CFA Societies Canada

Canadian Advocacy Council

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September 5, 2019

Financial Services Regulatory Authority of Ontario
5160 Yonge Street, 16th Floor
Toronto, Ontario
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Dear Sirs/Mesdames:

Re: Proposed Supervision Approach for High-risk Syndicated Mortgage Investments (the "Proposal")

The Canadian Advocacy Council of CFA Societies Canada[1] (the CAC) appreciates the opportunity to provide the following comments on the Proposal.

The Proposal indicates that FSRA's level of oversight on a mortgage brokerage will depend in part on its complexity and risk profile. We value the transparency being provided to market participants by FSRA explaining its risk metrics, as well as the targeted approach to concentrate resources on investments that could put retail investors at the highest risk of loss. The description of the red flags found by FSRA based on its analysis of past transactions is particularly helpful in understanding the policy rationale for the Proposal. We are also broadly supportive of requiring additional information to be provided to retail investors for riskier investment opportunities. In our view and consistent with comments we have previously provided to the CSA with respect to the prospectus and registration regime for syndicated mortgages, changes to the way such mortgages are described and distributed are important for investor protection.

Red Flags of Potential Harm to Investors from High-risk Syndicated Mortgage Investments

We wish to note at the outset of our comments that the proposed approach to supervision appears to target the sale to retail investors of interests in syndicated construction financing for commercial real estate ("CRE"). By nature, even non-syndicated ground-up construction financing is typically riskier than term mortgage financing (collateralized by stable CRE assets). This level of risk is often augmented by inter-lender rights under a syndication agreement and/or a servicing agreement (when a servicer acts as both lender and servicer).

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[1] The CAC is an advocacy council for CFA Societies Canada, representing the 12 CFA Institute Member Societies across Canada and over 18,000 Canadian CFA charterholders. The council includes investment professionals across Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada. Visit www.cfacanada.org to access the advocacy work of the CAC.
CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow. There are more than 165,000 CFA charterholders worldwide in 164 markets. CFA Institute has nine offices worldwide and there are 156 local member societies. For more information, visit www.cfainstitute.org.

One of the red flags identified by FSRA is a high LTV ratio. In addition to the LTV ratio, we believe that for construction loans the Loan-to-Cost (LTC) ratio should also be disclosed, as it may be more objective of the level of risk associated with commercial real estate debt investments. The value in the LTV ratio is predicated on various assumptions made by the appraiser, such as the market value of comparable projects in the same market, the discount rate or capitalization rate used in discounting projected cash flows, and if a condo construction project is involved, the net realizable value of the condo units based on qualified pre-sales with staggered deposits. The value should be stress tested in various ways to demonstrate that it is realistic.

One method of stress testing the value of a property is through value sensitivity, such as a stress test showing the break-even point, from a value perspective, where the borrower's equity and projected profits are potentially eroded by an increase in construction costs. Another method is testing projected sales sensitivity, which shows the break-even point when the projected decline in sales price of the project (or condo units) is insufficient to cover the amount (including capitalized interest during the term) of a projected construction loan.

The LTC ratio is an objective test that is less impacted by various assumptions. The ratio demonstrates how much equity a borrower has injected into a development project relative to the leverage used. Borrowers will often include in their equity factors such as the increase of the value of the land after a period of time, land assembly, re-zoning, as well as the addition of certain services if the purchase was of raw land. We believe that a construction loan with an LTC ratio of greater than 85% is an extremely risky investment because the borrower would only have 15% of its equity in a development project. If an event of default happens under a construction loan, this remaining equity can easily be eroded as (i) interest is typically capitalized (i.e. not paid by the borrower throughout the loan but added to the capital and only paid out at maturity) and (ii) realization costs often amount to approximately 10% of the cost of a project.

The LTC ratio should be stress tested to show cost sensitivity. From a cost perspective, breakeven usually occurs at the point where the total project costs (excluding the cost of land acquisition) is the same as the borrower's capital (defined as the sum of the projected profits and the borrower's contributed equity). FSRA could also require the brokerage to specifically indicate how the borrower intends to repay the construction financing – for example, through the sale and closing of condo units, office space or retail space as contrasted with a term mortgage loan that will be refinanced for the balance of the construction loan at maturity (which relates to the Term Loan risk set out in Table 1 of Form 3.1). FSRA could also consider requiring the brokerage to monitor both the LTV and LTC ratios and provide supplemental disclosure if there is a material adverse change to either of them. The later requirement should not be additional work for the lender/servicer because this monitoring is part of their usual asset management tasks (i.e. reviewing the construction monitor reports and assessing periodically the progression of the project development).

Form 3.2 and Form 3.2.1 could indicate in bold font that a construction loan with an LTC ratio of greater than 85% is an extremely risky investment.

Currently, s. 31.1(1)(2) of O. Reg. 188/08 requires that an appraisal be prepared within 12 months before the day the syndicated mortgage disclosure form was provided to the lender or investor. We believe FSRA should encourage brokerages to provide an appraisal within 6 months, or a more recent appraisal if an event has had a material adverse impact on the value of the property within that time frame, such as an unforeseen expropriation of surrounding properties.

Form 3.2 Section 3, Part B, Question #9 includes a text box for the brokerage to input information relating to other encumbrances. It may assist investors to indicate that such other creditors may rank in priority, such as for unpaid realty taxes, unpaid trade liens, or certain advisory fees, further eroding the equity in the project.

The brokerage should also have to disclose whether the funding of the drawdown requests by the borrower are done on a cost-to-complete basis (vs a cost-in-place basis) and whether any senior or subordinated loans will fund sequentially or on a *pro rata* basis. If funding is done on a cost-to-complete basis, it helps to ensure that the equity of the borrower is injected into the loan first and the construction finance funds are advanced thereafter. When funding is performed on a cost-to-complete basis, cost overruns are born by the equity investor – not by the lenders – therefore reducing the risk to the lender. Sequential funding is usually advantageous to the senior lender because the junior lender(s) injects the funds before the senior lender but after the equity. *Pro Rata* funding is usually more favourable to the junior lender because the senior and junior loans fund concurrently after the equity injection.

The second red flag identified by FSRA is the existence of a subordination clause. This approach appears to contemplate a syndicated mortgage investment that is junior to a traditional senior bank construction financing. In such instances, a senior lender will typically require the junior lender to sign a priority and standstill agreement under which the junior lender would grant the senior lender priority over all the interests it has in the project, along with provisions such as: (i) the repayment in full of the senior loan prior to any payment of principal to the junior lender; (ii) until the senior lender is repaid in full, the junior lender will not challenge the realization proceedings of the senior lender; (iii) the junior lender will not initiate realization proceedings; (iv) the junior lender will not amend the junior loan without the consent of the senior lender (however, the senior lender is able to amend the senior loan without the consent of the junior lender); (v) the junior lender is not permitted to accept prepayment of the junior loan until the senior loan is repaid in full; and (vi) the junior lender is not permitted to assign the junior loan without consent from the senior lender. The importance of the potential impact of the subordination clause may not be fully appreciated by all retail investors that invest in junior mortgages and thus a further requirement to explain the ramifications of the clause could be considered.

The third red flag identified by FSRA is the existence of a conflict of interest where the borrower or developer is related to the mortgage administrator and thus the administrator may not properly represent the interests of investors against the borrower. We are of the view that if the borrower is related to the mortgage administrator or if the mortgage administrator also acts as the lender, the obligations of the mortgage administrator should be set at the highest standard. The mortgage administrator should not be permitted to take a position against that of the interests of the investors, or to be perceived to have such an interest. The description of conflicts and the risk of conflicts (and potential conflicts) should include "perceived conflicts" and consider other conflicts that investors would want to know, including any potential conflicts with the appraiser.

Proposed Form 3.2.1

The template disclosure Form 3.2.1 is intended to highlight the risks typical of high-risk syndicated mortgage investments, including high loan-to-value ratios, subordination and conflicts. Once the form is signed it will need to be filed, in hard copy, with FSRA within five days following the date on which it is provided by or on behalf of the brokerage to the first potential or actual retail investor. While we understand that FSRA requires information in real time, we query whether the time frame could be moved to ten days to provide the brokerage with more time and to harmonize with, for example, the time frame within which a report of exempt distribution would need to be filed with the applicable securities regulator. In future, it may also be helpful for participants if there were an electronic filing portal for such forms in lieu of hard copy delivery.

While the information in Form 3.2.1 will supplement additional disclosure provided to investors by the broker and the three "red flags" that are highlighted are not exhaustive, we are concerned that investors may still view the risks highlighted in the form as being the primary risks. Worse still, investors may believe they are the only risks related to these type of syndicated mortgages.

FSRA could consider highlighting in a text box or otherwise highlight the cross reference to Table 1 – General Risks for Non-Qualified Syndicated Mortgages in Form 3.1, particularly those related to the creditworthiness and track record of the borrower / sponsor and the financial strength of any person or entity offering a covenant, guarantee or financial commitment (described as Borrower Risk and Personal Covenant Risk in Table 1). The disclosure of material risks found in Form 3.1 Section 3.1(d) and Form 3.2 Part E should also be highlighted. For example, it could include any other material factor that would result in an impairment of the mortgage loan security, risks relating to the debt service ratio, risks relating to cost overruns, and material events that could impact payments such as prior insurance claims.

FSRA should also consider adding a requirement for the brokerage to specifically reference other factors set out in any offering document or marketing materials provided to investors and the location of such disclosure.

With respect to the first factor on Form 3.2.1 indicating that the investor may be subordinate to other lenders, it may be prudent to expand the description to include other reasons why the investor may not be first in line for payment – for example, as a result of taxes owing, as described above.

The forms do not appear to plainly describe the meaning of high credit risk to potential investors. For example, issuers may engage in high credit risk transactions such as unsecured lending involving high interest rate spreads over risk free bond rates. Requiring a specific reference to “credit spread risk” in one of the disclosure forms (potentially in Table 1 of Form 3.1) would enhance the regulatory disclosure to investors. Usually, mortgage loans with higher spreads have a riskier profile.

The description of the appraisal of the property being financed in Form 3.2 could be enhanced with disclosure that addresses the risk of the assumptions that may be used in the valuation, or changes to those assumptions (such as the effect of a change in the discount rate used in the valuation). Investors should be made aware of the limitations of the method used to value the property, in order to better understand the investment. If there have been past changes to the firm performing the appraisal, such information could be emphasized as well.

In Form 3.2 Section 3, Part D, Question #3, the brokerage has to disclose if funds will be called in stages, presumably relating to a mortgage that requires ongoing capital raises for progress draw mortgages or investments subject to cash calls. In the details to be provided, it would be helpful if there was an explicit statement regarding total committed capital and prior cash calls, which would provide investors with clear disclosure of the conditions precedent to funding progressive advances and the remaining amount of capital to be called. It may also be helpful to cross reference the general Financing Risk noted in Table 1 in Form 3.1. As noted in the Forms, the ability to raise further funds as progress in development or construction takes place will pose an additional risk to investors.

Other Comments

We understand that there is limited to no data available to the public on the Canadian syndicated loan sector, and the lack of transparency contributes to the importance of clear disclosure to potential investors. A public database of syndicated mortgage loans, including high-risk loans, would facilitate comparison across the types of properties and brokers. The data compiled by FSRA from the information disclosed in Form 3.1 and the other forms could be the basis for such a public database.

When the new Form requirements come into force, brokerages might find it helpful if the requirements were accompanied by both guidance and FSRA outreach to ensure that expectations are met.

We are encouraged by FSRA’s leadership in the area of protection for retail investors, but note that due to the nature of provincial regulation over mortgage broker activities, there remains an opportunity for regulatory arbitrage for high risk syndicated mortgages in other jurisdictions. It is important that purchasers of these investments are protected throughout the country. We continue to encourage FSRA, its other provincial counterparts, and the CSA to seek harmonization of disclosure requirements wherever possible to avoid investor confusion. We also support ongoing efforts to collaborate with other regulators, not only to deal with the potential for regulatory arbitrage but to work on reducing duplicative regulation as it relates to mortgage activities.

Concluding Remarks

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have and appreciate the time you are taking to consider our points of view. Please feel free to contact us at cac@cfacanada.org on this or any other issue in future.

(Signed) *The Canadian Advocacy Council of*
CFA Societies Canada

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