory" relative to other approved lenders and that the foreclosure ratio is equal to or better than the national average of claims for similar risk of National Housing Act (NHA) loans;
- A commitment to ongoing fulfillment of all the duties and responsibilities expected of NHA approved lenders.

Credit Union Implications

While the nature of the potential changes to the approved lender designation is unclear, it is important to recognize that at a minimum, the criteria are an obvious channel or conduit by which the federal government can directly influence residential underwriting practices at credit unions. For example, discussions with CMHC officials confirm that the Crown institution is considering how it might integrate elements of the B-20 guideline (discussed next) into these criteria.

[15] Based on discussions with Atlantic Central, CMHC at one point considered, for example, imposing a requirement that approved lenders must have at least $1 million in *share* capital rather than the current rule, which applies to *total* capital (share capital + *retained earnings*). CMHC has since withdrawn from this position but has said that changes will be coming.

Section 4: OSFI MORTGAGE UNDERWRITING GUIDELINES

Earlier this year, and in response to concerns about an over-valued housing market, OSFI introduced a guideline document that explains how the regulator expects federally-regulated financial institutions (FRFIs) to underwrite, track, and manage risk associated with issuing residential mortgages. OSFI expects that FRFIs will implement the guideline no later than fiscal year-end 2012. While the guideline includes considerable detail structured along five core principles (see Appendix B), it can be roughly summarized as follows. To begin with, OSFI expects FRFIs to put together a plan – overseen by the board of directors – that will govern its residential mortgage activities. This plan in turn should set out how the institution will implement prudent lending practices, including its tools/practices to: (a) evaluate the borrower's *willingness* and *ability* to pay; (b) accurately assess the value of the underlying property being purchased; and (c) evaluate the viability of firms that sell it mortgage insurance products. OSFI says it expects FRFIs to take a "risk-based approach" to the guideline, meaning they have some latitude with respect to the more detailed elements of the guideline.

Credit Union Implications

While OSFI cannot impose the guideline on provincially-regulated credit unions, it does bear on organizations owned by the system such as Concentra Financial and League Savings and Mortgage Co.,[16] the provincial Centrals and future federal credit unions. As discussed above, Credit Union Central of Canada (Canadian Central) also anticipates that elements of the B-20 guideline could find their way into CMHC's Approved Lender criteria. Elements of the guideline could also, of course, be incorporated into provincial regulatory standards, which would further extend its reach into the credit union system. As discussed earlier, Canadian Central has been told that two major provincial regulators are already encouraging credit unions to follow the B-20 guideline.

Generally speaking, the guideline – especially in its final form (the draft was far more prescriptive) – appears to largely conform to existing credit union underwriting practices. In that sense, it does not pose much of a challenge to the system, especially since the risk-based approach seems to build in some degree of interpretational latitude, and may even serve to improve the system's competitive position by making it more difficult for non-traditional institutions to play at the margins and creating a negative "race-to-the-bottom" kind of environment.

[16] To the extent that the guideline facilitates securitization, it could be viewed as favourable to both these institutions since they actively help credit unions package and sell mortgages, a process greatly facilitated by commodification and certainty with respect to underwriting practices.

At the same time, by codifying a set of underwriting expectations, the guideline could also be construed as a step towards standardizing mortgage contracts, something that – to the extent the guideline reaches into the system – could harm the system's ability to provide mortgages to the "non-conforming" borrowers discussed earlier, i.e., low-income individuals, immigrants, rural Canadians (where incomes tend to be more volatile), Aboriginal people or simply members the credit union knows well but for whom income documentation is hard to come by, including "asset rich, income poor" individuals.

Coupled with OSFI expectations that FRFIs will assess the financial capability of those who sell mortgage insurance, the B-20 guideline seems to point towards a broader federal policy objective of facilitating and even encouraging the use of products such as traditional *National Housing Act* (NHA) mortgage backed securities or covered bonds (refer to Section 5). These kinds of products *require* relatively homogenous and transparent underlying assets coupled with faith in the underwriting process and related mortgage insurance (where applicable).

Section 5: COVERED BONDS AND INCREASED CMHC OVERSIGHT

The federal budget bill passed earlier this year[17] introduced a new covered bond framework designed to entice institutional investors and help create a deep and liquid covered bond market. The same bill also gave the Department of Finance much greater control over CMHC, including a seat on its Board.

With respect to covered bonds, the new legislative framework outlines some key protections, conditions, and limitations. These include (a) legal protection for purchasers of covered bonds in the event of bankruptcy/insolvency of the registered issuer; (b) a requirement that covered bond issuers must register with CMHC; and (c) stipulations that covered bond collateral *cannot* include: loans insured by CMHC or private mortgage insurers; loans with loan-to-value ratios greater than 80 per cent; more than 10 per cent worth of Government of Canada securities; *and* any "prescribed asset" unless regulations are made to the contrary.

With respect to increased CMHC oversight, the federal government introduced (and passed) in that same Budget Bill legislative amendments that, among other things, task OSFI with supervising CMHC to ensure that the corporation is "carrying on its activities … in a safe and sound manner, including whether it is carrying on those activities with due regard to its exposure to loss." Note that while CMHC was not, until the legislation, subject to OSFI oversight, the corporation already "adhered to the capital guidelines that are applied (by OSFI) to its private counterparts."[18] In keeping with the federal government's concern about Canada's housing finances, the amendments also introduced changes to the *National Housing Act* that define new objectives for CMHC and which underlined the government's concern about financial stability and its exposure to losses. In particular, the new objectives require CMHC to: (a) promote the efficient functioning and competitiveness of the housing finance market; (b) promote and contribute to the stability of the financial system, including the housing market; and (c) have due regard to the Corporation's exposure to loss.

The amendments also introduced measures that increase the Department of Finance's influence and control over CMHC which, technically, reports to Parliament through the Department of Human Resources and Skills Development (HRSDC). Under these measures, the Minister of Finance has the right to:

- Approve and/or specify terms and conditions governing the principle and interest payment guarantee tied to securities issued on the basis of housing loans (i.e., securitized assets such as National Housing Act Mortgage Backed Securities (NHA MBS);

---

[17] The 2012 Budget Bill (Bill C-38), *The Jobs, Growth and Long-term Prosperity Act* received Royal Assent on June 29, 2012.

[18] CMHC, *Canadian Housing Observer 2011*, p. 21, available at: http://www.canadianmortgagetrends.com/canadian_mortgage_trends/Article_Files/2012/CMHC-2011.pdf. According to CMHC, as of December 2010, CMHC's capital level was more than double that of the minimum requirement.

- Make regulations respecting classes of housing loans and the criteria to be met by loans in each of those classes in order for the corporation to be able to provide insurance against risks relating to those loans; and
- Recommend regulations to the Governor in Council respecting a broad range of CMHC activities found in Part I of the *National Housing Act*, including for example activities related to the terms and conditions tied to mortgage insurance and payment guarantees related to securitized assets.

Finally, the amendments add the Deputy Minister of Finance to CMHC's board of directors (as well as HRSDC's Deputy Minister). In keeping with the federal government's desire to improve coordination among its key financial system institutions, the legislation also provided OSFI with the power to disclose any information/records collected as part of its CMHC oversight to the Minister of Finance, Minister of HRSCD and to the Bank of Canada.

Credit Union Implications

The credit union implications of these changes depend very much on why they are happening. The OFSI oversight and the new Department of Finance powers over CMHC point very clearly to a desire by the federal government to constrain CMHC in some fashion. Ostensibly, the goal is to discourage CMHC from behaving in a way that contributes to speculation in housing, although the federal government has refrained from explicitly pointing the finger at any CMHC wrongdoings and CMHC has made efforts to shore up its credibility by pointing to its large equity base (for example). At a minimum, it would seem to point to the possibility or probability of even more changes that "tighten up" the terms and conditions associated with CMHC mortgage insurance.

The covered bond framework however potentially suggests a more ambitious objective, namely to create a situation whereby the federal government extricates itself from the direct sale of mortgage insurance. If this was the government's intention, there are models it could follow. In Denmark[19] for example, the mortgage market is girded by a covered bond legal framework that ensures ample funding and other potentially desirable features, including notably the absence of a state-sponsored mortgage insurance company; callable covered bonds with strict limits on maturity transformation;[20] the opportunity for borrowers to effectively "buy back" their mortgage at a discount in the event of a major crisis/downturn by purchasing an equivalent amount of covered

[19] For a good overview of how the Danish market works, see John Campbell, "Mortgage Market Design," available at: http://scholar.harvard.edu/campbell/files/mortgagemarketdesign081612.pdf.

[20] Covered bonds are a type of debt instrument secured by dedicated mortgage assets which remain on the books of the mortgage originator (and covered bond issuer). A "callable" bond simply means that the issuing institution can "call on" the buyer to sell back the bond under conditions outlined in the covered bond covenant. "Limits on maturity transformation" refers to the idea that the underlying mortgage assets tend to be for fixed terms that cannot easily be changed. Covered bonds offer several benefits from a policy perspective. They discipline lenders by exposing them to borrower default because the underlying assets stay on the books while limits on maturity transformation mean that investors bear interest-rate risk (i.e., the risk that their covered bond asset will decline in price if rates rise).

bond debt;[21] zero prepayment penalties meaning that homeowners are fully incentivized to refinance when rates decline; assumable mortgages which allow home buyers to “assume” (take over) the mortgage of the seller; strict regulation and conservative underwriting standards incentivized by the callable bond market; and a large, diversified and relatively liquid covered bond market because of the aforementioned features.

For a government with a tendency to generally favour market-based solutions and consumer-friendly policies, this model holds a great deal of appeal. First, the Danish example shows how a mortgage market without a state-sponsored insurer can work while minimizing speculation (the Danish market is notably stable). Second, it aligns with the federal government’s existing efforts to tighten up residential mortgage lending standards through the B-20 guideline and its changes to CMHC mortgage insurance terms. Third, it has some consumer-friendly features, including the “buy back,” “zero prepayment penalty,” and “assumable” options. Fourth and finally, it is likely to simultaneously appeal to at least some financial institutions that already have covered bond programs and want to expand them. Regardless of whether this situation comes to pass, the thrust of these measures – the covered bond framework plus greater CMHC oversight by Finance and OSFI – point in one direction: more regulatory control over mortgage underwriting which, again, point in the direction of greater commodification with all its attendant consequences.

[21] In this scenario, the homeowner would buy a covered bond with characteristics (maturity, principle, interest rate) similar to his or her mortgage at a discount to the covered bond’s nominal value.

Section 6: NEW CAPITAL ADEQUACY REQUIREMENTS

In anticipation of international reforms that will come into effect for Canadian deposit-taking institutions on January 1, 2013, OSFI recently released for comment a revised *Capital Adequacy Requirements (CAR) Guideline*. The draft Guideline consolidates the two current CAR guidelines, Guideline A and A-1, and institutions presently using the simpler CAR approaches will only be required to refer to the chapters relevant to their capital adequacy measures.

The proposed revisions by OSFI are driven by measures directed at internationally active financial institutions that were agreed to by the Basel Committee on Banking Supervision (BCBS) in September 2010 (the "Basel III" accord). The proposals aim to strengthen the regulation, supervision and risk management of the banking sector by addressing regulatory capital and liquidity failures that contributed to the 2007-2009 global financial crisis. Although the draft Guideline will only directly apply to OSFI-regulated banks and trust and loan companies, including in future, federally chartered credit unions, it is possible that some provincial jurisdictions will also model their capital requirements on this Guideline, thus impacting provincially regulated credit unions.

The draft Guideline, which focuses on more and higher quality capital (i.e. common shares) that must be held to absorb unexpected losses, is divided into nine chapters, of which one addresses the definition of capital and the remainder speak to the methodologies to be used in estimating the risk exposures of various types of assets. Notably, the draft Guideline sets out minimum standards for the assets to capital multiple and three risk-based capital ratios. In doing so, the draft Guideline articulates:

- A new definition of regulatory capital;
- An increase in the minimum amount of common equity capital required; and
- The concepts of a "capital conservation buffer" and a "countercyclical capital buffer."

Under the draft Guideline, federally-regulated financial institutions will be expected to meet minimum risk-based capital requirements that are commensurate with their exposure to credit, operational and market risks. In order to determine this level of capital, financial institutions must compute a risk-weighted assets number for the credit risk they face using the applicable models set out in the Guideline, and add this number to capital charges for operational and market risk calculated using one or a combination of the approaches also set out in the Guideline for this purpose. The resulting total risk weighted assets are then divided into regulatory capital (see definition below[22]) to calculate three key capital ratios: Common Equity, Tier 1 (CET 1) capital; Total Tier 1 capital; and Total Capital. Consistent with the Basel III phased-in approach, the percentage of

[22] Total Regulatory Capital is defined as the sum of: Tier 1 capital (= Common Equity, Tier 1 capital + Additional Tier 1 capital) and Tier 2 capital.

these ratios progressively increase annually starting in 2013 and by 2015[23] must equal at a minimum, 4.5 per cent, 6 per cent and 8 per cent, respectively. This represents an increase of 2.5 per cent in CET 1 capital and 2 per cent in Tier 1 capital over Basel II requirements. The total capital ratio remains at 8 per cent.

In addition, to help avoid breaches of the minimum capital requirements, institutions will be expected to hold a "capital conservation buffer" that can only be met with CET 1 capital. OSFI expects that a capital buffer will be held at levels above the regulatory minimum during periods of stress, and if drawn down, will be rebuilt within a reasonable amount of time. The phase-in period for the capital buffer will run from 2016 to 2019, at which time it should equal a minimum of 2.5 per cent of risk-weighted assets. This will mean that, including the capital buffer requirement, the CET 1 capital, Tier 1 capital, and Total capital ratios must equal a minimum of 7, 8.5 and 10.5 per cent, respectively, by the first fiscal quarter of 2019.

However, OSFI expects all institutions to reach these target capital ratios early in the transition period. This means an 'all-in' target of 7 per cent for CET 1 is expected to be reached by the first quarter of 2013, and the targets of 8.5 and 10.5 per cent respectively for Tier 1 capital and Total capital by the first quarter of 2014. Should an institution fail to meet the relevant target ratios, "supervisory action will be taken proportional to the shortfall and circumstances that caused the shortfall and may include a range of actions, including restrictions on distributions." As well, the Guideline states, "the Superintendent may set higher target capital ratios for individual institutions or groups of institutions where circumstances warrant. This could include additional capital required when aggregate credit growth is judged to be associated with a build-up or material system-wide risk in Canada or other jurisdictions where an institution has credit exposures." Such a measure would provide a discretionary "countercyclical capital buffer" that would help ensure capital and asset growth remain proportionate.

And lastly, the Guideline reaffirms an assets to capital multiple of 20:1, although OSFI will consider granting approval of multiples up to 23:1 under specific circumstances.

Credit Union Implications

Currently, only retail associations, e.g. Concentra Financial, and provincial Centrals come under OSFI supervision. With respect to the Centrals, OSFI's focus seems to be on their capacity to act as liquidity providers to credit unions. As a result, the *currently* applicable OSFI CAR guideline for co-operatives has placed emphasis on a "borrowing multiple" test, specifying that total borrowings should be no greater than 20 times capital, although the Superintendent may prescribe a lower, or higher, multiple. In making this calculation, "borrowings" are defined as being comprised of total deposit liabilities and other loans payable, while "total capital" is comprised of Tier 1, or "core capital," and Tier 2, or "supplementary capital." Importantly

[23] The phase-in of certain regulatory adjustments and phase-out of non-qualifying capital instruments, however, continues to 2021.

for affected Centrals, “core capital” is defined as including membership shares, where repayment is subject to the Superintendent’s approval; contributed surplus; and retained earnings, as well as qualifying non-cumulative perpetual preferred shares.

The draft Guideline is clear in its application to banks and trust and loan companies. However, a key concern about this framework from a credit union system perspective is its future application to a federal credit union, which will be considered a “bank” under the *Bank Act,* and its potential use as a template for provincial regulatory capital requirements. Under the draft CAR, for shares to qualify as CET 1 capital they must meet thirteen criteria taken from Basel III, including, crucially, requirements that: (a) share principal is “perpetual and never repaid outside of liquidation;” (b) shares are “in the form of issued capital that takes the first and proportionately greatest share of any losses as they occur;” and (c) where “the institution does not, in the sale or marketing of the instrument, create an expectation at issuance that the instrument will be bought back, redeemed or cancelled, nor do the statutory or contractual terms provide any feature which might give rise to such expectation.”

Credit union share capital does not typically meet these criteria and the potential impact of this is so significant that The World Council of Credit Unions Inc. (WOCCU) recently released a White Paper on the issue of *Credit Union Shares as Regulatory Capital under Basel III*. In exploring the issue, the paper points out that “The EU’s draft legislation to implement Basel III—which is known as the ‘CRD IV Package’—would treat cooperative shares as Common Equity Tier 1 capital if they are not redeemable or have significant restriction on their redemption, can absorb losses on a going-concern basis, and meet other similar requirements (such as being accounted for as ‘equity’)” and suggests that “credit union supervisors who plan to implement Basel III regulatory capital rules for credit unions should adopt an approach that is the same as or similar to the EU’s approach.” If regulatory bodies heed this suggestion, the capital requirements will be no more onerous for a federal credit union than for banks of similar size and characteristics.

It is important to recognize, however, that OSFI’s proposed guideline does not appear to carve out any special place for federal credit unions. This would seem to suggest that ***if*** federal credit unions wish to have their member shares recognized as CET 1, these shares will have to look and feel very much like common equity – that is, they will among other things have to be non-redeemable (i.e., perpetual), fully paid-in and loss absorbing, and entitled to an unlimited and variable residual claim (after all claims have been paid in liquidation). This kind of “member share” light could be seen as challenging some core credit union notions, including:

- The *unlimited and variable claim* requirement potentially opens the door to predatory demutualization because it closes the door to bequeathing credit union surplus (upon dissolution) to charities, government, or other cooperatives – all practices used in other jurisdictions to limit demutualization. It should be noted, however, that despite few impediments to demutualization in most Canadian jurisdictions, there is no record of a credit union having demutualized in Canada.

- The changes could also make it more challenging to establish a federal credit union. Founding members may be reluctant to invest in a new federal credit union knowing their "investment" is forever locked up in the institution. In any investment, liquidity is a key concern. To address this concern, federal credit unions may feel compelled to issue founding members some combination of traditional (but non-redeemable) equity and some amount of equity shares that could be traded on public exchanges.

Section 7: CHANGES IN LIQUIDITY MEASURES

The Basel III framework also contains changes to liquidity risk management requirements and in February 2012, OSFI released its Guideline B-6, *Liquidity Principles* that outlines the framework within which the content and effectiveness of liquidity risk management in Canadian banks and federally regulated trust and loan companies will be assessed. Guideline B-6 reiterates Basel III's 13 principles that encompass issues such as the requirements for a clearly articulated liquidity risk tolerance, a sound process for identifying, measuring, monitoring and controlling liquidity risk, as well as a formal contingency funding plan that articulates strategies for addressing liquidity shortfalls in emergency situations. Stress testing is also a key aspect of the principles, as is the maintenance of a cushion of high quality, unencumbered liquid assets which would be held as insurance against stress scenarios.

However, B-6 stops short of adopting Basel III's two minimum standards for funding liquidity that assess the robustness of liquidity arrangements under a variety of runoff assumptions and other stress scenarios, and will come into force in 2015 as per an internationally agreed timeline. Instead, while OSFI intends to implement the Basel liquidity standards and monitoring metrics as per the agreed upon timeline, it intends to use a home-grown measure dubbed the "Net Cumulative Cash Flow", or NCCF,[24] in the interim and possibly retain it as an additional metric post implementation of the Basel framework in 2015.

The BCBS already has an "observation period" of the two quantitative standards in Basel III liquidity framework underway. The first standard is the Liquidity Coverage Ratio (LCR) which is designed to ensure that an institution has sufficient high quality, unencumbered assets to survive a significant stress scenario lasting for 30 calendar days. Affected institutions will be expected to meet the LCR at all times. In calculating this ratio—which does not consider intraday liquidity needs—cash outflows and inflows over the 30-day stress period need to be considered and a buffer of high quality liquid assets equal to or greater than the net outflow needs to be maintained.

The second Basel III standard is the Net Stable Funding Ratio (NSFR). Targeted for implementation in 2018, this ratio is an assessment of the robustness of an institution's funding position over a one-year period of less severe stress, such as a significant decline in profitability or solvency, a potential downgrade in debt or a material event affecting the reputation or credit quality of the institution. Intended to steer liquidity profiles away from short-term funding mismatches towards longer-term stable funding, this ratio underscores the

[24] The NCCF is described in B-6 as a "survival horizon metric that quantifies the length of time before an institution's cumulative net cash flow turns negative, once factoring in the stock of available liquid assets."

intricate inter-relationship between capital and liquidity by requiring an assessment of all on and off-balance sheet assets, identification of the illiquid portion of each over the one year stress period, and the holding of equity capital or particular types of longer term debt that are expected to be reliable sources of funds over a one year time horizon.

In addition, the Basel accord sets out various tools to be used in the ongoing monitoring of the liquidity risk exposures and in communicating these exposures to regulators. These tools are intended to further strengthen and increase consistency in liquidity risk supervision and include four metrics that are to be viewed over various time periods.

- *Contractual Maturity Mismatch*—the mismatch between cash inflows and outflows;
- *Concentration of Funding Sources*—the identification of wholesale funding sources, which if withdrawn, could trigger liquidity problems;
- *Available Unencumbered Assets*—the monitoring and reporting of the quantity, type, currency and location of available unencumbered assets which could be used to raise liquidity at a reasonable cost; and
- *LCR by Significant Currency*—a monitoring tool intended to monitor the LCR in significant currencies.

Credit Union Implications

Although the Basel III liquidity standards are intended to apply to "internationally active" banks, national regulatory authorities will determine which banks fall into that category. And as with capital requirements, it is possible that provincial jurisdictions will adopt, or in some way adapt, the liquidity standards as well. The ultimate impact on the credit union system will depend on how regulators in various jurisdictions interpret and apply the requirements.

Nonetheless, on a general level, the obvious impact of such a regime on financial institutions is one of increased cost. To begin with, there will be cost increases related to holding more capital and liquidity. Liquidity requirements may also compel financial institutions to securitize more of their loans, which of course depends on a supply of standardized/commoditized loans. Over and above these impacts, there will also be implementation/transition costs and on-going reporting costs. And ultimately, these costs will find their way to the level of consumers and impact the economy at large through reduced investment and consumption.

Recognizing that implementing stronger prudential standards around capital and liquidity comes at a cost to institutions and the economy, the Bank of Canada attempted to quantify these costs in a research paper released in 2010.[25] At a microeconomic level, the paper identified various methods an affected financial institution might use to meet requirements for higher levels of regulatory capital. Those that could be

---

[25] *Strengthening International Capital and Liquidity Standards: A Macroeconomic Impact Assessment for Canada.* Bank of Canada, August 2010.

applicable to the credit union system include the internal generation of capital via retained earnings, higher interest rate spreads, increasing non-interest fee income, reducing operating expenses, issuance of investment shares and lowering the risk-weighted asset denominator in the capital ratio calculations by slowing the growth of, or even disposing of, assets that do not generate sufficient revenue to justify the associated capital charges. At least some of these measures are likely to deepen pressures to commoditize loan products and move away from more difficult-to-assess loans to some of the groups identified earlier.

With respect to liquidity requirements, which are expected to be finalized by the end of 2012, the situation is somewhat different as there are concerns the measures may curtail banks' lending and longer-term investment activity. In response to these fears, the BCBS has gradually relaxed the definition of "liquid assets," and continues to discuss the contentious issue of the make-up of assets usable in calculating the LCR. As well, assumptions on run-off rates and client draw-downs on liquidity lines have been eased. And regulators for their part have become increasingly aware of the unintended consequences and challenges associated with setting liquidity requirements and are committed to addressing them. It is worth, noting however, that assuming these liquidity requirements end up being applied to credit unions, some may find that their banking systems make it difficult or impossible to accurately hive off less from more liquid assets for the purposes of regulatory reporting on liquidity, leading to substantial regulatory burden costs.

Overall, the 2010 Bank of Canada research paper determined that "for each 1-percentage-point increase in the bank capital ratio, lending spreads would increase by about 14 basis points, which is very close to the international median of 15 to 16 basis points. New liquidity requirements are also estimated to add about another 14 basis points, in total, to lending spreads. As a result, the cost of a two-percentage-point increase in capital requirements, in conjunction with the new liquidity standards, should be an increase in lending spreads of about 42 basis points. This would reduce the level of GDP by about 0.3 per cent relative to a baseline trends over the long run." At the same time, the Bank of Canada paper concluded that Canada "should benefit significantly from the anticipated reduction in the likelihood of future financial crises as a result of strengthened capital and liquidity requirements" and estimated this benefit to about 13 per cent of GDP, or $200 billion on a net present-value basis. It is important to recognize, however, that the Bank of Canada's research implicitly assumes that financial institutions have the pricing power suggested by these widening spreads. The effort to standardize and regulate residential mortgages suggests however that this is unlikely to happen since, again, standardization begets commodification which begets lower prices and hence lower spreads.

Conclusion

The recent trajectory of events, in the context of the financial crisis, offer some hints as to the future direction of federal financial sector policy and potential credit union implications. Generally, we can infer that, chastened by the financial crisis, the federal government has an interest in expanding its reach into the credit union system to ensure future financial stability. Some provincial governments might eventually be tempted to accommodate the ostensible federal desire for increased responsibility over, or at least understanding of, credit unions.

We can also infer that the federal government *remains* committed to a policy course that favours a market-oriented approach to financial sector policy. Prior to the crisis, this translated into deregulating the rules that frame the residential mortgage market. Now, given the subsequent reversal detailed above and in Appendix A, this same commitment to a market-oriented approach means something very different.

First, it means a *more* forceful role for the government in terms of setting the rules and enforcing them. Second, there is reason to believe that the government is trying to balance – or even leverage – these more stringent (and enforced) rules by building the institutional mechanisms needed for it to withdraw from the direct provisioning of mortgage insurance. The covered bond framework, B-20 guideline and limits on CMHC mortgage insurance (which are moving closer to being breached), could be part of that policy shift, as could OSFI's expectations, under the B-20 guideline, that federally-regulated financial institutions (FRFIs) assess the financial abilities of mortgage insurers, something that hardly seems necessary for a company like CMHC which enjoys explicit federal government (i.e., sovereign) backing.

While this conjecture about a shift away from government provided mortgage insurance is at first blush at odds with efforts to tighten mortgage rules, these are in fact consistent objectives. If the private sector is going to assume full responsibility for issuing mortgage insurance and if covered bonds are going to be an increasingly important part of the financial landscape, then these activities flourish best when girded by a solid set of well-thought out – and enforced – rules that help commoditize loan products. It is no wonder then that the CD Howe Institute, an advocate of privatizing CMHC, praised the federal government's recent covered bond and CMHC budget changes as "superb long-term measures" and note that "as the market matures, we should find that the housing finance system can function perfectly well, out from under the umbrella of taxpayer guarantees.[26] As indicated in the introduction, it also noteworthy of course that Finance Minister Jim Flaherty has recently indicated that the government is considering just such a privatization of CMHC.

---

[26] Greg Quinn and Andrew Mayeda, "Canada Sets New Rules on Covered Bond Market," *Bloomberg*, April 26, 2012. Accessed October 6th, 2012, available at: http://www.bloomberg.com/news/2012-04-26/canada-says-insured-mortgages-can-t-be-covered-bond-colla.html.

Third, the government's market-oriented approach translates into the pursuit of a strategy that empowers consumers by means of financial literacy and consumer-friendly policies around credit cards, loans and other measures aimed at helping consumers help themselves (or avoid getting too far into debt). The underlying philosophy is that consumers have some degree of responsibility to manage their own financial affairs; government's role is to help them with some degree of protection from abuse coupled with the educational tools they need to make informed decisions in their best interests.

Assuming the federal government really does have a strategy of withdrawing from the direct sale of mortgage insurance, what does this mean for credit unions? First, it is important to recognize that if this is going to happen, it likely will not be anytime soon – these are at best medium to long-term plans contingent on electoral cycles and thus highly susceptible to being derailed. Finance Minister Flaherty for example has talked about this occurring in five to ten years. In short, there is no need for any kind of immediate response – credit unions should simply carry on issuing mortgages in the prudent but responsive way they always have. This is especially true since some of the changes discussed here do not bear directly on credit unions, at least not yet.

Second, looking out into the medium to long-term term when there may be federal credit unions and assuming many of these rules get translated provincially, the system will need to think about how it can work collaboratively to manage transition costs that might result from a move away from CMHC insurance. The system might, for example, consider the costs and benefits of pooling its resources to measure the financial stability of mortgage insurers, a new OSFI requirement for federally-regulated financial institutions. It might also work together to consider what a credit union covered bond issue might look like. It may also mean deepening partnerships with groups like the Canadian Federation of Independent Business (CFIB), whose membership undoubtedly includes some members who fall into the "asset rich, income poor" category.

Third, from a lobbying perspective, the system might wish to direct Canadian Central to argue the case for carving out space for credit unions that want to behave a little differently than their bank competitors. In practical terms, this could mean some kind of proportionality test and/or limited exemptions to the general rules for credit unions that want to avoid the commodification trend and focus on old-fashioned relationship banking of the kind they have long excelled at providing.

Regardless of the likely direction of federal policy changes, the system would be well served by at least understanding the new thrust of federal policymaking, a policy direction that has consistently surprised market participants, very few of whom anticipated the sharp tightening of mortgage underwriting standards by OSFI and the Department of Finance in the last two or three years or the many related financial sector policy changes.

APPENDIX A

POLICY CHANGES SINCE (AND BEFORE) THE FINANCIAL CRISIS; MORTGAGE INSURANCE MEASURES (CMHC, GENWORTH, CANADA GUARANTEE)

A. Pre-Crisis: Financial “Innovation” or Deregulation by Stealth

- 2006: Doubled amount of available mortgage insurance “space” to $200 billion and opened up this additional room to new competitors (Budget 2006) – raised subsequently to $600 billion currently;
- 2006: Allowed CMHC and private insurers to increase maximum permissible mortgage insurance amortization period to 40 years;
- 2007: Lowered requirement to purchase mortgage insurance to those with less than a 20% down payment from 25% previously;
- 2006 – 2008: Allowed competition to drive minimum down payment for owner-occupied homes to 0%, reduce minimum down payment to 5% for “speculative” properties and increase maximum refinancing to 95%.

B. Post-Crisis: Re-Regulation

- Increased minimum down payment for owner-occupied dwellings to 5% from 0% before the crisis;
- Increased minimum down payment for “speculative” (non-owner-occupied) properties to 20% from 5% before the crisis;
- Reduced the maximum loan/value refinancing in three successive steps to 80% from 95% before the crisis;
- Lowered maximum amortization for CMHC-insured mortgages to 25 years in three successive steps from 40 before the crisis;
- Limited the availability of government-backed insured mortgages to homes with a purchase price of less than $1 million;
- Introduced new requirement that CMCH-insured (or private-sector insured) borrowers who want a variable rate mortgage must qualify for fixed 5-year term;
- Eliminated the sale of mortgage portfolio insurance on Home-Equity Lines of Credit (HELOCs);
- Limited the gross debt service ratio to 39 per cent and total debt service ratio to 44 per cent;
- Established a consistent minimum credit score requirement of 620 (with a limited basket of exceptions available);
- Required the lender to make a reasonable effort to verify that the borrower can afford the loan payment;
- Introduced new loan documentation standards to ensure that there is evidence of reasonableness of property value and the borrower’s sources and level of income;
- Capped the sale of mortgage portfolio insurance to the financial services industry and assigned shares based on historical usage (detrimental to the credit union system since we only recently started using mortgage portfolio insurance)
- Capped the total amount of mortgage insurance (individual + portfolio) at $600 billion (increased from $450 billion, during the crisis)

OTHER POST-CRISIS RESIDENTIAL MORTGAGE CHANGES

- Introduced new mortgage underwriting guidelines called the B-20 guideline that apply to all mortgages, insured or not;
- Introduced in recent budget a new “covered bond” legislative framework that will allow banks and other FIs (including larger credit unions) to issue covered bonds;
- Introduced in recent budget legislation giving OSFI regulatory oversight over CMHC and which also gives Dept of Finance considerable control over CMHC terms and conditions around mortgage insurance products (they also get a seat on CMHC’s board).

POST CRISIS CONSUMER-ORIENTED POLICY CHANGES

Over and above these changes, the federal government has also introduced what could be characterized as "consumer friendly" measures aimed at helping consumers make more informed better decisions, a situation which should help improve the financial service sector's efficiency. These include:

1. Funding Task Force on Financial Literacy which issued its final report in the winter of 2011.

2. Funding a Financial Literacy "Champion" or "leader" to spearhead a financial literacy strategy for the country.

3. Increasing funding to the Financial Consumer Agency of Canada, which is most responsible for Financial Literacy currently.

APPENDIX B

APPENDIX B: GUIDELINE B-20 OVERVIEW

The B-20 guideline is organized in terms of five key principles, each containing considerable detail on OSFI's expectations. Herewith follows a brief description of those principles and some of that detail.

- Principle 1: OSFI expects FRFIs to have a "comprehensive" residential mortgage underwriting policy (RMUP) that reflects the size, nature and complexity of the FRFIs' residential mortgage. The RMUP should identify items such as (but not limited to) limits on any exceptions to normal underwriting standards, processes for such exceptions, and roles and responsibilities of those charged with overseeing the RMUP. Significantly, OSFI expects the FRFI's board to provide "high-level guidance" and oversight of senior management's implementation of the RMUP.

- Principle 2: OSFI expects FRFIs to performance "reasonable" due diligence to record and assess the borrower's identity, background, and *willingness* to pay his or her debt on a timely basis. Under this principle, OSFI outlines a number of core documents it would expect to find related to this due diligence process, including for example a description of the purpose of the loan, proof of employment status and verification of income, credit bureau reports and so on. This information should be collected at origination and any subsequent refinancing but **not** necessarily at renewal as was proposed initially in the draft document (a major point of objection by Canadian Central and other interveners).

- Principle 3: OSFI expects FRFIs to "adequately" assess the borrower's *capacity* to service his or her debt on a timely basis. To satisfy this principle, OSFI expects FRFIs to calculate well-known debt service ratios (gross debt service and total debt service ratios), perform due diligence on any guarantors/co-signors, and consider other factors such as the borrower's assets, other living expenses (condo fees for example) and risks to the borrower's income from job loss.

- Principle 4: OSFI expects FRFIs to have a good understanding of how much the properties underlying its residential mortgages are worth, i.e., "sound collateral management and appraisal processes." In particular, OSFI advocates a risk-based approach that among other things employs a mix of valuation methods (on-site, third-party and automated valuation appraisals), ensures legal enforceability and respects maximum loan-to-value measures delineated internally, outlined in law (e.g., mortgage insurance required for LTV in excess of 80%) or suggested by regulators (OSFI says it expects FRFIs to impose a maximum LTV ratio of less than or equal to 65% for non-conforming residential mortgages).

- Principle 5: OSFI expects FRFIs to have effective credit and counterparty risk management practices and procedures. This principle means that FRFIs should for example understand the strengths and weaknesses (risks) of those firms – including CMHC – which sell them mortgage insurance. They should similarly understand the underwriting practices of firms that sell them mortgage assets. FRFIs should also "stress test" the impact of unlikely scenarios on their portfolios, periodically have their valuation and bankruptcy models evaluated by outside parties, and generally exercise "heightened prudence" for non-conforming mortgages.

Credit Union
Central of Canada

300 The East Mall, Suite 500
Toronto, ON M9B 6B7
(416) 232-1262
www.cucentral.ca

208-350 Sparks Street
Ottawa, ON K1R 7S8
(613) 238-6747