Valuation - the real risk to mortgage fund investors

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Scope of presentation

- This presentation focuses on Mortgage Investment Corporations (MICs) and valuation issues

- Includes discussion on:
  - provisions of the Alberta Business Corporations Act (BCA)
  - consequences of poor valuations and risk to investors
  - valuation techniques – acceptable vs unacceptable practices

Note on non-MIC mortgage entities

- Trusts/Partnerships – BCA not applicable to these entities

- Provisions in Trust Indentures and Partnership Agreements relating to valuation need to be considered and understood

- Otherwise, issues relating to valuations in MIC and non-MIC contexts would be generally similar

Business Corporations Act (BCA) - overview

- Dividends and share redemptions: MIC must meet certain tests
- Two Kinds of Tests (sections 36 and 43)
  - Net Realizable Value (NRV) Test
  - Solvency Test
- Purpose of Tests
  - protect creditors
  - protect investor capital
- Directors liable to restore loss due to non-compliance
- Directors also have fiduciary duties under BCA (section 122)

Net realizable value – key concept

- Need to calculate **Net Realizable Value** (NRV) when considering dividends or redemptions
- NRV – the value realizable on sale of MIC’s assets (net of sale costs), less MIC’s liabilities
- NRV may be different from net book value (per financial statements)
- NRV dividend and redemption tests also include a share capital component

At issue

- Industry must follow reasonable standards for calculating a mortgage portfolio’s NRV
- Not using reasonable standards could result in Managers not recognizing the true risk of capital loss their impaired mortgages pose
- Potential of exposing investors to serious financial risks

BCA and valuation issues

- Primary concern is the lack of compliance with the NRV and solvency tests in sections 36 and 43 of BCA when paying dividends and redeeming shares

- Also there are issues of potentially overstating Fund valuation and performance when reporting to investors and raising new capital

BCA requirements - redeeming shares

- Fund share redemptions are subject to the limitations in section 36 of the BCA.
- Shares cannot be redeemed if there are **reasonable grounds for believing that**:

    1. the Fund would be unable to pay liabilities after redeeming those shares (**solvency test**); or
    2. the Realizable Value of the Fund's assets post-redemption would be less than the sum of the Fund's liabilities and the remaining shares valued at that redemption price (**redemption NRV test**). (Assumes one class of redeemable shares)

- In addition, assuming the above tests are met, the redemption price must not be greater than the stated or calculated redemption price as set out in the Fund's articles.

Redeeming shares - redemption NRV test

Section 36(2)(b) arithmetic formula for NRV test:

Realizable value - redemptions ≥ fund liabilities + (remaining shares x redemption price)

Table 1 Comparative effects of recognizing and not recognizing capital impairments			
	(A)	(B)	(C)
	No Impairment	**Impairment Recognized**	**Impairment Not Recognized**
	Assets	**Assets**	**Assets**
Cash	$125,000	$125,000	$125,000
Mortgages Receivable	$1,000,000	$1,000,000	$1,000,000
Provision for Credit Loss	$0	-$100,000	$0
Total Assets	**$1,125,000**	**$1,025,000**	**$1,125,000**
	Liabilities	**Liabilities**	**Liabilities**
Management Fee (2% of Stated Capital)	$20,000	$20,000	$20,000
Accounts Payable	$15,000	$15,000	$15,000
Dividends Payable	$0	$0	$0
Total Liabilities	**$35,000**	**$35,000**	**$35,000**
	Equity	**Equity**	**Equity**
Investment Shares (10,000 Shares issued $100 ea.)	$1,000,000	$1,000,000	$1,000,000
Dividends Declared	$0	$0	$0
Net Income	$90,000	-$10,000	$90,000
Total Equity	**$1,090,000**	**$990,000**	**$1,090,000**
Total Liabilities and Equity	**$1,125,000**	**$1,025,000**	**$1,125,000**
Unrecorded Mortgage Impairment	**$0**	**$0**	**$100,000**
Reported Net Book Value Per Share	$109	$99	$109
Net Realizable Value Per Share	$109	$99	$99
Reported Annual Return	9.0%	-1.0%	9.0%
Actual Annual Return	9.0%	-1.0%	-1.0%
Allowable Redemption Price Per Share	$100	$99	$99
Maximum Allowable Dividend Per Share	$9	$nil	$nil

Table 2 Alberta Business Corporations Act - redemption test

Section 36(1)&(2) - Redemption of Shares by a Fund	(A) No Impairment		(B) Impairment Recognized		(C) Impairment Not Recognized	
Calculating Redemptions						
Redemption Requested	**$25,000**		**$25,000**		**$25,000**	
Paid up Capital / Share (contemplated Redemption Price)	**$100**		**$100**		**$100**	
Dividend per Share (Paid Prior to Redemption)	$9		$0		$9	
Book Value of Assets (*After Dividend is Paid)	$1,035,000*		$1,025,000		$1,035,000*	
Unrecorded Impairment	$0		$0		$100,000	
Realizable Value of Assets	$1,035,000		$1,025,000		$935,000	
Contemplated Redemption At $100 Per Share	$25,000		$25,000		$25,000	
Realizable Value Less Redemption	**$1,010,000**	**1**	**$1,000,000**	**1**	**$910,000**	**1**
Liabilities + (Remaining Shares x Redemption Price)	**$1,010,000**	**2**	**$1,010,000**	**2**	**$1,010,000**	**2**
If 1 ≥ 2 Then Redeem At $100 Per Share	**Yes**		**No**		**No**	

BCA requirements - paying dividends

The BCA also sets limits on declaring/paying dividends, as set out in section 43

Cannot pay dividends if there are **reasonable grounds for believing that**:

1) the Fund would be unable to pay liabilities before or after the payment (**solvency test**); or
2) the Realizable Value of the Fund's assets post-dividend would be less than the sum of the Fund's liabilities and the stated capital of all classes of shares outstanding (the **dividend NRV test**)

Declaring/paying dividends – dividend NRV test

Section 43(b) arithmetic formula:

Realizable value of assets ≥ liabilities + stated capital

Stated capital

- Stated capital is usually equal to the amount paid by investors for Fund shares – e.g. the subscription price
- Once NRV goes below aggregate stated capital, the Fund will not be able to pay dividends
- In certain circumstances, stated capital can be reduced
- Legal, tax and accounting issues need to be considered if this is contemplated

Table 3 Alberta Business Corporations Act - dividend test						
	(A)		(B)		(C)	
Section 43 - Dividends Paid by a Fund						
Calculating Dividends						
Proposed Dividend per Share	**$9**		**$9**		**$9**	
Book Value of Assets	$1,125,000		$1,025,000		$1,125,000	
Unrecorded Impairment	$0		$0		$100,000	
Realizable Value of Assets	$1,125,000		$1,025,000		$1,025,000	
Proposed Dividend	$90,000		$90,000		$90,000	
Realizable Value Less Proposed Dividend	**$1,035,000**	**1**	**$935,000**	**1**	**$935,000**	**1**
Liabilities (Excluding Dividend)	$35,000		$35,000		$35,000	
Stated Capital	$1,000,000		$1,000,000		$1,000,000	
Liabilities + Stated Capital	**$1,035,000**	**2**	**$1,035,000**	**2**	**$1,035,000**	**2**
If 1 ≥ 2 Dividends May Be Paid	**Yes**		**No**		**No**	

BCA requirements – director responsibility and liability

- Directors need to consider solvency and NRV tests when voting on, or consenting to, dividend payments or share redemptions
- Directors need to establish that there are “**no reasonable grounds**” for believing solvency and NRV tests would not be satisfied when authorizing dividends and redemptions
- Section 118 of the BCA provides that Directors have personal liability if they approve redemptions or dividends in contravention of sections 36 or 43
- In case of contravention, Directors are liable to restore contravening amounts to the Fund

Other considerations

- Directors have fiduciary duties to the Fund
- Manager also has a fiduciary duty to the Fund
    - Securities Act
    - Management Agreement
- Investment Fund Manager has duty to calculate and report Net Asset Value
    - should be consistent with determination of NRV
- Manager should ensure that all Fund valuation requirements are met, including in connection with redemptions, dividend payments, reporting to investors, and raising capital

Poor valuations – negative consequences

- Long periods of real estate appreciation may make it possible for some marginal real estate investments to perform well
- Some Managers may not regularly assess the NRV of their Funds
- Issues may become evident when the real estate market abruptly declines

Negative consequences

Some negative consequences of such conduct include:

- Loss of shareholder capital
- Overstated Fund performance
- Overpayment of dividends
- Redeeming shares at a price in excess of NRV per share
- Selling new shares at a price greater than the NRV per share
- Shares being redeemed, and/or dividends being paid, in contravention of the BCA
- Managers using new investment capital to meet dividend and redemption obligations rather than to make new mortgage investments
- Directors and Manager Liability

Unacceptable practices - making matters worse

- Managers not measuring NRV regularly may not recognize impairments accordingly

- Unacceptable practices may result in Funds continuing to pay dividends, redeeming shares and reporting higher than actual yields when the NRV of their portfolio is less than their Net Book Value

Unacceptable practices

Overstating realizable value	Potential mortgage losses are understated in order to overstate the NRV.
Recapitalizing loan payments	Future mortgage payments are capitalized and added to the mortgage principal in order to keep the loan current.
Amortizing losses	Losses from liquidated mortgage receivables are amortized rather than reported when incurred.
Delaying the foreclosure	Commencement of foreclosure is delayed to avoid having to report the existence of a non-performing mortgage receivable.
Assetizing foreclosed properties	Avoiding recording a loss by putting a property on the balance sheet at the value of the defaulted loan and not the true lower value.
Accruing interest on impaired loans	A delinquent loan is being treated as current **-** with interest being accrued as if earned, which results in the overpayment of dividends, share redemptions, management fees and management bonuses.
Using "as complete" values	The "as complete" value is used to calculate and report the loan to value of a mortgage when the "as is" value is considerably less. Thus overstating the value of the security collateralizing the mortgage.

Portfolio and loan to value

- A common measure of risk in mortgage lending is **loan to value** (LTV). LTV compares the total debt financing to the total value of the real estate security
- Generally, a lower LTV implies lower risk of financial loss in the event of a foreclosure
- LTV can be misleading when applied to an entire portfolio of loans without additional disclosure of portfolio characteristics
- It is unacceptable to advertise a Fund's overall loan to value based:
  - not on the Fund's actual NRV, or
  - on the original appraised value with no consideration to the current value of the collateral for each mortgage

Portfolio and loan to value

Mortgage portfolios are typically diversified by a number of factors:

- Number of borrowers
- Types of mortgages (i.e., construction, development, fixed term, land, etc.)
- Types of mortgage security (i.e., residential, commercial, agricultural, etc.)
- Geographical location
- Mortgage priority (i.e., first, second, or third)

Portfolio and loan to value

Consider two $100M mortgage portfolios with differing risk profiles:

Mortgage Portfolio	**A**	**B**
Average LTV	75%	65%
Number of borrowers	1,000	10
Type of mortgage	Residential owner-occupied	Land development
Geographical location	Urban	Rural
Mortgage priority	First	Second

Portfolio A has lower risk profile despite having a higher average LTV

Portfolio and loan to value

- Securities regulators require issuers to disclose sufficient information to allow investors to make an informed investment decision – Form 45-106F2

- Multilateral CSA Staff Notice 45-309 notes that required disclosure may include disclosing detailed portfolio information within section 2.2 of OMs:
    - required disclosure may also include the basis of loan to value calculations, whether or not the loan is in good standing, and the nature of the security
    - the “sufficient information” test should always be considered

- This disclosure is beneficial to new investors and publicly available to existing investors on SEDAR

Correcting the problem

- The BCA requires that the NRV be calculated prior to a Fund paying dividends or redeeming shares
- Managers need to frequently and diligently calculate the NRV of their Fund's mortgage portfolio
- Managers can employ reasonable valuation methodologies to adequately anticipate the financial risk associated with a Fund's impaired mortgage receivables
- Using such methodologies will assist in properly determining a mortgage portfolio's value, in turn offering additional protection to both investors and directors

Valuation methodology and legal requirements

- Valuation methodology must meet the “reasonable grounds” (NRV tests) and fiduciary duties standards
- Realizable Value methodologies are used to determine value based on the best available information
- Use of a systematic and prudent methodology will assist in demonstrating compliance with these requirements

A defensible methodology

- A defensible valuation methodology should consider the following:

- Valuation of the security (i.e., appraisal and/or Realtor's Comparative Market Analysis)

- Value changes are measured by considering the value of comparable properties sold in the same geographical region

- Distressed properties should be valued with a "forced sale discount"

A defensible methodology

- Every valuation for impaired mortgages must include an allowance for both the real estate selling commissions and legal costs associated with foreclosure

- Additional charges such as property management, insurance, utilities, repairs and maintenance are added to the mortgage receivable as they are incurred

- Any prior encumbrances are a further reduction in Realizable Value
    - the balance of any mortgages registered on title ahead of the Fund’s mortgage, outstanding municipal taxes, condominium fees, etc.

Table 4 Realizable value calculation

Mortgage Principal	2nd mortgage		$178,500	
Charges Incurred			$4,023	
Accrued Interest			$2,403	
Mortgage Receivable			**$184,926**	**1**
Realizable Value:				
Appraisal at Jan 1 2018			$900,000.00	
Forced Sale Discount		7%	-$63,000.00	
Decline in market since Jan 1 2018		5%	-$45,000.00	
Estimated Current Market Value			**$792,000.00**	**2**
Less:				
Prior Encumbrance	1st mortgage		$581,942.00	
Property Tax Outstanding			$3,500.00	
Legal Costs (Estimate)			$12,000.00	
Real Estate Fees (Includes GST)			$29,148.00	
Total Deductions			**$626,590.00**	**3**
Realizable Value of Mortgage (2 -3)			**$165,410.00**	**4**
Provision Required (1 - 4)			**$19,516.00**	

Thank You