SETTING THE RECORD STRAIGHT ABOUT SYNDICATED MORTGAGES

At the end of last April, Dana Flavelle, a reporter at the Toronto Star sounded the alarm on "Syndicated Mortgages" largely, if not wholly, based on her investigation into the pooled mortgage investments offered publically to finance projects by Fortress Real Developments. https://www.thestar.com/business/2016/04/29/the-high-risk-world-of-syndicated-mortgages.html. A few days later, on April 4th 2016 MacLean's magazine came out with an article entitled, "Just how safe is the "safe" world of syndicated mortgages?" http://www.macleans.ca/economy/realestateeconomy/syndicated-mortgages-and-the-coming-condo-market-crash/ . This article also sounded an alarm assuming there is some need to sound one, on "Syndicated Mortgages".

This particular article is not about the so called "alarm", or the practices, or investment pro's and con's of companies like Fortress, or the recently demised "Titans" of our industry, but rather the informal, very troubling and misleading definition the media has given to the term "Syndicated Mortgages". The media, writers, editors, and some of our regulators at FSCO, and the OSC have imputed "high risk" into the broader meaning of "Syndicated Mortgages". This could pose a very dangerous proposition for our industry. There is little differentiation between mortgages syndicated for the purpose of providing mezzanine lending for development projects and all other syndicated mortgages. Therefore, in the minds of non-industry participants, it appears that all "Syndicated Mortgages" are created equal. I for one suggest that this could have major consequences for our industry if not addressed.

Let me put this into proper perspective. A syndicated mortgage is quite simply any mortgage in which two or more individuals participate as lenders in a single mortgage. That mortgage could rank as a first charge ("mortgage"), second, third, fourth or even fifth or higher charge on the security of real estate. The words "syndicated mortgage" does not define or relate specifically to any of the risks associated with a mortgage investment, including risks associated in dealing with and governing the rights of each of the participants in the mortgage. The term does not speak to risk whatsoever. A syndicated mortgage can be a mortgage on a home, a trailer park, a cottage, an apartment building, an industrial building, a hotel, a cemetery, a farm, development land, or a residential or commercial condominium. Yes, it could be for the development or construction of any one of these types of property as well, but it does not specifically or necessarily, has to be syndicated for that purpose. So why define the development/construction/preconstruction mortgage investment for a development project as a "Syndicated Mortgage? Why not use the term Pooled Mortgage Investment ("PMI")? Perhaps the reason is because it was simpler; or perhaps because it sounds sophisticated enough for those who sell them to investors, to diminish the real risks associated with early stage real estate development loans? I don't have the answer, but what I do know, is that there is a large disconnect between what the media, and possibly many of our regulators know or say about the risks associated with syndicated mortgages. None of them seem to properly address mortgage risk among different types of syndicated mortgages or are purposely avoiding this important issue. The proper name for these high risk development/construction/preconstruction mortgage investments for real estate development or construction is "Mezzanine Mortgage Loan". A Mezzanine Mortgage Loan can be defined as "*a mortgage relating to or denoting secured, higher-yielding loans or mortgages that are subordinate to bank loans and other secured loans but rank above equity".* This neglect to properly define syndicated mortgages is to the detriment of the public, and potentially the future of our private mortgage lending industry.

All types of real estate can be mortgaged. One financial structure for funding a mortgage is syndication. Hence, the term a “Syndicated Mortgage”. Other financial structures to facilitate mortgage investments and funding are PMI’s which are facilitated by a MIC or Mortgage Trust structure. However, it is the underlying asset securing the mortgage and the terms of the mortgage contract or charge, the history and experience of the borrower, the credit worthiness of the borrower and guarantor, the availability of proper property insurance and title insurance, the expertise of the lawyer closing the transaction, the location of the property, the availability of debt coverage, the key underwriting data including “Loan to Value Ratio’s”, “Loan to Cost Ratio’s”, real equity rather than appraisal surplus and more than a dozen other factors that defines at least part of the risk associated with a mortgage investment. The act of syndication and otherwise the pooling of funds, has little to do with defining the risk of a mortgage investment save and except the required use of a document or agreement to govern the rights and actions of and between the investors who are participating in the syndication or PMI. Mortgage syndication more specifically refers to a structure for bringing several investors together in equal or different investment amounts to be invested in a single one time mortgage investment secured by real estate. The investor has direct participation in choosing each individual mortgage investment. A PMI refers to a pool of mortgage investments where the investor generally has little say if any in the mortgage investments funded. In a PMI the investor relies on fund managers to oversee all mortgage investments in the PMI.

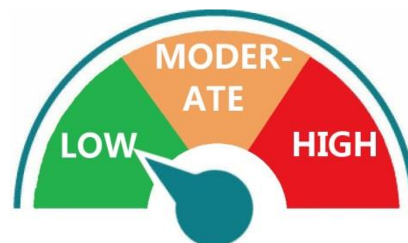
Let us not forget that Banks, Credit Unions and Trust Companies syndicate mortgages between themselves, and even with private mortgage lenders. For them, the sharing or syndicating in mortgages is largely practiced to limit exposure to a single borrower, or to stay within lending limits set by institutional regulators. The fact that these mortgages are syndicated has nothing to do with the risks of the actual mortgages themselves.

The media however, has propagated high risk “mezzanine”, mortgage lending for high rise residential condominiums and other early stage real estate development projects as the definition of “Syndicated Mortgages”. The articles noted earlier, spoke of a number of specific mortgage syndications, but did so in some cases without qualification or reference to a required broader definition. Not only is the public being trained to accept this “Syndicated Mortgage” definition, with its high risk imputed, but it appears the regulators may have as well. This is misleading and has consequences for the private mortgage industry in Canada which often syndicates investor money to fund mortgage investments, or pools funds in a PMI such as a MIC or Mortgage Trust.

A simple first or second mortgage on a residential home funded by a syndication of a mortgage broker, his friend and a few family members is nothing like the syndicated mortgages such as those portrayed by the media in their recent articles. To better understand how risk varies, let us compare the “Capital Stack” of these very different mortgages.

Example:

a) <u>A simple syndicated residential or commercial first mortgage:</u>



What is on the title after closing? Answer: First Mortgage

What is the Borrowers equity? Answer: Typically 15% - 25% or more

Compared to:

b) <u>The secret ranking of a media defined “Syndicated Mortgage” for development of a multi residential building (“A Mezzanine Mortgage Loan”):</u>

What is on the title after closing? Answer: A ***First Mortgage*** (Land or Construction)

And possibly a ***second mortgage*** (could be for land servicing)

For more astute investors, very high risk starts here in third place or at an earlier ranking based on a multitude of factors which go beyond a simple "Loan to Value Ratio". However, this is often the ranking where a Syndicated Mezzanine Mortgage for development like those noted in the media finds itself. During the development process the ranking of the mortgage may be pushed back due to the necessity for postponement. This requirement relates to the need for capital to be advanced to complete the project. Also, there will be a number of other required registrations which often take priority over this type of syndicated mortgage such as those set out in this example.

A ***third mortgage*** securing the city for completion of development works.

Where is this mezzanine mortgage loan ranked?

A ***fourth mortgage*** securing a deposit insurer (allows the builder to use the proceeds of purchaser deposits in reduction of otherwise borrowed funds to be included in the construction budget)

The ranking of the subject mezzanine syndicated mortgage could become ***a fifth ranked mortgage or fourth if the deposit insurer will agree to postpone behind the mezzanine mortgage loan.***

In sixth place may be a mortgage to secure the borrower's equity if any.

What is the borrower/developer's equity in example b)? Answer: Often 0% - 20%. This will vary depending on prior charges and where the project is in the development/building process.

Is it fair to say that these two syndicated mortgage risks are alike? The risk profile is not remotely alike. However, the media may have the public buying into the more risky of the two scenarios as the definition of a "Syndicated Mortgage" investment.

Why is this concern and where is the harm?

If the public is buying into the media's thin and dangerous definition of syndicated mortgages which imputes high risk, then likely the regulators are too. Much of what the regulators do is to protect the public. We have seen the demise of one mezzanine mortgage lending company (Titan). The media is picking on another, and warning the public and the regulators of some possible future cataclysmic event, that one day could have consequences for those who invest in their version of a syndicated mortgage investment. Despite the fact that I only have praise for FSCO and that I think they are doing a good job of regulating our industry, they recently singled out *"Syndicated Mortgages as an area of concern".* The May Maclean article mentioned earlier candidly quoted FSCO saying that, while compliance among mortgage brokers has improved in recent years, it intends to conduct a more detailed investigation of syndicated mortgage transactions over the next 12 months:

"given the significant risk syndicated mortgage investments pose to consumers."

I'm sorry but I couldn't help notice the specific risks they were speaking of. Hello! Which risk was that? The syndicated 1st residential or commercial mortgage of our previous examples, or the development mortgage that starts in second or third place and may ultimately postpone to fifth place due to the requirements of the project and resulting capital stack of a development project? Perhaps we can't blame the media when our regulators speak in such general terms.

It is being suggested that the OSC rather than FSCO might better regulate syndicated mortgage activity. In a recent mandate review of FSCO for the Minister of Finance it was recommended that:

"The government should require that documents issued to raise capital for syndicated mortgage investments be subject to the same level of regulation as the securities regulator applies to other offering documents used to raise capital in the Province"

I suggest that the media has defined a Syndicated Mortgage with a big broad brush stroke. I am afraid that future legislation and regulation will be needlessly applied to "ALL" mortgage syndicators rather than on the few, where it is most needed. Instead of focusing on the highly sophisticated and risky lending of soft cost/development mezzanine mortgage lending, where there is little borrower equity, regulations regarding all types of mortgage syndication will fall into a broad category simply called "Syndicated Mortgages".

Unless we as an industry speak to the Media, the deceived public and the regulators, we can be assured that future legislation, regulations and oversight will be applied with a broad brush stroke – private "Syndicated Mortgages".

Reporting requirements, red tape and costs will become prohibitive for the small lenders and established successful lower risk private lenders and mortgage syndicators will be annihilated. The result will be to the detriment of consumers and the mortgage industry at large, as this robust economic stimulator of private mortgage lending through syndications will cease, and only a few larger lenders will survive. Competition will be largely diminished and private lending rates will rise to the benefit of those who can afford to survive, and to the detriment of all consumers. This includes but is not limited to the house buying consumer who needs a second mortgage or a short term bridge loan; the small builder who the banks won't lend too; the small business person seeking their own office; the home builder or businessman or anyone who has been turned down by an institutional lending system that has turned away from common sense lending, to automatic credit scoring and adjudication. What about those seniors or retirees who on limited savings require a higher then GIC rate of return to keep a roof over their heads, and food on the table? There is a huge population of elderly investors, who rely on participating in lower risk common sense syndicated mortgage investments provided by trusted mortgage brokers.

The ramification of a further failure to educate the public, the media, and our regulators of the improper use of the term "Syndicated Mortgages", and to start using "Mezzanine Mortgage Loans", is dangerous. When you combine this with a potential large scale failure by any of the companies the media has focused on, this could spell the demise of private lending as we know it. It is clear that the media has misled the public, and perhaps has influenced some of our regulators. They have accomplished this by misrepresenting the true meaning and proper application of terminology relating to mortgage syndication. It is therefore now up to us to educate them and preserve a very important part of our industry and economy.