BCMMA MIC Mortgage Underwriting for Brokers

A GUIDE FOR MORTGAGE BROKERS IN BRITISH COLUMBIA

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TABLE OF CONTENTS

Please note – this document is not intended to be legal advice. Professional advice about investments, mortgages or related topics should be sought elsewhere.

Section 1 – British Columbia MIC Managers Association (BCMMA) Purpose and Information

The BCMMA was founded by a core group of 12 MIC management companies in 2010 with three main goals:

1. Facilitate the exchange of information and best practices within the industry,
2. Educate regulators and the public on what a MIC is and its role in the economy, and
3. Establish and uphold MIC industry standards for ethics, education, and professionalism.

The BCMMA is currently comprised of 35 MIC management companies with aggregate assets under management of greater than $2 billion. Our membership is a diverse group of residential, commercial, and land development MICs with many years of industry experience.

To qualify for membership, Member Candidates must, in the opinion of the Board of Directors, meet the following criteria:

- Their primary source of income is derived from managing a 'Mortgage Investment Corporation', as defined in the Canadian Tax Act;
- The 'Mortgage Investment Corporation' under management has a minimum of $10 million in shareholder capital;
- Their head office is situated in British Columbia; and
- They conduct business in an ethical, professional, and respectful manner.

Member Candidates recommended by the Board of Directors will be considered at Member Meetings and will be voted upon using sealed ballots and must be approved by no less than 75% of the ballots cast.

B.C. MICs are registered under the Mortgage Brokers Act. The Act regulates the brokering and lending activities of MICs. British Columbia Financial Services Authority (BCFSA) oversees mortgage brokering activity. Capital raising and investment marketing activities are regulated by the British Columbia Securities Commission (BCSC).

For more information:

British Columbia MIC Managers Association – BCMMA- www.bcmma.org

British Columbia Financial Services Authority – BCFSA - www.bcfsa.ca

British Columbia Securities Commission - BCSC - www.bcsc.bc.ca

Section 2.1 – What is a MIC?

As a Mortgage Broker it helps to understand the nature of the investment vehicle and the motivation of MIC investors who together are the source of funds to Borrowers.

Mortgage Investment Corporations (MICs) were created in 1973 by the Residential Mortgage Financing Act. At the time, Parliament believed a housing crisis was coming. With population growth in Canada expected to generate the need for new homes by 1981, it was estimated that mortgage financing would be required annually for new housing. The Canadian economy was facing an annual funding gap and to compound the problem, traditional lenders like the Chartered banks started to tighten their lending guidelines as inflation became a concern and interest rates began to rise.

Simply put, a MIC is a company that pools shareholder investment, lends that capital out as mortgages, earns income via interest and fees and pays 100% of its net income back to the shareholders. MIC shares may be RRSP, RRIF, RDSP, LIRA, TFSA, and RESP eligible.

A MIC is different than the private lending market in which individuals directly lend their own funds to Borrowers. Private lenders have been operating in Canada for many years and are generally challenged to quickly scale up to fill funding gaps in the mortgage market. Private lending also requires individual investors to have large amounts of capital as well as expert knowledge of the mortgage lending and recovery process. Private lenders' mortgage investments are also generally illiquid and their loan portfolios generally lack diversification.

MICs make passive mortgage investing available to a much wider base of investors. A professionally managed MIC allows smaller investors to pool their funds together and utilize professional management with established corporate expertise in areas such as portfolio risk management, full-time mortgage underwriters, recovery specialists and administrators. These mortgage pools generally offer increased liquidity and diversification versus the private lending market.

As competition in mortgage lending increased over the years, and as Borrowers increasingly looked for additional mortgage offerings to meet their needs, the role of Mortgage Brokers became more prominent as a professional source of new clients to MICs. A variety of MICs specialize in areas of lending that are underserviced by traditional lenders, such as small-scale construction, equity-based lending, bridge financing and lending to new immigrants.

At the time of writing, the MIC market in Canada is estimated to be $10 billion and growing. The industry serves two groups: those looking for an investment vehicle and the borrowers who do not meet the banks' lending guidelines and/or require interim financing.

Section 2.2 – What are four key elements MIC investors consider?

MIC investors generally consider four key economic factors as well as other risks with this type of investment:

1. Income

A MIC strives to minimize risk by being prudent in both its credit decisions and in assessing the value of the underlying real property offered as security. A MIC maintains a mix of mortgage types in its portfolio which could include: residential, commercial, land or a combination of real estate. When a MIC funds a mortgage it generates monthly income through interest and servicing fees over the lifetime of the loan. The net income of the corporation flows to investors via dividends. Investors in a MIC can usually choose to have those dividends paid out in whole or in part as cash or in-kind (shares) to have the dividends re-invested.

2. Rate of Return

The rate of return a MIC earns from its mortgage loans is determined by dividing the net income by the total shareholder capital of a MIC. Net income is determined by reducing the total income generated by amounts for eligible expenses such as management fees, operational expenses, actual mortgage loan losses and potential loss reserves (an amount that may occur in the future). Any dividend distributions of a MIC are considered as an expense of a MIC for tax purposes (and by law MICs pay out all income to their shareholders) and the dividend is taxable as interest income to the investors. The rate of return may vary with economic conditions, industry competitiveness and other factors. Past performance is no indication of future returns.

3. Capital Preservation

The primary security for a MIC capital investment is the underlying real property assets in its portfolio.

- **Secured by Real Property**

Most MIC assets are held in mortgages, which are a full-recourse debt in most provinces. A full-recourse debt means that no matter what happens—be it illness, job loss, or death of the borrower—the mortgage lender has options to recover the debt. If a borrower defaults on the mortgage loan, the lender may demand payback of the loan by initiating the foreclosure process. Through this process, the lender may sell the real estate security in order to recover the mortgage funds. If the lender does not fully recover its principal, interest and expenses through the sale of the security, the foreclosure process also grants the lender personal judgement against the borrowers and/or guarantors. This allows the lender to seek recovery of the mortgage shortfall from the borrowers and any assets they may have. In most cases these enforcement actions are not required and are considered to be the least desirable option as a MIC is normally able to work closely with the Borrowers to find solutions to bring the mortgage payments up-to-date or to encourage the sale or re-finance of the property.

- **Share Value**

A MICs share value can only fluctuate when expenses are more than the total annual income of the entire portfolio of mortgages. Portfolio risk (and reward) is shared across all MIC investors. Through the application of prudent underwriting and management, a MIC attempts to mitigate risks before they result in loss of principal or share value. If a default occurs that could create a loss of income or principal a MIC strives to protect the investment via demand and foreclosure proceedings. As with any mortgage recovery process, it is possible the total amount recovered may be less than the total mortgage resulting in a possible loss of income and principal of the specific mortgage within the portfolio's assets.

4. Liquidity

As with most private company shares, MIC shares are generally not traded on a public exchange and there is no secondary market. Share liquidity is linked to portfolio liquidity and the terms of the specific shares offered by a MIC. The mortgage portfolio primarily has an average term to maturity of fewer than 2 years (due to the short-term nature or situational needs of a MIC's typical Borrower). Due to this portfolio liquidity, a MIC is usually able to accommodate requests for redemption upon receipt of notice from the investor – each MIC will have their own specific policy for share redemption.

It is typically a MIC's goal to be close to fully invested to achieve the highest rate of return for investors. Notwithstanding the goal of being in a fully invested state, there may be times when a MIC needs to limit potential mortgage funding due to its anticipated liquidity requirements. Mortgage Brokers may find it helpful to know that liquidity management is a normal component of a MIC business model and is usually temporary as funding resumes once the liquidity requirement is satisfied.

Section 2.3 – Understanding a MIC Mortgage and its Material Risks

How does a MIC lending solution meet the needs of Borrowers?

There are many reasons why people cannot qualify for a mortgage with a traditional financial institution – even when a Borrower has equity in their real estate and/or other assets. Not qualifying for a mortgage with a traditional financial institution does not eliminate the Borrower's need to find a mortgage. MICs may offer solutions to some, but not all, of these Borrowers.

MICs can meet the needs of Borrowers including: self-employed, new immigrants, newly established businesses, real estate developers, people in-between jobs, income-challenged, bruised credit, recently divorced, and a myriad of other situations.

MICs provide solutions to Borrowers who have established assets or real estate equity that can be pledged as security. The goal is that within a relatively short time the Borrower can meet the qualification requirements to refinance with a traditional lender or sell their property in an orderly manner.

The pricing (rates and fees) of a MIC mortgage is greater than a traditional financial institution and reflects the higher risk of the Borrower, the security being pledged, the circumstances (the story) of the Borrower, and their ability to repay the mortgage.

Due to the short-term nature of these mortgages, Borrowers typically have an exit strategy in place to either refinance or pay out the mortgage via the sale of the property. While MIC mortgages are like traditional mortgages they are also unique in many ways, even amongst the various MICs, as they each have unique characteristics related to their investors risk and return appetites.

Section 2.4 – Educating Yourself as the Broker

The following are some key questions a broker may use to educate themselves and assist Borrowers in their understanding of mortgage financing with a MIC.

1. Will the Borrowers be able to afford the mortgage?
Consider not just how much money or equity the Borrowers have today but consider their financial position for the term of the mortgage. Ask the Borrower if they can continue to make the payments in full and on time. Even if they can, have them consider how the payments will affect their ability to service other debt, maintain their lifestyle expenses and deal with sudden or unexpected financial needs.

2. How stable is the Borrower's income and employment?
This is especially important for self-employed, seasonal and contract workers as well as all Borrowers where a significant portion of income is variable (commission, bonus, overtime). A decrease in pay or job loss could seriously change the affordability of the mortgage and their ability to make the mortgage payments.

3. How much does owning a home cost?
Owning a home costs more than the amount of the mortgage payment. When they purchase a home, there are closing costs, including legal and other fees, property taxes, appraisal fees, and land transfer taxes. Once the home is purchased, there are moving expenses, property taxes, insurance, strata fees, home repairs, and so on. Make sure to include all these expenses as part of the total cost when Borrowers are considering if they can afford a mortgage.

4. Will owning a home affect a Borrower's other financial and life decisions?
Mortgage payments could limit a Borrower's ability to manage other expenses. After making the mortgage payments, would they have enough money to pay for the things they might need in the years ahead? They might need a vehicle, wish to travel, or add to their family in the future. Consider if a mortgage could prevent them from managing other commitments or goals.

5. What type of mortgage best suits your Borrower's short-term need?
The most common options are fixed rate, variable rate and home equity line of credit (HELOC). Sometimes these mortgage types are available in combinations. A fixed rate mortgage has the rate set for a specific term and the rate only changes at the end of the term. A variable rate mortgage often has an initial rate that may be adjusted lower or higher during the term. The variable rate is subject to change based on a formula established at the outset and may change at the end of the term. A line of credit provides an amount that one can borrow and use it when needed. One can pay back principal and use it again, like a credit card. Typically, payments are interest only on the amount one has used. Credit reporting agencies sometimes treat a HELOC as consumer credit when reported. The credit limit on a HELOC is subject to change at the discretion of the lender.

6. Will a subject property's value increase or decrease in future?
A home is often viewed as a good investment. However, like all assets, the market value of real estate fluctuates. A decrease or increase in value can result in a loss or gain of owner's equity which may be temporary but may also be realized over the long term. Changes in value may also affect the mortgage at renewal or if refinancing.

7. What is the total cost of the mortgage?
The total cost of the mortgage depends on the terms and conditions for paying it back, such as the interest rate, fees and the amount of time it takes to pay off the entire mortgage or "amortization period" (which is not applicable if "interest only"). The Borrowers need to determine if the rate, amortization period and total cost of the mortgage are right for them. The mortgage broker or lender must provide them with a disclosure document that estimates the total cost of borrowing for the term of the mortgage.

8. How does the Interest rate affect the cost of the mortgage?
While the actual rate being charged is important there are other factors to consider. Choosing a variable, fixed, or convertible rate will have an impact on the cost of borrowing over the mortgage term. The frequency of the compounding period will also have an impact. With a more frequent compounding period, the higher the effective interest rate will be. **MICs generally utilize a monthly compounding period.**

Ask the Borrower to consider if the interest rate is reasonable for them and if they can afford it. If the interest rate is variable, there is the risk that it might go up. Even if the rate is fixed, the interest rate can still increase when they renew the mortgage. Increasing interest rates can raise their payment amounts and can make the total cost of the mortgage much higher in the long run. What is the impact on their finances if interest rates increase?

9. Do you understand all the fees over the mortgage term?
Not all mortgages are the same. There are often fees included in a mortgage contract at inception, during the term, at renewal, and at discharge. Be sure to understand not only which fees may apply and when, but also how the lender calculates the fees. There can also be broker fees in addition to lender fees. Lenders and brokers must provide information on fees to Borrowers.

10. Are there pre-payment options?
A pre-payment is the process of paying more than the scheduled payment amount or paying off the entire mortgage ahead of schedule. "Closed" mortgages may offer pre-payment options that can help pay the mortgage back faster but most mortgages have rules and restrictions and some don't allow pre-payments at all. Depending on the terms of the mortgage, pre-payments can come with penalties. Make sure the Borrower understands the pre-payment privileges, rules, administrative fees, and penalties included in the mortgage and determine with the Borrower whether the terms are suitable for them.

Open mortgages generally allow prepayment of the mortgages with no rules, restrictions, or pre-payment penalties.

11. Is the mortgage contract portable?
Most traditional mortgages allow homeowners to keep the same mortgage contract and transfer it to a new home if they move. This is mortgage portability. **Most MIC mortgages *are not* portable.** If the lender offers this feature they could charge a fee/prepayment penalty if the Borrower wants their mortgage transferred to a new property. Ensure that the Borrower understands the timing of when they can move their mortgage. Typically, lenders will re-qualify Borrowers and the new property.

12. Can the mortgage be assumed by a purchaser in a sale?
Some traditional financial institutions allow homeowners to sell their property by allowing the purchaser to take over their mortgage contract. This is a mortgage assumption. **Most MIC mortgages *are not* assumable.** All Borrowers should consult their solicitor prior to accepting an offer that includes the purchaser assuming their mortgage.

13. Will selling the property trigger additional fees or penalties?
You cannot pay some mortgages in full until the end of the term. The only exception would be if the Borrowers sold their house but likely there would be a prepayment penalty applied. **This condition is *rarely found* in MIC mortgages.** A broker will want to inform a Borrower if this applies to their mortgage.

14. Can a mortgage contract restrict a change in use during the term?
A mortgage might include a restriction on how the Borrower may use the property. There can be restrictions that may not allow them to change how the property is used (e.g., changing the property from a residence to a place of business or a rental property, or removing or altering structures). The lender may have the right to foreclose when there is a change of use.

15. Can a late payment or other circumstances result in additional fees?
A lender may charge fees if the Borrower is late making a mortgage payment. A lender can pay overdue property taxes, property insurance, and strata fees or assessments and may charge fees for doing so. When these fees apply the amount charged depends on the lender. Borrowers should understand both the triggers and the amount of the fees. If the Borrower demonstrates a history of these types of delinquencies, the lender may not offer to renew the mortgage and if not paid out promptly the lender may issue a demand letter for the mortgage at the end of the term. It is always best to make payments on-time and in-full.

16. What is an Inter Alia Mortgage?
An inter-alia mortgage is set-up as one mortgage over two or more properties. There are two situations where an inter-alia mortgage may help a Borrower:

a) to take an existing property that a Borrower has for sale and inter-alia it with the home they are buying. Once their initial property sells that property is discharged, the new home purchase is the only property registered against the mortgage. Lenders will determine how much is required to pay down the mortgage to release each property.

OR

b) to take one or more additional properties that a Borrower may own and inter-alia them with the primary property to provide enough equity to support the funds the Borrower needs.

An Inter Alia can also be used to reduce the Loan to Value (LTV) and moderate other credit risks of the Borrower.

17. What happens if a Borrower can't pay for the mortgage?
Not paying a mortgage on-time and in-full can negatively affect their credit score, cause them to incur fees, default, and even lead to foreclosure. If the Borrower is in default, the lender has the right to act on its interest via the foreclosure process and/or potentially take possession of the property to recover the money still owed on the mortgage. If the lender sells the home for a price that is less than what is owed on the mortgage (a shortfall) the Borrower is personally liable and has to pay the difference to the lender.

Section 2.5 – How long will the process take?

MICs are most often able to complete a file, from application to funding, much faster than traditional financial institutions. However, certain factors must be considered as there is reliance on third parties whose timelines are not within the MICs control. For example, the appraiser and lawyer/notary. The steps involved are outlined below.

What can you expect?

- An application is completed and submitted to the lender with the credit bureau report, at minimum;
- The lender reviews the documentation and undertakes appropriate due diligence;
- The lender provides a written offer of financing (Commitment Letter) subject to specific conditions being met (documentation, appraisal, inspection, etc.);
- Terms are accepted by the Borrower and the commitment is returned signed together with a good faith deposit, if required;
- An appraisal, if required, is ordered and other documentation is gathered and provided to the lender;
- Once the lender is in receipt of all requested documentation, including the appraisal report, and is satisfied with the results, the Solicitor will be provided with the lender's Mortgage Instructions (The Lender can also adjust the terms or loan amount or decline the loan at this point);
- The Solicitor is required to complete a number of tasks in order to be in a position to ensure that the lender has a good and valid mortgage charge;
- When all documentation is in order, an appointment will be made for the Borrower to meet with the Solicitor/Notary for signing;
- Finally, the Solicitor will request funds from the lender in order to complete the transaction.

Section 2.6 – What is Mortgage Fraud?

Mortgage fraud is a crime. It is the deliberate misrepresentation, misstatement or omission of information to obtain mortgage financing that would not necessarily have been granted if the truth had been known.

Borrowers and professionals are motivated to commit mortgage fraud for different reasons. The two primary types are: fraud for housing and fraud for profit.

Fraud for housing is committed by Borrowers who, often with the assistance of others, misrepresent or omit relevant details about employment, income, liabilities, credit, property value, and condition with the goal of obtaining or maintaining real estate ownership. It is important to note that fraud for housing can be committed by individuals who intend to occupy a property as a primary residence, or by investors who intend to rent the property as a source of income or to re-sell for profit.

Fraud for profit is committed by professionals who misstate, misrepresent or omit relevant details about their personal or their clients' employment, income, liabilities, credit, property value and condition with the goal of maximizing profits on a loan transaction. Fraud for profit can be committed by any professional in the loan transaction chain including: the builder, realtor, sub-mortgage broker, credit/debt counselor, appraiser, property inspector, insurance agent and lawyer/notary. Industry professionals can also work in concert, as a network, to defraud lenders and maximize fees and share profits on all mortgage-related services. These actions are motivated either by the desire to gain commissions or profit financially.

It is important that the broker properly identifies the person or company they are working with.

Fraud can often be identified by carefully reviewing the documentation provided and ask questions. If a broker becomes aware or there are reasonable grounds to suspect fraud the broker should decline the loan and let the lender know as soon as possible. The broker should also alert BCFSA so they are aware of the Borrower/situation. They will advise next steps.

Section 3 – Glossary of Common Mortgage Terms

<u>Appraisal</u>
This is a report, prepared by an independent Professional Real Estate Appraiser, to determine a fair market value in order to support a mortgage loan. Requirement for an appraisal and the preferred appraiser(s) will vary from lender to lender.

<u>Costs of Borrowing</u>
There are numerous costs associated with arranging a mortgage loan. These will include, but are not limited to, land transfer tax (if purchase), appraisal fee, legal fees, lender fee, mortgage broker fee. The APR (Annual Percentage Rate) together with a breakdown of the costs are provided by way of the Cost of Credit or Cost of Borrowing Disclosure Statement on residential mortgages.

<u>Interest Rates</u>

- **Prime Rate**
  The Prime Rate is the annual interest rate often used by banks and major financial institutions to set mortgage lending rates. Rates are often expressed as a percentage above or below "Prime". Prime Rate typically refers to the Bank of Canada Prime Rate however it may also reflect a specific major bank's prime lending rate.

- **Fixed-Rate Mortgage**
  A Fixed-Rate mortgage has a set interest rate that will remain constant throughout the term despite any fluctuations to the Prime Rate.

- **Variable-Rate Mortgage**
  The interest rate for a Variable-Rate mortgage is usually expressed as the Prime Rate plus (or minus) a certain percentage. The interest portion of the payments for this mortgage would change whenever the Prime Rate changes.

- **Annual Percentage Rate (APR)**
  The Annual Percentage Rate reflects the overall annual percentage rate including costs of borrowing (interest to be paid over the term of the mortgage, lender fee, broker fee, appraisal fee, legal fees, etc.) The APR will be higher than the stated rate of the mortgage as a result. The APR, together with a breakdown of the costs, are provided by way of the Cost of Credit or Cost of Borrowing Disclosure Statement on residential mortgages.

Loan-To-Value Ratio (LTV)

This ratio represents the loan amount to property value. Example: Mortgage Loan Request $700,000; Property Market Value $1,000,000. $700,000 divided by $1,000,000 equals 70% (Loan to Value Ratio). If the property has an existing mortgage and is obtaining a 2nd mortgage the existing and new mortgage amount are added together to calculate the LTV. Each lender will have their established threshold for their LTV Ratio.

Payments

- **Repayment Frequency**
  Typically, mortgage repayment occurs monthly, semi-monthly, bi-weekly or weekly. Flexibility on accelerated repayment will vary from lender to lender.

- **Interest-Only Payments**
  This is one method of mortgage repayment that may be available. As it states, the expected payment represents the interest component only; therefore, the principal mortgage balance (gross loan) will not reduce at any time during the term of the loan (non-amortized).

- **Principal and Interest Payments (P&I)**
  Payments of an amortized loan include paying the interest owing as well as an additional amount to reduce the principal of the loan.

- **Amortization**
  The number of years, at a constant rate of repayment, required to repay the mortgage in full (longer amortization = lower payments = longer to repay in full; shorter amortization = higher payments = shorter time to repay in full). Repayment of an amortized loan is a blended principal and interest payment. Amortization periods may differ between mortgage lenders.

Prepayment Penalty

Some mortgages may require a penalty should the mortgage be paid out prior to its maturity date or may only allow the mortgage to be paid out on a bona fide sale. Each mortgage is unique and will vary by institution and product.

Prepayment Privilege / Terms

Some mortgages may contain allowances for mortgage payout or principal pay down without penalty. These include, but are not limited to:

- Fully Open – allowance for payment directly to principal and/or allowance to increase monthly payments.

- Closed – meaning that there will be a fee or penalty for additional principal reductions during the term of the mortgage. Details will depend on the mortgage terms.
- Open (partially) – meaning that there is some allowance or privilege for extra principal repayment during the term. Details will depend on the mortgage terms.

Security

This is the property or properties offered as security for the mortgage loan.

Standard Mortgage Terms

Standard Charge Terms are part of every mortgage document. These may vary slightly from lender to lender but basically represent the expectations of performance and obligations of the Borrower in more detail.

Term / Maturity

The length of time that the mortgage's conditions, such as interest rate, are fixed. At the end of the term (maturity date), the Borrower will be offered a renewal or will be requested to repay the loan in full.

Types of MIC Mortgages

- **Purchase**
  A mortgage arranged to complete the purchase of a property.

- **Refinance (Re-fi)**
  Replacing a mortgage on title with a new mortgage or re-negotiating a current mortgage.

- **Debt Consolidation (Debt Consol.)**
  A mortgage arranged to combine (consolidate) debts into one payment, usually at a lower rate than the current debts.

- **Equity Take Out Mortgage (ETO)**
  An Equity Take Out mortgage is a mortgage that draws on the equity portion of the security. Equity is the difference between the property value and the balance of any mortgages on title.

- **Renovation (Reno)**
  This is an Equity Take Out mortgage (see above) where funds are utilized for home improvement.

- **LOC – Line of Credit, PLOC – Personal Line of Credit, HELOC – Home Equity Line of Credit**

A mortgage loan that is re-advanceable or revolving and allows the Borrower to draw on funds paying interest only on the advanced portion of the loan.

- **Inter Alia Mortgage**
  A mortgage that is registered over two or more properties.

- **Reverse Mortgage**
  A reverse mortgage (sometimes referred to as a CHIP mortgage) is a mortgage available to homeowners age 55+ who have substantial equity in their property. Interest is added to the principal of the loan, thereby allowing the homeowners' equity to pay for the loan payments in lieu of monthly repayment.