Changes in Financing Practice, With a Focus on Real Estate Lending

Prepared for: Legal Education Society of Alberta
51st Annual Refresher: Business

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For presentation in:
Lake Louise, Alberta – May 6 – 8, 2018

CHANGES IN FINANCING PRACTICE, WITH A FOCUS ON REAL ESTATE LENDING

As with lawyers practicing in other areas of law, lawyers acting for lenders and borrowers have seen their practices evolve over the last decade. Some of the topics to be addressed here are the impacts on lending and borrowing practices of the following:

1. the evolution of the regulatory regime governing financial institutions and other lenders. This portion of the discussion will touch on anti-money laundering requirements and requirements of the Office of the Superintendent of Financial Institutions ("OSFI");
2. privacy and security requirements governing law firms themselves;
3. the increased push to have borrowers' counsel provide enforceability opinions;
4. changes in CMHC Master Loan Insurance Policy – September 1, 2016 in comparison with the Master Loan Insurance Policy Terms and Conditions – December, 1990 – CMHC Form 2891;
5. changes in environmental law and what lenders may be concerned about in leases from an environmental perspective when lending on the security of real property;
6. the increased use of title insurance to cover the registration gap at Land Titles and lender's due diligence requirements;
7. the increased number of due diligence searches being required by lenders' lawyers; and
8. the change in lending based on relationships in light of the increased competition in the market.

More detailed information about some of the topics will be found in the Appendices at the end of these materials. These materials do not cover all changes in financing practice, but do highlight some areas where changes have increased or changed the pressures on lawyers in financing transactions.

One of the most significant changes in lending results from the increased scrutiny governing lending institutions and their operations. While all of the requirements are internal to the lending institutions, some of them also impact financing practice for borrower's and lender's lawyers. Two of the areas where we have seen changes in practice are Anti-Money Laundering requirements and OSFI's requirements and guidelines.

REGULATORY REQUIREMENTS RESPECTING ANTI-MONEY LAUNDERING ("AML")

Although the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (Canada) ("**PCMLTFA**") has been in place since 2000, it seems to have crept into financing practice more in the last 10 years than it did prior to that time.

Much of the information in this portion of the presentation comes from the Government of Canada's website at: www.fintrac-canafe.gc.ca. I will not go through the information provided on the website in detail, but further information can be found in Appendices 1 and 2 or by going to the website itself.

Who must comply with the PCMLTFA requirements?

> "Under the PCMLTFA, financial entities include:
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> > All Canadian banks, foreign banks in Canada, and full service and lending foreign bank branches in Canada. These entities are established under Canada's Bank Act and are regulated by the Office of the Superintendent of Financial Institutions (OSFI);
> >
> > Financial services cooperatives, savings and credit unions and caisses populaires that are regulated by a provincial Act; as well as credit union centrals when they provide services to anyone other than a member institution;
> >
> > Trust companies and loan companies that are regulated under the federal Trust and Loan Companies Act, or that are regulated by a provincial Act that is equivalent to the Trust and Loan Companies Act;
> >
> > Departments, agents and mandataries of the Crown that accept deposit liabilities when providing financial services to the public. Deposit liabilities are amounts that are left with the agent or mandatary of the Crown, but that the agent or mandatary of the Crown owes to the person or entity that left the funds."[1]

The impact on lending practice has been the fulfillment of the "Know your client" obligations by financial entities. While some financial entities take care of these requirements on their own without the involvement of the lawyers in the transaction, other financial entities have the lawyers assist in meeting their compliance obligations. Most of the Schedule I banks seem to take care of AML requirements directly with their borrowers. Life insurance or trust companies seem more inclined to use the assistance of the lender's lawyer in the process. Lawyers acting for the lender should ascertain when they are instructed whether the lender will be handling the AML requirements on its own or whether the lawyers will be involved in the process. Non-compliance will hold up funding and, in my experience, no one is happy when that happens.

[1] www.fintrac-canafe.gc.ca/re-ed/fin-eng.asp

In my experience, it seems to be the tendency of both lender and borrower counsel to pass the forms on to be completed without a great deal of direction or oversight, resulting in borrowers using identification which a financial institution may not accept (such as health care cards) or missing portions of the forms. In many cases, borrowers' counsel simply forwards completed forms to the lenders' counsel and lenders' counsel sends it on to the lender without review. As with all lending requirements, it is helpful if the lawyer acting for the lender can give detailed and clear instructions on the fulfillment of these requirements. Similarly, borrower's lawyers are well served by spending some time to understand the requirements and ensure that the forms are accurate and correctly completed, or to seek clarification where the information requested is unclear (for example, when dealing with a trust, is it the beneficiaries of the trust the lender wishes to identify or the trustee of the trust). Increasingly, borrower's lawyers are also being asked to certify the correctness of items being provided as evidence of ownership (i.e. share registers and organizational charts, or trust deeds), and so must take steps to satisfy themselves in terms of such certification or to qualify their certification as necessary based upon their review of minute books, partnership records, etc. My suggestion is for both borrower and lender counsel to spend a little more time on this item to avoid last minute delays in funding.

As part of the AML process, financial entities must identify beneficial owners. For the purposes of the FINTRAC requirements: "Beneficial owners are the actual persons who directly or indirectly own or control 25% or more of an entity, which includes corporations. Beneficial owners cannot be another corporation or entity, they must be the actual persons who are the equitable owners of an entity. In order to determine the beneficial owners, you must search through as many levels of information as necessary in order to determine the actual persons."[2] The use of the term "beneficial owner" in this context is distinct from whether or not the borrower entity is a trustee. The goal is to trace ownership to individuals, notwithstanding that shareholders or unitholders, as the case may be, are not "beneficial owners" from a legal perspective.

Financial entities were given a transition period to adopt the new methods of verifying identities, but effective January 24, 2018, the transition period ended and financial entities are required to fully comply with the client identification methods outlined on the Government of Canada's website at: www.fintrac-canafe.gc.ca/guidance-dirctives/client-clientele/Guide11/11-eng.asp.

[2] www.fintrac-canafe.gc.ca/guidance-directives/client-clientele/bor-eng.asp

OSFI REQUIREMENTS

OSFI regulates federally regulated financial institutions: banks, trust companies, loan companies, life insurance companies, fraternal benefit societies and property and casualty insurance companies. See http://www.osfi-bsif.gc.ca/Eng/wt-ow/Pages/wwr-er.aspx?1 for more detail about the regulated entities.

"OSFI publishes guidelines, which are essentially best or prudent practices, that it expects financial institutions to follow."[3] Financial institutions must comply with OSFI guidelines: "Guidelines are "best" or "prudent" practices that OSFI expects federally regulated financial institutions to follow. Guidelines set standards for industry activities and behaviour. They address areas such as: solvency standards (e.g., capital adequacy), prudential standards (e.g., large exposure limits), and accounting standards (e.g., non-accrual loans)."[4]

The impact on lenders' lawyers is in connection with the guidelines on sound business and financial practices, which include requirements with respect to outsourcing of business activities, functions and processes. "Under this Guideline, FREs [Federally Regulated Entities] are expected to:

- evaluate the risks associated with all existing and proposed outsourcing arrangements;
- develop a process for determining the materiality of arrangements;
- implement a program for managing and monitoring risks, commensurate with the materiality of the arrangements;
- ensure that the board of directors, chief agent or principal officer receives information sufficient to enable them to discharge their duties under this Guideline; and
- refrain from outsourcing certain business activities to the external auditor (see Section 4.3)."[5]

Further, the guidelines provide that: "At a minimum, the contract or outsourcing agreement is expected to set out the FRE's requirements for confidentiality and security. Ideally, the security and confidentiality policies adopted by the service provider would be commensurate with those of the FRE and should meet a reasonable standard in the circumstances. The contract or outsourcing agreement should address which party has responsibility for protection mechanisms, the scope of

[3] http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/default.aspx

[4] http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/default.aspx

[5]http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/b10.aspx