HOUSING RESEARCH REPORT

Impact of Credit Unions and Mortgage Finance Companies on the Canadian Mortgage Market

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June 2017

Preface

Our team at Deloitte is pleased to present the following report to CMHC reviewing the impact of credit unions and mortgage finance companies on the Canadian mortgage market.

CMHC approached Deloitte in hopes of gaining a better perspective on what potential impacts credit unions and mortgage finance companies could have on the Canadian mortgage market. CMHC had a particular focus on risk, and understanding if the strategies, operations, and practices of these lenders introduce incremental risk to Canada's mortgage market compared to the operations of bank lenders. Therefore, throughout this report, we made efforts to compare these types of lenders and explore relative performance, while uncovering distinctive practices.

For this engagement, we conducted a combination of primary and secondary research including interviews with and data gathering from a cross section of credit unions and mortgage finance companies. The project team worked collaboratively with CMHC to augment the analysis with insights from credit bureau data and engaged in secondary research to develop a fulsome perspective.

We trust that this report will contribute to more informed decision-making for CMHC and its key partners.

Best,

Andrew Hamer
Senior Manager
Monitor Deloitte

Executive Summary

Key Insights

The Canadian residential mortgage market has demonstrated strong growth over the past decade. Banks dominate the landscape, but credit unions and mortgage finance companies (MFCs) are also significant players, holding 17% of market share in 2016.

Credit unions and MFCs play an important role in the Canadian residential mortgage market. Their presence promotes healthy competition among lenders and offers borrowers an alternative to the major banks. Credit unions specifically provide options to borrowers who are either outside the target trade areas of major banks, or may fall outside the risk appetite of those banks. MFCs, largely prime lenders, disproportionately serve younger homebuyers, a proxy for first-time homebuyers. MFCs are also integral to the stability of the mortgage broker channel – a distribution channel that, based on it consistently representing more than 30% of annual industry origination volume, is a valued alternative to lender-owned distribution channels.

This report finds no evidence that credit unions and MFCs are introducing material levels of incremental risk to the Canadian residential mortgage market based on borrower or portfolio profiles, credit and liquidity risk management practices, and growth strategies. Available data sourced from Equifax and from study participants indicates that portfolio composition and performance are directionally similar to that of the major banks. While risk management practices vary across credit unions, the large players have guidance in line with OSFI's standards; mid-tier and small credit unions have less structured risk management practices but maintain segregation of duties and lines of oversight, while monitoring delinquency rates and other indicators. MFCs follow OSFI's underwriting guidelines and are under close scrutiny from insurers and investors. In general, MFCs have robust risk management practices and have historically shown average delinquency rates lower than those of other lenders. It is important to note that delinquency rates are indicators of past performance and this report does not, nor does it attempt to, answer how credit unions and MFCs will perform in modeled financial distress scenarios.

An important future consideration is the impact of interprovincial expansion in the credit union system. Credit unions' level of local market expertise is a key advantage, translating into the ability to selectively extend credit to borrowers who are perceived as 'riskier' (e.g., unscorables), at acceptable incremental risk levels to the enterprise. As credit unions enter new markets, their credit writing capacity and expertise may be tested. Greater competition from more mortgage alternatives should be a positive outcome for borrowers and if credit adjudication based on deep knowledge of local markets is truly a core competency then credit unions will adapt to the nuance of new local markets. In this case, expansion should result in more options for borrowers, particularly those who might be considered to be on the fringe of prime by a major bank, but would fall within the risk appetite of a credit union. What is unknown is if the pressure to drive growth and extend credit in new local markets will impact the prudence demonstrated by credit unions today.

The regulatory changes introduced by the Department of Finance in the fall of 2016 appear to have helped stabilize the housing market. However, a unified view that emerged through consultation for this report is that these changes have disproportionately hurt the competitiveness of MFCs. For example, due to the changes in insurance eligibility, it is no longer economically feasible for MFCs to continue competing for refinance business or serve certain customer segments altogether (e.g., borrowers seeking properties over $1 million). This reconstituted competitive landscape presents a new set of challenges for MFCs to compete with banks and solutions are not readily available.

Summary of Analysis

While banks and credit unions are increasing mortgage lending as a share of total loans, growth of residential mortgage lending as a share of total lending at credit unions outpaced that at banks over the last decade. Market penetration for credit unions (i.e., percentage of population that use a credit union) varies dramatically across provinces; credit unions have over 1/3 market penetration in some provinces compared to ~5% in others, and tend to have significantly higher penetration in non-metropolitan areas. Credit unions rely heavily on deposits for funding, generally in the range of 70-90% of all mortgage lending. In recent years, credit unions have started funding loans increasingly using demand rather than term deposits, and through securitization.

Credit unions have demonstrated strong growth since the financial crisis, primarily fueled by organic membership and market growth and partially due to industry consolidation. Growth strategies vary by size of lender; some are considering non-traditional sources of driving origination volume, such as increasing reliance on the mortgage broker channel and large credit unions especially are looking at new technology investment as a means to drive growth and remain competitive. Credit unions face many uncertainties associated with growth including: member demographics; greater commoditization of financial products with buyers increasing making decisions solely based on rate; and their ability to modernize and streamline their processes. There will likely be a continued divergence in business models between smaller and larger credit unions, and access to funding to drive growth will remain a critical concern for larger players.

MFCs rely heavily on securitization as well as agreements with balance sheet lenders (i.e., whole loan sales and commitments) to drive revenue. Sale of whole loans and spreads on securitized mortgages compose just over half of MFC revenue. MFC business models look similar across organizations; they are broker-dependent, compete nationally and generally diversify revenue between the 'originate to sell' mortgage model and mortgage business process outsourcing. MFCs have felt a significant impact due to regulatory changes and are seeking new funding sources, and to drive more revenue through business process outsourcing. Their dependence on other lenders is likely to increase as they strengthen their position as infrastructure providers and rely more on whole loan sales and commitments from investors. MFCs consulted for this report are expecting to lose market share of originations.

Most major Canadian lenders self-declare as prime only lenders; the risk profiles of different lenders are fairly similar, with each lender type having ~10% of business in the non-prime segment. The more significant differences in borrower creditworthiness, as proxied by the Equifax Risk Score (ERS), are regional, varying from 7% of borrowers with ERS lower than 670 (Quebec) to as high as 15% (New Brunswick). There is significant difference in age profiles, with MFCs serving a disproportionately high number of young borrowers (i.e., those below 41) and credit unions serving a disproportionately high number of older borrowers (those over 50). Credit unions and MFCs consistently demonstrate lower arrears rates than bank lenders: 0.13% at credit unions, 0.14% at MFCs, and 0.29% at banks. The relatively low arrears rates at credit unions are primarily driven by large and mid-tier credit unions, with small credit unions having arrears rates roughly equal to those at banks. Generally, mid-tier and small credit unions have more concentration risk than larger lenders due to their limited geographic footprints, and are therefore more susceptible to regional impacts.

Both credit unions and MFCs continue to rely on the broker channel, a significant and growing channel in the Canadian landscape, representing ~40% of purchases and with a high concentration among first-time home buyers. The broker channel is an important source of volume for credit unions, as it increases access to customers and provides operational scale. The MFC business model is almost entirely reliant on brokers for originations.

The dynamics of the channel may change in response to recent regulatory shifts, as credit unions and MFCs have indicated they will be unable to match prices being offered by banks in the prime 'uninsurable' segment, decreasing the value proposition of the broker as a source of competitive rates for borrowers. However, the ability of the broker to place volume among lenders may be increasingly important as the complexity of the lending environment increases; lenders are increasingly stratifying their rates by borrower segment as regulatory changes have significantly impacted the economics of different segments. This increases the value of the broker's ability to compare different offerings and match borrower risk profiles with the right product offering.

Resumé

Perspectives

Le marché hypothécaire résidentiel canadien a connu une forte croissance au cours de la dernière décennie. Les banques dominent le paysage, mais les coopératives de crédit et les sociétés de crédit hypothécaire sont aussi des acteurs importants, avec une part de marché de 17 % en 2016.

Les coopératives de crédit et les sociétés de crédit hypothécaire jouent un rôle important sur le marché canadien du crédit hypothécaire résidentiel. Leur présence favorise une saine concurrence entre les prêteurs et offre aux emprunteurs une solution de rechange aux grandes banques. Les coopératives de crédit offrent des solutions aux emprunteurs qui ne font pas partie des secteurs commerciaux cibles des grandes banques, ou qui se trouvent en dehors des zones à risque de ces dernières. Les sociétés de crédit hypothécaire, qui ne consentent généralement que des prêts à faible risque, desservent un nombre démesurément élevé de jeunes acheteurs, dont des accédants à la propriété. Les sociétés de crédit hypothécaire font également partie intégrante de la stabilité du réseau des courtiers hypothécaires, un réseau de distribution qui représente de manière constante plus de 30 % du volume annuel de prêts émis par le secteur et qui constitue une solution de rechange appréciée aux réseaux de distribution appartenant aux prêteurs.

Dans le présent rapport, rien n'indique que les coopératives de crédit et les sociétés de crédit hypothécaire présentent des niveaux importants de risque supplémentaire sur le marché canadien du crédit hypothécaire résidentiel, d'après le profil de l'emprunteur ou du portefeuille, les pratiques de gestion du risque de crédit et de liquidité et les stratégies de croissance. Les données disponibles provenant d'Equifax et des participants à l'étude indiquent que la composition et le rendement du portefeuille sont semblables à ceux des grandes banques. Bien que les pratiques de gestion des risques varient d'une coopérative de crédit à une autre, les grands intervenants disposent de directives conformes aux normes du Bureau du surintendant des institutions financières (BSIF); les petites et moyennes coopératives de crédit ont des pratiques moins structurées de gestion des risques, mais elles maintiennent la séparation des tâches et des secteurs de supervision, tout en surveillant les taux de prêts en souffrance et d'autres indicateurs. Les sociétés de crédit hypothécaire respectent les lignes directrices du BSIF en matière de souscription et font l'objet d'un examen minutieux de la part des assureurs et des investisseurs. En général, les sociétés de crédit hypothécaire ont des pratiques de gestion rigoureuses du risque et ont toujours affiché des taux de défaillance moyens inférieurs à ceux des autres prêteurs. Il est important de prendre note que les taux de défaillance sont des indicateurs du rendement antérieur et que le présent rapport ne définit pas ni ne tente de définir la manière sont les coopératives de crédit et les sociétés de crédit hypothécaire se comporteront dans des scénarios modélisés de difficultés financières.

L'incidence de l'expansion interprovinciale du système des coopératives de crédit constitue un facteur important à prendre en considération à l'avenir. Le niveau d'expertise des coopératives de crédit sur le marché local est un avantage clé, ce qui se traduit par la capacité d'accorder de façon sélective des prêts à des emprunteurs considérés comme « plus à risque » (p. ex., des emprunteurs dont il est impossible d'établir la cote) à des niveaux de risque supplémentaires acceptables. Au fur et à mesure que les coopératives de crédit pénétreront de nouveaux marchés, leur capacité de souscription et leur expertise pourront être mises à l'épreuve. Une plus grande concurrence concernant les solutions de rechange hypothécaires doit être un résultat positif pour les emprunteurs et, si l'approbation du crédit fondée sur une connaissance approfondie des marchés locaux est véritablement une compétence fondamentale, les coopératives de crédit s'adapteront à la réalité des nouveaux marchés locaux. En pareil cas, l'expansion devrait se traduire par davantage de solutions offertes aux emprunteurs, en particulier ceux qui pourraient être considérés comme étant en marge d'un taux préférentiel accordé par une grande banque, mais qui seraient en dehors des zones à risque d'une coopérative de crédit. On ignore si les pressions exercées pour stimuler la croissance et accroître le crédit sur les nouveaux marchés locaux auront une incidence sur la prudence dont font preuve les coopératives de crédit aujourd'hui.

Les changements réglementaires apportés par le ministère des Finances à l'automne 2016 semblent avoir contribué à stabiliser le marché du logement. Toutefois, une vision unifiée qui est ressortie de la consultation aux fins du présent rapport est que ces changements ont nui de façon disproportionnée à la compétitivité des sociétés de crédit hypothécaire. Par exemple, en raison des changements de l'admissibilité à l'assurance, il n'est plus économiquement possible pour les sociétés de crédit hypothécaire de continuer de faire concurrence aux sociétés de refinancement ou de desservir certains segments de clientèle (p. ex., les emprunteurs qui cherchent des propriétés de plus de 1 million de dollars). Ce paysage concurrentiel reconstitué présente un nouvel ensemble de défis que doivent relever les sociétés de crédit hypothécaire afin de rivaliser avec les banques, et les solutions ne sont pas facilement accessibles.

Résumé de l'analyse

Bien que les banques et les coopératives de crédit augmentent les prêts hypothécaires en proportion du total des prêts, la croissance des prêts hypothécaires résidentiels en proportion du total des prêts accordés par les coopératives de crédit a dépassé celle des banques au cours de la dernière décennie. La pénétration du marché par les coopératives de crédit (c.-à-d. le pourcentage de la population faisant affaires avec une coopérative de crédit) varie considérablement d'une province à l'autre; les coopératives de crédit ont plus du tiers de la pénétration du marché dans certaines provinces comparativement à environ 5 % dans d'autres, et elles ont tendance à afficher une pénétration beaucoup plus élevée dans les régions non métropolitaines. Les coopératives de crédit comptent largement sur les dépôts à des fins de financement, généralement dans une fourchette oscillant entre 70 et 90 % de tous les prêts hypothécaires. Ces dernières années, les coopératives de crédit ont commencé à financer des prêts en utilisant de plus en plus la demande et la titrisation, plutôt que les dépôts à terme.

Les coopératives de crédit ont connu une forte croissance depuis la crise financière, principalement alimentée par l'adhésion des membres et la croissance du marché, mais aussi en partie par la consolidation du secteur. Les stratégies de croissance varient selon la taille du prêteur; certains prêteurs tiennent compte des sources non traditionnelles du volume des prêts consentis, comme le recours accru au réseau des courtiers hypothécaires, et les grandes coopératives de crédit, en particulier, considèrent les nouveaux investissements technologiques comme un moyen de stimuler la croissance et de demeurer concurrentielles. Les coopératives de crédit sont confrontées à de nombreuses incertitudes liées à la croissance, notamment les suivantes : le profil démographique des sociétaires; une plus grande marchandisation des produits financiers, combinée à la prise de décisions des acheteurs fondées uniquement sur les taux; ainsi que la capacité de moderniser et de rationaliser les processus. Il y aura probablement une divergence continue dans les modèles d'affaires entre les coopératives de crédit de plus petite taille et de plus grande taille, et l'accès au financement pour stimuler la croissance demeurera une préoccupation cruciale pour les grands acteurs.

Les sociétés de crédit hypothécaire se fient largement à la titrisation et aux ententes conclues avec les prêteurs sur bilan (c.-à-d. aux ventes de prêts et aux engagements) pour produire des revenus. La vente de prêts et les écarts sur des hypothèques titrisées représentent un peu plus de la moitié des revenus des sociétés de crédit hypothécaire. Les modèles d'affaires des sociétés de crédit hypothécaire se ressemblent d'une société à l'autre; les organisations dépendent des courtiers, se font concurrence à l'échelle nationale et diversifient généralement leurs revenus entre le modèle « visant à monter en vue de vendre » et l'impartition des processus opérationnels hypothécaires. Les sociétés de crédit hypothécaire, qui ont subi des répercussions importantes à la suite des changements réglementaires, cherchent de nouvelles sources de financement et produisent plus de revenus grâce à l'impartition des processus opérationnels. Leur dépendance à l'égard des autres prêteurs risque d'augmenter à mesure qu'elles renforceront leur position en tant que fournisseurs d'infrastructures et qu'elles se fieront davantage aux ventes de prêts et aux engagements des investisseurs. Les sociétés de crédit hypothécaire consultées dans le cadre du présent rapport s'attendent à perdre leur part de marché des prêts hypothécaires.

La plupart des principaux prêteurs canadiens sont d'avis qu'ils consentent seulement des prêts à faible risque; les profils de risque des différents prêteurs sont assez semblables, chaque type de prêteur ayant environ 10 % des activités dans le segment des prêts à risque élevé. Les écarts les plus importants dans la solvabilité des emprunteurs, tels qu'ils sont estimés selon le pointage de crédit d'Equifax, sont régionaux, oscillant entre 7 % des emprunteurs ayant un pointage de crédit inférieur à 670 (au Québec) et 15 % (au Nouveau-Brunswick) selon Equifax. Il existe d'importants écarts dans les profils d'âge, les sociétés de crédit hypothécaire desservant un nombre démesurément élevé de jeunes emprunteurs (c.-à-d. de moins de 41 ans) et les coopératives de crédit desservant un nombre démesurément élevé d'emprunteurs plus âgés (c.-à-d. de plus de 50 ans). Les coopératives de crédit et les sociétés de crédit hypothécaire affichent constamment des taux d'arriérés inférieurs à ceux des banques : 0,13 % dans les coopératives de crédit, 0,14 % dans les sociétés de crédit hypothécaire et 0,29 % dans les banques. Les taux d'arriérés relativement faibles des coopératives de crédit sont principalement attribuables aux grandes et moyennes coopératives de crédit, les coopératives de petite taille ayant des taux d'arriérés à peu près égaux à ceux des banques. En général, les petites et moyennes coopératives de crédit présentent un risque de concentration plus élevé que les prêteurs de plus grande taille en raison de leur empreinte géographique limitée; elles sont donc plus sensibles aux répercussions régionales.

Les coopératives de crédit et les sociétés de crédit hypothécaire continuent à compter sur le réseau des courtiers, un réseau important et croissant dans le paysage canadien qui représente environ 40 % des achats et qui est fortement concentré parmi les accédants à la propriété. Le réseau des courtiers est une importante source de volume de prêts pour les coopératives de crédit, car il accroît l'accès aux clients et fournit une échelle opérationnelle. Le modèle d'affaires des sociétés de crédit hypothécaire dépend presque entièrement des courtiers pour les prêts hypothécaires consentis.

La dynamique du réseau pourrait changer à la suite des changements récents de la réglementation, car les coopératives de crédit et les sociétés de crédit hypothécaire ont indiqué qu'elles ne seront pas en mesure d'égaler les taux offerts par les banques dans le segment des prêts « non assurables », ce qui réduira la proposition de valeur du courtier comme source de taux concurrentiels pour les emprunteurs. Toutefois, la capacité du courtier à placer le volume de prêts émis entre les prêteurs peut être de plus en plus importante à mesure que la complexité du contexte des prêts augmente; les prêteurs stratifient de plus en plus leurs taux par segment d'emprunteurs, étant donné que les changements réglementaires ont eu une incidence importante sur l'économie de différents segments. Cela accroît la valeur de la capacité du courtier de comparer différentes offres et de jumeler les profils de risque des emprunteurs à l'offre de produits qui convient le plus.

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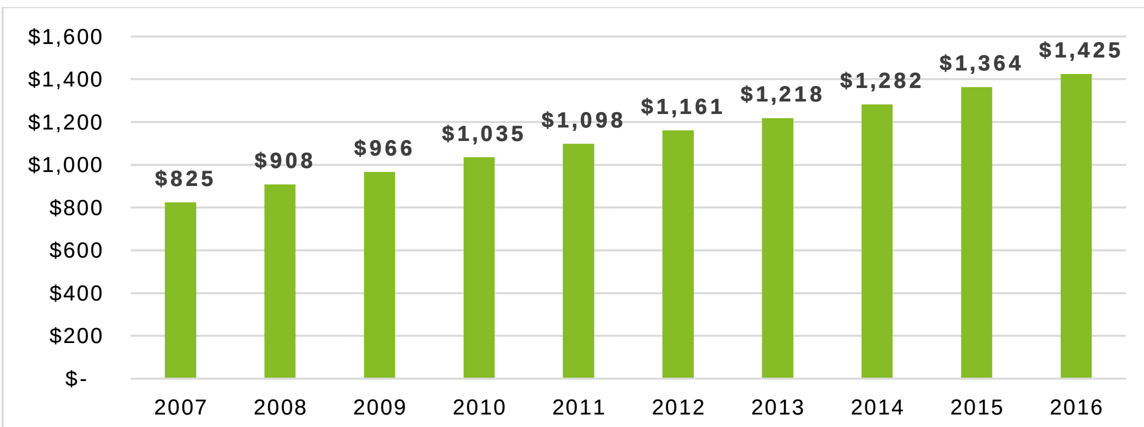
1. Canadian Residential Mortgage Market Overview

Residential real estate is the single largest line item on the balance sheet of Canadian households.[1] Among financial institutions, the residential real estate secured lending business (inclusive of secured lines of credit and secured term loans, collectively referred to as the "mortgage business" in this report), typically among the largest retail lines of business, is a customer relationship anchor and a key contributor to overall earnings. A stable and robust mortgage market is critical to households and lenders alike.

The Canadian residential mortgage market has experienced strong growth for most of the past decade. As Figure 1 indicates, in 2016, the value of Canadian residential mortgages outstanding reached $1.4 trillion CAD, up 73% from 2007. The cumulative average rate was 4.2% from 2012 to Q3 of 2016.[2]

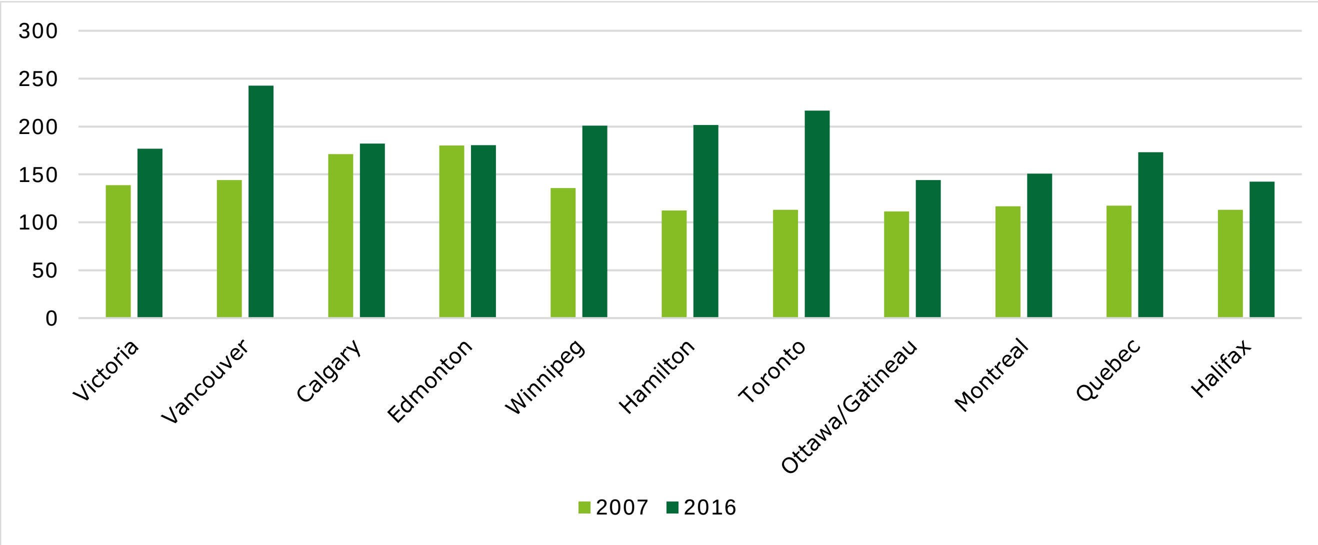
Figure 1: Canadian Residential Mortgage Market, 20017-Q32016 ($B)



Mortgage growth has been supported by strong real estate markets in key urban and suburban centres (Figure 2) and low borrowing costs. Most urban and suburban centres grew by more than 25% from 2007 to 2016; Toronto led with 91% growth while Hamilton and Vancouver grew at 79% and 69%, respectively.[3] Despite the overall strong health of the Canadian mortgage landscape, many observers believe that near-term growth will be moderate as a result of slower property appreciation and regulatory reform.

[1] Household Balance Sheet 2016. Investor Economics
[2] "Housing Finance." ***CMHC, 2016***. https://www.cmhc-schl.gc.ca/en/hoficlincl/homain/stda/data/data_005.cfm
[3] "Index History." ***House Price Index, 2017***. https://housepriceindex.ca/index-history/

Figure 2: Real Estate Markets House Price Index in Key Urban and Suburban Centres[4]



Estimates for annual residential real estate secured lending origination volume vary based on inclusion of secured lines of credit and hybrid "all-in-one" products[5]. Origination volume in 2016 was an estimated $300B - $350B.[6]

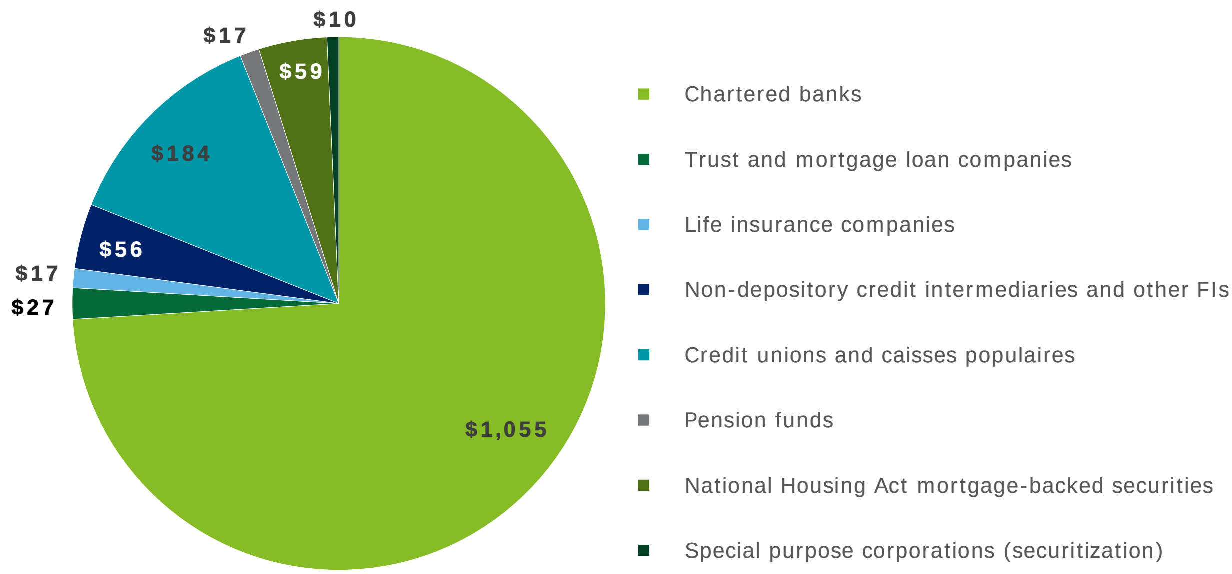
Market Players

Three major types of lenders in Canada dominate the residential mortgage industry: Chartered schedule 1 banks, credit unions and caisses populaires, and mortgage finance companies (MFCs). Collectively, these institutions represent 91% of the mortgage market as measured by credit outstanding.

Banks largely dominated the market with 74% market share in Q3 of 2016 (Figure 3). Credit unions and *caisse populaires* held 13% market share; and non-depository credit intermediaries and other financial institutions, including MFCs, held approximately 4% market share. Market shares of different lender types have largely remained the same from 2012 to Q3 of 2016. See Appendix A for a description of each lender type.

[4] Ibid; Indexed to June of 2015
[5] "All-in-one" products refer to solutions that combine the functionality of a primary transaction account, a line of credit and a term loan – where the credit portion is secured against residential real estate
[6] Equifax and Deloitte analysis.

Figure 3: Residential Mortgages Outstanding by Funder Type, Q3 2016 ($B)[7]



Distribution

There are three primary distribution channels for mortgages in Canada:

1. Physical branches owned and operated by banks and credit unions
2. Tied mobile advisors (employees of a bank or credit union), and
3. Independent mortgage brokers

Digital distribution is nascent in the Canadian market and despite recent introduction of digital pre-approvals and digital applications, there is no meaningful origination volume being driven 'end-to-end' through digital channels in Canada.

Distribution dynamics have shifted in the last decade toward mobile sales and mortgage brokers. The physical branch channel has decreased in value and market share as lenders shift credit writing expertise out of the branches and invest in mobile mortgage advisors. Lenders are increasingly routing more complex deals from branch to mobile advisors. From 2010 to 2016, several bank lenders increased the strength of their mobile salesforce channel by proportions ranging from 25% to as high as 200%.[8]

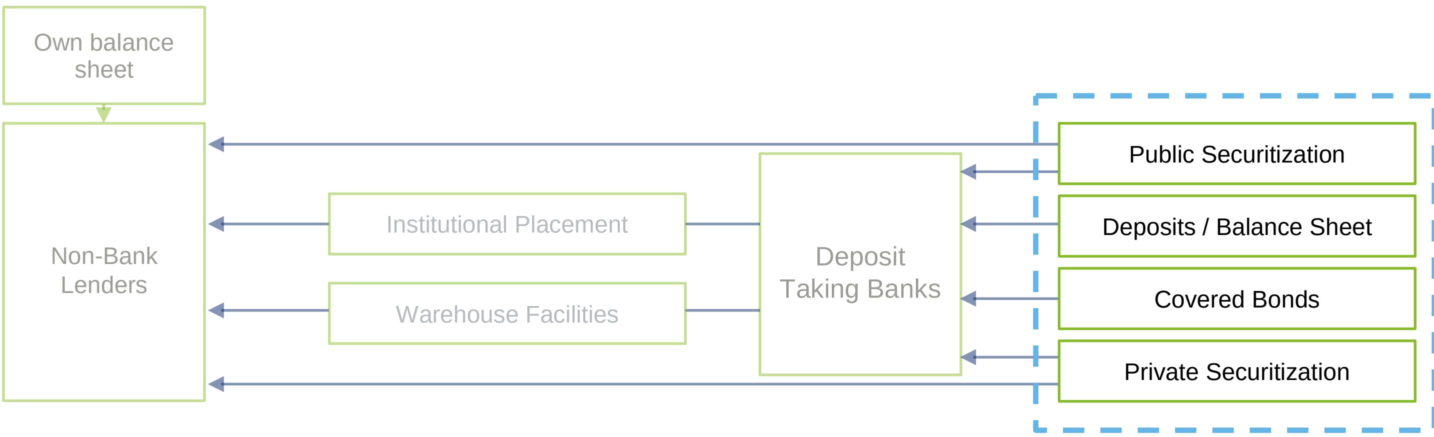
The broker channel was initially the major beneficiary of the branch channel's decline but this trend has declined as lenders increasingly focus on investment in their proprietary mobile advisors as a source of volume over brokers. However, despite lenders exiting, the broker channel has remained a strong and stable source of industry originations.

[7] Ibid.
[8] Ibid.

Mortgage Lending Funding

Mortgage lenders have different funding sources, including retail deposits, wholesale deposits, and capital market instruments such as covered bonds and securitization.[9] Please refer to Appendix B for a summary of funding sources.

Illustrative: Sources of Mortgage Lending Funding

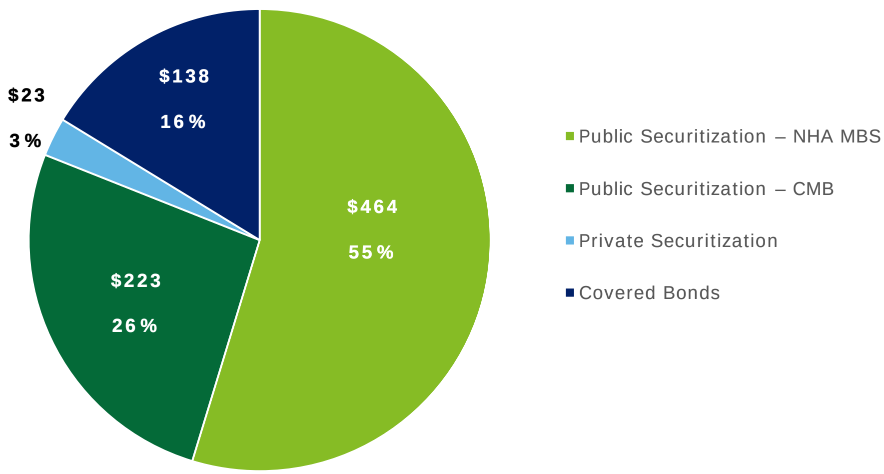


Covered Bond and Securitization Volumes

At the end of 2016, the total outstanding balance of covered bonds and both public and privately securitized mortgages stood at $850B. Public securitization through NHA MBS and CMB represented the vast majority – 81% of all funding through debt instruments (Figure 4). When compared with the total volume of credit outstanding in Canada, this indicates that public securitization is a significant source of funding for lenders and that reduced access to securitization – either due to changes to default insurance eligibility or issuance restrictions – will challenge lenders unable to rely entirely on deposits for funding.

[9] Ibid.

Figure 4: Outstanding Balances of Covered Bonds and Securitization Programs, Q4 2016 ($B)[10]



2. Industry Overview

1. Credit Union Industry Overview

Credit unions are branch-based financial institutions that focus on retail and small business customers. Credit unions' core products include everyday banking, personal lending, and residential mortgage lending. Credit unions are predominantly "balance sheet lenders", meaning that they hold the mortgages that they originate on their balance sheets and fund with deposits. Historically, credit unions have served disproportionately older customers and a greater share of small business owners compared with other types of lenders.[11]

Industry Size and Concentration

There are close to 270 credit unions in Canada with more than 1,800 locations serving approximately 5.6M[12] Canadians.[13] Total credit union membership has stayed fairly flat for the past three years. At the end of 2016, credit unions held (Figure 5):[14,15]

- $203B in assets (a 7.5% increase from 2015) of which:
  - $170B in loans (a 7.6% increase from 2015)
  - $174B in deposits (a 6.5% increase from 2015)

The analysis in this report excludes the Desjardins network of caisse populaires.

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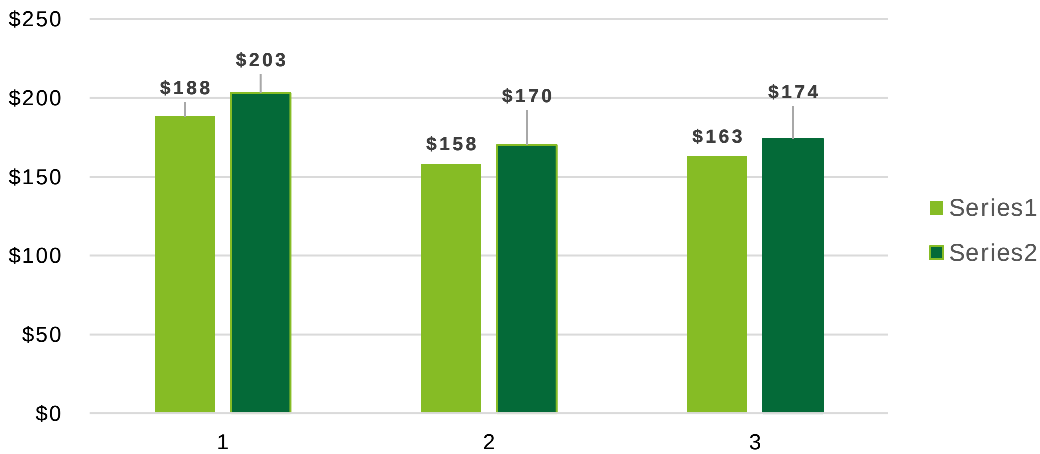
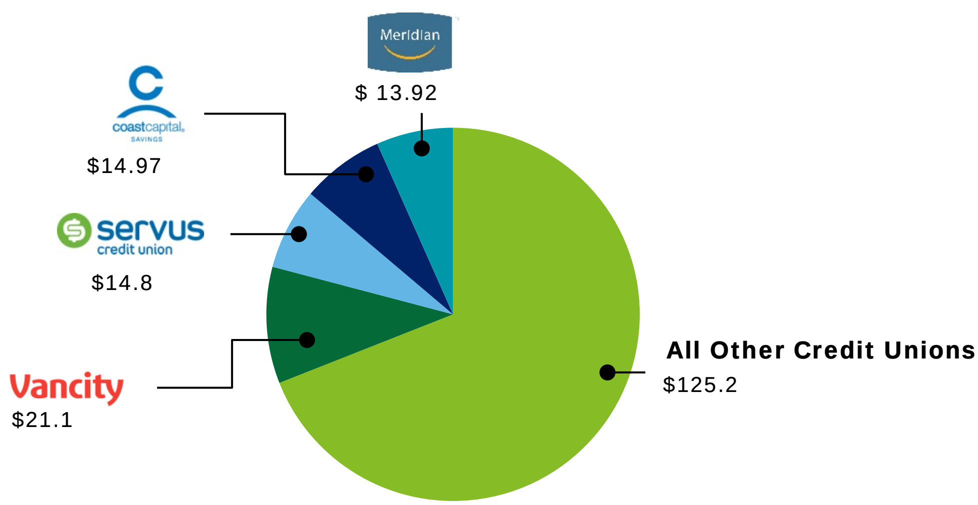
[10] CMHC Housing Finance data
[11] Deloitte analysis.
[12] Millions
[13] This excludes over 300 Desjardins *caisses populaires* in Ontario and Quebec
[14] Canadian Credit Union Association, 2017. ***National System Results, Fourth Quarter 2016.*** https://www.ccua.com/~/media/CCUA/About/pdfs/4Q16SystemResults_7-Mar-17.pdf
[15] All figures in this report exclude entities that are non-affiliated credit unions of the Canadian Credit Union Association (there are only 3, all located in Ontario, which are not material) and Desjardin *caisses populaires.* There are over 300 Desjardin *caisses populaires* across Canada; the majority is located in Quebec, some are located in Ontario. Desjardins *caisses populaires* hold $164.4B in assets, $118.7B in deposits, and $137.8B in loans.

Figure 5: Credit Union Assets, Deposits, and Loans, 2015 - 2016 ($B)[16,17]



The credit union system continues to consolidate with the top 10 credit unions accounting for 47% of total credit union assets in 2016[18], a doubling in share from 24% in 1980[19]. As Figure 6 indicates, the top 4 credit unions alone account for 31% of total system assets.

Figure 6: Credit Union Market Share by Asset Size, Q4 2016 ($B) (Excluding Quebec)[20]



[16] Ibid.
[17] Canadian Credit Union Association, 2017. ***National System Results, Fourth Quarter 2016.*** https://www.ccua.com/~/media/CCUA/About/pdfs/4Q16SystemResults_7-Mar-17.pdf
[18] "Largest 100 Credit Unions / Caisses Populaires", Canadian Credit Union Association, 2016. https://www.ccua.com/~/media/CCUA/About/facts_and_figures/documents/Largest%20100%20Credit%20Unions/2015_03_18_top100_4Q14.pdf
[19] Deloitte Canada, 2012. ***21st Century Cooperative: Rewrite the Rules of Collaboration.*** https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/financial-services/ca-en-financial-services-21st-century-co-operative.pdf
[20] "Largest 100 Credit Unions / Caisses Populaires", Canadian Credit Union Association, 2016. https://www.ccua.com/~/media/CCUA/About/facts_and_figures/documents/Largest%20100%20Credit%20Unions/2015_03_18_top100_4Q14.pdf

Big Players

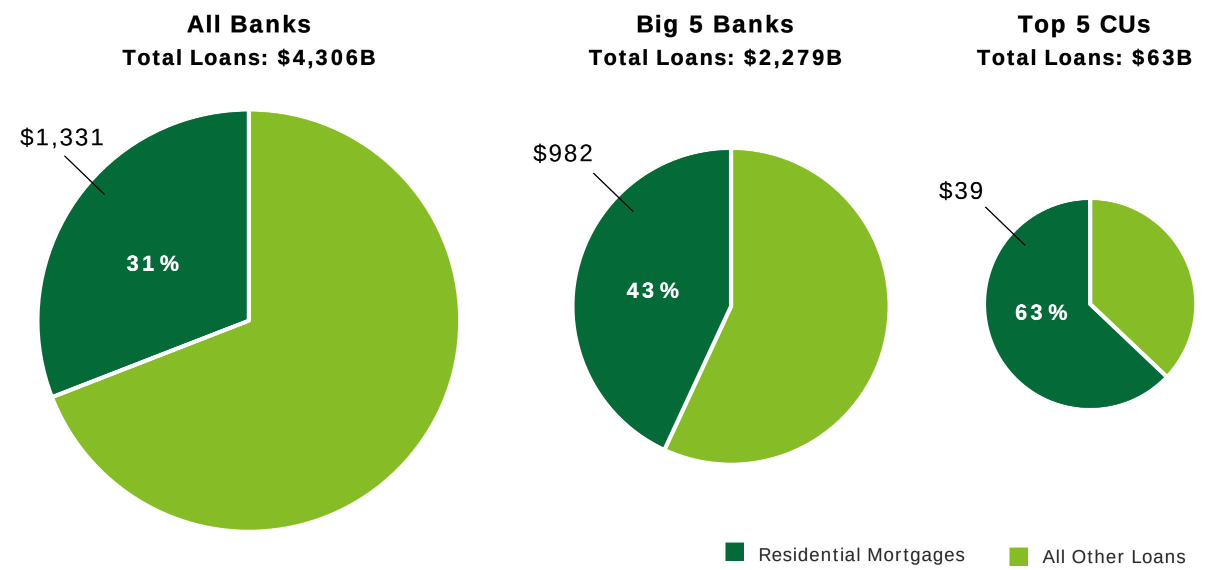
The top ten credit unions in Canada held assets ranging from $4.3B to $21.1B as of the end of 2016 (Figure 7).[21]

Figure 7: Top 10 Credit Unions by Asset Volume, 2016[22]

Rank	Name	Province	Asset Volume ($B)	Number of Members	Number of Location
1	Vancity	BC	21.1	471,057	58
2	Coast Capital Savings Credit Union	BC	15.0	543,127	54
3	Servus Credit Union	AB	14.8	369,764	101
4	Meridian Credit Union	ON	13.9	297,217	92
5	First West Credit Union	BC	9.5	220,317	54
6	Conexus Credit Union	SK	5.6	122,652	41
7	Affinity Credit Union	SK	5.1	122,652	66
8	Steinbach Credit Union	MB	5.0	86,145	3
9	Assiniboine Credit Union	MB	4.4	111,002	20
10	Connect First Credit Union	AB	4.3	101,271	27

As outlined in Figure 8 (below), on average, credit unions hold a higher percentage of residential mortgages as a share of total loans than do banks. The top five credit unions by assets collectively have a 20% greater share of residential mortgage lending over total lending than the Big Five banks. As a result of greater relative residential mortgage exposure, credit unions may be more sensitive to changes in the residential mortgage industry than banks.

Figure 8: Residential Mortgage as a Percentage of Total Loans, 2016 ($B)[23,24]

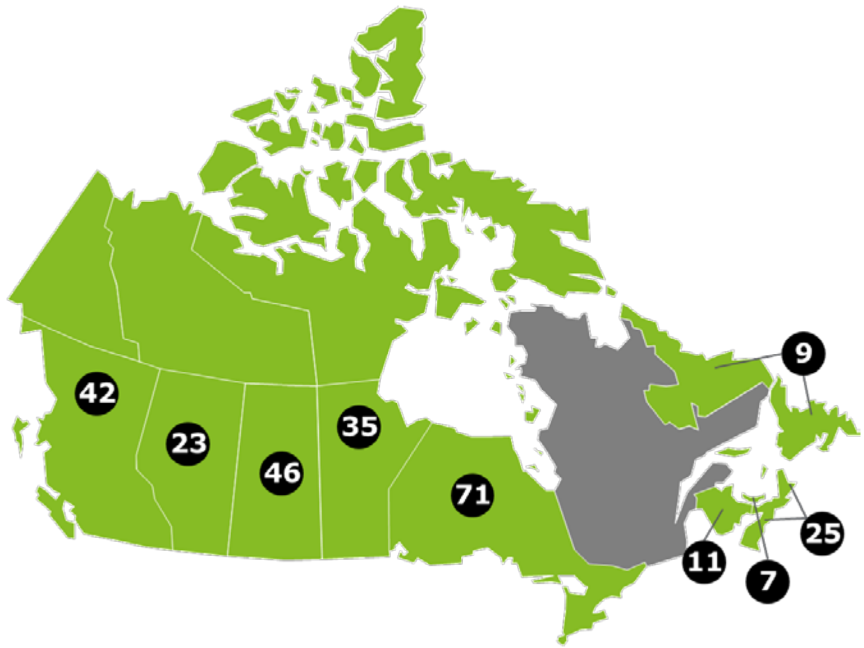


[21] Canadian Credit Union Association, 2017. ***The Largest 100 Credit Unions / Caisses Populaires, Fourth Quarter 2016.*** https://www.ccua.com/~/media/CCUA/About/facts_and_figures/documents/Largest%20100%20Credit%20Unions/top100-4Q16_11-Apr-17.pdf
[22] Desjardins was excluded per CMHC's request as it is not comparable to other credit unions due to its size
[23] "Financial Data for Banks." ***OSFI, 2016***. http://www.osfi-bsif.gc.ca/Eng/wt-ow/Pages/FINDAT.aspx
[24] Annual Report of the Big Five Banks and the top five credit unions by assets; Not to scale

Geographic Presence

Excluding Quebec where Desjardins dominates the market, British Columbia, Ontario, and Manitoba represent the three largest markets for credit unions by assets (Figure 9).[25]

Figure 9: Number of Credit Unions by Province, 2016 (Excluding Quebec)[26]



	BC	AB	SK	MB	ON	NB	NS	PEI	NL
Credit unions	42	23	46	35	71	11	25	7	9
Members	1,909,300	616,000	474,126	643,891	1,408,881	213,094	146,988	50,248	53,639
% of Pop[27]	41.1%	14.7%	41.4%	49.7%	11.6%	29.4%	15.7%	34.3%	10.2%
Assets ($M)	$71,938	$24,516	$21,596	$28,641	$44,897	$4,845	$2,409	$991	$1,191

Per CMHC's analysis[28], on average, credit unions have a larger position of their overall market share in non-census metropolitan areas (CMAs) than do other types of lenders[29]. This finding is in line with the general view that credit unions' residential mortgage portfolios are relatively more geographically concentrated and more exposed to smaller, non-urban communities.

[25] Canadian Credit Union Association, 2017. ***National System Results, Fourth Quarter 2016.*** https://www.ccua.com/~/media/CCUA/About/pdfs/4Q16SystemResults_7-Mar-17.pdf

[26] Also excludes 3 credit unions in Ontario that are non-affiliated with the Canadian Credit Union Association

[27] Canadian Credit Union Association, 2016. ***2016 Credit Union Community & Economic Impact Report***. https://www.ccua.com/~/media/CCUA/member_corner/publications/pdfs/2016CUCEIReportDigital.pdf

[28] CMHC conducted analysis on Equifax consumer data, which is believed to represent the vast majority of consumers with a credit history. It is important to note that the data is not complete as there are financial institutions that do not report to Equifax. Therefore, there may be discrepancies between analysis based on the Equifax data and other sections of the report. The analysis here is to show general trends in the industry rather than precise market statistics.

[29] Census metropolitan area is define by Statistics Canada as "[a]rea consisting of one or more neighbouring municipalities situated around a core. A census metropolitan area must have a total population of at least 100,000 of which 50,000 or more live in the core." (http://www12.statcan.gc.ca/census-recensement/2011/ref/dict/geo009-eng.cfm)

Regulatory Landscape

The majority of credit unions operate in only one province and are therefore subject to the guidance of provincial regulators. However, since 2012, credit unions have had the option of applying for a national charter allowing them to operate across the country as a Federal Credit Union (FCU); operating under this charter would bring them under the regulation of OSFI[30]. See Appendix C for a summary of provincial regulatory bodies.

Post-Global Financial Crisis Growth

Credit unions have benefitted from market and population growth in Canada since the financial crisis, decreasing the need for aggressive growth strategies and campaigns. Trends such as continued strong immigration have created opportunities for credit unions to tap into new customer segments, increasing membership and overall growth through organic means. Consolidation between credit unions has also allowed these lenders to drive growth through traditional means (e.g. focusing on branch distribution and growing core deposits).

Quantitatively, post-financial crisis credit union growth is demonstrated by a 10% CAGR in total deposits between 2011 and 2016 across the top 5 credit unions in Canada[31]. Some credit unions question the stability of driving mortgage growth through traditional strategies, instead choosing to consider alterative growth strategies such as digital distribution and increased use of brokers. However, many credit unions continue to see organic growth in membership as a sustainable path.

2. MFC Industry Overview

MFCs are for-profit financial services companies that act as lenders in the mortgage market but do not take deposits from individuals or institutions. They rely on mortgage brokers for distribution and fund their lending through securitization or loan sales to deposit-taking institutions and institutional investors such as pension funds, insurance companies, or asset managers.[32]

Industry Size and Geographic Presence

Due to differing disclosure requirements compared to other financial institutions, publicly available MFC market data is limited. In 2015, MFCs underwrote and serviced ~$165B in outstanding residential mortgage volume – roughly 12% of the total outstanding residential mortgage credit in Canada at that time.[33]

Distribution and the Role of the Broker

MFCs originate nearly all of their residential mortgage volume through the mortgage broker channel. This gives MFCs access to a strong distribution network. Deloitte estimates that there are approximately 3,700 - 4,200 <u>active</u> individual mortgage broker agents operating in Canada[34]. Established relationships in this network give MFCs the ability to easily scale origination volumes (assuming availability of funding). Reliance on the mortgage broker channel can create competitive tension between MFCs and brokers over customer ownership at the point of renewal and the potential for channel conflict as some MFCs explore the viability of direct distribution via digital channels.

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[30] "Credit unions to go national". Canadian Business, 2012. http://www.canadianbusiness.com/business-news/industries/financial/credit-unions-to-go-national/

[31] Deloitte analysis

[32] Bank of Canada, 2016. ***The Rise of Mortgage Finance Companies in Canada: Benefits and Vulnerabilities***. http://www.bankofcanada.ca/wp-content/uploads/2016/12/fsr-december-2016-coletti.pdf

[33] "Financial Systems Review – December 2016." ***Bank of Canada*** http://www.bankofcanada.ca/2016/12/fsr-december-2016/

[34] Deloitte Analysis. Note this estimate includes only those individual broker agents that engage in residential mortgage broking on a full-time equivalent basis and is therefore considerably lower than total membership figures quoted by industry associations

Regulatory Landscape Overview

MFCs are not directly regulated by any federal or provincial prudential regulatory body. However, they are indirectly impacted by regulation for three main reasons:

1. Many MFCs are reliant on the CMHC's securitization programs to help fund lending activities, constraining the types of mortgages they can originate and subjecting them to OSFI Guideline B-21
2. Many MFCs originate mortgages to be sold on a whole loan basis to provincially or federally regulated lenders; in order for the regulated lender to hold these mortgages on their balance sheet, the underwriting must be compliant with guidelines set by OSFI; therefore, the underwriting practices of MFCs must be compliant such that they are able to sell mortgages to regulated lenders
3. OSFI regulation B-10 provides direct regulatory guidance on outsourced business activities, to which underwriting outsourced to MFCs must adhere

3. Changing Regulation in the Residential Mortgage Market

Response to the 2008 Financial Crisis

In the wake of the 2008 financial crisis, the Financial Stability Board (FSB)[35] provided recommendations for stricter housing finance regulations in the G-20 countries.[36] In response to these recommendations, OSFI introduced a new set of guidelines aimed at preventing a future housing market distress in Canada.

OSFI Guideline B-20

Effective June 2012, OSFI introduced residential mortgage underwriting guidelines designed to ensure lenders follow sound underwriting practices and do not introduce excessive risk into the housing market. OSFI's guidelines were drafted for banks and federal trust companies and did not apply to provincially regulated credit unions; this gave credit unions a slight advantage in areas such as home equity line-of-credit (HELOC) issuance. OSFI limited bank-issued HELOCs' maximum loan-to-value ratio to 65%, while credit unions remained under provincial guidelines (e.g., in Ontario, credit unions are able to provide HELOCs up to 80% in loan-to-value ratio).[37,38]

At the time OSFI Guideline B-20 was introduced, Canada's largest provincial credit union regulators (DICO, FICOM, and CUDGC) concluded that credit union guidelines were reasonably prudent and stricter legislation was not required given credit unions' well-capitalized balance sheets.[39]

OSFI Guideline B-21

In April 2014, OSFI announced underwriting guidelines for residential mortgage insurance to support sound mortgage insurance underwriting practices and improve the stability of the financial system.[40,41] While credit unions are not directly regulated by OSFI, any insured residential mortgages originated by credit unions must adhere to Guideline B-21. As a result, certain competitive advantages held by credit unions prior to Guideline B-21 were diminished. For example, credit unions were no longer able to offer 100% residential

[35] An international entity that makes recommendations about the global financial system.
[36] "B-20 Breakdown." ***Mortgage Broker News.*** http://www.mortgagebrokernews.ca/people/a-b20-breakdown-171135.aspx
[37] "Residential Mortgage Underwriting Practices and Procedures." ***Office of the Superintendent of Financial Institutions, 2014***. http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/b20.aspx
[38] "Home equity line of credit." **Rapport Credit Union.** https://www.rapportcu.ca/Personal/ProductsAndServices/Borrowing/HELOC/
[39] "OSFI Rules Spell Opportunity for Some Credit Unions." ***Canadian Mortgage Trends***. https://www.canadianmortgagetrends.com/canadian_mortgage_trends/2012/07/osfi-rules-spell-opportunity-for-some-credit-unions.html
[40] "B-21 to erode credit union competitive advantage." **Mortgage Broker News.** http://www.mortgagebrokernews.ca/news/b21-to-erode-credit-union-competitive-advantage-178640.aspx
[41] "OSFI issues guideline supporting sound residential mortgage insurance underwriting." ***OSFI, 2014***. http://www.osfi-bsif.gc.ca/Eng/osfi-bsif/med/Pages/b21_nr_1114.aspx

mortgage financing (i.e., mortgage with no down payment).[42] However, some sources of advantage were left intact; for example, credit unions remained able to offer 80% LTV on HELOCs[43].

[42] "100% Financing Home Loans 2017" **My Mortgage Insider.** https://mymortgageinsider.com/100-financing-home-loans-zero-down-mortgage/
[43] "B-21 to erode credit union competitive advantage", Mortgage Broker News. http://www.mortgagebrokernews.ca/news/b21-to-erode-credit-union-competitive-advantage-178640.aspx

3. Portfolio and Borrower Profile

The residential mortgage portfolio of credit unions and MFCs consists of borrowers and loans of diverse characteristics, though most lenders would self-declare as 'prime lenders'. The specific composition of each portfolio is determined by factors such as credit score, borrower age, collateral type (i.e., the type of dwelling offered as security), loan-to-value ratio, and payment behaviour. This analysis compares bank, credit union, and MFC residential mortgage portfolios across four dimensions:

1. Borrower credit worthiness using the credit score, Equifax Risk Score (ERS), as a proxy;
2. Borrower age;
3. Delinquency; and:
4. Region

The analysis was performed using data reported to Equifax, which consists of a statistically representative subset of mortgage lending activities in Canada for banks and credit unions. The Equifax data captures approximately 50% of the MFC lending activities, and therefore MFCs were excluded from certain analyses.

Credit Score

Credit score is often used as a proxy for a borrower's overall creditworthiness. One method of gauging the quality of lenders' residential mortgage portfolios is to examine borrowers' credit scores. For this analysis, borrower credit scores were grouped into four segments[44]: <580, 580-669, 670-779, and >780. While there is no formally defined credit score break point at which a borrower is considered 'sub-prime', the commonly accepted industry range is anything below 580-600. It should be noted that credit score is one element of creditworthiness that defines a prime, Alternative-A, or sub-prime borrower. For this analysis, a credit score of less than 580 is considered subprime while the non-prime segment (Alternative-A and subprime) is considered to be composed of borrowers with credit scores lower than 670.

The average ERS across the Big Five banks and credit unions of various sizes is comparable, in the range of 760-770 range. MFCs' average ERS, around 745-755, is lower than that of the Big Five banks and credit unions but firmly in the prime range. In 2016, approximately one million new originations were reported to Equifax, of which approximately 6.3% (63,000) had an ERS lower than 670, totalling $101B and representing 9% of total volume. From 2014 to 2016, the proportion of credit outstanding of borrowers with an ERS below 670 stayed fairly consistent, at 9-10%. In 2016, Quebec had 7% of its credit outstanding to borrowers with an ERS of less than 670, the lowest across Canada (excluding the territories), while New Brunswick had the highest at 15%.

For each type of lender, 9-11% of the business is in the non-prime segment. MFCs have the most borrowers with an ERS below 580, while credit unions lend marginally more into the Alternative-A segment (an ERS between 580 and 669) compared to the Big Banks (Figure 10). By 2016 Q4, credit unions of all sizes had increased their share of borrowers with an ERS lower than 670 (Figure 11). This observation may suggest that facing increasing competition, credit unions are becoming more willing to take on borrowers with a lower ERS, potentially seeing some risk-appropriate opportunity in segments that are underserved by other lenders.

[44] A small segment of consumers with no credit scores were excluded from the analysis.

Figure 10: Distribution of Lenders' Residential Mortgage Outstanding by ERS, 2016 Q4 (%)

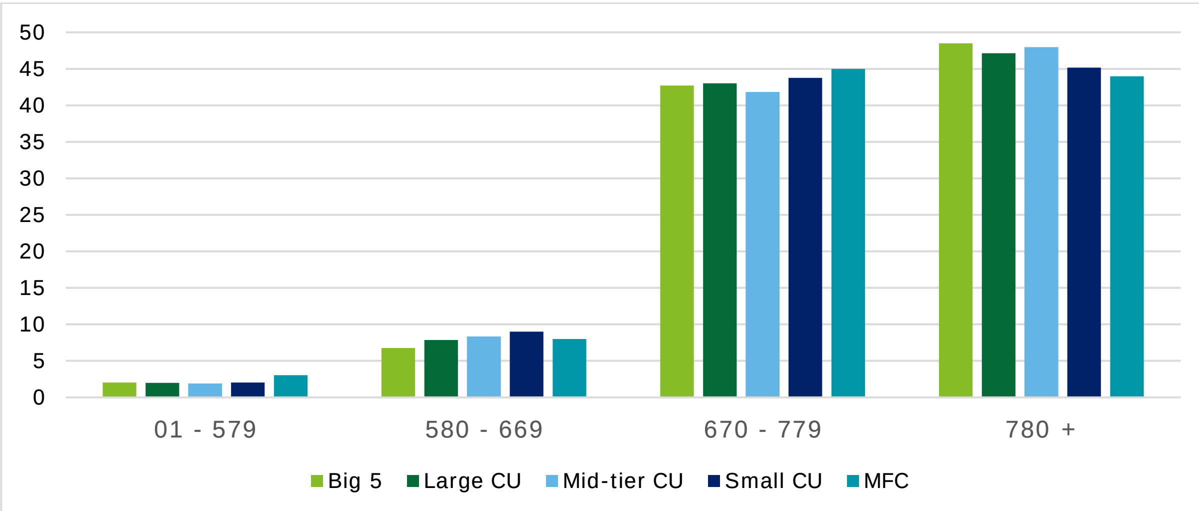
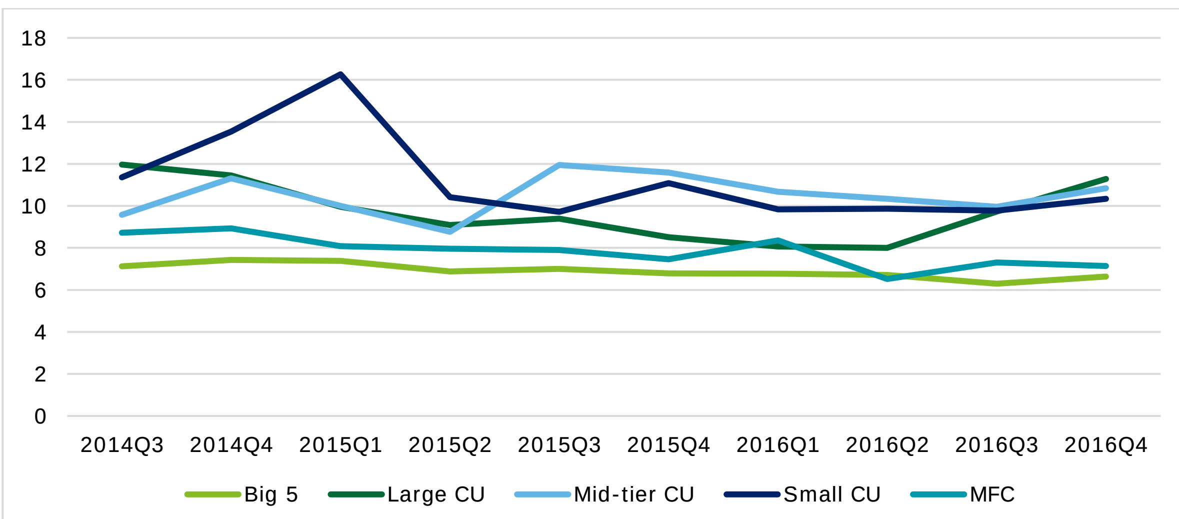


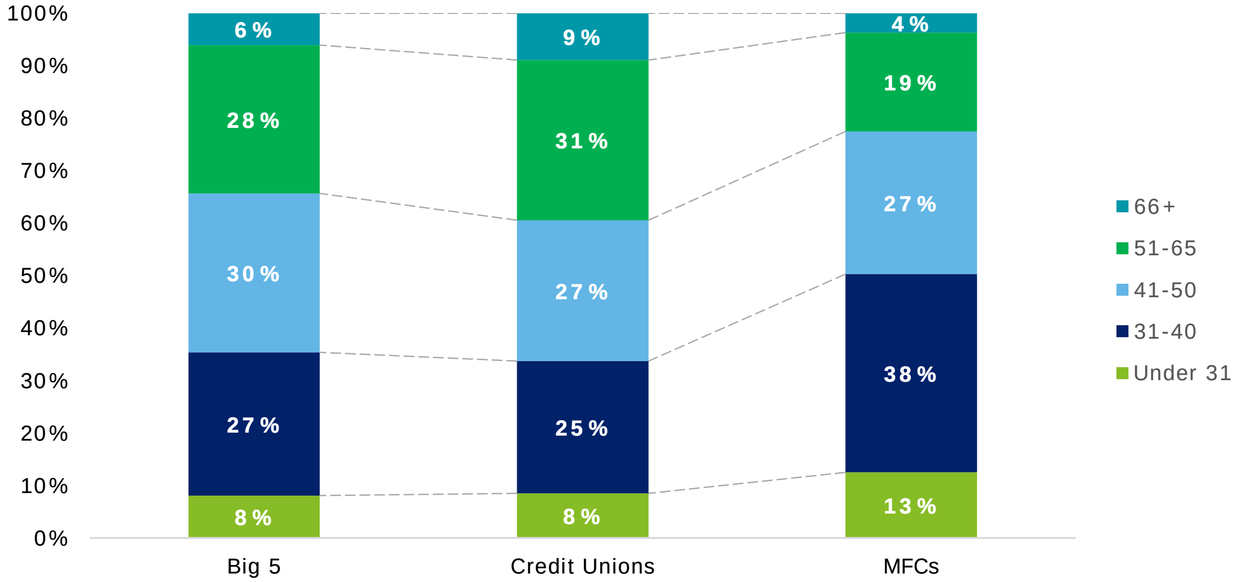
Figure 11: Market Share of Residential Mortgage Origination with an ERS of <670, 2014 Q3 to 2016 Q4 (%)



Borrower Age

Figure 12 shows the age distribution of residential mortgage credit outstanding at the intersection of age and lender type. Credit unions' residential mortgage portfolios have, proportionally, the most borrowers older than 50 years of age compared to other types of lenders: close to 40% of credit unions' portfolios is held with borrowers older than 50. Small credit unions have a greater concentration of borrowers in the 50+ age group, at 45%.

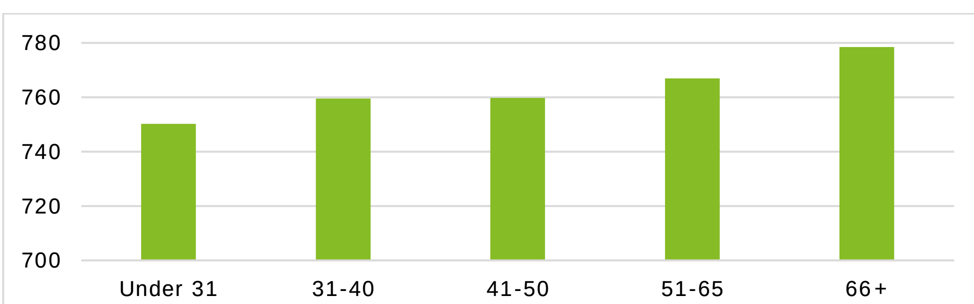
Figure 12: Age Distribution of Residential Mortgage Credit Outstanding by Lender Type, 2016 (%)



MFCs' residential mortgage portfolios are concentrated with borrowers less than 41 years of age; a majority of the MFC portfolio observable in Equifax data is represented by borrowers younger than 41. This is consistent with the observation that first-time home buyers tend to use the broker channel more and brokers drive volume to MFCs. Mortgage brokers are effectively positioned in the market as independent experts. First-time home buyers may feel more comfortable talking to brokers who demonstrate knowledge, have no explicit ties to a specific financial institution, and are able to shop across the market for the price, product features and underwriting conditions that meet the needs of the prospective borrower.

Credit unions have historically served older members. The observation of more borrowers in the older age groups at small credit unions is also consistent with them operating in rural areas, where the average age of the population is older.[45] On average, older borrowers have higher credit scores, likely supported by a longer history of quality, stable employment allowing these borrowers to service debt obligations (Figure 13). Using credit scores as a proxy for credit worthiness, this borrower characteristic may offset the geographic concentration risk to which small credit unions may be exposed.

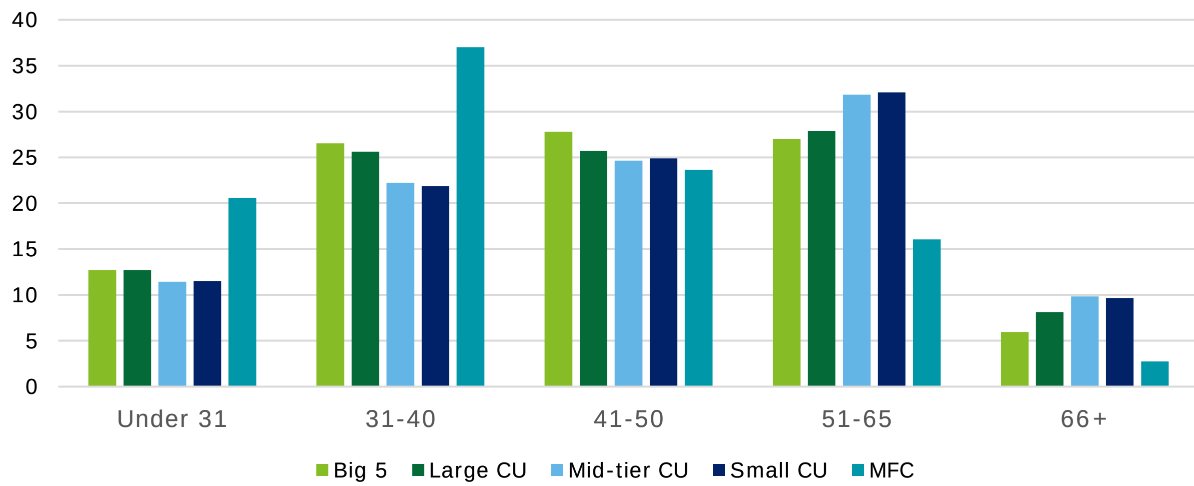
Figure 13: Average Equifax Credit Score of Borrowers by Age Group, 2016



[45] "Section 1: Census metropolitan areas." ***Statistics Canada, 2015***. http://www.statcan.gc.ca/pub/91-214-x/2015000/section01-eng.htm

In 2016, the age distribution for residential mortgage originations reported by Equifax is generally consistent with that of residential mortgage credit outstanding (Figure 14). MFCs originated 58% of their residential mortgage volume with borrowers younger than 41, the most of any type of lenders. Credit unions originated more volume with borrowers older than 50 (36-42%).

Figure 14: Age Distribution of Residential Mortgage Origination by Lender Type, 2016



From 2014 to 2016, credit unions' share of borrowers under the age of 41 relative to all borrowers increased by one percentage point, from 32% to 33%. Credit unions are continuing their efforts to target younger generations – in 2016, on average, credit unions of all sizes originated 2-4% more younger borrowers compared to the age distribution for credit outstanding.

From 2014 to 2016, MFCs' share of borrowers under the age of 41 relative to all borrowers decreased by one percentage point, from 51% to 50%. In 2016, however, MFCs experienced material growth in origination from the younger generation, with 58% of all residential mortgage origination from borrowers younger than 41. As such, it seems that in 2016, brokers extended their advantage in the younger borrower segments and continue to drive strong growth of MFC lending with younger borrowers.

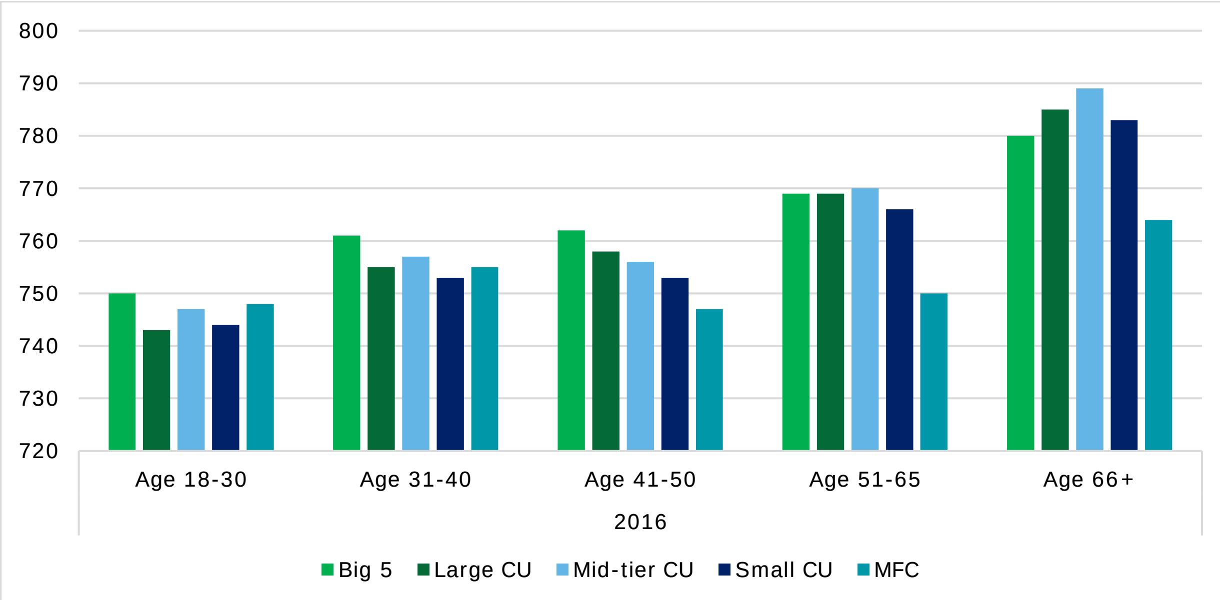
Credit Score and Age

Although younger borrowers' credit scores are, on average, lower than those of older borrowers, the average credit score for the under 31 age category is within the prime segment – to be expected given that the population for observation consists of borrowers who have a mortgage.

Based on Figure 15 below, the MFC average credit scores of borrowers ages 18-30 and 31-40 are directionally similar to those of the Big Five banks. Therefore, it is inconclusive whether the relative youthfulness of borrowers translates to more risk to MFCs. Despite a larger difference in credit scores for borrowers ages 51-65 and 66+ between MFCs and the other lenders, MFCs' borrowers still have an average score of 750 or more, which may indicate a healthy level of credit worthiness. The 90-day delinquency rate, defined as the number of all loans that are 90+ days past due as a percentage of the total number of outstanding loans, for MFCs supports this claim. According to Bank of Canada, the 90-day delinquency rate for MFCs is 0.14%, much lower than the average of 0.28% at banks.[46]

[46] Bank of Canada, 2016. ***The Rise of Mortgage Finance Companies in Canada: Benefits and Vulnerabilities***. http://www.bankofcanada.ca/wp-content/uploads/2016/12/fsr-december-2016-coletti.pdf

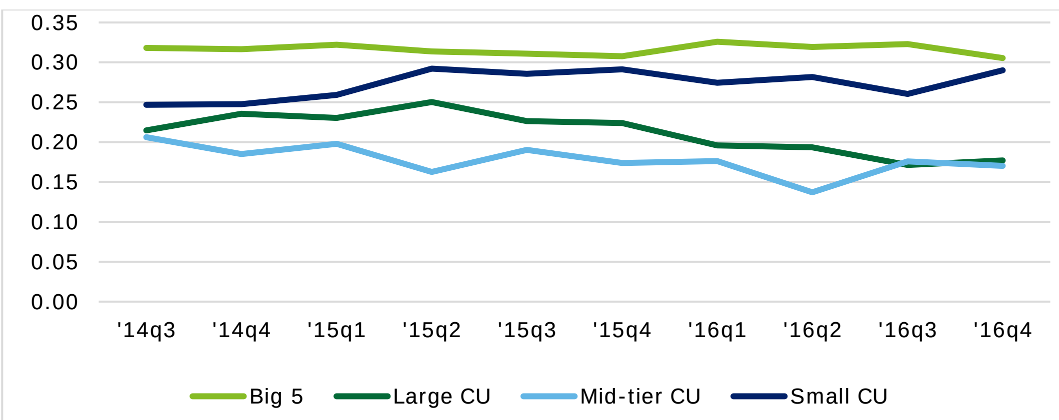
Figure 15: Average Equifax Credit Score by Age Group by Lender Type, 2016



Delinquency

The 90-day delinquency rate is approximately 0.13% at credit unions and 0.29% at the banks per Canadian Mortgage Trends while it is 0.14% at MFCs per the Bank of Canada.[47,48] CMHC's analysis of proprietary Equifax data also suggests a lower 90-day delinquency rate for credit unions compared to banks (Figure 16). The overall lower rate in credit unions is primarily driven by large and mid-tier credit unions. Equifax data did not have a representative sample of MFCs' delinquency rate and therefore MFCs were excluded from this analysis.

Figure 16: 90-Day Delinquency Rate by Type of Lender, Q3 2014 to Q4 2016



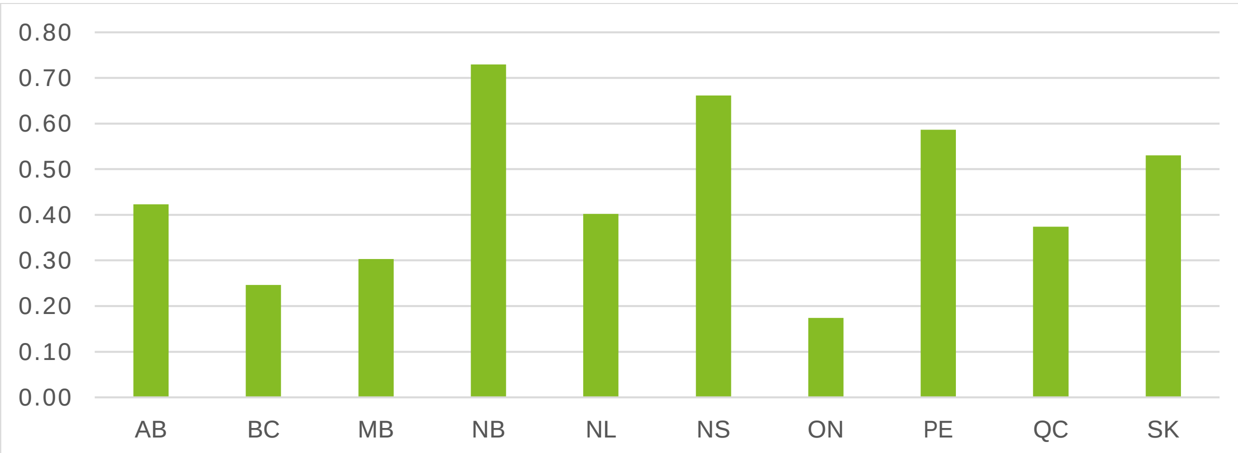
Based on 90-day delinquency rates, MFCs and credit unions tend to have less delinquency than the Big Five Banks despite MFCs having a greater number of younger borrowers, and credit unions have a greater

[47] "Credit Unions in the Mortgage Market." **Canadian Mortgage Trends**. https://www.canadianmortgagetrends.com/canadian_mortgage_trends/2016/04/credit-unions-in-the-mortgage-market.html
[48] Ibid.

number of older borrowers. This suggests that there is not a strong correlation between age and borrower risk.

While delinquencies may be low across Canada and across lender type, figure 17 illustrates that lenders are experiencing high delinquency rates in New Brunswick, Nova Scotia, PEI, and Saskatchewan. This is likely influenced by regional economic conditions.

Figure 17: Delinquency Rate by Province, 2016 (%)



Region

Close to one-third of residential mortgages originated by credit unions from 2014 to 2016 were in non-CMAs[49] [50]. Large credit unions were well below the industry average, while about 38% of the residential mortgages originated by mid-tier credit unions were in non-CMAs and 44% were in non-CMAs for small credit unions[51]. This suggests that small credit unions are more reliant on non-CMAs for their residential mortgage business.

In comparison, non-CMA originations for the Big Five banks was approximately 24%, lower than the credit union industry average, yet higher than the large credit union average[52]. For MFCs reporting to Equifax, the share of residential mortgage originations in non-CMAs averaged around 23% in 2016, an increase from 21% in 2015[53].

In terms of credit outstanding, credit unions hold the biggest share in non-CMAs of all lender types relative to their own portfolio size – 23% in 2016. As with originations, large credit unions were below the credit union industry average and the Big Five bank average in 2016; mid-tier credit unions had about 36% (32% in 2015) of credit outstanding in non-CMAs – roughly the same share as small credit unions.

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[49] Census metropolitan area is define by Statistics Canada as "[a]rea consisting of one or more neighbouring municipalities situated around a core. A census metropolitan area must have a total population of at least 100,000 of which 50,000 or more live in the core." (http://www12.statcan.gc.ca/census-recensement/2011/ref/dict/geo009-eng.cfm)
[50] CMHC conducted analysis on Equifax consumer data, which is believed to represent the vast majority of consumers with a credit history. It is important to note that the data is not complete as there are financial institutions that do not report to Equifax. Therefore, there may be discrepancies between analysis based on the Equifax data and other sections of the report. The analysis here is to show general trends in the industry rather than precise market statistics.
[51] Ibid
[52] Ibid
[53] Ibid

In comparison, the Big Five banks hold 19% of their loan portfolios from non-CMAs as opposed to 20% for MFCs.[54]

The Big Five banks hold an outsized share of the residential mortgage market in most CMAs. Excluding Montreal where Desjardins is the biggest player, the Big Five banks have over 70% of credit outstanding in Toronto, Vancouver, and Calgary (Figure 9). However, the share of mortgage credit outstanding captured by credit unions rose from under 4% to 4.5%[55] [56] in Canada from 2015 to 2016. Credit unions hold a larger share in Vancouver where Vancity and Coast Capital are leading players.

[54] Ibid
[55] Ibid
[56] It is not entirely clear how much of this increase in mortgage credit outstanding capture is due to increased credit union reporting rates with Equifax

4. Key Trends, Business Models, and Growth Strategies

Credit Unions

Introduction

This section addresses the business model choices and growth strategies observed in the credit union market in the context of key market trends driving these choices. The business model discussion focuses first on an industry-level discussion of funding models, followed by a discussion of three business model archetypes highlighting distinct combinations of model choices around product, pricing, distribution, and funding. Together, these choices highlight the archetypal growth paths credit unions are pursuing.

Key Trends

Through interviews and market research, Deloitte identified key trends across the credit union industry:

Inter-provincial Expansion

Historically, credit unions have been disadvantaged in expanding their operations across provincial borders due to the difficulty in obtaining operating licenses across multiple jurisdictions.[57]

In order to encourage continued growth of credit unions nationally, the Government of Canada passed legislation in 2014 to provide guidance for credit unions to incorporate federally and allow them to expand across provincial boundaries.[58] The first FCU was formed in 2016, when the Caisse populaire acadienne Itée became an FCU under the name UNI Financial Cooperation.[59] While other credit unions, such as Coast Capital Savings, are taking steps towards becoming an FCU, the people, process, technology, and regulatory implications of national expansion contribute to the limited number of expansions to date[60]. Additionally, some credit unions are reluctant to lose the unlimited deposit guarantees that various provincial deposit insurance regulators provide. Others feel that the investment required for a transformation of such complexity is better directed at opportunity in their local markets. Lastly, Vancity Savings and Alterna Savings each own Schedule 1 Bank subsidiaries, allowing them to operate, albeit indirectly, on a national basis.

Industry Consolidation

In order for credit unions to compete effectively with banks on products and services, channels, access to capital, and operating efficiencies, both provincial centrals and credit unions are consolidating. In 1966, there were over 3,200 credit unions in Canada; in 2016, there were fewer than 272[61]. The number of credit unions is expected to decrease by 2.3% annually until 2021, resulting in a projected 242 credit unions still remaining in that year[62]. Figure 18 below illustrates the actual and projected pace of industry consolidation

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[57] "Ontario, B.C. credit union members vote to merge." ***The Globe and Mail, 2009***. http://www.theglobeandmail.com/report-on-business/ontario-bc-credit-union-members-vote-to-merge/article962547/

[58] Government of Canada, 2015. **ECONOMIC ACTION PLAN 2015 ACT, NO. 2** http://www.gazette.gc.ca/rp-pr/p2/2015/2015-05-06/html/si-tr30-eng.php

[59] "Minister Morneau Welcomes Canada's First Federal Credit Union." ***Department of Finance Canada, 2016***. http://www.fin.gc.ca/n16/16-086-eng.asp

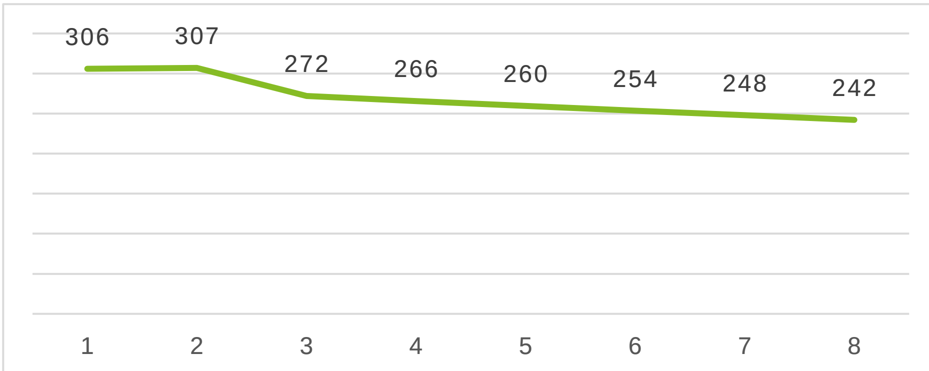
[60] "Members vote in Favour of Coast Capital Savings Becoming a Federal Credit Union". **MarketWired.** http://www.marketwired.com/press-release/members-vote-in-favour-of-coast-capital-savings-becoming-a-federal-credit-union-2183405.htm

[61] "National System Results – Fourth Quarter 2016". Canadian Credit Union Association, 2016. https://www.ccua.com/~/media/CCUA/About/pdfs/4Q16SystemResults_7-Mar-17.pdf

[62] "Bank on it: Consolidation and a larger asset base will allow credit unions to compete with banks". IBISWorld 2016. https://www.ibisworld.ca/industry/credit-unions.html

between 2014 and 2021.

Figure 18: Historical and Expected Number of Credit Unions in Canada, 2014 to 2021[63]



Consolidation of credit unions results in larger asset bases for a few large players, allowing them to compete with banks. There have been 11 amalgamations and acquisitions in Ontario alone since the beginning of 2016.[64] Consolidation within the credit union industry has influenced the emergence of the distinct business model archetypes discussed subsequently.

Changing Basis of Competition

The basis of competition in the industry is changing as digital offerings improve and new regulatory rules have increased competition in insurable market segments. Credit unions' value proposition of cooperatives and community engagement may no longer be an effective differentiator, especially with younger and more rate-sensitive borrowers. Many credit unions, typically the smaller entities, have relied on population growth and other exogenous market factors to drive their growth for the past several decades, and are only recently beginning to consider the necessity of active growth paths (organic or inorganic).

Despite demographics being a core concern for credit unions, small and mid-tier credit unions are trying to build their brand presence through traditional methods including increased community outreach, with the intention of generating word-of-mouth referrals.

Human-Centered Design Product Innovation

Credit unions continue to view the value proposition of deep engagement with, and understanding of, their communities as being core to growth; some credit unions are introducing alternative product offerings designed around a particular borrower circumstance and decisioning process. In February of 2017, Meridian created a 'Family and Friends' Mortgage which formally markets the typically complicated process of having multiple co-borrowers on the application. The innovation lies in the design of the process and experience rather than the product itself. Other credit unions have followed suit, designing solutions that combine an understanding of the borrower and market circumstances with the borrowing decision process. For example, DUCA has launched the 'More Together' Mortgage targeting younger borrowers in the Greater Toronto Area. DUCA offers tools and an advice process to guide the development of co-ownership arrangements. These product developments represent creative solutions over the traditional product feature-based way of thinking

[63] "Bank on it: Consolidation and a larger asset base will allow credit unions to compete with banks". IBISWorld 2016. https://www.ibisworld.ca/industry/credit-unions.html
[64] Deposit Insurance Corporation of Ontario, 2017. ***Insured Institution Mergers***. https://www.dico.com/design/1_2_Eng.html

about product innovation (e.g. product-centred vs. human centred) focusing specifically on under-served customer segments.

Strategic Investment in Technology

Some large and mid-tier credit unions are pursuing investments in technology to increase geographic reach, attract younger borrowers, and increase efficiency; these investments are increasingly being seen as necessary to remain competitive with big banks. Many credit unions are exploring digital as a distribution channel for core products to augment current distribution and increase distribution reach. In the mortgage market specifically, there are emerging examples of credit unions establishing or investing in digital mortgage application flows – allowing borrowers to submit an application and supporting documents (e.g., proof of income and proof of down payment) via digital channels. Alterna Savings, for example, recently launched what is currently among the Canadian market-leading digital mortgage offerings as measured by breadth of capability. The Alterna solution currently delivers a digital approval with conditions and routes borrowers to a secure digital portal for document ingestion.

Strategic Use of Process Outsourcing

Credit unions, particularly as part of expansion initiatives, are increasingly considering mortgage credit operations to be a non-core competency offering a path toward 'capital light' expansion versus expanding in-house credit operations. They view ownership and design of the customer experience as core, the design and management of credit rules and policy as core, but the execution of those rules as non-core. For example, in October of 2016, DUCA partnered with Paradigm Quest to gain efficiencies in mortgage underwriting and servicing[65]. DUCA owns product design, customer experience, and credit policy, leaving Paradigm Quest to execute on DUCA's credit rules.

Credit Union Business Models

Residential Mortgage Funding Models

Credit unions fund the majority of lending activities through three methods: retail and small business deposits (balance sheet), whole loan sale, and public securitization (NHA MBS and CMB). As illustrated in Figure 19, the current funding composition of credit unions[66] is heavily weighted towards funding through deposits. Uniformly, credit unions interviewed for this report stated a continued goal to fund the majority of their mortgages through deposits. Credit unions actively monitor funding composition to ensure that they are managing liquidity risk prudently. Reliance on deposit funding requires that credit unions maintain close oversight of the stability, source, and mix (e.g., transactional bank accounts, high interest savings accounts, term deposits / GICs) of those deposits. For example, liquid 'high interest savings' deposits sourced via financial intermediaries such as deposit brokers behave differently than do branch sourced term deposits. Intermediary-sourced deposits tend to be less sticky than deposits sourced through proprietary channels. The popular 'high interest savings' deposit is effectively a demand deposit and tends to be less sticky than term deposits[67].

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[65] "DUCA and Paradigm Quest Partner on Mortgage Underwriting and Servicing for Mortgage Brokers." ***DUCA, 2016***. https://www.duca.com/about-us/resources/duca-news/duca-and-paradigm-quest-partner-on-mortgage-underwriting-and-servicing-for-mortgage-brokers/
[66] Deloitte analysis
[67] *Ibid*

Figure 19: Current Credit Union Funding Composition[68]

Funding Sources*	Range
Balance sheet	70%-90%
Whole loan sales	0%-25%
CMHC securitization	0%-25%
Other	0%-5%

Credit unions continue to rely on traditional funding sources, with between 70-90% of total 2016 funding coming from their balance sheets (i.e. deposits) on average, followed by 0-25% from public securitization vehicles, 0-25% from whole loan sales, and 0-5% on average from other sources of funding[69].

Trends in Credit Union Deposit Funding Composition

Based on an analysis of the financial disclosures of the top 5 largest credit unions in Canada as measured by total assets (Vancity, Coast Capital, Servus, Meridian, and First West)[70], in 2012, term deposits accounted for 51% of total credit union deposits while demand deposits only accounted for 38% of total deposits (Figure 20). By 2016, term and demand deposits accounted for an almost equal share of total deposits, at 46% and 44% respectively. This means that between 2012 and 2016, growth in demand deposits was relatively greater than growth experienced in term deposits.

Figure 20: Deposit Composition Breakdown, 2012 and 2016 (%)

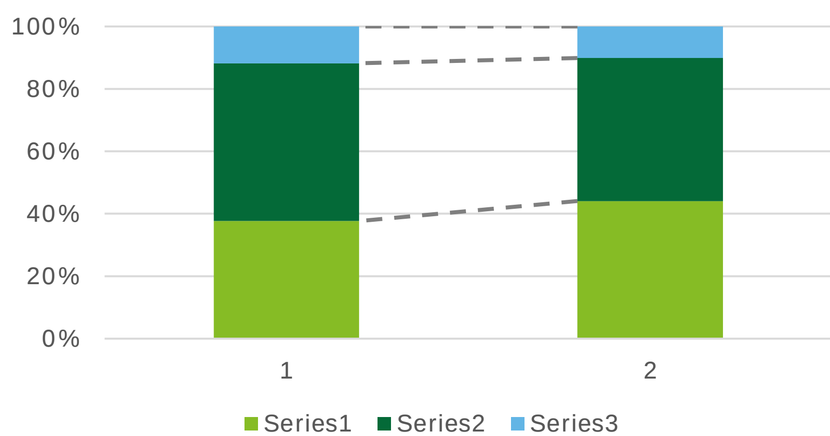

Figure 21 further investigates these changes in deposit composition, showing growth in different types of deposits as a share of total funding growth. Total funding growth was approximated by using net change in deposit balances as a proxy, acknowledging that deposits fund other lending activities in addition to mortgages.

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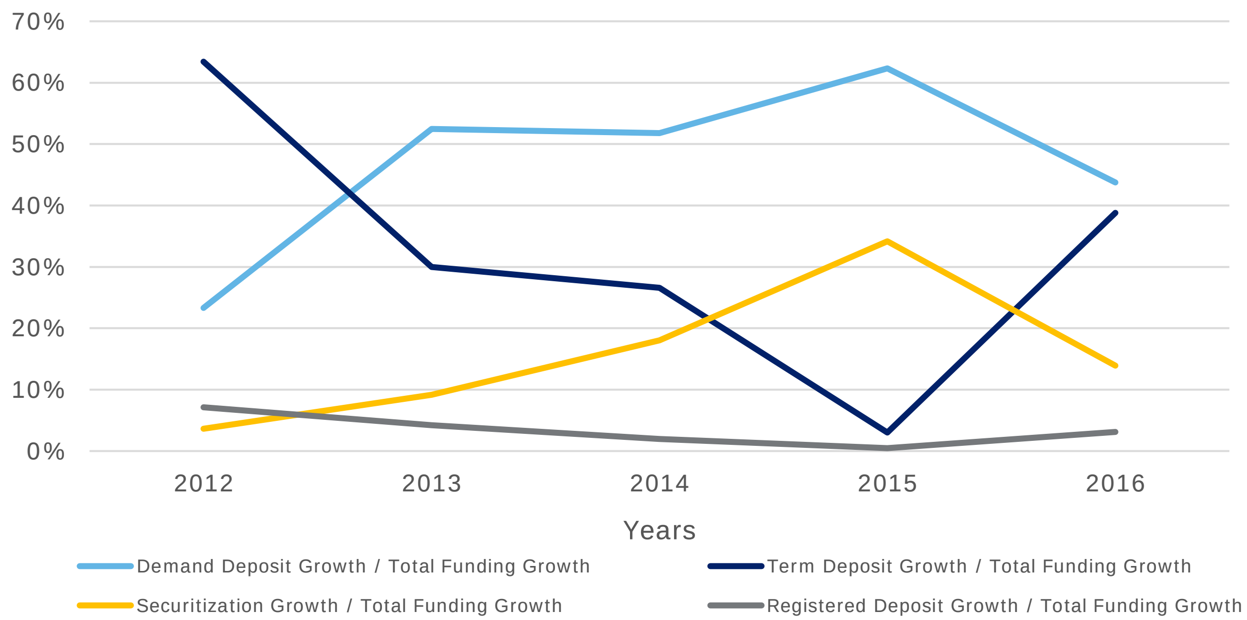
[68] Deloitte interviews, calculated average across the credit unions analyzed; this is provided as a directional analysis of funding composition
[69] Deloitte analysis based off of data provided by credit unions analyzed
[70] Top 5 represent 37% of total credit union system assets

The trend of growth of demand over term deposits was especially significant between 2014 and 2015, where term deposit growth accounted for only 3% of net change in total funding growth while demand deposit growth accounted for 62% of net change in total funding growth.

Between 2012 and 2015, credit unions increasingly used securitization to fund lending activities, with securitization accounting for 34% of total funding growth in 2015. This level of securitization growth decreased between 2015 and 2016, but continues to present a funding alternative which helps diversify credit unions' risk, and reliance on customer deposits.

Figure 21: Composition of Funding Growth by Source, 2012 to 2016 (%)[71]



Growth in Total Funding, 2012 to 2016 ($B)

($ millions)	2012	2013	2014	2015	2016
Growth in Total Funding ($)	$3,925	$2,852	$3,185	$5,812	$5,317
2012 – 2016 CAGR in Deposits					10%

Figure 21 also shows the high growth rate of the deposit-based funding pool. Between 2012 and 2016, deposits grew at a 10% CAGR. Based on insights from credit union interviews, growth in deposits is expected to remain the main driver of mortgage funding in the near term.

Expected consolidation at the provincial central level could provide credit unions the ability to place their mortgages into larger mortgage pools, potentially creating a funding opportunity through private securitization vehicles (e.g., covered bonds).

Overall, credit unions currently have stable sources of funding, using their balance sheets to fund mortgages through a mixture of demand and term deposits, while using securitization to supplement mortgage funding where necessary and diversify complete reliance on deposits.

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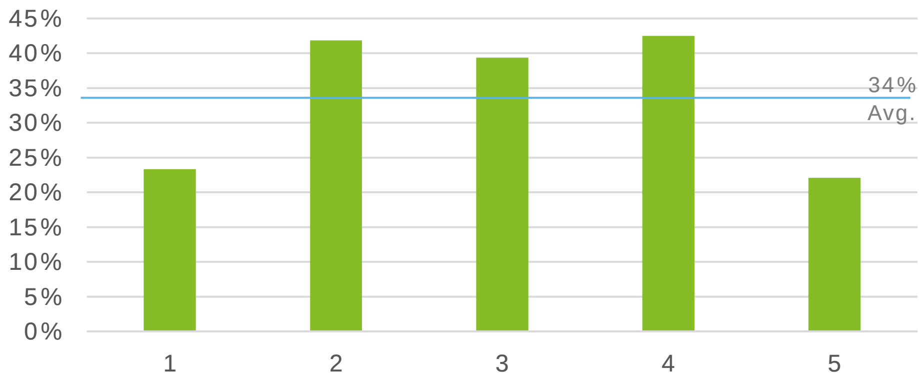
[71] This analysis represents each funding methods' net-in net-out % composition of total funding

Pricing

As emphasized during industry interviews, many credit unions intentionally avoid price leadership, but aim to offer rates slightly higher than the lowest offering in order to control volumes and not to drive down returns. This is emphasized by the fact that credit unions have the lowest spread amongst price offerings, representing the shared mindset to price close to competitors. This trend is further supported by the fact that over the same 4 year time period, 34% of rates offered by credit unions were within 5% of the lowest offered rate (Figure 22).

Figure 22: Percentage of CU Rates Within +0-5% of the Lowest Offered Rates, July 2013 to June 2017 (%)



Business Model Archetypes

Through interviews and market observations, Deloitte identified different business model choices credit unions have made across seven different dimensions.

Primary Dimensions

- **Region / Segment Focus:** Where and on what type of borrower(s) does the credit union choose to focus?
- **Distribution:** Through which channels does the credit union originate residential mortgages?
- **Product:** Does the credit union compete on product / experience design innovation?

Secondary Dimensions

- **Pricing:** Does the credit union aspire to be a price-leader or to closely follow the market?
- **Funding:** What funding sources does the credit union use?
- **Credit Operations:** How are deals processed and adjudicated?
- **Risk Appetite:** To what degree is the credit union willing to take on credit risk to grow the residential mortgage book and/or meet the needs of members?

Three archetypes emerged, each with associated growth strategies, strengths, and weaknesses.

Business Model Archetypes	Strategy	Key Business Model Dimension Choices	How They Win
"Grow with Those You Know"	Solidify market position by growing membership base in existing trade areas and diversify product offering through proprietary channels	*Primary Choices* • Focus on existing geographic areas and existing customer segments • Originate mortgages through proprietary channels (i.e., branch and mobile advisor) • Offer innovative products that serve the needs of target member segments to build share of wallet with existing members and attract new members with similar needs (e.g., a low-rate, same-day loan to be repaid with the next paycheque) *Secondary Choices* • Offer competitive pricing but do not lead the market on price • Fund mortgages nearly or entirely through the balance sheet; no requirement to diversify funding sources in order to increase potential origination volumes • Credit operations are strategic - likely to leverage auto-decisioning as part of an in-house underwriting function • Generally conservative risk appetite, with some willingness and expertise to take on near-prime and bruised credit borrowers within target markets or segments where they choose to focus	• Win on experience design and product innovation • Focus on developing products to better meet the needs of existing members • Focus on delivering better experience than competitors to solidify relationships with existing members and to attract new members within the target risk appetite to generate more business • Credit writing expertise as competitive advantage – faster to decision at no incremental risk • Win on speed to credit decision
"Grow Outside of the Box"	Expand geographical presence by entering into new markets and attracting new members from various segments with competitive products and a strong distribution network of both proprietary and	*Primary Choices* • Focus on all member segments inside new or underpenetrated geographic • Use both proprietary and third party distribution channels to build a strong distribution network with wide reach across the target geography • Lead with existing, competitive products *Secondary Choices* • Stay competitive on price – lead the market 'opportunistically' (e.g., rate	• Win on wide distribution of feature- and rate-competitive products • Support a strong product offering with a leading origination and servicing experience for borrowers and brokers (e.g., quick turnaround times, consistent decisioning)

	third party channels	sales, channel specific promotions, segment specific promotions) • Fund through balance sheet and securitization as required to meet target origination volume growth • Credit operations are non-strategic, with potential for external staff augmentation or process outsourcing in expansion markets • Allows the lender to focus on designing a leading experience to customers and distribution partners (i.e., brokers) • Fairly broad risk appetite, willing to serve members of different characteristics, including rental, business for self, and near-prime	• Set broad tolerances on customers that fall within the risk appetite • Leverage mortgage brokers to expand reach into new markets, selectively win with price (temporary promotion or rate sales), and source particular risk profiles opportunistically (e.g., specific programs for self-employed borrowers)
"Business as Usual"	Maintain strong presence inside typically limited footprint; lead with branch presence; focus on organic growth	*Primary Choices* • Focus on existing geographic areas and existing customer segments • Lead with the branch channel and strong embedding in local communities; may also rely on limited broker engagement or a small mobile salesforce depending on the unique characteristics of the trade area (e.g., the branch model may not suit rural regions where members may be far from a branch) • Typically limited product shelf aligned to core banking needs *Secondary Choices* • Stay competitive on price • Fund primarily through balance sheet; may use alternate sources (e.g., securitization, whole loan sales) for liquidity purposes • Build credit operations with a high degree of discretion for atypical deals • Maintain conservative risk appetite; focus on prime lending only	• Win on deep understanding of target customers and segments • Win on physical presence and proximity relative to competitors • Grow organically at pace with local population and market growth • Fund primarily through deposits, with an option to opportunistically use other funding sources for liquidity or to support origination volume spikes • Win with local market credit writing expertise in underserved locales (e.g., writing atypical deals)

Business Model Archetypes	Strengths	Weaknesses
"Grow with Those You Know"	• High degree of expertise on deals given the limited trade areas • Relatively insulated from regulatory changes due to high reliance on internal funding • Ability to implement uniform pricing policy for all originations • Strong economics due to the focus on proprietary channels	• Concentration risk in limited trade areas – if the housing market declines, then the business will be heavily impacted • Potentially limited growth due to reliance on balance sheet for all funding, and population growth in limited geographical footprint
"Grow Outside of the Box"	• Access to a wide range of customers through geographical expansion and mortgage broker engagement • Access to more funding sources by using both balance sheet and securitization programs • Ability to scale originations up and down easily due to greater role of the broker channel	• May take on higher levels of portfolio risk by lending to customers outside the prime tranche • Lower degree of expertise on deals and borrowers due to the larger trade area, may require external expertise (e.g., outsourcing or staff augmentation) • Inability to implement uniform pricing policy for all originations due to the use of third party channels • Challenge franchising customers originated in the broker channel • Success depends on remaining highly competitive on rate, product, and servicing experience
"Business as Usual"	• Ability to implement uniform pricing policy for the majority of originations • Favourable distribution economics due to the focus on proprietary channels • Deep knowledge of local markets; able to effectively underwrite atypical deals • Will experience organic growth closely tied to population growth and market growth in trade area	• Growth is limited to population increase within trade area • Unfavourable member demographics (i.e., concentration of older members) • Exposure to major negative economic shocks that impact a particular local market disproportionately (e.g., Fort McMurray)

Summary

Based on interview insights shared by credit unions of various sizes, credit unions have different growth strategies depending on their size and market focus; some are actively pursuing growth while others are comfortable with market-pace growth. They continue to see strength in the core credit union value proposition of deeply understanding member needs and investing in their communities.

Credit unions do not position themselves as price leaders and tend to offer rates that are competitive with the market. At times, a credit union may offer "rate sales", offering a market-leading rate if it has excess deposit funding on hand. Credit unions do not choose to win in the market through price, but rather they focus on member experience and servicing members' needs.

Each credit union business model archetype has distinct strengths and weaknesses. Overall, credit unions' business model and related strategic choices appear to add little, if any incremental, risk to the Canadian residential mortgage market. This is supported by credit unions' risk management practices and low delinquency rates that are aligned with other lender types.

MFCs

Introduction

The MFC business model is characterized by concentration. Their main product category is residential real estate secured credit, predominately sold through the single distribution channel of mortgage brokers. Consequently, MFC revenue sources are also concentrated. MFCs derive revenue from direct lending activity as well as mortgage processing. Business models look very similar across organizations. While some key differentiators exist (such as Paradigm Quest's multi-brand structure, or Street Capital's recent transition to a deposit-taking bank) the most important distinctions are the degree of concentration among revenue sources and funding mix. These become especially important as lenders begin to feel the impacts of new regulatory changes. Lenders that rely heavily on securitization are expected to experience material revenue erosion, while those that earn a greater share of revenue from whole loan sales and loan servicing on behalf of other lenders will likely find themselves better insulated from shifts in the market.

Key Trends

There are three main trends shaping the MFC industry today:

1. Increasing focus on business process outsourcing as a means of revenue diversification
2. Investment in process automation and technology to drive faster time to decision
3. Exploration of digital as origination channel

Increasing Focus on Business Process Outsourcing

Recent regulatory changes are pushing MFCs to shift their focus away from proprietary mortgage lending and towards business process outsourcing activities such as servicing and underwriting. These revenue streams are critically important as public securitization becomes more restricted. Moreover, servicing in particular creates earnings stability as this delivers revenue over multiple years compared to mortgages originated for sale which generate fee revenue at a single point in time.
Many MFCs are also exploring how their core competencies developed in the mortgage business can be applied to other lending categories, with some extending further and considering process outsourcing opportunities in other financial services.

Investment in Process Automation and Technology

MFCs believe that their current value proposition will continue to drive growth after recent regulatory changes, but that they must continue to refine their capabilities to remain competitive. Specifically, they believe that superior service to brokers and end borrowers through the ability to deliver a credit decision faster than bank competitors will bolster their competitive position. This is a customer and broker experience-led strategy designed to address consistent borrower irritants such as process opacity and long turnaround times[72]. Key investments include:

- **Technology:** Many MFCs operate on comparatively advanced technology platforms relative to other lenders, creating strong process efficiencies – most MFCs interviewed agreed that continuous improvement of technology, with a heightened focus on innovations that remove friction from the borrower and broker experience, is required for MFCs to continue growing. A simple but pertinent example of such an investment is establishment of digital document ingestion, a capability that

[72] Deloitte Analysis

allows the borrower and / or the broker to digitally upload key pieces of documentation required to decision an application or fulfill conditions on an approval.

- **Process Automation:** MFCs consider themselves to be credit operations domain experts. Several are making material investments in applying that expertise to their own business processes, seeking opportunities to automate tasks, thereby removing cost from their operations and increasing speed of application processing.

Most MFCs agreed that maintaining a processing and technology advantage over banks and credit unions is critical to their ongoing viability. This will both buttress their position to compete with deposit-taking lenders but also increase their attractiveness as a potential outsourcing partner to those same deposit-taking lenders.

Exploration of Digital as an Origination Channel

The recent regulatory changes are pushing MFCs to consider new pathways to drive growth. While nascent, some MFCs are considering the possibility of direct-to-consumer distribution, despite the potential for head-to-head competition with established broker channel partners. The digital origination channel is expected to become a viable source of volume in the next 2-3 years. Investment by MFCs to date has been exploratory in nature, focusing on point solution capabilities (e.g., digital document ingestion) and small scale proofs of concept. It is unclear at present if these exploratory investments will transition to transformational investments.

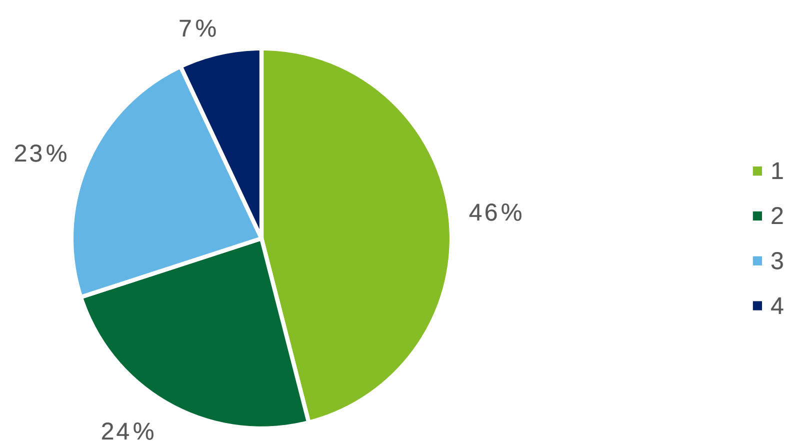
MFC Business Models

Funding Models

MFCs fund residential mortgages primarily through three methods:

1. Mortgage securitization through NHA MBS and CMB
2. Whole loan sales to balance-sheet lenders
3. Commitments from institutional investors[73]

Figure 23: Estimated MFC Funding Breakdown, 2016 (%)[74]



[73] Deloitte research through interviews

[74] Analysis performed using data from First National, MCAP, Paradigm Quest, and CMLS

Figure 24: Range of Key Sources of Funding, 2016 (%)

Funding Source	High End	Low End
Whole loan sales	60%	30%
Securitization	40%	0%
Commitments to investors	70%	0%
Other	20%	0%

At an aggregate level, the largest funding source for MFCs is whole loan sales, making up almost half of the estimated funding mix. The shares of securitization and commitments to investors are roughly equal and make up most of the remainder of MFC funding. Balance sheet equity and other sources are a very small portion of total funding.

Individual MFCs show considerable differences in their reliance on different sources of funding. While whole loan sales are significant for all MFCs, making up roughly a third to two thirds of total funding, the usage of securitization and investor commitments vary dramatically. On the high end, securitization can represent up to 40% of total funding but some MFCs indicated that they did not securitize any of their originated volume in 2016. The variance in the use of commitments to investors is even more significant, ranging from 0% to 70% of total funding.

These variations suggest an element of the business model diversity among MFCs, as well as their varying degree of reliance on other entities in the market. MFCs that rely more on securitization are relatively less impacted by business conditions for other lenders in the market, but are more vulnerable to changes in regulatory policy. Those MFCs that rely on investor commitments face challenges that mirror the investor's strategy, be it securitization or holding mortgages on balance sheet.

Revenue Models

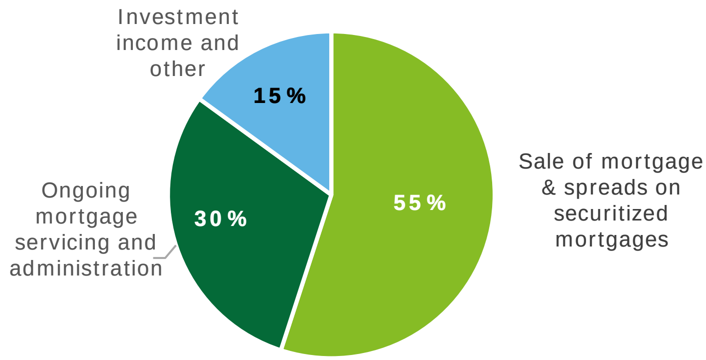
MFCs typically generate revenue five different ways[75]:

- **Sale of whole loans**: MFCs earn proceeds from the sale of funded whole loans
- **Spread on securitized mortgages**: MFCs earn a spread on securitized mortgages under the NHA MBS and CMB programs
- **Net interest from holding mortgages**: MFCs warehouse mortgages until they are sold to balance-sheet lenders or securitized; during this period, MFCs earn interest income
- **Mortgage servicing income**: Some MFCs act as process outsourcers for other lenders; these MFCs have contractual arrangements with other lenders where the MFC will adjudicate and service residential mortgages typically but not exclusively originated in the broker channel. Lenders have various business cases for outsourcing credit operations. The dominant case is driven by efficiency gain as some MFCs have advanced technology and processes that provide a turnaround time or cost advantage over the lender's proprietary processing
- **Placement fees**: MFCs charge a fee for helping investors to originate mortgages based on rules set by the investor[76]

Whole loans sales and spreads on securitized mortgages represented the majority of revenue for Canada's top three MFCs over 2014 and 2015 (Figure 25); whole loan sales typically account for a slightly higher share of revenue than spreads on securitized mortgages[77]. Mortgage servicing and administration fees make up another third of revenue. This revenue model is likely to shift due to regulatory pressures that constrain MFCs' ability to originate loans. Mortgage servicing and administration is expected to grow in importance.

[75] Deloitte research through interviews and First National 2016 Annual Report
[76] Deloitte research through interviews and First National 2016 Annual Report
[77] Deloitte research through interviews

Figure 25: Revenue Composition of the Top Three MFCs, 2014-2015 (%)[78]



MFC Business Model

Strengths

The MFC business model has significant strengths that have driven industry growth, specifically in the past decade when the top four MFCs' share of mortgage underwriting doubled, from roughly 6% to more than 12%[79].

Mortgage Domain Expertise

- MFCs create value through targeted domain expertise, providing partners with reliable industry knowledge and experience embedded within their service offerings
- MFCs' domain expertise allows them to provide optionality through offering a wide variety of capabilities such as nimble pricing models, the ability to turn around and service a client quickly, an avenue for lenders to enter a new geography or customer base, and strong credit risk acumen
- MFCs have extensive experience and expertise dealing with mortgage brokers, allowing them to best use broker relationships to find high-quality volume

Leading Credit Operations

- MFCs have leading loan origination and servicing platforms and processes; they offer fast turnaround times, adjudication expertise, and consistent decisioning both to their own borrowers and to lenders that outsource their business processes
- MFCs have robust risk management and underwriting practices; MFCs must adhere to OSFI's underwriting guidelines in order to sell loans to OSFI-regulated lenders
- MFCs' stringent adjudication and underwriting guidelines, credit acumen, and sophisticated risk management practices result in very low arrears rates (in many cases, <0.20%)

[78] Bank of Canada, 2016. ***The Rise of Mortgage Finance Companies in Canada: Benefits and Vulnerabilities***. http://www.bankofcanada.ca/wp-content/uploads/2016/12/fsr-december-2016-coletti.pdf
[79] Bank of Canada, 2016. ***The Rise of Mortgage Finance Companies in Canada: Benefits and Vulnerabilities***. http://www.bankofcanada.ca/wp-content/uploads/2016/12/fsr-december-2016-coletti.pdf
*Note: RMBS securitization is not, at present, an actively utilized funding source in the Canadian market

Strong Distribution Networks

- MFCs have a wide distribution network, with many broker relationships across the country; this allows them to avoid concentration risk and insulates them against shifts in local markets
- MFCs' deep reliance on brokers is increasingly being seen as a strength as the broker channel gains share; new mortgage rules have also had the side effect of increasing the value of expert advice and the ability of brokers to look at multiple potential lenders to find the best fit for a borrower's specific needs

Weaknesses

MFCs also have structural weaknesses, many of which are exacerbated by recent regulatory changes.

Limits on Funding

- Despite diversification of funding sources, MFCs have historically been dependent on public securitization programs for a significant proportion of their funding, and are now experiencing a material funding squeeze
- MFCs have no sustainable in-house funding mechanisms (i.e., no equivalent to the stability of deposit funding for banks and credit unions)
- Due to their smaller scale relative to bank lenders and the need to sell or securitize mortgages fairly quickly after issuance, MFCs have limited ability to assemble the large pools of similar loans required for private securitization or covered bond issuance

High Dependence on Other Lenders

- MFCs are increasingly reliant on other lenders as servicing, whole loan sales, and placements for institutional investors become increasingly important parts of their business, increasing their sensitivity to slowdowns experienced by these lenders and reducing their negotiating leverage (e.g., determining the breakdown of a portfolio of loans to be sold to another lender, negotiating placement fees)

Key Customer Segments are no Longer Profitable

- MFCs are very reliant on specific market segments (i.e., prime insurable and insured business) due to securitization; the cost of funds makes playing in uninsurable segments challenging for a non-bank lender
- MFCs have historically had a large share of their originations (e.g., 25-50%) in categories that are now uninsurable (e.g., refinances) and are now challenged to find funding sources for these loans
- Mortgage volume is highly dependent on price; MFCs must remain rate-competitive in some of the most contested borrower segments to maintain volume

Conclusion

The primary growth path for the MFC business model is to leverage adjudication and servicing capabilities on a fee-for-service business process outsourcing (BPO) basis. In these arrangements, such as First National's partnership with TD bank[80], the MFC applies specific credit rules on behalf another lender – owning the application of credit policy but making no credit decisions of their own. The consensus view from MFCs is that their ability to grow through their traditional 'originate to sell' model has been dampened by the recent regulatory changes. The secondary growth path observed in the market is the migration away from the traditional MFC model to becoming a deposit-taker. Street Capital's launch of Street Bank is intended to

[80] *"TD Outsources Broker Underwriting to First National"* **Canadian Mortgage Trends**, 2014. https://www.canadianmortgagetrends.com/2014/07/td-outsources-broker-underwriting-to-first-national/

create funding alternatives and offer revenue diversification through the addition of other retail credit products[81].

Given growth paths available, there is little evidence to suggest that MFCs will add risk to the mortgage market in pursuit of that growth. A shift toward BPO reduces MFC reliance on the originate-to-sell model, effectively limiting their presence in market. Converting to a schedule 1 bank would bring the full activity of an MFC under the purview of OSFI. Following the logic of the argument that direct prudential regulating oversight reduces risk, then the growth strategy of becoming a bank should be viewed as reducing risk.

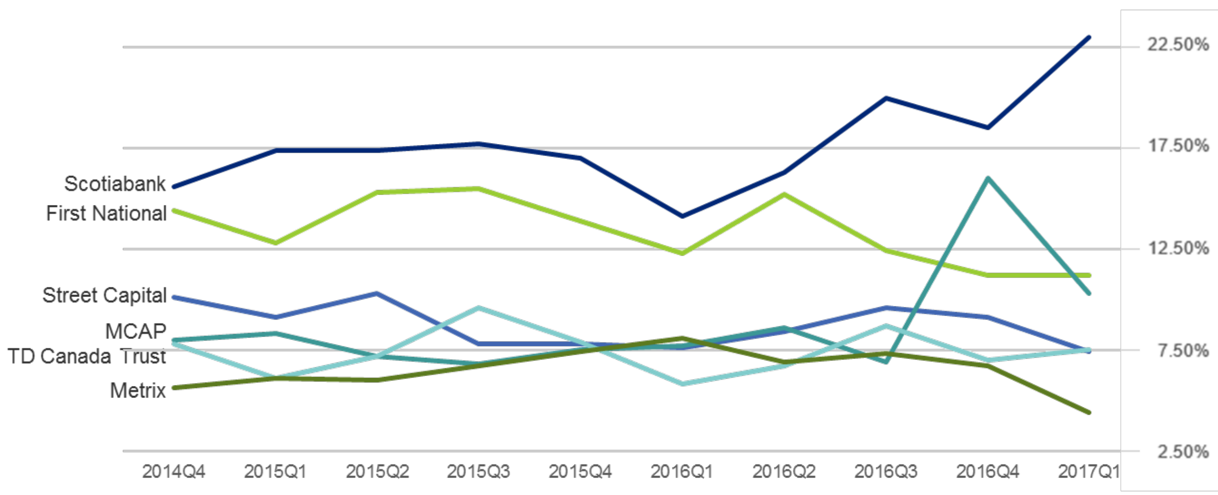
[81] *"Street Capital Bank of Canada Commences Operations"* **Street Capital Group Investor Memo**, 2017. https://streetcapital.ca/news/street-capital-bank-canada-commences-operations

5. Role of Mortgage Brokers

The broker channel continues to grow within the residential mortgage market, with brokers seeing 12% more business in Q4 of 2016 compared to 2015.[82] Some of the increase in business was driven by borrowers' heightened activity prior to the mortgage rule changes coming into force on November 30th. However, brokers have significantly increased their share of the repeat buyers market (42% of repeat buyers in 2015, up from 32% in 2012) and captured over half of first time homebuyers in 2015 (55%, up from 48% in 2012)[83].

The broker channel is highly consolidated, with the top 10 broker channel lenders (including the 4 largest MFCs (Figure 26) originating roughly 85% of total broker volume.[84]

Figure 26: Quarter-over-Quarter Broker Lender Market Share, Q4 2014 to Q1 2017 (%)[85]



The Canadian Credit Union Association reports that credit unions source approximately 18% of their members through mortgage brokers.

Use of the Broker Channel

Mortgage brokers are a significant origination channel in the Canadian residential mortgage landscape. As Figure 27 shows, broker originations have grown to represent approximately 1/3 of total industry originations in the last 5 years, though the composition of lenders in the broker channel has changed significantly.[86] On average, 41% of borrowers from 2012 to 2016 obtained their mortgage through a broker.[87] While use of the broker channel is lower for renewals and refinances, the channel remains a strong, stable presence in the

[82] "Broker Lender Market Share Q4 2016." ***Canadian Mortgage Trends.*** https://www.canadianmortgagetrends.com/canadian_mortgage_trends/2017/03/broker-lender-market-share-q4-2016.html
Note: this is sourced from D+H Filogix and therefore captures a majority but not all of the broker market (i.e., ~90%).
[83] CAAMP
[84] Ibid.
[85] Data for the analysis pulled from **"Broker Lender Market Share – Q4 2014 to Q1 2017",** Canadian Mortgage Trends, 2017. https://www.canadianmortgagetrends.com/2017/05/broker-lender-market-share-q1-2017/
[86] "Annual State of the Residential Mortgage Market in Canada." ***Mortgage Professionals Canada, 2014-2016.*** https://www.mortgageproscan.ca/en/page/industry-and-consumer-reports
[87] "Annual State of the Residential Mortgage Market in Canada." **Canadian Association of Accredited Mortgage Professionals, 2012-2013**. https://www.ratehub.ca/docs/mortgage-reports/caamp-annual-2012.pdf; https://www.ratehub.ca/docs/mortgage-reports/caamp-annual-2013.pdf

competitive landscape and is an important source of volume for many credit unions. The broker channel is the primary source of volume for MFCs.

Figure 27: Estimated Broker Share of Total Industry Originations by % of Mortgages, 2012 to 2016 (%)[88]

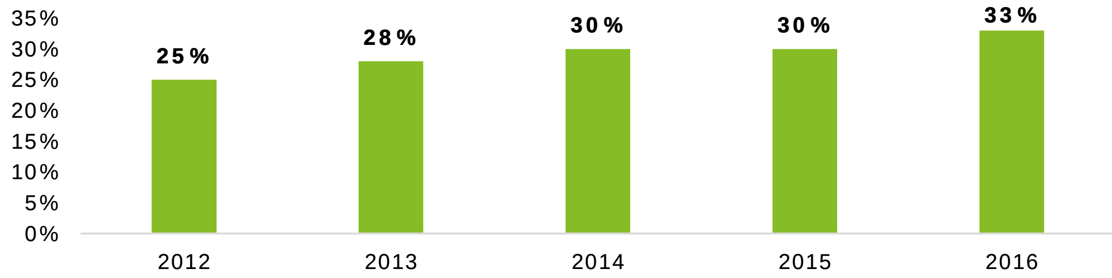
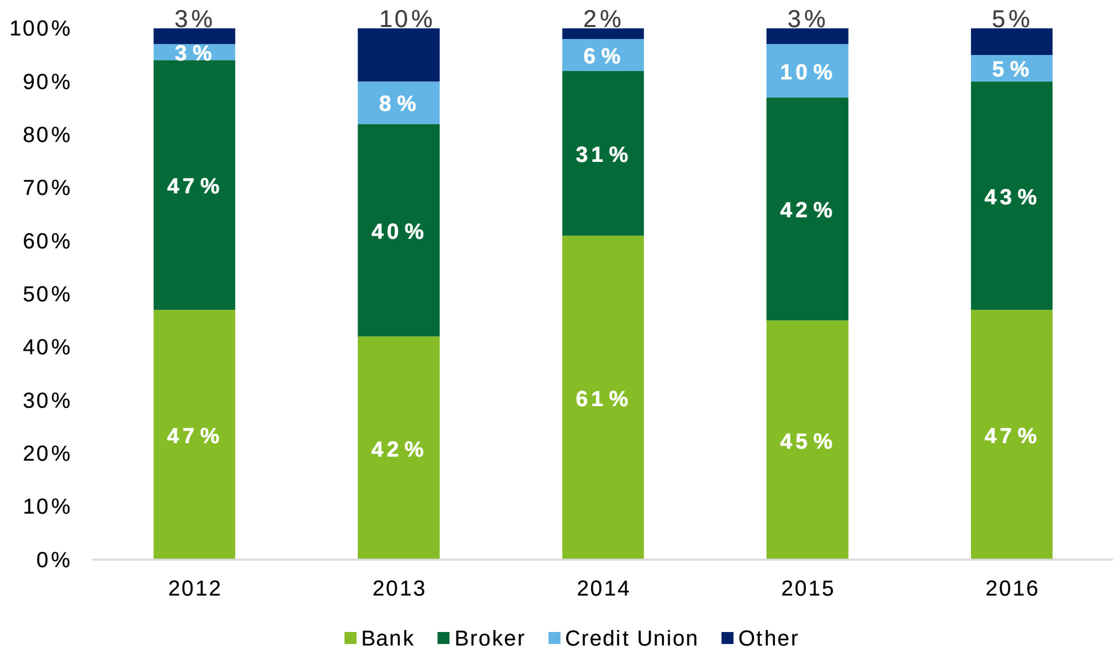


Figure 28: Mortgage Purchase Volume by Competitor Type, 2012 to 2016 (%)[89]



Credit Unions

Credit unions vary in their use of the mortgage broker channel. Some, like Vancity Savings, have made the strategic decision to exit the channel.[90] Organizations making this choice typically cite little success in franchising customers, losing business back to the broker upon renewal, and unfavourable economics compared to origination through the branch networks or tied mobile advisors. Others see the channel as an important <u>secondary</u> source of origination volume. Among credit unions that use brokers, there are three general "roles" that the channel fills as part of the broader distribution strategy:

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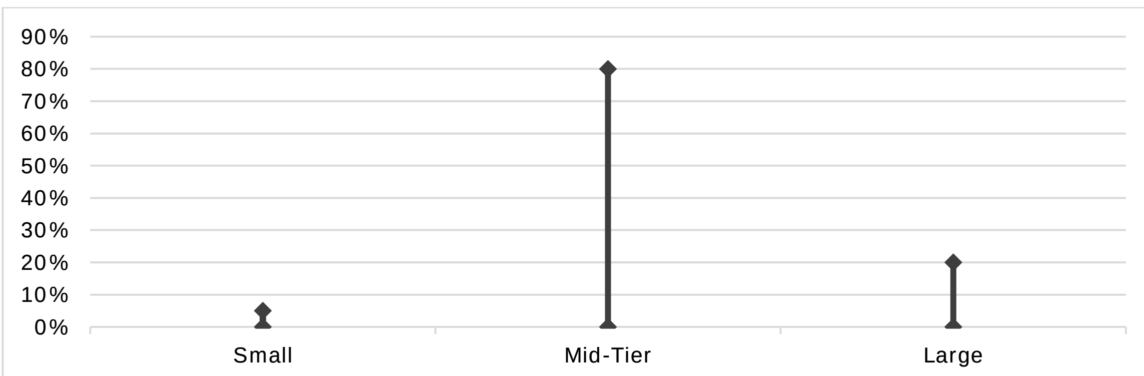
[88] Previous two sources combined.
[89] Ibid.
[90] "Vancity Divorces Brokers." ***Canadian Mortgage Trends, 2016***. https://www.canadianmortgagetrends.com/2016/07/vancity-divorces-brokers/

1. **Access to customers:** Some credit unions engage brokers to generate business from new geographies in which the credit union does not have a presence
2. **Targeting customer segments:** By increasing commissions for certain types of business, credit unions use brokers to drive volumes in targeted customer segments. For example, credit unions are able to source more profitable deals by focusing on borrower segments where deals are priced at a premium (e.g., business for self, bruised credit), provided that they have the underwriting expertise
3. **Operational scale:** Credit unions are able to scale up their operations in a certain geography much more quickly by using brokers than by expanding their own sales force

Figure 29 illustrates the range of origination share that the broker channel owns in the credit union sector.

Figure 29: Broker Channel Originations as a Share of Total Originations, by Credit Union Size (n=8), 2016 (%)



For large credit unions, the broker channel is an opportunistic asset gathering channel, secondary in importance to distribution through proprietary channels. Large credit unions have the scale and infrastructure required to support proprietary channels such as mobile advisors and therefore do not have to rely as extensively on brokers to increase their volume as do smaller lenders. These large lenders are also able to be selective with the volume that they get through the channel, and adjust broker incentives according to the types of deals they want to write.

Mid-tier credit unions' use of the broker channel varies significantly.

Small credit unions tend to have very little business generated from the broker channel. These lenders are able to source sufficient volume from branch traffic within their trade areas, and the economics of the broker channel can be prohibitive for them due to the additional layer of cost. However, some credit unions are considering limited involvement in the broker channel to grow their business as they begin to reach saturation of branch traffic.

Irrespective of size, credit unions generally prefer to distribute through proprietary channels where possible but use the broker channel strategically to fill specific distribution strategy gaps. The size of the broker channel makes it an important market in which to play for many credit unions.

MFCs

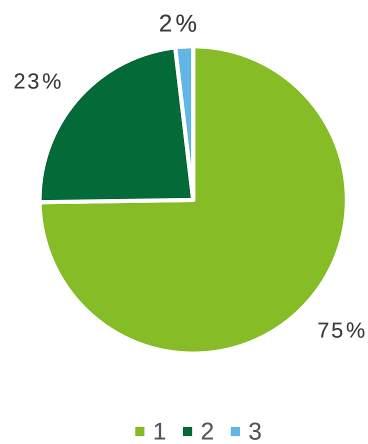
MFCs rely on mortgage brokers as the primary distribution channel for mortgage origination. Most MFCs lack the infrastructure today to distribute directly and none demonstrate the appetite to invest in tied distribution (e.g., an employee sales force). While some maintain a modest inside sales or affinity lead generation capability, there is no evidence to suggest a strategic shift away from the mortgage broker channel. The broker channel is likely to continue to provide nearly all the residential mortgage volume that MFCs generate.

MFCs display varied intent toward establishing direct distribution in the near future. Direct distribution entails the establishment of a digital application capability that is either self-serve or is complimented by remote assistance (e.g., phone support, live chat, etc.). Some have taken a strategic decision not to go direct as it would result in head-to-head competition with their existing brokers, while others are considering or are investing in direct distribution capabilities as a secondary source of originations. Those making this investment believe that the direct channel will become more popular in the next 5 years, and that direct distribution will deliver superior economics versus broker originations.

Pricing Tactics and Positioning

MFCs appear to be more likely than credit unions or banks to use price as an explicit, mass market customer acquisition tactic. Using 96 bi-monthly snapshots covering the entire prime mortgage market between July 2013 and June 2017, it is observable that MFCs offered the lowest five-year fixed mortgage rate 75% of the time compared to banks and credit unions (Figure 30)[91,92]. Credit unions offered the lowest rate 23% of the time, while banks offered the lowest rate only 2% of the time.[93]

Figure 30: Percentage Breakdown of Lowest Rate Offered by Lender Type, July 2013 to June 2017 (%)



Looking at pricing by lender organization between July 2013 and June 2017 (Figure 31), HSBC offered the lowest bank rate 71% of the time, which is significantly higher than the closest bank competitor[94]. Cambrian Credit Union was the CU price leader 26% of the time during the same time period, but was closely followed by Meridian and Coast Capital at 19% and 18% of the time respectively. In the MFC landscape, Xceed Mortgage offered the lowest rate 57% of the time, a 37% lead over the nearest MFC competitor[95]. For all three types of lenders, the price leader outlined below is not among the market share leaders, supporting the argument made by study participants that price-leadership is not a main driver of the ability to capture mortgage market share, but rather an opportunistic tactic used to periodically drive volume.

[91] Internal Deloitte analysis – rates provided by RateSpy
[92] Rates used in this analysis are considered 'discounted' rates, gathered from websites, in-person discussions, and through alternative methods of data collection. Since mortgage lenders adjust their offered rates on a case-by-case basis, it is possible that some of the rates used in our analysis are not reflective of the actual negotiated rate between borrower and lender
[93] Historically, major banks have been more likely to present rates to the market that embed within them a margin for discounting by front line staff. These rates consist of both 'posted' mortgage rates as well as 'discounted' rates presented to the market
[94] Internal Deloitte analysis – rates provided by RateSpy
[95] Ibid

Figure 31: Percentage Breakdown of Time as a Price Leader by Lender Organization, July 2013 to June 2017

Bank	% of Time as Price Leader	CU	% of Time as Price Leader	MFC	% of Time as Price Leader
HSBC Bank Canada	71%	Cambrian CU	26%	Xceed Mortgage	57%
Alterna Bank	11%	Meridian CU	19%	Marathon Mortgage	20%
Presidents Choice Financial	5%	Coast Capital Savings CU	18%	Canadiana	15%
ATB Financial	4%	Prospera CU	16%	Lendwise	2%
CFF Bank	4%	DUCA CU	8%	First National	1%
BMO Bank of Montreal	2%	First Ontario CU	5%	MCAP	1%
TD Canada Trust	2%	Steinbach CU	4%	Merix Financial	1%
Manulife Bank of Canada	1%	Interior Savings CU	3%	Think Financial	1%
Scotiabank	1%	Libro CU	1%		

Comparing average rates across three lender channels, credit unions and MFCs have historically marketed, and continue to market, lower rates than the banks[96]. As of 2016, MFCs started to offer lower average prices than credit unions – a trend which has continued into the first half of 2017[97]. When analyzed by distribution channel (Figure 32), brokers consistently market the lowest rates overall, which is expected since they represent the market and are typically well positioned to help customers take advantage of isolated rate discount offers.

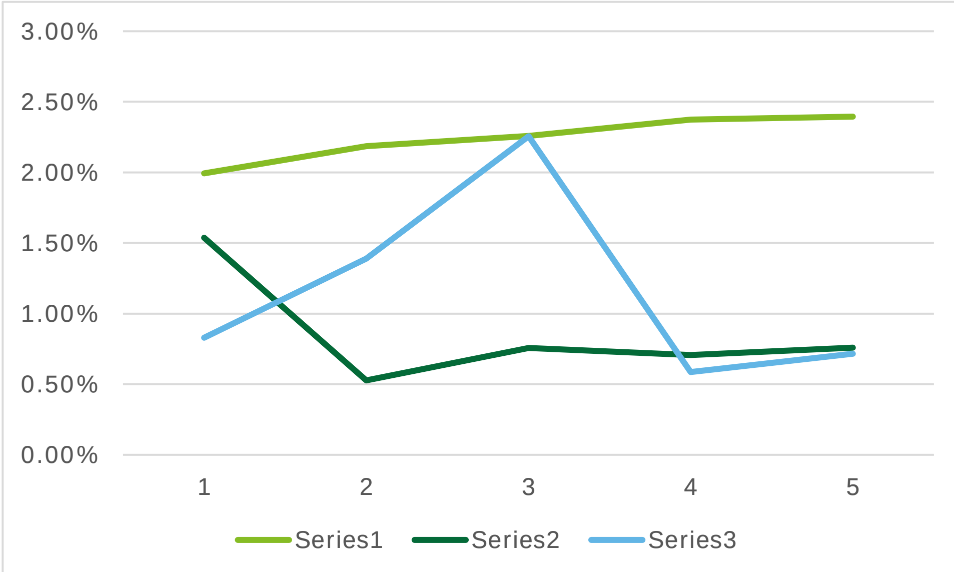
Figure 32: Average Yearly Incremental Lender Rate Compared to Broker Channel, July 2013 to June 2017 (%)

Lender Channel	2013	2014	2015	2016	2017	4-Year Average
Broker	**3.42%**	**3.04%**	**2.69%**	**2.51%**	**2.55%**	**2.84%**
Credit Unions	+0.17%	+0.18%	+0.15%	+0.17%	+0.20%	+0.18%
MFCs	+0.23%	+0.38%	+0.31%	+0.12%	+0.15%	+0.24%
Banks	+0.73%	+0.93%	+0.97%	+0.85%	+0.68%	+0.83%

Interestingly, as outlined in Figure 33, banks have the greatest spread between the lowest and highest rates offered across bank competitors, while MFCs and Credit Unions have little difference between their rates offered.

Figure 33: Spread between the Lowest and Highest Offered Rates by Lender Type, July 2013 to June 2017

96 Internal Deloitte analysis
97 Ibid



Competitive pricing in the prime mortgage market is a 'table stakes' tactic. It has historically been, and continues to be, an area that mortgage lenders monitor closely. Lenders are clearly selective about when and how they will use price as an explicit mass market acquisition tactic. Price leadership is, however, a key element of the mortgage broker channel value proposition.

Advantages and Disadvantages

Advantages of the broker channel include:

- Brokers allow lenders to generate sales without building a sales team or other sales infrastructure
- Brokers can reach customers in geographies in which lenders do not have a brand presence
- Some brokers have credit writing expertise and are well positioned to qualify complex deals
- Brokers have better expertise with complex borrower circumstances compared to branch employees who are generalists across all products. Consumers appreciate this expertise as it tends to result in a smoother application experience and a greater likelihood of receiving an approval
- Lenders can easily scale volume up and down by adjusting rates in this channel (e.g., offering special rates for a limited time)
- Lenders that have strong relationships with brokers can be selective about the type of deals that they accept, using brokers to source very specific types of borrowers or credit profiles to suit the strategic objectives and risk appetite of the lender (e.g., first time home buyers or higher margin Alternative-A business)

Disadvantages of the broker channel include:

- Lenders are often not able to franchise the customers they reach through the broker channel (i.e., the broker rather than the lender maintains the relationship with the customer)
- Customers in the broker channel tend to be highly rate-sensitive, forcing lenders to compete on price to get significant volume as seen in the above Figure 32
- Lenders pay a premium to brokers and receive a smaller margin on residential mortgages originated from the broker channel
- Strong broker relationships may discourage lenders, MFCs especially, from pursuing direct distribution as it may be seen as a competitive challenge by broker partners

Conclusion

While MFCs and credit unions of different sizes vary in their degree of reliance on the mortgage broker channel, the channel remains of significant importance in the Canadian residential mortgage landscape. Lenders treat their involvement in the channel very differently: for some lenders it is a source of opportunistically gathered volume, while for others it is a central source of volume that they cannot drive through other channels. Some lenders also see brokers as a source of growth as branch-driven growth weakens.

The role of the broker has also shifted in the wake of the recent regulatory changes. MFCs and credit unions indicate that recently, they are unable to match prices being offered by bank lenders in this channel for prime uninsurable business. They posit that they are unable to compete for certain business due to the combination of restrictions on portfolio insurance eligibility, increased insurance costs, and comparatively little access to low-cost funding sources. MFCs and credit unions suggest that this has shifted the competitive landscape and broker value proposition. However, the ability of brokers to place deals in an increasingly complicated environment remains valuable. As a result of the regulatory changes, some lenders have increased the complexity of their rate sheets to match new loan categories (e.g., the “prime uninsurable” segment) and the associated economics of each segment. These lenders believe that brokers will be crucial resources in an increasingly complicated lending environment.

6. Governance and Risk Management

Summary and Key Insights

Credit unions are required by provincial regulators to meet various financial thresholds reflecting the soundness of their current financial position. These thresholds also serve as a mechanism for credit unions to ensure that they are managing risk effectively. However, standards and requirements differ substantially across provinces and therefore risk management practices also vary. Additionally, credit unions have a high degree of flexibility in their implementation of risk control practices.

MFCs are not directly regulated but implement their own practices to control risk across the business. They are also indirectly aligning their practices to meet OSFI underwriting guidelines and other requirements for customer onboarding for the loans that they sell to OSFI-regulated lenders (i.e., banks) or the loans that they originate and service on behalf of these lenders.

Regulatory Guidance on Risk Management

Provincial regulators provide guidance on how credit unions should mitigate those risks inherent in their operations. These guidance notes sometimes detail specific thresholds which credit unions are expected to meet. Regulatory requirements and best practices differ across provincial jurisdictions in the Canadian credit union system. In addition to inconsistent regulatory requirements, a credit union's unique size, nature, and complexity contribute to the development of risk management frameworks across institutions.

In order to best understand credit unions' risk exposure to the overall housing finance system, insights were gathered into the risk management regimes of Canada's top 10 credit unions by assets. Analysis of risk frameworks was facilitated through a review of available financial disclosures to develop perspectives on the maturity of the following risk regimes:

- Liquidity: Extent of reliance on mortgage securitization, deposit growth and external borrowing facilities as means to diversify an organization's sources of liquidity.
- Capital: Composition of capital reserves, frequency of capital planning and considerations for maintaining adequate capital levels.
- Credit: Management of concentrations of credit risk across different counterparties and the organization's overall exposure to the housing finance system.

A focus was taken to understand how the credit unions' risk frameworks align with regulatory expectations and whether there were any similarities between credit unions and Canada's schedule 1 banks.

Risk Governance

Typically, a board of Directors is accountable for the management of risks inherent in the credit union or MFC. The Board will define a risk appetite statement and related risk tolerances which communicate the amount and type of risks to be assumed in the institution's operations. Management is tasked with developing risk management frameworks to ensure the organization's risk profile remains within the Board's approved limits.

Risk governance frameworks consist of tools, policies, and processes which the organization employs to manage those risks inherent in the pursuit of its strategic objectives. The Board at a minimum approves policies governing capital management, credit risk, market risk, liquidity and operational risk management practices. Senior Management develops risk monitoring and control practices to comply with the Board's policies and overall risk appetite.

Credit unions establish and maintain an Enterprise Risk Management (ERM) program covering all operating areas that expose the institution to material financial, legal, regulatory or reputational risks. The purpose of the program is to:

i. ensure that sound and prudent practices are supported by effective organizational and procedural administrative systems;
ii. establish effective internal controls to enhance the reliability of financial and other reports; and
iii. create confidence in compliance with applicable laws, regulations, standards and established policies.

The goal of the ERM program is to ensure that all relevant and emerging risks are identified and that they are managed in a balanced manner.

Large credit unions have established a 'three lines of defence' risk governance model and implemented an independent risk management function and an Internal Audit function. Medium to small size credit unions do not always have the scale to establish well-resourced, independent 2nd and 3rd line of defence functions.

Liquidity Risk

Description

Liquidity risk arises from a credit union's potential inability to meet both expected and unexpected current and future cash flow and collateral needs without affecting daily operations or its financial condition. Credit unions must ensure they have adequate financial resources available to satisfy cash flow obligations in a timely and cost-effective manner.

Liquidity Risk Management – Credit Unions

Deloitte validated liquidity risk management practices from the credit unions across Canada. The following commonalities in liquidity regimes were identified:

i) Diversified funding sources
ii) Liquidity measurement

Diversified Funding Sources

Sustainable liquidity management practices ensure growth in lending is supported through sustainable growth in deposit balances.[98] Maintaining robust deposit balances supports credit unions' ability to grow their lending portfolios in a conservative manner. To mitigate the risk of a reliance on a significant number of large deposits, DICO, for example, requires that credit unions a) set limits on large deposit withdrawals and b) identify and monitor deposits over a certain size to establish a notice period before the withdrawal can be made. Credit unions monitor deposit liability concentrations with respect to individual depositors, type of deposit instrument, term-to-maturity, and market source of funds or currency of deposit, as applicable.

Securitization is permitted, provided that the Board of Directors establishes limits on the aggregate amount of each type of securitization. Regulators have contemplated establishing securitization caps but the industry resisted this change. Based on the feedback provided by mid-tier credit unions, internal rule of thumb is to have no more than 40% of funding from securitization. Securitization offers attractive funding for credit unions at low cost.[99] Additionally, under low interest rate environments, securitization activity is more prominent as a source of funding to manage liquidity.[100]

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[98] Meridian, 2016. **Annual Report**. https://www.meridiancu.ca/Meridian/media/images/PDFs/2016_Annual_Report.pdf
[99] Ibid.
[100] International Monetary Fund, 2016. **Credit, Securitization and Monetary Policy: Watch Out for Unintended Consequences**. https://www.imf.org/external/pubs/ft/wp/2016/wp1676.pdf

Credit unions may borrow funds provided that regulatory limits on borrowing are adhered to. For example, a credit union in Ontario may not borrow more than 50 per cent of the credit union's regulatory capital and deposits.[101] Many institutions (e.g., Meridian, Servus, Conexus, Affinity, Coast Capital and First West) maintain lines of credit. Access to borrowing facilities effectively diversifies funding sources and provides a reliable option to obtain funding in a timely manner.[102] In order to obtain favorable terms on lines of credit, collateral in the form of loans or residential mortgages can be pledged to lenders.[103] Maintaining pre-authorized loan agreements with Canadian charter banks and provincial centrals is a common practice.[104]

Liquidity Measurement

Some credit unions monitor total operating liquidity needs on a monthly basis. The review encompasses a detailed forecast of imminent liquidity requirements and a broad projection of cash needs for the next three-month period. Summary measurements of liquidity are reported to the Board at least quarterly.[105]

Liquidity measurement ratios measure whether current levels of liquidity are sufficient to meet cash flow obligations as they become due.[106] The liquidity level of credit unions is measured using a minimum liquidity ratio (a ratio of cash and cash equivalents to Member deposits and borrowing).[107] However, only Vancity, Coast Capital and Meridian out of the top 10 credit unions publish an annual minimum liquidity ratio. Specifically, Meridian states an operating target liquidity range of between 7.75% to 15% of deposits and borrowings.[108] Servus measures liquidity positions using the operating liquidity ratio. The operating liquidity ratio is defined as available liquidity and cash inflows divided by cash outflows.[109] Available liquidity includes investment securities that are immediately available as cash or marketable securities in an active secondary market. This ratio allows credit unions to assess normal day-to-day and seasonal funding requirements against expected cash balances. Affinity and Conexus, which both calculate the operating liquidity ratio, seek to maintain this ratio at greater than or equal to 150%.[110]

Liquidity Risk Management – MFCs

MFCs can strategically manage liquidity by focusing their lending in Canadian mortgages rated as prime. Lending in the prime segment allows MFCs to sell whole loans at profitable margins provided that there is sufficient demand from banks for prime loans. Securitizing mortgages through capital markets can be costly given mortgages may need to be held for some time before they can be pooled for securitization purposes. As a result, MFCs leverage revolving lines of credit to fund mortgages awaiting securitization.

MFCs can mitigate liquidity risk through funding strategy. Focusing on commitment sales allows MFCs to focus liquidity risk management on the commitment pipeline, and meaningfully reduces the potential risk of liquidity constraint related to warehousing for securitization or whole loan sales. This typically presents a trade-off between potentially superior economics versus liquidity risk.

Credit Unions Regulatory Regime

[101] DICO, 2016. Guidance Note: Liquidity. https://www.dico.com/design/Publications/En/Consultations/Consultation_Guidance%20Note_Liquidity_July%202016.pdf
[102] Conexus, 2016. **Annual Report**. https://www.conexus.ca/SharedContent/documents/AnnualReports/2016/2015_Consolidated_Financial_Statements.pdf
[103] Ibid.
[104] Affinity Credit Union, 2016. **Annual Report**. https://www.affinitycu.ca/YourCreditUnion/About/Documents/2016%20Consolidated%20Financial%20Statements.pdf
[105] International Monetary Fund, 2016. **Credit, Securitization and Monetary Policy: Watch Out for Unintended Consequences**. https://www.imf.org/external/pubs/ft/wp/2016/wp1676.pdf
[106] Ibid.
[107] Meridian, 2016. **Annual Report**. https://www.meridiancu.ca/Meridian/media/images/PDFs/2016_Annual_Report.pdf
[108] Ibid.
[109] Ibid.
[110] Affinity Credit Union, 2016. **Annual Report**. https://www.affinitycu.ca/YourCreditUnion/About/Documents/2016%20Consolidated%20Financial%20Statements.pdf

Recent guidance on liquidity requirements indicates the majority of provincial regulators are aligning their standards in accordance with Basel III requirements for banking institutions introduced by the Basel Committee on Banking Supervision and adopted by OSFI.[111] Basel III liquidity standards are more conservative than the principle-based credit union liquidity requirements which preceded them. Basel III prescribes haircuts to be applied to assets which are held for liquidity purposes. These haircuts discount the carrying value of assets and may require credit unions to hold a greater portion of liquid assets than in previous years to meet regulatory standards.

DICO, FICOM and CUDGC of Saskatchewan released guidance on revised liquidity standards for credit unions. The level of revised regulatory requirements however is inconsistent across provincial regulators (Figure 34). For example, DICO requires that credit unions with assets over $500 million report on the results for Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR) and Net Cumulative Cash Flow (NCCF). Other provincial regulators only require a subset of these metrics, or do not require any metrics to be reported. Provincial regulators require an LCR ratio of over 100%, but have set different timelines for the implementation of this change; DICO requires credit unions to conduct monthly LCR calculation and provide quarterly reports to DICO commencing in December 2017 whereas FICOM and CUDGC of Saskatchewan will require meeting this threshold in 3-4 years.

Figure 34: Comparison of Selected Regulatory Guidelines on Liquidity Risk Management

Category	DICO	FICOM	CUDGC (SK)	CUDGC (AB)
Limits	LCR, NSFR ratios should be no less than 100% NCCF – credit unions are required to set a time period for which the ratio must be positive	LCR ratio must meet minimum threshold of 100% by 2020 NCCF liquidity metric to measure a survival horizon up to 12 month time horizon.	LCR ratio must meet minimum threshold of 100% by 2019	No specific metrics identified
Policies	Requirements include: - Measure and monitor sources of liquidity (projections for the next 3 months) at least monthly - Conduct periodic assessment of funding shortfall/surplus - Perform liquidity stress testing on a periodic basis - Revise contingency funding planning at least quarterly - Disclose in the financial statements	Periodic stress tests should be performed using greater than 30-day time horizons	Periodically perform forward-looking stress testing to complement and validate risk management approaches	On a regular basis, credit unions should: - Review contingency funding plan - Adhere to liquidity controls - Provide the Board with reporting on liquidity positions

[111] Analysis of DICO, FICOM, and CUDGC of Saskatchewan guidelines

	information related to assets held for liquidity (e.g., total assets held for liquidity as a percentage of total assets and borrowings, unencumbered liquid assets, encumbered liquid assets, etc.) - Provide annual funding plan to DICO			

Capital Adequacy Management

Description

Managing financial capital resources requires holding a level of capital deemed sufficient to protect against unanticipated losses, provide prudent depositor security, and exceed applicable regulatory requirements and long-term internal targets. Credit unions must maintain a prudent cushion of capital to ensure their ongoing economic stability while deploying the necessary capital to finance new growth opportunities.

Regulatory Regime

Regulatory capital adequacy standards are inconsistent; provincial regulators set different thresholds for the capital levels that credit unions must maintain (Figure 35). For example, CUDGC of Saskatchewan is implementing conservative reporting metrics that are more in line with the Basel III standards followed by banks, while other provincial regulators have not revised their principles-based frameworks.

Figure 35: Comparison of Selected Regulatory Guidelines on Capital Adequacy Management

Category	DICO	FICOM	CUDGC (SK)	CUDGC (AB)
Governance	Capital constraints, goals, and objectives must be established by the Board of Directors	Board of Directors is accountable for approving capital planning process	Board of Directors is accountable for capital adequacy management	Board of Directors must establish appropriate and prudent liquidity and funding management policies
Limits	Leverage Ratio > 5% Risk Weighted Assets Ratio > 8%	Risk Weighted Assets Ratio > 8%	Common Equity Tier1 ratio > 7% Total Tier 1 > 8.5% Total Eligible Capital > 10.5% Leverage Ratio > 5%	No specific metrics identified
Policies	Board of Directors is required to: - Review capital management goals and objectives on an annual basis	Board of Directors is required to: -Establish risk appetite and overall risk management program	Credit unions are required to: - Ongoing analysis to ensure capital levels are adequate	Credit unions are required to: - Annually review capital policies pertaining to quality and quantity

	- Review periodically the performance and risk level of the capital portfolio - Review profitability metrics on a periodic basis to identify trends affecting capital levels	-Approve process for determining internal capital targets -Conduct annual review on the appropriateness of the internal capital target	- Periodically assess whether capital levels are appropriate for risk profile, risk appetite and risk tolerance - Annually assess if capital limits are aligned to stress testing program and ICAAP	- Regularly measure and monitor capital position to assist in forecasting future capital requirements

Recent guidance on capital adequacy management reveals large differences in regulatory standards across provinces. While CUDGC Saskatchewan is implementing capital adequacy standards which contribute to greater safety and soundness of capital structures, these requirements may be difficult to meet. Schedule 1 banks, which are regulated in accordance with Basel III, meet Tier 1 capital thresholds through common equity and retained earnings.[112] However, credit unions do not have public access to market and cannot issue common equity, therefore Tier 1 capital balances are entirely comprised of retained earnings. This poses challenges in maintaining higher levels of retained earnings for capital purposes without compromising members' preference for distributing earnings as dividends over earnings retention.[113]

Capital Adequacy Management - Credit Unions

Deloitte validated capital adequacy risk management practices from the 10 largest credit unions across Canada. The following commonalities in capital adequacy regimes were identified:

i) Focused retained earnings growth
ii) Prudent capital levels and capital planning

Focused Retained Earnings Growth

Credit unions cannot readily access capital markets to raise equity capital, therefore retained earnings serve as the primary source of capital. Retained earnings are the highest quality, most stable form of capital. Retained earnings growth is generated through strong financial performance, underscoring the importance of competitive pricing and expense management in generating strong financial performance. Credit unions may seek to diversify their capital sources through investment shares. Investment shares allow credit union members to make equity investments in their credit unions and earn potentially attractive rates of return as the credit union grows.

As seen in Figure 36, on average, investment shares constitute 13% of the top five credit union's Tier 1 capital.

Figure 36: Top Five Credit Union Investment Shares as a Percentage of Tier 1 Capital, 2016 (%)

[113] Laval University, 2016. Basel III capital buffer requirements and credit union prudential regulation: Canadian evidence. http://www.uvic.ca/iwfsas2016/assets/docs/Session2-Paper2-Lai.pdf

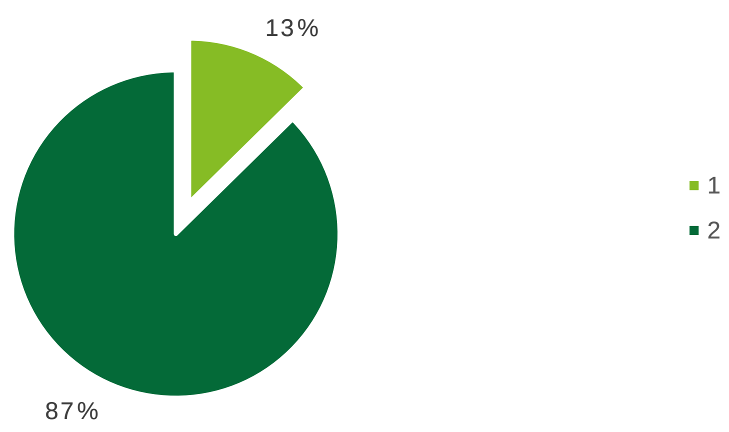
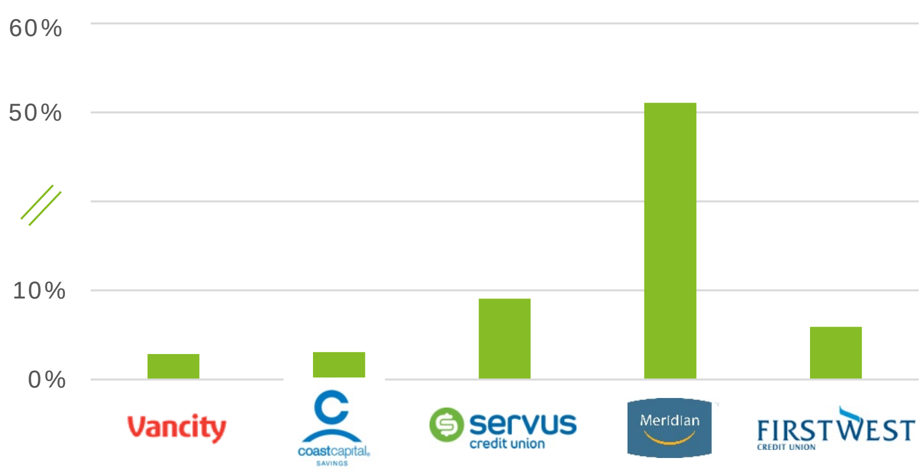


Figure 37 shows each credit union's ratio of investment shares to total Tier 1 capital. Meridian maintains the highest proportion of investment shares to Tier 1 capital at 51%, while Vancity maintains the lowest proportion of investment shares at 2.87%.

Figure 37: Top Five Credit Union Percentage of Investment Shares to Tier 1 Capital*, 2016 (%)



Although investment shares assist credit unions in raising capital, payment of dividends can be costly. As a result, credit unions focus on retained earnings to meet regulatory capital requirements while also issuing investment shares to provide a buffer above regulatory requirements.[114]

Prudent Capital Levels and Capital Planning

[114] Alterna Savings, 2016. "Investment Shares". https://www.alterna.ca/Personal/Investments/SpecialShares/ASClassASpecialSharesSeries3/
Note: Top 5 credit unions represented 35% of total CU assets in Q4 2016

Among Canada's largest credit unions, a majority of institutions will maintain minimum capital levels according to regulatory standards in addition to a safety cushion. Internal limits are adjusted by the Board to suit the level of risk detected in the economic environment of the credit union.[115] Internal capital targets are also benchmarked against current capital levels of Canadian schedule 1 banks.[116] Credit unions' objective in managing capital is to generate value for members while simultaneously exceeding regulatory minimums.[117] Credit unions maintain prudent capital cushions above regulatory standards as a means to absorb unexpected losses and signal financial strength[118]. Although maintaining capital requirements above regulatory standards has opportunity cost due to not deploying the liquidity to a profit driving vehicle, credit unions view this as a necessary cost to maintain risk levels and to ensure maximum stability in the instance of financial distress.

Deloitte benchmarked regulatory capital levels of the two largest credit unions domiciled in Saskatchewan with a sample of Canada's schedule 1 banks. Comparisons can be drawn as both type of institutions adhere to Basel III standards for capital management requirements (Figure 38).

Figure 38: Comparison of capital adequacy: Banks v Credit Unions, 2016[119,120]

Institution	Total eligible capital (in $K)	Total risk weighted assets (in $K)	Total eligible capital / Total risk weighted assets	Common equity tier-1 capital / Risk-weighted assets	Total tier-1 capital / Risk-weighted assets	Minimum leverage ratio
Affinity Credit Union	412,740	3,084,783	13.38%	13.19%	13.19%	7.55%
Conexus Credit Union	433,151	3,205,519	13.51%	12.11%	12.11%	7.68%
Scotiabank	53,330,000	365,000,000	14.6%	11.0%	12.4%	4.5%
RBC	64,758,528	449,712,000	14.4%	10.8%	12.3%	4.4%
TD	61,816,000	406,684,211	15.2%	10.4%	12.2%	4.0

OSFI Basel III guidelines require that for Domestically Systemic Important Banks (DSIBs), capital ratio requirements are applied with a 1% capital surcharge to the requirements set forth by CUDGC of Saskatchewan.[121] As a result, those largest credit unions within Saskatchewan are well capitalized in comparison to both regulatory standards and their peer schedule 1 banks. Other provincial large and medium CUs such as Meridian, Vancity, and DUCA are also well capitalized at 12-13% risk weighted capital ratios.

[115] Meridian, 2016. **Annual Report**. https://www.meridiancu.ca/Meridian/media/images/PDFs/2016_Annual_Report.pdf
[116] Affinity Credit Union, 2016. Annual Report. https://www.affinitycu.ca/YourCreditUnion/About/Documents/2016%20Consolidated%20Financial%20Statements.pdf
[117] Conexus, 2016. **Annual Report**. https://www.conexus.ca/SharedContent/documents/AnnualReports/2016/2015_Consolidated_Financial_Statements.pdf
[118] Ibid.
[119] Regulatory minimum ratios for credit unions are as follows: Total eligible capital, Common Equity Tier 1, Total Tier 1 Capital ratios are 10.5%, 7%, 8.5%, respectively. A minimum leverage ratio of 5% is required by CUDGC Saskatchewan.
[120] Regulatory minimum ratios for banks are as follows: Total Eligible Capital, Common Equity Tier 1, Total Tier 1 Capital ratios are 4.5%, 6%, and 8%, respectively. OSFI expects Canadian banks to include an additional capital conservation buffer of 2.5%, effectively raising the Total Eligible Capital, Common Equity Tier 1, Total Tier 1 Capital ratios minimum requirements to 7%, 8.5%, and 10.5%, respectively. The leverage ratio is calculated as per OSFI's Leverage Requirements guideline and has a regulatory minimum requirement of 3%.
[121] Scotiabank, 2016. **Annual Report**.

Capital Adequacy Management – MFCs

Deloitte reviewed capital management practices among the largest MFCs in Canada and found that the practices varied. For example, Street Capital is in the process of obtaining a license to become a Schedule 1 bank. As a result, their capital management practices include capital management policy and compliance with regulatory capital ratios, well above national regulatory minimum required for CET 1 ratio, Tier 1 Ratio, Total Capital Ratio, and Leverage Ratio.

Alternatively, other MFCs such as Paradigm or CMLS have little-to-no information disclosed on their capital adequacy position. First National publically discloses their access to an established $1B credit facility with a syndicate of eleven financial institutions. Similarly, a number of Canadian banks are lenders to MCAP under one or more credit facilities.

Credit Risk Management

Description

Credit risk is the risk of financial loss incurred as a result of the failure of a counterparty to meet contractual commitments or obligations. Credit risk arises principally in a credit union's lending activities from loans and advances. Credit unions must employ credit risk management techniques to ensure that members make timely payments on borrowed funds and that pledged collateral is sufficient to mitigate loss in the event of default.

Credit Unions Regulatory Regime

Provincial regulators' guidance on credit risk management is principles-based with the expectation that credit unions develop prudent internal lending limits, taking into account their business environment, risk tolerance, and the strength of their current financial position. Specifically, it is noted that for residential mortgage loans, provincial regulators have established guidance for credit unions' lending practices, but still provide credit unions considerable discretion in managing their loan portfolio concentration across geographies and industry segments (Figure 39).

Figure 39: Comparison of Selected Regulatory Guidance on Credit Risk Management

Category	DICO	FICOM	CUDGC (SK)	CUDGC (AB)
Limits	No specific metrics prescribed by way of regulatory guidance			
Policies	Credit unions are required to: - Develop written procedures outlining how policies will be implemented and monitored - Incorporate credit scoring systems into their credit	Credit unions are required to: - Record and aggregate borrower data at loan origination and monitor throughout extent of agreement - Focus on the oversight of individual residential	Credit unions are required to: - Engage in high mortgage loan to value ratio only if they are insured through a government agency[122] - Develop appropriate policies	Credit unions are required to: - Develop appropriate policies on exposure limits for a single risk (i.e. counterparty, geography or sector)

[122] Guidance on mortgage lending from regulators in other provincial jurisdictions do not place similar limits on credit unions as does CUDGC of Saskatchewan. Peer regulator guidance on high loan to value mortgage lending is as follows. DICO: The regulatory limit for residential mortgage loans that are not insured is 100% of the credit union's aggregate lending limit. FICOM: A distinction on limits for uninsured versus insured mortgages is not included in their guidance on residential mortgage underwriting. CUDGC (AB): Standards of sound business and financial practice do not place restrictions on high LTV ratio for uninsured mortgages.

	evaluation process for mortgage loans - Employ a risk rating system for all loans other than personal and mortgage loans - Establish limits on large exposures to specific counterparties	loans while balancing the risk of the loan or portfolio - Maintain a level of risk in the loan portfolio which reflects the risk appetite and limits, strategy, and policies set by the board - Review residential mortgage loan portfolio on a monthly basis by management and semi-annually by Board of Directors	on exposure limits for single individuals	- Define decision-making authority for approving credit exposures -Monitor outstanding credit exposures on an ongoing basis

Credit unions monitor exposures of their loan portfolios to ensure credit risk is not concentrated across similar jurisdictions and loan types. It remains to be seen whether regulators will impose metrics on credit union loan portfolios in addition to credit risk management requirements. Given the remote clientele credit unions provide credit solutions to, guidance remains principle-based, providing organizations significant discretion in managing their loan portfolios.

Credit Risk Management – Credit Unions

Deloitte noted credit risk management practices from the top credit unions by assets across Canada. The following commonalities in credit risk management regimes were identified:

i) Established Risk Committees
ii) Loan Concentration Analysis
iii) Underwriting Practices

Established Risk Committees

The risk committee establishes limits on the amount of credit risk accepted, and acceptable risk profiles for borrowers. Risk committees also monitor commercial loan portfolios given the larger principal balances of these advances. Risk committees will establish and review portfolio metrics on a regular basis and consider appropriate responses to changes. Additional oversight approval is provided where lending amounts exceed the authorization levels for retail management or where underwriting is outside of the operational lending policies.

Loan Concentration Analysis

In managing credit risk, credit unions will ensure loan portfolios are diversified with the objective of spreading risk. Loan exposures are categorized according to industry sectors, geography, and contract length to ensure exposures are not concentrated at one or more of these variables. In order to ensure appropriate diversification, the Credit Union will implement thresholds limiting the exposure of loans according to certain geographic areas, for example. These limits are in place to manage the overall credit risk of the loan portfolio and establish parameters to measure credit diversification. Limits for the credit portfolio can exist based on type (e.g., agriculture, consumer mortgage, consumer non mortgage, and commercial loans) and industry, as well as maximum borrowing limits for individual borrowers.

Risk management capabilities vary depending on the size, scope and complexity of the credit union, however irrespective of the size, it is noted that credit unions monitor and report on concentration risk for each of the following: GDS/TDS, credit bureau score, LTV, amortization and policy exceptions.

Underwriting Practices

DICO and FICOM tend to adhere to OSFI B-20 underwriting standards, and therefore, large credit unions also monitor these regulatory underwriting developments by OSFI. Credit unions with plans to expand inter-provincially must align their underwriting practices with OSFI expectations prior to expansion. Those credit unions that leverage public securitization as a funding source adhere to OSFI B-21.

Credit Risk Management – MFCs

Deloitte validated credit risk management practices from a sample of MFCs. The following commonalities were identified:

i) Underwriting practices
ii) Mortgage and counterparty credit quality

Underwriting Practices

MFCs use stringent underwriting criteria and experienced adjudicators to mitigate risks associated with mortgage underwriting. MFCs align their practices with OSFI's B-20 and B-21 requirements. Application of consistent credit policies and prudent arrears management is taken with all securitized mortgages. These policies are continually developed and refined in accordance with changing market conditions. Factors considered in mortgage underwriting include collateral quality, loan-to-value ratio, debt service ratio, property location, and economic factors.

Mortgage and Counterparty Credit Quality

Ensuring mortgage credit quality remains an important measure to secure continued demand from institutional investors for mortgage-based investment vehicles. In order to be securitizable, mortgages must be insured against default with CMHC or a government-backed private insurer. This makes the residual credit risk to the MFCs underwriting these products immaterial overall. As with insured mortgages, credit risk on liquid assets, the vast majority of which are cash and cash equivalents, is relatively limited as all counterparties are Schedule 1 Canadian banks with high credit ratings assigned by international rating agencies.

Summary

Credit Unions Risk Management Summary

Credit unions are overseen by provincial regulators. Through conducting a series of interviews, the following observations were made of credit unions' risk management practices.

All of the credit unions that were interviewed report risk related activities and metrics to the Board of Directors for oversight.

Large credit unions' risk management practices are fairly robust. These credit unions have formalized risk management practices in line with OSFI's guidance. They report on specific metrics and perform stress testing based on various scenarios. Large credit unions typically use three lines of defense as part of their risk governance model, which is viewed as common industry practice among banks.

Mid-tier credit unions, due to their size constraints, do not all implement a structured three lines of defense model, however, segregation is maintained between origination and underwriting functions and those who independently oversee the underwriting quality and risk management. Some mid-tier credit unions outsource certain risk management execution activities due to cost efficiency and/or the lack of capacity to perform these internally.

Small credit unions monitor delinquency rates as their main risk management indicator. Small credit unions often do not have formally established risk management practices and typically rely on individual employees to manage risks within their area of responsibility.

Although the sophistication, risk appetite, and supporting risk management systems differ among credit unions of various sizes, the delinquency rate of the industry is generally low – the majority of credit unions' delinquency rates are within the 0.05% to 0.40% range. There is some evidence that certain credit unions are willing to expand their risk appetite, which may introduce increased level of inherent risk into the portfolio.

MFCs Risk Management Summary

Although MFCs are unregulated, they follow OSFI's underwriting and outsourcing guidelines because they transact with federally regulated financial institutions (FRFIs), which are regulated by OSFI. Some market players may hold the view that MFCs do not take on risks associated with mortgages, as MFCs often operate under the "originate-to-sell" model. MFCs do not agree with this view, however, as they are incentivized to maintain high quality portfolios – without these, MFCs would lose their ability to generate new business. Through consultation for this report, MFCs expressed frustration with the perception that their operations are more risky than those of more heavily regulated lenders; they point to their low arrears rates and adherence to OSFI guidelines for underwriting. 90 day delinquency data sourced directly from MFCs consulted for this report and from Equifax show portfolio performance that is less delinquent than that of the major banks. It is important to note, however, delinquency rates are measures of past performance and this report does not, nor does it attempt to, answer how MFCs' portfolios will perform in financial distress.

There are frequent audits by insurers and portfolio reviews by investors conducted at MFCs. MFCs need to ensure they have stringent risk management practices in place to satisfy insurers and existing investors, and continue to attract new investors. Some MFCs also use best-in-class technology platforms to manage risk.

7. Regulatory Developments

Recent Regulatory Changes

Since 2008, there have been concerns that the Canadian housing market is inflated and Canadians are taking on too much household debt. The Harper government introduced a number of policy changes including reducing amortization lengths for insurable mortgages from 40 years to 25 years, and reducing the maximum amount of refinancing from 95% of home value to 80%[123]. However, concerns about the stability of the housing market persisted and the Trudeau government introduced a new set of regulations in 2016 designed to continue to reduce the rate of increase in housing prices, especially in the Greater Toronto Area and Greater Vancouver Area. These regulatory changes have been regarded by some industry participants as damaging to non-bank lenders and harmful to competition in the market overall. See Appendix D for a summary of rule changes established in 2016.

Potential Impact of Macro-Prudential Policy Developments

Regulatory Impact on the MFC Business Model

Since the announcement of the federal macro-prudential rule changes in October 2016, MFCs and other market participants have been anticipating negative impacts to their origination volumes. Although the true impact of these policy developments will be felt with time, various market stakeholders have publically hypothesized what these potential impacts might look like.

Significant Origination Volumes Disqualified by New Stress-Testing Rules

The Bank of Canada states that 43% of high-ratio insured mortgages originated by MFCs between Q4 2015 and Q3 2016 would not have received approval under the new stress-testing requirements.[124] Alternatively, the Bank of Canada states that traditional lenders such as banks would have only lost 27% of their high-ratio insured mortgages[125]. Various other market experts have echoed this thought, stating that these regulations could push out 20% of all Canadian homebuyers[126], with lenders specializing in high-ratio mortgages fielding the majority of these losses.

Decline in Origination due to Mandatory Qualification under High-Ratio Criteria

Potentially even more impactful is the requirement of low-ratio mortgages now having to qualify under the same metric-driven criteria as high-ratio mortgages. In the same report, the Bank of Canada states that under these new regulations, 59% of portfolio-insured MFC loans would have been affected, while only 38% of traditional lenders' (i.e. banks) portfolio-insured loans would have been affected.

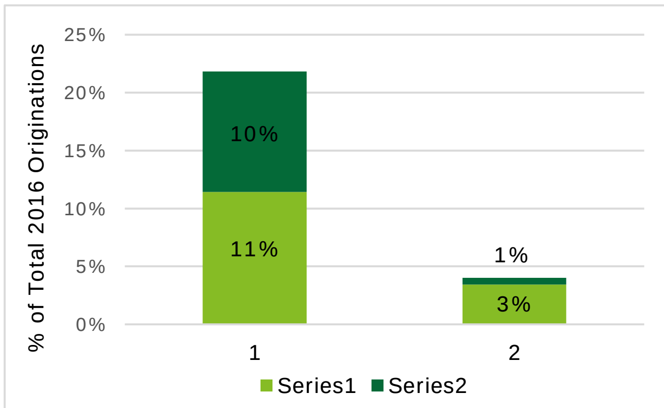
Decreased Mortgage Volumes due to Lack of Ability to Insure Low-Ratio Mortgages Under Various Circumstances

Internal Deloitte analysis on the overall mortgage market estimated a 30% decrease in prime-mortgage originations (based on Q4 2016 data) due to the new criteria around insurance for mortgages with a 25-year or less amortization period. This same analysis estimated a 15% decrease in growth due to non-owner occupied home insurance regulation, and a 17% decrease in originations due to insurance regulation around

[123] "Ottawa tightens mortgage rules: What the analysts say". ***Financial Post, 2016.*** http://business.financialpost.com/news/economy/ottawa-tightens-mortgage-rules-what-the-analysts-say
[124] "*The Rise of Mortgage Finance Companies in Canada: Benefits and Vulnerabilities*". Bank of Canada, 2016. http://www.bankofcanada.ca/wp-content/uploads/2016/12/fsr-december-2016-coletti.pdf
[125] Ibid
[126] FINA Committee Meeting, Canadian House of Commons, 2017. http://www.ourcommons.ca/DocumentViewer/en/42-1/FINA/meeting-70/evidence

borrowers with a credit score lower than 599.[127,128] While these impacts must be considered on a non-cumulative basis, the potential impact is considerable. Based on data representative of the top 5 credit unions and MFCs (Figure 40), on average, 21% of credit union mortgage originations and 4% of MFC 2016 originations would cease to qualify for mortgage insurance due to a purchase price of $1M or greater.

Figure 40: Estimated Share of Originations $800K or Greater, 2016 (%)



Low ratio mortgages involving refinances and properties with value of over $1M are no longer eligible for portfolio insurance. Portfolio insurance is an important tool for smaller lenders such as credit unions and non-balance sheet lenders such as MFCs to fund residential mortgages as insured mortgages are more marketable to investors than uninsured mortgages. Based on interviews with credit unions and MFCs, both types of lenders are actively seeking alternative methods of funding refinances. They also view this rule change as detrimental to their competitiveness with the Big Five banks. The discussed macro-prudential policy developments could apply significant pressure to MFC business models by decreasing origination volumes, harming mortgage broker relations, and potentially damaging the value proposition that makes MFCs an attractive partner to banks and other lenders.

Market Insights on Impact of Regulatory Changes

Industry-Level Impacts

Many market participants expect these regulatory changes to have a profound impact on the residential mortgage lending market in Canada. Non-bank lenders, particularly MFCs, suggest that they are disadvantaged by new restrictions on mortgage securitization. While some MFCs consulted voiced their agreement with the decision to eliminate insurance for mortgage refinances, many highlighted significant challenges to the viability of their current business models.[129] MFCs anticipate decreasing mortgage origination, margin compression, and reduced ability to offer a full product shelf to mortgage brokers. There is a widely held concern that these changes may impair the value proposition of MFCs.

[127] Deloitte Analysis
[128] The Deloitte analysis impacts are not independent of each other
[129] Deloitte interviews

Some industry level impacts include:

Industry-Level Impact	Rationale
Shifting product / category focus	• Non-balance sheet lenders are finding that it is no longer economical to play in the new 'prime uninsurable' segment; 'prime uninsurable' consists of borrowers who would previously have qualified for low-ratio mortgage insurance, but are now ineligible as a result of the low-ratio mortgage insurance eligibility requirement changes; this includes categories such as refinances and mortgages on properties over $1M. • Lenders are now unable to bulk insure these mortgages and instead must insure them individually; the cost of insuring a single mortgage is not economical at the rates that lenders offer to prime borrowers and therefore this segment is not attractive to lenders who rely on securitization programs as a significant share of funding • Lenders are moving focus away from prime uninsurable categories (e.g., refinances); some credit unions are increasingly focusing on growth categories such as near-prime borrowers and bruised credit situations
Portfolio shift from insurable to uninsurable business	• Lenders are seeing their share of insurable to uninsurable business shift significantly, as low-ratio business that would previously have been insurable no longer falls into this category; one MFC stated that their portfolio share of uninsurable mortgages has gone from 2% to 10% in the last year and they expect to see it rise to 20% over the next 12 months • This is especially true for categories such as refinances that represent a large share of business for many lenders (up to 50% of all business)
Compression of funding sources	• Non-balance sheet lenders (i.e., MFCs) as well as institutions without large deposit bases to rely on (e.g., small to mid-tier credit unions, newer deposit takers such as Street Bank) are searching for new sources of funding for mortgages that were previously insurable • These lenders have further seen their funding flexibility reduced by the ban on the use of insured mortgages in private securitization; previously, lenders were able to place atypical insured loans (i.e., those that could not be pooled) in ABCP

Consideration of alternative funding	• Lenders are increasingly considering private securitization vehicles (e.g., RMBS) to replace the funding lost as a result of public securitization restrictions
	• However, there are structural barriers that inhibit the development of private funding alternatives
	    o The requirement for pools of similar loans limit the ability of small lenders to assemble pools for securitization; some credit unions are considering the possibility of issuing 'pooled' covered bonds but this is still a very tentative consideration
	    o Strict rating requirements on private issuance of securitized mortgages limit the ability of smaller lenders to pursue them

Shifting business model priorities	• Diversified lenders are beginning to rely more on non-proprietary lending (e.g., deriving more revenue from placement fees) • These business models make non-balance sheet lenders increasingly reliant on balance sheet lenders as purchasers of whole loans or lead generators who will then use another lender to underwrite and service loans; this further increases the dependence of non-bank lenders on bank lenders to support their businesses

Increased rate competition	• Rate competition has increased for the insured and insurable market segments; in some cases, this appears to be a customer capture tactic rather than a deliberate and sustainable strategic decision • There is a sense that banks can offer rates for conventional business that other lenders cannot match

Credit Union-Specific Impacts

The impact of regulatory changes varies considerably across credit unions; smaller lenders have seen almost no impact, while larger credit unions see themselves as being disadvantaged relative to big banks who have much larger balance sheets.

- Small credit unions that rely primarily or entirely on deposits for funding have not seen significant changes to their businesses as a result of regulatory changes as these changes
- Most mid-tier and large credit unions have seen their insured book shrink; larger credit unions have seen significant impact, with their volume of insurable mortgages dropping from ~70% to as low as 15%
- The primary concern of many lenders is being able to serve members who are seeking to refinance
- Credit unions are looking at the possibility of issuing new products to members who may not qualify under new rules (e.g., re-advanceable hybrid-mortgages to replace refinancing, but requiring a collateral charge on the subject property)
- Large and mid-tier credit unions are looking for new ways to close the funding gap that has opened up as a result of restrictions on securitization

MFC-Specific Impacts

The impact of regulatory changes also varies across MFCs, based on the degree of diversification in their business model; however, all MFCs feel that the regulatory changes have significantly reduced their ability to compete with big bank lenders and grow their businesses.

- MFCs with diversified income sources (e.g., business process outsourcing and whole loan sales as well as proprietary lending) are better positioned to respond to these changes as they can refocus on non-securitization funding sources and adjacent business activities
- MFCs are looking to build out new funding sources for uninsurable mortgages, and are looking at alternative funding sources in general but the view is that these changes are still some distance out
- The prevailing market sentiment is that banks are well positioned to take market share away from other lenders, as banks are able to fund good quality debt that other lenders cannot hold due to the size of their balance sheets and their reduced access to securitization

Summary

Lenders who rely on securitization to serve borrowers have seen a significant funding gap open; while this impact differs by organization, there is a strong sentiment across the industry that the rule changes give banks a significant advantage in the market and reduce the ability of non-bank lenders to compete for profitable business and serve their customers. While lenders are considering different solutions, most of these potential solutions will require significant time and effort before they become viable.

Appendix

Appendix A – Key Types of Residential Mortgage Lenders

Chartered Schedule 1 Banks	
Description	Banks are the largest player in Canada's mortgage landscape. These multi-line institutions are able to make loans against their balance sheet of deposits and debt issuance. There are 32 OFSI-regulation domestic banks operating in Canada, but the landscape is dominated by the 'Big Five' banks: Royal Bank of Canada, TD Bank, CIBC, Bank of Montreal, Bank of Nova Scotia
Key Facts	In 2016, the Big Five banks held: • $4,443B in assets • $3,012B in deposits • $2,266B in loans[130] As of 2016, the $4.6B in assets held by the 'Big Five' banks made up 90% of all banking assets in Canada[131].
Market Share	The Big Five and other banks (collectively, the chartered banks) held 74.1% of mortgage credit outstanding in Canada in 2016 Q3[132]

Credit Unions	
Description	Credit unions and *caisses populaires* are co-operatives that provide deposits, loans, and investment services. For the purposes of this report, *caisses populaires* are out of scope and only credit unions will be discussed. Unlike banks, credit unions are owned by members and each has a Board of Directors which consists of elected members. Every member has an equal vote regardless of their asset level.[133] Credit unions and banks also differ in the way they manage profits: the profits of credit unions are returned to members in the form of dividends and donated to communities via different initiatives.[134] According to the Canadian Credit Union Association, credit unions' contribute ~5.7% of its pre-tax profits on average, much more the industry best standard of 1%.[135] Credit unions are privately held and member-owned and therefore cannot issue equity as a source of funding.

[130] Annual reports of the Big Five banks (i.e., RBC, TD, BMO, Scotiabank, and CIBC)
[131] "Supporting a Strong and Growing Economy: Positioning Canada's Financial Sector for the Future". Department of Finance, 2016.
[132] CMHC, 2016. ***Residential Mortgage Credit Outstanding, by Financial Institution Type, 2002 – 2016 Q3***. https://www.cmhc-schl.gc.ca/en/hoficlincl/homain/stda/data/data_005.cfm
[133] "The Credit Union Difference." ***Canadian Credit Union Association***. https://www.ccua.com/credit_union_difference
[134] Ibid.
[135] "2016 Credit Union Community & Economic Impact Report." ***Canadian Credit Union Association, 2016***. https://www.ccua.com/~/media/CCUA/member_corner/publications/pdfs/2016CUCEIReportDigital.pdf?la=en

Key Facts	At the end of 2016, credit unions held: • $203B in assets • $174B in deposits • $170B in loans[136] Canadian household sector's net worth in 2016 Q4 totalled $10,268B; credit unions' assets represent of 2.0% of total Canadian household net worth.[137]
Market Share	Credit unions hold 12.9% of mortgage credit outstanding in Canada in 2016 Q3[138]

Mortgage Finance Companies (MFCs)	
Description	MFCs are non-depository financial institutions that are not subject to federal banking regulations.[139] They generally originate mortgages through brokers and, therefore, do not have a branch presence. In addition, some MFCs have credit operations outsourcing businesses where they underwrite and service mortgages originated from the broker channel on behalf of other lenders.[140] MCAP Financial Corporation (MCAP) and First National Income Trust (now First National Financial Corporation) were the first two MFCs in Canada, entering the market in the late 1990s and early 2000s, respectively. By the end of 2015, $165B in outstanding residential mortgage loans were underwritten by the four largest MFCs (including mortgages originated by MFCs and other lenders which MFCs service), representing more than 12% of the total market.[141]
Key Facts	The four biggest players are: First National, MCAP, Street Capital, and Paradigm Quest / Merix[142]
Market Share	MFCs originated <3.9% of mortgage credit outstanding in Canada in 2016 Q3[143]

[136] Canadian Credit Union Association, 2017. ***National System Results, Fourth Quarter 2016.*** https://www.ccua.com/~/media/CCUA/About/pdfs/4Q16SystemResults_7-Mar-17.pdf
[137] "National balance sheet and financial flow accounts, fourth quarter 2016." ***Statistics Canada, 2016***. . http://www.statcan.gc.ca/daily-quotidien/170315/dq170315a-eng.htm
[138] CMHC, 2016. ***Residential Mortgage Credit Outstanding, by Financial Institution Type, 2002 – 2016 Q3.*** https://www.cmhc-schl.gc.ca/en/hoficlincl/homain/stda/data/data_005.cfm
[139] "Financial Systems Review – December 2016." ***Bank of Canada*** http://www.bankofcanada.ca/2016/12/fsr-december-2016/
[140] Bank of Canada, 2016. ***The Rise of Mortgage Finance Companies in Canada: Benefits and Vulnerabilities***. http://www.bankofcanada.ca/wp-content/uploads/2016/12/fsr-december-2016-coletti.pdf
[141] "Financial Systems Review – December 2016." ***Bank of Canada*** http://www.bankofcanada.ca/2016/12/fsr-december-2016/
[142] Deloitte Analysis.
[143] CMHC, 2016. ***Residential Mortgage Credit Outstanding, by Financial Institution Type, 2002 – 2016 Q3.*** https://www.cmhc-schl.gc.ca/en/hoficlincl/homain/stda/data/data_005.cfm

Appendix B – Summary of Funding Sources

Deposits / Balance Sheet

Retail Deposits

Retail deposits are the typical deposits from individual "retail" bank customers. Building a retail deposit base either requires a large branch network to reach a significant customer base or a willingness to pay above market rates to source deposits via financial intermediaries or digital channels. Interest paid on retail deposits is typically lower than the potential return available on other retail savings and investment vehicles – representing a nearly 'risk free' return[144]. Retail deposits are considered "core" funding methods for lending institutions as they provide a generally secure level of liquidity which can be used to fund mortgages, loans, and other lending. Retail deposits can be broken down into demand deposits, term deposits, and registered deposits.

Demand Deposits

Demand deposits typically consist of chequing accounts or savings accounts. Depositors typically deposit these funds for a short-term duration, and require a very low interest rate on their deposits. Demand deposits provide lenders with a cheap source of immediate funding liquidity, but require the ability to be withdrawn at any time without notice. Due to the ability to withdraw the deposits at any time, deposit lenders have specific regulations and requirements around how much of the deposits can be lent out at once, and how much liquidity needs to be on hand in case of deposit withdrawal [CUCPA 1994][145].

Term Deposits

Term deposits, are retail deposits that are deposited for a pre-determined period of time at a pre-determined interest, which can range from a few months to several years. Term deposits require a higher deposit interest rate than demand accounts due to the longer time frame and security around deposit duration. A large portion of term deposits (e.g., non-Cashables) cannot be withdrawn without financial penalty until the end of the pre-determined time period, and even then require an advanced notice of withdrawal. Term deposits provide lenders with an immediate source of funding liquidity, which is relatively guaranteed to be available for a set period of time. This deposit certainty provides a decreased level of funding risk, which is why term deposits are typically the most sought after by lenders[146]. The most common form of a term deposit account is a GIC.

Wholesale Deposits

Wholesale deposits are deposits from corporate, government, or high net-worth clients such as federal funds, public funds, foreign deposits, or large ticket sized brokered deposits. Wholesale deposits demand a higher interest rate due to increased bargaining power on behalf of the depositor, and therefore cost the deposit-taking institution more. One channel of wholesale deposit generation is through deposit brokers, who deposit large sums of money on behalf of wealthy clients or institutions to diversify funds and meet insurance applicability requirements. Conversely, corporations and institutions have the capabilities to form a relationship directly with a bank, eliminating the need to deposit through a deposit broker. Wholesale deposits are less preferred to retail deposits, as they can be riskier, come with increased regulatory

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[144] CDIC Insurance products depositors up to $100,000 against the risk of bank failure
[145] **"Modernizing the Credit Unions and Caisses Populaires Act (CUCPA)",** 2009. http://www.fin.gov.on.ca/en/consultations/cu-cp/cu-cp09.html
[146] Based on discussion with Deloitte Treasury and retail banking experts

requirements (i.e. level of liquidity on hand), and can apply more pressure to the deposit institutions' balance sheet during financial distress[147].

Covered Bonds

Covered bonds are securities created by financial institutions and secured by a pool of mortgage assets as collateral. Investors receive periodic interest and principal payments. [148] Mortgages that are insured through CMHC are not eligible as collateral for covered bonds.[149]

Covered bonds differ from securitization in that the bonds remain a direct obligation of the issuer. In the event of issuer default, investors have recourse to the collateral.[150]

In Canada, OSFI has set a regulatory limit for covered bond issuance to be 4% of the total assets of the financial institution.[151] This issuance threshold is a much lower than other advanced economies where issuance is either unlimited or has a higher threshold (e.g., 8-20%).[152] Covered bond issuance can be cost prohibitive to small lenders for multiple reasons. When a lending institution issues covered bonds, they effectively decrease the asset base CDIC can collateralize against, causing CDIC to increase deposit insurance premiums to account for the loss of collateral.[153] Therefore, covered bond issuance may not be economical for small lenders since they tend to already pay relatively high deposit insurance premiums compared to larger lenders. Alternatively, 2014 regulation was put in place that prohibited publically insured residential mortgages can be included in the residential mortgage pool for covered bonds. [154] Since private insurance typically costs more than public insurance, it can be un-economical for small lenders to cover the cost of private insurance to issue covered bonds.

Securitization

Mortgage securitization provides lenders with an alternative source of funding to using their balance sheets resources (i.e., deposits). Mortgage securitization is central to MFCs as these lenders do not have the large balance sheet of deposit-taking banks and therefore cannot hold significant volumes of mortgages against their deposits.

Mortgage securitization has grown significantly; the share of total mortgage credit outstanding that is securitized has grown from 10% in 2000 to 33% in 2016 according to Bank of Canada and CMHC data.[155] Public securitization as a share of total securitization has increased from 50% to almost 100% in 2013, as private securitization largely disappeared after the 2008 financial crisis.[156] To be eligible for the public securitization programs, mortgages must be insured.

[147] "Reliance on wholesale funding by Canada's largest banks offset by funding mix and strong liquidity". ***Moody's, 2016.***
[148] "What is a Registered Covered Bond?" ***CMHC, 2017***. https://www.cmhc-schl.gc.ca/en/hoficlincl/cacobo/cacobo_002.cfm
[149] "Securitization." ***CMHC, 2017***. https://www.cmhc-schl.gc.ca/en/corp/about/whwedo/whwedo_003.cfm
[150] Bank of Canada, 2013. ***The Residential Mortgage Market in Canada, a Primer***.
http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.496.651&rep=rep1&type=pdf
[151] "Revised Covered Bond Limit Calculation." ***OSFI, 2014***. http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/adv-prv/Pages/cvbnds2014.aspx
[152] "OSFI to Reconsider 4% Limit?" ***US Covered Bonds, 2016***. http://www.us-covered-bonds.com/2016/02/01/osfi-4-limit/
[153] "How to make the world safe for (and from) covered bonds", 2015. **C.D. Howe Institute.**
https://www.cdhowe.org/sites/default/files/attachments/research_papers/mixed/e-brief_214.pdf
[154] "Covered bonds a sweet spot for Canadian banks as BNS raises US$2.5 billion in latest deal". 2016. **Financial Post**.
http://business.financialpost.com/news/fp-street/covered-bonds-a-sweet-spot-for-canadian-banks-as-bns-raises-us2-5-billion-in-latest-deal

[155] Ibid. 33% is still applicable for 2016 Q3 as calculated using housing finance data published on the CMHC's website.
[156] Bank of Canada, 2015. ***Residential Mortgage Securitization in Canada: A Review.*** http://www.bankofcanada.ca/wp-content/uploads/2015/12/fsr-december2015-mordel.pdf

There are two main paths by which Canadian lenders can securitize their residential mortgages:

1. Public securitization: *National Housing Act* Mortgage-Backed Securities (NHA MBS) and Canada Mortgage Bonds (CMB)
2. Private securitization

Public Securitization – NHA MBS and CMB

Under public securitization, CMHC offers two programs, providing cost-effective funding sources to mortgage lenders: NHA MBSCMB.[157] NHA MBS make blended monthly payments of principal and interest to investors. CMB convert monthly cash flows into typical bullet bond-like payments where the investor receives the entire principal when the bond matures, eliminating prepayment risk for investors.[158,159] NHA MBS and CMB payments are guaranteed by CMHC, which is fully backed by the federal government.[160]

Private Securitization

Private securitization of uninsured mortgages in non-CMHC sponsored securities usually consists of asset-backed commercial paper (ABCP) and residential mortgage-backed securities (RMBS). [161] ABCP is a short-term debt instrument, typically issued by financial institutions, collateralized by financial assets with maturity usually between 90-180 days. RMBS is a longer term mortgage-backed debt instrument. Although there has been limited issuance of RMBS in Canada in recent years in April 2017, BMO announced its plans to issue $1.96B in RMBS backed by prime uninsured residential mortgages.[162,163] This issuance has received industry and media attention for its potential impact on the mortgage financing market by providing a new funding source that could be adopted by other banks and mortgage lenders. Market participants consulted for this report were uniformly sceptical of the broader market impact – citing prohibitive costs to structure and execute in the current rate environment. BMO's announcement comes at a time when lenders are facing increased barriers to financing due to recent federal rule changes. While media has characterized the event as "trailblazing" [164] many industry participates believe that a resurgence of RMBS in the near term is unlikely.

Appendix C – Summary of Bank and Financial Service Regulators

The Canadian banking system is regulated and governed by numerous regulators operating under the mandate of federal legislation. There are five main entities:

Office of the Superintendent of Financial Institutions (OSFI)	Canada Deposit Insurance Corporation (CDIC)	Department of Finance	Financial Consumer Agency of Canada (FCAC)	Bank of Canada

Office of the Superintendent of Financial Institutions (OSFI)

- OSFI is responsible for supervising and regulating banks and all federally chartered insurance companies, trust and loan companies, and fraternal benefit societies to ensure that they are in sound financial condition and in compliance with the laws that govern federally regulated financial institutions (FRFIs)

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[157] Ibid.
[158] Mortgage-Backed Securities Issuer Association, 2017. ***NHA MBS and CMB.*** http://www.mbsia.ca/nha-mbs-and-cmb
[159] Bank of Canada, 2016. ***The Rise of Mortgage Finance Companies in Canada: Benefits and Vulnerabilities***. http://www.bankofcanada.ca/wp-content/uploads/2016/12/fsr-december-2016-coletti.pdf
[160] Mortgage-Backed Securities Issuer Association, 2017. ***NHA MBS and CMB.*** http://www.mbsia.ca/nha-mbs-and-cmb
[161] Bank of Canada, 2015. ***Residential Mortgage Securitization in Canada: A Review.*** http://www.bankofcanada.ca/wp-content/uploads/2015/12/fsr-december2015-mordel.pdf
[162] Bank of Canada, 2016. ***The Rise of Mortgage Finance Companies in Canada: Benefits and Vulnerabilities***. http://www.bankofcanada.ca/wp-content/uploads/2016/12/fsr-december-2016-coletti.pdf
[163] Bloomberg, 2017. ***BMO Bundles Uninsured Mortgages in a Canadian Bond First.*** https://www.bloomberg.com/news/articles/2017-04-17/bank-of-montreal-to-offer-mbs-as-canada-shrinks-mortgage-support
[164] Ibid.

Canada Deposit Insurance Corporation (CDIC)

- CDIC is a federal Crown corporation created to insure Canadians' deposits (up to C$100,000) made with member institutions in case of their failure
- Although CDIC and OSFI share common interests in the safety and soundness of CDIC member institutions, they carry out separate mandates

Department of Finance

- Banking activities in Canada fall under the exclusive jurisdiction of the federal government (i.e., Parliament of Canada) and are subject to the Bank Act
- The Bank Act and related legislations are put into force primarily by the Minister of Finance in conjunction with OSFI

Financial Consumer Agency of Canada (FCAC)

- FCAC is responsible for enforcing the consumer-oriented provisions of the federal financial institution statutes, monitoring the industry's self-regulatory initiatives designed to protect the interests of consumers and small businesses, promoting consumer awareness and responding to general consumer inquiries

Bank of Canada
As Canada's central bank, its principal role, as defined in the Bank of Canada Act, is "to promote the economic and financial welfare of Canada"[165]

Credit unions in Canada are regulated at the provincial level. Provincial regulators generally serve two functions:

- Monitor and regulate credit unions, and
- Provide deposit protection

In most provinces, these functions are undertaken by separate regulatory bodies. In New Brunswick, Saskatchewan, and Newfoundland and Labrador, there is a single provincial body that acts as both the regulator and the deposit insurer for credit unions.[166] The remaining provinces (except for Quebec, which has been excluded from the analysis) each have distinct entities for regulation and deposit insurance.

Provincial Credit Union Regulators

Province	Regulatory Authorities
British Columbia	Financial Institutions Commission (FICOM) Credit Union Deposit Insurance Corporation (CUDIC)
Alberta	Alberta Superintendent of Financial Institutions (ASFI) The Credit Union Deposit Guarantee Corporation (CUDGC)
Saskatchewan	Credit Union Deposit Guarantee Corporation (CUDGC)
Manitoba	Financial Institutions Regulation Branch of Manitoba Family Services and Consumer Affairs Deposit Guarantee Corporation of Manitoba (DGCM)
Ontario	Financial Services Commission of Ontario (FSCO) Deposit Insurance Corporation of Ontario (DICO)
New Brunswick	New Brunswick Credit Union Deposit Insurance Corporation (NBCUDIC)
Nova Scotia	Financial Institutions Division of the Nova Scotia Department of Finance Nova Scotia Credit Union Deposit Insurance Corporation (NSCUDIC)
Prince Edward Island	The Financial Services section of the Prince Edward Island Department of Environment, Labour and Justice

165 "About the Bank". ***Bank of Canada, 2017***. http://www.bankofcanada.ca/about/
166 Consumer Information Canada, 2014. ***Banks and Credit Unions – Provincial and Territorial Information***. http://www.consumerinformation.ca/eic/site/032.nsf/eng/01107.html

	Prince Edward Island Credit Union Deposit Insurance Corporation (PEICUDIC)
Newfoundland and Labrador	Credit Union Deposit Guarantee Corporation (CUDGC)

Appendix D – Recent Regulatory Changes

Increased Guarantee Fees

Effective July 1, 2016, CMHC changed both the guarantee fees that it charges issuers of NHA MBS and CMB and the thresholds for these fees.

- The threshold for the 30 bps guarantee for 5-year NHA MBS increased from annual guarantees under $6B to $7.5B
- The fee on annual guarantees above this threshold increased from 60 bps to 80 bps
- The fee on 5-year CMB guarantees changed from 40 bps to 30 bps plus the market NHA MBS fee

CMHC's objective was to decrease the price difference between government-sponsored and private market funding options, thereby promoting the use of private market funding options and reducing the government's exposure to the residential mortgage market[167,168,169]. However, smaller lenders such as MFCs that heavily depend on securitization will feel a greater impact than bigger lenders with more diversified funding sources[170], and may find it harder to compete for volume.

Restrictions of Securitization for Insured Mortgages

Effective July 1, 2016, CMHC implemented a rule preventing lenders from placing insured mortgages in non-CMHC sponsored securities. This primarily impacts lenders who securitize insured mortgages in ABCPs who will have to find alternative funding vehicles for these mortgages.[171]

ABCP has been a less restrictive securitization method for lenders due to the requirement for similar pools of mortgages to qualify for NHA MBS. While lenders can still sell mortgages indirectly into ABCPs, these changes would increase cost of funding significantly.[172] This change will therefore reduce funding options and rate competitiveness for MFCs.

Timeline for Securitization

Effective July 1, 2016, lenders are required to securitize portfolio insured mortgages within 6 months of being insured, or the insurance will be cancelled.[173] This rule change will likely cause a funding squeeze for small lenders, who will have more trouble assembling pools of similar loans due to their smaller reach than large banks and MFCs.

Stress-testing all Insured Mortgages

[167] "Mortgage Costs About to Rise". ***Canadian Mortgage Trends, 2016***. https://www.canadianmortgagetrends.com/2016/05/mortgage-costs-about-to-rise/
[168] "CMHC Announces Changes to its Securitization Programs". ***CMHC, 2015***. https://www.cmhc-schl.gc.ca/en/corp/nero/nere/2015/2015-12-11-0900.cfm
[169] "Why Housing Matters to Canada's Financial Stability: Insights on Housing Market Risks and CMHC's Financial Stability Role" **C.D. Howe Institute Roundtable Luncheon.** https://www.cmhc-schl.gc.ca/en/corp/nero/sp/2016/2016-03-14-1530.cfm
[170] "Mortgage Costs About to Rise". ***Canadian Mortgage Trends, 2016***. https://www.canadianmortgagetrends.com/2016/05/mortgage-costs-about-to-rise/
[171] "Mortgage Costs About to Rise". ***Canadian Mortgage Trends, 2016***. https://www.canadianmortgagetrends.com/2016/05/mortgage-costs-about-to-rise/
[172] Ibid.
[173] "Canada's new rules on financial of insured mortgages". **Torys LLP, 2016.** http://www.torys.com/insights/publications/2016/03/canadas-new-rules-on-financing-of-insured-mortgages

Effective October 17, 2016, the mortgage stress test that formerly applied only to high-ratio borrowers will now apply to all homebuyers seeking an insured mortgage. The stress test measures the borrower's ability to make payments with a rate equal to the Bank of Canada's posted rate for a five-year fixed rate mortgage. As of October 19th, 2016 the rate is 4.64%, a considerably higher rate than most lenders would offer a borrower[174]. The stress test also measures a potential homeowner's Total Debt Service ratio and home-carrying costs to ensure that they do not rise above specified thresholds[175].

Changes to Insurance Eligibility Requirements

Effective November 30, 2016, lenders will no longer be able to insure certain low loan-to-value ratio mortgages and types of transactions. To be eligible for portfolio insurance, low ratio mortgages much meet the following requirements for them to be eligible for portfolio insurance:

1. "A loan whose purpose includes the purchase of a property or subsequent renewal of such a loan;
2. A maximum amortization length of 25 years;
3. A property value below $1,000,000;
4. For variable-rate loans that allow fluctuations in the amortization period, loan payments that are recalculated at least once every five years to conform to the established amortization schedule;
5. A minimum credit score of 600;
6. A maximum Gross Debt Service ratio of 39 per cent and a maximum Total Debt Service ratio of 44 per cent, calculated by applying the greater of the mortgage contract rate or the Bank of Canada conventional five-year fixed posted rate; and,
7. If the property is a single unit, it will be owner-occupied."[176]

Appendix E – Mortgage Default Insurance in Canada

Mortgage Insurers

CMHC applies mortgage insurance underwriting standards as part of its mandate. Federally regulated lenders are required to purchase mortgage default insurance on all "high ratio" mortgages (i.e., mortgages where the borrower has made less than a 20% down payment on the property). The cost of the insurance is typically borne by the borrowers. For mortgages on properties with more than 20% down payment, lenders can purchase portfolio insurance, assuming that the mortgages will be securitized within six months of being insured, subject to certain exceptions.[177]

Canada has three approved issuers of mortgage default insurance, as designated by the Ministry of Finance:[178]

- Canada Mortgage and Housing Corporation (CMHC), a federal Crown Corporation, holding approximately 50% market share;[179] and
- Genworth Canada and Canada Guaranty, private insurers, accounting for the remaining 50% of outstanding mortgage insurance

CMHC-insured mortgages are 100% backed by the federal government; for private insurers, claims less 10% of original mortgage amount are guaranteed. CMHC and private insurers pay the government a premium for these guarantees.[180]

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[174] "How to Stress Test Your Mortgage" ***RateHub*** https://www.ratehub.ca/blog/how-to-stress-test-your-mortgage/
[175] "Technical Backgrounder: Mortgage Insurance Rules and Income Tax Proposals (revised October 14, 2016). Department of Financial Canada, 2016.
[176] "Technical Backgrounder: Mortgage Insurance Rules and Income Tax Proposals (Revised October 14, 2016)." ***Department of Finance Canada, 2016***. https://www.fin.gc.ca/n16/data/16-117_2-eng.asp
[177] "Canada's New Rules on Financing of Insured Mortgages." ***Torys LLP, 2016***. http://www.torys.com/insights/publications/2016/03/canadas-new-rules-on-financing-of-insured-mortgages
[178] Ibid.
[179] "Why Housing Matters to Canada's Financial Stability: Insights on Housing Market Risks and CMHC's Financial Stability Role" **C.D. Howe Institute Roundtable Luncheon.** https://www.cmhc-schl.gc.ca/en/corp/nero/sp/2016/2016-03-14-1530.cfm
[180] Bank of Canada, 2013. ***The Residential Mortgage Market in Canada, a Primer.*** http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.496.651&rep=rep1&type=pdf

Appendix F – Credit Union Centrals

Infrastructure Support

Provincial centrals are bodies that are owned by their member credit unions and provide members with professional assistance such as treasury services, payment solutions, and compliance guidance. For example, some centrals will lend funds to those credit unions with liquidity needs; some may also provide policy development support frameworks and help credit unions understand regulatory requirements.[181,182,183]

The following provincial centrals are currently operating in Canada:

- Central 1 Credit Union (representing British Columbia and Ontario)[184]
- Credit Union Central Alberta Limited
- Credit Union Central of Manitoba
- SaskCentral
- Atlantic Central (representing New Brunswick, Newfoundland and Labrador, Nova Scotia and Prince Edward Island)

[181] "We are Central 1" ***Central 1, 2017***. https://www.central1.com/
[182] "Trade Services." ***Central 1, 2017***. https://www.central1.com/trade-services
[183] "Treasury Services." ***Central 1, 2017***. https://www.central1.com/treasury-services
[184] In order to establish efficiencies among two of Canada's largest provincial centrals, Credit Union Centrals of British Columbia and Ontario were merged into Central 1 Credit Union in 2008

Internal External Secondary Research Primary Research

Research Approach

Research Sources

We drew from multiple research sources to ensure our report is inclusive and exclusive:

Key Ecosystem Stakeholders

We leveraged knowledge and insights from **industry stakeholders and leaders** within the Canadian mortgage industry who are playing an active role in shaping the industry

Source Type:

Local Deloitte SMEs

We called upon local **Deloitte Subject Matter Experts** focused on the Canadian mortgage market, risk management, and financial lending services to provide market insights

Source Type:

Global Deloitte Network

We leveraged access to the **global Deloitte network** to develop a global perspective on the Canadian mortgage market

Source Type:

Industry Reports

We utilized **proprietary Canadian reports, tools, and services** to augment our knowledge base

Source Type:

Research Methodology

Our research was based on industry participant interviews, primary data collection and analyses, accelerated aggregation of secondary research, and detailed SME consultation to develop a clear vision of the mortgage ecosystem

CMHC Communication

- Continuous communication and revision with CMHC on report progress and insights – gathering CMHC opinions and approval
- Final report deliverable and in-person meeting to discuss findings

Primary Research

- Conducted 10 interviews (5 Credit unions & 5 MFCs) across Canada to gain first-hand perspective on the Canadian mortgage market
- Validated and expanded upon the foundational research through interviews with ecosystem stakeholders and Deloitte SMEs
- Designed a high-level survey & data request for interview participants

Foundational Secondary Research

- Collected internal / external industry reports on *the Canadian mortgage market, credit unions, MFCs,* and other relevant content to the Canadian mortgage ecosystem
- Developed an empirical fact base in partnership with CMHC's
- Established a baseline perspective on *regulations and focus areas* by scanning and aggregating existing research
- Developed a holistic view and created hypotheses on the impact that credit unions and mortgage finance companies might have on the Canadian mortgage market

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