



8/21/2020

Ms. Gina Stephens
Senior Policy Advisor
Financial Services Policy Division
Ministry of Finance
95 Grosvenor St. – 4th Floor
Toronto, ON M7A 1Z1

Re: **FSRA's Draft Guidance**

Dear Ms. Gina Stephens,

Background

I am writing to you on behalf of Marshall Group Inc. as both a Mortgage Brokerage and a Mortgage Administrator, which may give us a somewhat unique perspective on the matters up for discussion. We are a large brokerage that primarily provides significant financing for the development and construction activity in Ontario. Our lenders provide critical capital not currently provided by other financial institutions to facilitate much needed construction of housing and infrastructure. The mortgages we typically provide are classified as Non-Qualified Syndicated Mortgage Investments (NQSMI's) and we exclusively work with parties that are institutional or have the qualifications of a Permitted Client. This type of mortgage activity is very different and more complex than the typical residential mortgage brokerage activity and as you are aware, has seen recent regulatory attention for all the wrong reasons.

In reviewing the proposed changes to the regulatory framework for NQSMIs, we have arrived at the following general comments in regards to the Financial Service Regulatory Authority (FSRA)'s draft Guidance document.

We believe treating retail investors and Permitted Clients differently from a regulatory perspective is absolutely required and the approach described in sharing the regulatory responsibilities between FSRA and the Ontario Securities Commission (OSC) for NQSMIs seems reasonable.

Requesting additional data to provide insight into regulated NQSMI transactions also makes absolute sense, as would leveraging the power of technology to analyze, monitor and identify transactions or brokerages requiring more scrutiny. This oversight should be accomplished in an "elegant" way and should not be an overly burdensome "stone tablet and chisel" approach (i.e. forms and specific templated reports that can be easily populated from brokerage electronic systems, clear/defined terms, make it easy to upload information to the Regulator's secure



website, enablement of electronic authorization, etc.) Further, we would suggest not catering to the laggards in the industry as they will negatively impact us all.

Leading organizations do not want to be impeded by a Regulator that is not keeping pace with current technology. Thoughtful “best practices” will put the Regulator in the best possible position to effectively and efficiently accomplish their mandate.

Proposed Recommendations

Our comments are primarily focused on the Quarterly SMI Data Report and the associated information/data requirements. We have provided detailed commentary on each of the items mentioned for inclusion in that report, however we have identified certain “themes” which we believe could strengthen or improve the proposed process – they are as follows:

- **Clarity on requirements** – As a theme, we, as mortgage administrators and brokerages want to know what we need to do in order to comply with the regulations. Defining exactly what the Regulator is looking for and why, makes it easier for the parties providing the information to comply. We recognize a prescriptive approach has not been the historical path taken by the Regulator, however as the Regulator moves into the world of data analytics, precision is critical to ensure the results derived from the data are reliable and useful for the purpose which they were collected. Further, data providers can establish systems and procedures to collect and populate the required data elements into any templated reports, forms, website data table interfaces to make compliance easier. This approach will be more effective and efficient for all.
- **Valuations** – Generally, valuing development and construction projects is difficult for a variety of reasons. Providing “standard” lending ratios create concern for those providing them because these ratios are not reflective of the related risks involved nor are they what the industry uses to assess risks tied to these types of projects. Appropriate metrics and methodology needs to be identified and incorporated into the data requirements.
- **Multiple Fundings** – Given how development/construction projects are funded and the associated security value improvement with each funding, reporting should consider multiple fundings and the cumulative nature of lender exposure in the required reporting. Viewing these transactions as “one-time” advances can create confusion and inaccurate or misinterpreted information.
- **Improved Data Interface / Software Tools / Website** – Any improvements that would allow the secure electronic input or uploading of requested information would serve all parties well by lessening the burden of providing this information. The Regulator would be in a position to easily analyze the data provided and by leveraging the right data sets, the Regulator will be able to be more effective/efficient in meeting their mandate and in the use of resources for testing and assurance. Further, the corporate resources necessary to provide this information will also be minimized.



NQSMIs with Permitted Clients – Quarterly NQSMI Data Report

Generally, we are supportive of the efforts the Regulator is taking to gain greater visibility into the transactions they are being asked to regulate by collecting additional data. That said, it is important that requested information be relevant, give appropriate insight into the transactions involved and are understood by those parties asked to provide the information.

In reviewing the requested quarterly NQSMI data request, there are some challenges/concerns in providing some of the requested information, especially when looking at financing related to development and construction activities (which is the primary business MarshallZehr conducts).

Please see our specific comments below:

<i>Project</i>	<i>Mortgage amount, term, purpose, use of funds, loan-to-value ratio, ranking, existence of subordination clause</i>
<i>Property</i>	<i>Type of property funded, estimated market value (also referred to as the 'as is' value of the property), location of the property</i>
<i>Transactions / Investments</i>	<i>Investors: Total number of investors, number of Permitted Clients involved, their names, the value of their respective investments, supporting documentation confirming the Permitted Client status and specific category of Permitted Client</i> <i>Borrowers: Borrower class (i.e., level of sophistication)</i>
<i>Mortgage Administrator</i>	<i>Name of mortgage administrator</i>
<i>Fees</i>	<i>Fee schedule (e.g., for fees received by / owed to the brokerage and related parties)</i>
<i>Related Parties</i>	<i>Actual and / or potential conflicts of interest within a transaction among the mortgage brokerage, the mortgage administrator, the borrower and developer</i>

- **PROJECT**

- **Mortgage amount** – Often the legal mortgage charge remains static throughout the term of the mortgage and typically the amount covers the entirety of a fully advanced loan facility and the potential for unpaid interest, costs and fees. Construction and development loans are typically advanced over the term of the mortgage through multiple fundings where the principal increases over the life of the project, and the “mortgage amount” may not necessarily be reflective of “lender exposure” at that time.

We would suggest the following:

- clarification on what is meant by “mortgage amount” (registered charge, total available loan, drawn portion of the facility, etc.), and
- perhaps the inclusion of a data element re. “advanced funds” with a clear definition of what that means (i.e. proxy for lender exposure, it may need to



include unpaid or accrued interest, fees, etc. to properly reflect that exposure accurately similar to a Net Asset Value calculation – everything accrued to a specific cutoff date).

- **Term** – The “term” in a development or construction loan is often not honoured by the borrower in development and construction loans, which are plagued with delays and projects not unfolding exactly according to the initial underwritten schedule/business plan. These risks should be considered and understood upfront and mitigated as much as possible. That said, delays obviously indicate “stress”, but it is somewhat normal course for development and construction projects. Further, borrowers know they have leverage in these situations – if the loan remains unpaid at maturity, lenders are left with difficult choices, which primarily distill to the following:
 - proceed with a realization scenario, which when dealing with a construction project is exceptionally complex and the security value available could suffer significant degradation (i.e. Tarion builder must be replaced, pre-sales with the initial Tarion builder potentially lost, no new Tarion builder wants to step into a half built project and assume the legacy and future risks involved without a meaningful profit margin, on a condo project there is no “cash event” until registration and stratified title is passed to the individual condo purchasers and delays in a late stage build are extremely damaging (say, on a \$100M+ high-rise condo build with a fully drawn loan at 10% = \$27K per day). Debt carrying costs will quickly “eat a project alive”, a distressed sale means buyers will be looking for favourable pricing, etc.; or
 - work with the existing borrower to complete the project if at all possible, however the borrowers are not always willing to paper formal extensions or amendments assuming they will avoid the related “fees” involved.

We would suggest capturing the “papered” maturity date (“term”) and an expected “repayment/refinancing date” (if known) (i.e. identify when is there a realistic opportunity for the existing lenders to exit this mortgage position or are they tied into a workout situation).

- **Purpose** – Some small changes to the Purpose classifications purchase, construction / development, renovation, refinancing (remove “renewal” as it is an option within the existing mortgage agreement and replace with “refinancing”). There may be a need for definitions or additional categories to ensure consistency from all reporting entities.
- **Use of funds** – This information will be difficult to provide. Most fundings related to development and construction are tied to the “stage” of the project and will often, but not always (i.e. early stage development typically would not engage a cost consultant), be supported with an external cost consultant report and may be a “blend” of the various classifications highlighted (i.e. land acquisition and/or development, equity take-out, soft and/or hard construction costs, zoning/plans/permits approvals, payout tax liens or mortgage arrears). Isolating use of funds by category with any accuracy would be tedious



and would not provide specific insights that are particularly useful in our opinion. There may be a need for definitions or additional classifications to ensure consistency from all reporting entities.

We are assuming the Regulator is not looking to have a budget variance analysis, by project, by cost category, etc. – this would be immensely difficult to produce and without incorporating an updated project schedule, impossible to interpret (i.e. “under budget” dollar wise, often perceived as a good thing, may mean the project is behind schedule, which may have a significant longer term negative impact). Further, Estimated Costs to Complete (ECCs) are exceptionally difficult to maintain by borrowers.

We would suggest a “stage of project” data field in the case of a development and construction financing rather than trying to breakout the individual “use” categories.

- **Loan-to-value (LTV) ratio** – This is a very problematic measure for construction and development projects. It is a fine measure for most other financings (i.e. a stabilized asset with term debt), however the “value” component of this equation is a significant challenge on an ongoing construction project where the security is being transformed or created.

As examples:

- If a borrower were to purchase a parcel of land for \$10MM and borrow an amount equal to 50% LTV – easy to understand, calculate and validate. If they now spend \$1 on planning, or engineering, or other soft costs – is the land now worth \$10,000,000 plus \$1 or is there some gearing ratio of value to be employed? This is where the challenge in valuation becomes evident.
- Take a more difficult scenario, a half-built \$300MM high-rise condo project, the borrower becomes unable to complete the project – what is the property now worth on an “as is” basis – there are very few buyers or parties willing to finance a takeout, Tarion pre-sales are wiped out, a new Tarion builder must be attracted to complete the project in order to get to registration, which creates the “repayment cash event” which could repay at least some of the lenders’ mortgage. Again, difficult to arrive at a meaningful value to use in the LTV ratio calculation.

We would suggest a loan-to-cost measure be used for construction and development mortgages rather than LTV. Further, the industry effectively “backs into” the valuation using future revenues less the costs to generate those revenues as the “proxy” for residual value. There may be other potential approaches, but in our opinion, LTV does not make sense for construction and development mortgages.

- **Ranking** – The concern here relates to whether all types of subordination are considered within different debt structures. Certain 1st or 2nd mortgages may have subordinated tranches within their structures – A/B structures with more conservative funds ranking in priority to a subordinated tranche if the loan was to go into a default scenario. This needs to be accommodated as this is a normal course structure in larger NQSMIs.



- **Existence of subordination clause** – Any ability to raise priority debt should be highlighted, but this ties closely to the comments made regarding ranking. Practically, in a construction and development “work-out scenario”, any new funds brought to a “distressed” scenario will demand priority to the existing lenders, otherwise existing lenders can put their own funds into the project to fix the problems and protect their existing investment “defensively”. Disclosure and a full understanding by the lender of the associated risks are a must in this area – they need to understand “what if something goes wrong?” scenarios, and what does a “workout” look like?

- **PROPERTY**

- **Type of Property Funded** – Additional clarity and data fields should be required for properties which are being “transformed” during construction and development – location, build type, how many units, estimated revenue per sq. ft., estimated cost per sq. ft., etc.

A more prescriptive approach will provide more valuable information and makes it easier to know what the Regulator is looking for and will help identify riskier situations.

- **Estimated market value (also ‘as is’ value of the property)** – please see comments re. Loan-to-value ratio. It is immensely difficult to provide an “as is” value during a development or construction period and it does not provide a reasonable proxy of the value that could be created through an appropriately managed “workout” scenario. No lender is ever going to hit “CTL-ALT-DEL” unless it is the absolute last resort as this can often yield a dramatically lower recovery.

If a “value” is to be provided, additional clarity must be provided on the valuation approach to be taken. It will need to be understood and make sense to the entities providing it or it will lead to erroneous information.

Again, a more prescriptive approach will provide more valuable information and makes it easier to know what the Regulator is looking for.

- **TRANSACTIONS / INVESTMENTS**

- **Total number of investors** – Simple, should be no issue
- **Number of Permitted Clients** – Simple, should be no issue
- **Participant names** – Simple, should be no issue, however privacy concerns need to be considered as individual participant information is being exchanged
- **Participant values** – Simple, should be no issue, but clarity around detail to be provided by mortgage (e.g. principal, accrued/unpaid interest, default interest and penalties, cutoff dates may play a part in earned interest that has yet to be paid if the Regulator is



looking for an accurate outstanding amount, similar to a Net Asset Value calculation) (again, privacy concerns need to be considered)

- **Supporting Documentation for Permitted Clients** – Is the requirement to send a form for each mortgage or only for their initial participation as “new” brokerage Permitted Clients? Most clients are repeat clients and maintaining a lender client list may be an easier way to maintain and provide support without creating duplication in efforts.
- **Borrower Class** – Clarity and a more prescriptive approach will provide more valuable information and makes it easier to know what the Regulator is looking for.

In our case, we work with the borrower to put together a suitable financing to meet their project’s needs and have a fiduciary responsibility to them. That said, we are not in a position to represent them to the lenders we are working on behalf of, given we are also a mortgage administrator and would pursue security on behalf of the lenders should that become necessary in a default scenario. In this situation are we being asked to “rate” the borrower – our lenders would do this on a multitude of factors before providing them with the mortgage (i.e. experience, Tarion deliveries, partner experience, credit worthiness, net worth, etc.). It is not clear what the rating scale would look like nor how it would be applied.

- **MORTGAGE ADMINISTRATOR**

- **Mortgage Administrator Name** – No issue. There should be consideration for transactions where in the case of a default, the Mortgage Administrator may change.

- **FEES**

- **Fees** – Clarity around the detail to be provided – is it by mortgage (e.g. brokerage fee, trailer fees, participation fees, administration fees, “default” fees, payment in kind, etc.), earned / unearned, deferred or contingent. Just to be clear, this is over and above the disclosures already provided on the appropriate FSRA forms.

Again, a more prescriptive approach will define exactly what the Regulator is looking for and why and makes it easier for the parties providing the information to comply. Everybody doing something different is not an efficient or an effective way to gather and work with data.

- **RELATED PARTIES**

- **Related Parties** – Clarity around the detail to be provided – again, this would be over and above the information that is currently disclosed in the various FSRA form or is it something different for some other purpose:?

Again, a more prescriptive approach will define exactly what the Regulator is looking for and why and makes it easier for the parties providing the information to comply.



Thank you for considering the commentary provided above. We would be happy to arrange a meeting to discuss these items and any other items you wish to discuss further. We appreciate the position you are in as a Regulator to protect the public interest and understand the need to adapt the regulatory framework to meet your mandate. Our desire remains to ensure all stakeholders are protected and understand the risks they are taking and balance that with workable regulations to achieve this objective.

A handwritten signature in black ink, reading 'Murray Snedden' in a cursive script.

Murray Snedden

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