



**The Appraisal Institute of Canada
Submission to the Finance Canada
Bank Act Review Consultation
November 2016**

Executive Summary

The Appraisal Institute of Canada (AIC) is the nation's leading real property valuation association with more than 5,100 members across Canada. Established in 1938, the AIC works collaboratively with its 10 provincial affiliate associations to grant the distinguished Accredited Appraiser Canadian Institute (AACI™) and Canadian Residential Appraiser (CRA™) designations. AIC members provide unbiased appraisal, review, consulting, reserve fund planning and machinery and equipment valuation services on all types of real property within their areas of competence. Our mission is "to promote and support our members in providing high quality property advisory services for the benefit of clients, employers, and the public." AIC is a self-regulated organization guided by By-Laws, Regulations, Canadian Uniform Standards of Professional Appraisal Practices (CUSPAP) and a Code of Conduct.

Introduction

The real estate market is a key building block of the Canadian economy. It affects every segment of our society and has the potential to help financial systems, investors and everyday Canadians prosper.

One of the core elements of a healthy and balanced real estate market is a systematic approach and commitment to reliable property valuations. Unbiased, independent and professionally prepared real estate appraisals play a vital role in assisting individuals, businesses and governments to make informed decisions during real property transactions.

On-site appraisals carried out by qualified professionals are the most effective way to mitigate lending and property investment risk. Appraisals help to ensure that properties are not overvalued and also help to detect and prevent mortgage fraud or other issues involving real property. When conducted by a qualified and experienced professional - drawing on a sophisticated methodology - an appraisal will validate the characteristics of the property, fully analyze the current market conditions and take into consideration the surrounding neighbourhood as well as other factors that contribute to a property's value.

Strong valuation fundamentals helped Canada's economy remain strong during the global financial crisis at a time when many of the world's leading economies faltered. Countries such as the United States and Ireland suffered through extended periods of recession and experienced the failure of lending institutions

and banks in part due to inherent weakness in risk management fundamentals. Members of the Appraisal Institute of Canada played a role in maintaining Canada's strong fundamentals by contributing their real estate expertise and knowledge to the lending industry and providing sound valuation advice to clients and key stakeholders.

AIC actively supports efforts to ensure that consumers are well educated about the appraisal process and its role within the mortgage financing process. This education will assist in maintaining the quality of the valuation fundamentals needed to protect the public and the financial system.

Recommendation

Expansion of OSFI's Guidelines B-20 and B-21 to Apply to All Mortgage Lending to Ensure Consistency and Effectiveness in Mitigating Lending Risk Across the Country

The Residential Mortgage Underwriting Practices and Procedures (B-20 Guidelines) and the Residential Mortgage Insurance Underwriting Practices and Procedures (B-21 Guidelines) introduced by the Office of the Superintendent of Financial Institutions (OSFI) include provisions for mortgage insurers and federally regulated financial institution (FRFIs) to obtain appropriate numbers of on-site inspections and third-party appraisals to verify the value of collateral used during the mortgage underwriting process. This policy is particularly important to mitigate risk when there is a high loan-to-value ratio, when markets are in flux or when the credit-worthiness of the borrower is questionable.

AIC believes that the risk-mitigation processes within the B-20 and B-21 Guidelines need to be expanded to include all organizations providing residential mortgage financing, not only federally-regulated institutions.

The expansion of B-20 and B-21 Guidelines to non-federally regulated financial institutions is critical - especially now with recent Finance Canada policy decisions that have added more scrutiny to potential homeowners, causing them to seek loans from secondary lenders. This is evident by the increasing percentage of non-regulated financial institutions within the marketplace.¹ These institutions serve a cohort of the Canadian market that may be higher-risk in nature than the median client of one of the federally-regulated institutions.

As a result, imbalances have been built up in our system and a parallel, less-regulated industry has established itself with a growing share of the Canadian mortgage market. Not all market players apply the same rigor to the credit-granting process as those that are federally-regulated. Due to this relative lack of oversight, institutions that fall outside of OSFI's responsibility bring people into the market that may not otherwise qualify for the same level of mortgage, exerting upward pressure on demand and therefore prices.

¹ Department of Finance Canada. *Supporting a Strong and Growing Economy: Positioning Canada's Financial Sector for the Future*. August 26, 2016. P. 15



In this higher-risk scenario, on-site appraisals will assist in mitigating risk. Rather than a lender relying on a computer algorithm in an automated valuation model (AVMs) to underwrite a loan, an on-site appraisal will more accurately verify the market value of the real estate collateral in the event of a default.

The accuracy and effectiveness of AVMs is limited and an over-reliance on AVMs poses a significant risk for all stakeholders. For example, the AVM value does not consider certain elements that are provided through an on-site appraisal value, including the:

- maintenance provided to the property;
- extensive and timely sales data on which to conduct comparable sales analysis;
- verification of the property's dimensions;
- current condition of the property;
- location of the property and its surroundings; and
- intangible features of the property.

Due diligence through on-site valuation ensures that the decision-maker and underwriters have a reliable appraisal report with a well-supported opinion of value. While AIC recognizes that federal regulatory oversight of the financial system has been very sound over the past challenging decade, it is time to ensure consistency across the country across all lenders by bringing non-federally-regulated institutions under the regulatory umbrella that has served Canadians and the economy well in the recent past.

AIC is very supportive of OSFI's Guidelines B-20 and B-21, and of all of the stabilizing policies that have been implemented by this government and its immediate predecessor. It is time to apply the same rules to everyone operating in Canada's mortgage space, in the interest of regulatory and market stability. This would help address both problems we have identified: over-reliance on AVMs and the recent emergence of a large, less regulated, and higher risk pool of borrowers and lenders currently operating outside of our sound federal regulatory framework.