Sherlock MORTGAGES

36 King Street East, Suite 400, Toronto, Ontario, M5C 3B2
Independently Owned & Operated, License #12976

August 16, 2019

Financial Services Regulatory Authority of Ontario
5160 Yonge Street, 16th Floor
Toronto, Ontario
M2N 6L9

Dear Regulator,

RE: REQUEST FOR FEEDBACK: PROPOSED SUPERVISION APPROACH FOR HIGH-RISK SYNDICATED MORTGAGE INVESTMENTS

As Principal Broker for Dominion Lending Centres Sherlock Mortgages, I am writing to provide FSRAO with:

1. Feedback on the proposed summary disclosure form 3.2.1, and

2. My views on why a 'compliance, risk-based' regulatory approach is insufficient to protect syndicated investors, agents, brokers and brokerages.

Feedback on Form 3.2.1:

Positives:

i. The form is straightforward, written clearly in plain language.

ii. Two important structural data items are identified and quantified, namely:
- whether there is sufficient asset-based security to protect investors, and
- whether investors face structural subordination risk to other creditors.

iii. The form helps quantify the level of conflict of interest arising from commissions.

Negatives:

i. The act of disclosing mortgage data such as Appraisal Value and Loan to Value does little, if anything, to protect syndicated mortgage investors from risk of loss.

ii. The act of disclosing conflicts of interests does little, if anything, to protect syndicated mortgage investors from receiving biased investment advice.

Why a "Compliance, Risk-Based" Regulatory Approach is Insufficient to Protect Syndicated Investors, Agents, Brokers and Brokerages:

Background:

FSRAO's compliance, risk-based approach is the premise behind its regulatory approach.

Historically, this approach produced satisfactory results because more than 99% of Ontario's mortgage agents deal in 'residential' mortgages; not 'commercial' mortgages.

Only a few agents deal in commercial mortgages. Such agents typically contact commercial account managers in regulated financial institutions and pass on documents collected from clients at the direction of the commercial account manager. The commercial account manager performs the underwriting and verification steps needed to keep the lender safe, and by default, the mortgage agent and brokerage, are also kept safe. The MBLAA and OSFI require regulated financial institutions to perform their own due diligence on commercial lending transactions. Placing commercial transactions with regulated financial institutions significantly reduces the potential for Errors & Omissions and the onus on agents to understand commercial mortgage credit risks.

This underwriting safeguard is circumvented when residential mortgage agents and brokerages are permitted to pool investors to participate directly on large mortgage transactions that are principally commercial in nature such as apartment, office and industrial buildings. By pooling, mortgage agents involve less sophisticated investors on complex commercial mortgages to which the investors would normally never have access.

The mortgage agent course and licensing test focus on residential mortgages; not commercial mortgages. As such, the vast majority of mortgage agents do not have the skills, knowledge and experience needed to structure, analyse and place commercial mortgages with either lenders or unsophisticated investors.

As residential mortgage agents are not equipped nor experienced in analysing and structuring commercial real estate credits, agents do not understand the commercial credit risk issues and by default, cannot communicate to investors what they, themselves, do not understand.

Investors need unbiased quantitative and qualitative advice from professionals who have commercial lending experience and risk-assessment expertise. Across Canada, there are probably only a dozen or so, active and accomplished commercial mortgage agents and brokers able to analyse commercial transactions like a seasoned commercial account manager in a financial institution. In fact, most commercial mortgage agents in the brokerage industry entered after a career in banking.

That said, any accomplished commercial mortgage agent will readily acknowledge that brokerages lack important safeguards, such as bank-level credit-risk adjudication policies and procedures, commercial credit committees, internal audit professionals and (depository) insurance for investors (to name a few). In a bank, these policies and procedures work together holistically to keep depositors (investors) safe. It is impossible for an independent mortgage agent to replicate the value of these programs for a syndicated investor group.

Beyond financial analysis, the qualitative expertise and consulting skills needed by the commercial mortgage agent or broker should not be underestimated. In the absence of depository insurance and in the face of conflicts of interest arising from deal commissions, only an agent with an exceptionally high moral and ethical compass has the backbone necessary to reject an investor based on the investor's character, risk-profile and investment objectives. These assessments cannot be translated into words on a FSRAO compliance form. These are judgement calls that must be made by an informed expert, possibly against the desires of an over eager investor who fails to understand the investment risks.

FSRAO's compliance, risk-based focus, as embodied in Form 3.2.1 does not address, nor can it reasonably mitigate the problem: residential mortgage agents do not have the commercial training and experience needed to deal with investors in syndicated mortgage investments.

Conclusions:

Regulated financial institutions deploy fundamentally different policies and procedures to analyse and process residential versus commercial mortgages. Residential mortgage applications are, by-and-large, straightforward. Adjudicators review check-the-box mortgage applications. This is evidenced by the Filogix Expert program that enables mortgage professionals to receive pricing, terms, conditions and funding approvals from multiple lenders.

Commercial mortgage applications are complex. Every transaction has qualitative factors that require oversight and approval by experienced lending professionals and credit risk management committees. Lenders rely on legal loan documentation prepared by lawyers acceptable to the lender to keep them safe. Every loan document is different. Every security package is different (albeit elements are similar).

FSRAO needs to acknowledge that its compliance, risk-based regulatory approach cannot adequately address the needs of syndicated investors.

The only way to keep syndicated investors safe is to give them access to competent, trained commercial professionals who evidence a moral and ethical track-record.

To accomplish this, syndicated mortgage investments should be managed by competent commercial-based brokerages, brokers and agents.

As an aside, although this conclusion may appear self-serving as I run a commercial-based brokerage, my brokerage's policies and procedures strictly prohibit dealing in syndicated mortgages. Furthermore, when dealing with non-conventional lenders, as the chief compliance officer, I ask questions to better understand the due diligence performed by the lender in raising pooled capital.

Yours sincerely,

Pierre Pequegnat

Pierre Pequegnat
Principal Broker

Appendix A

Credentials

PIERRE PEQUEGNAT
PRINCIPAL BROKER
PRESIDENT
LICENCE M-15001991
C : 647 995 4943

Pierre Pequegnat is a Mortgage Broker specializing in all forms of commercial credits. He has a track record in structuring complex transactions where a skilled negotiator is needed to align lender and owner interests. He is a results-oriented, professional with Fortune 500 and Board experience. Pierre delivers out-of-the-box, customized lending solutions that instill confidence in the loan application process by fostering trust and a transparent risk-assessment environment. Strong relationships, teamwork, trust and integrity, and speed-to-market are his trademarks.

Pierre has held leadership positions at Butterfield Bank, Ernst & Young, Macquarie Financial, Scotiabank and William Mercer. He has consulting expertise in strategy and corporate development, business restructurings and loan workouts.

Pierre headed Commercial Banking, Credit Solutions and Credit Risk Management for a Scotiabank subsidiary. He is licensed by FSCO in Ontario, and holds an MBA from York University and a BASc. in Mechanical Engineering from University of Toronto. He is an adjunct professor at Ryerson University teaching Corporate Finance, Real Estate Finance and Growth in SMEs.

DLC SHERLOCK MORTGAGES
LICENCE NO. 12976
C : 647 995 4943

Dominion Lending Centres ("DLC") Sherlock Mortgages is an independently owned and operated franchise of Dominion Lending Centres. DLC Sherlock Mortgages has professional residential and commercial Agents who bring choice, convenience and counsel to homeowners and management teams who desire credit terms tailored to their families and businesses. Our Agents work with private and institutional lenders and provide objective unbiased guidance.