What the German Report Got Wrong

Money laundering is a serious hindrance to housing affordability and the functioning of the mortgage industry, so it's important to get the facts straight

BY SAMANTHA GALE

Many members of the mortgage industry will be aware of the British Columbia government's recent probe into money laundering in the real estate sector, which takes a good, long, hard look at the role of mortgages in cleaning dirty money. Two government reports came out of B.C., the impact of which will in all likelihood reverberate throughout the country.

A B.C. Ministry of Finance Report estimates that over $5 billion has been laundered through the sale, mortgaging and flipping of real estate, primarily funnelled through Canada's most expensive city, Vancouver. According to the report's authors, this activity amounts to about five per cent of all real estate transactions, and has the unintended impact of escalating real estate values by about five per cent. If the conclusions of the authors are true, money laundering has a real impact on the mortgage industry's client base, by making home ownership even less affordable.

A second report came from former RCMP deputy commissioner Peter German, entitled "Dirty Money." It concludes that Canadian real estate has become a hotbed of money laundering for international criminals. This is primarily due to lax financial reporting rules combined with vastly inadequate policing and prosecutorial resources directed to curbing white-collar crime. German found international organized criminals, such as Joaquín "El Chapo" Guzmán's Sinaloa Cartel, the mainland Chinese gang called the Big Circle Boys and Iranian-based gangs to be embedded and active throughout Metro Vancouver.

According to legal analyst Kevin Comeau, money laundering is challenging to detect as it is a derivative crime. Criminals are able to disguise the origin of illegally obtained funds so they look like they are from a legitimate source.

The predicate crime, such as drug or human trafficking, occurs long before the multi-layered laundering activity. "That separation of time, place and actors creates the appearance of a benign event – merely another legitimate transaction in a world of millions of legitimate transactions." The crime of money laundering is therefore seemingly invisible and profoundly challenging to detect.

In the real estate sector, recent skyrocketing real estate prices in Canada's major urban centres created an undeniable feeding frenzy, with flippers looking for a quick, easy lift. A surge of legitimate cash changing hands through real estate transactions gave launderers the ideal backdrop to launder significant illegally obtained funds without a serious risk of detection.

To help prevent money laundering, German and others have made a lengthy list of recommendations which essentially aim to beef up policing resources and create more transparency with corporate structures and real estate transactions. CMBA-BC got behind the problem by teaming up with other real estate industry groups and making its own recommendations for shared industry best practices, which include:

1. All real estate sector professionals accept funds only in forms that are verifiable through Canadian financial institutions.

2. Anti-money laundering education be mandated for mortgage and other professionals so that they are trained in recognizing and reporting suspicious transactions.

3. Federal anti-money laundering legislation allow FINTRAC intelligence to be made available to additional regulatory authorities.

4. Governments and regulatory agencies, including FINTRAC, better utilize on-the-ground experience of real estate professionals to develop compliance resources and test policy ideas. This will more likely result in well crafted, practical regulation and foster a culture of compliance to protect consumers and the economy.

5. FINTRAC implement a framework to identify and report trends on a regular basis and do so in language that is consistent and understandable to professionals, the public and the media.

Very clearly, the mortgage industry holds a shared, universal view that there is no place for money laundering in the real estate sector and supports reforms to ensure the elimination of money laundering. However, one challenge is that the government needs to learn from industry to get a more accurate understanding of how it works and is regulated. The term "unregulated lenders" is riddled throughout the German report and is intended to refer to private mortgage lenders. Of course this is a complete misnomer; private mortgage lenders are regulated by both mortgage broker and securities regulators.

In scrutinizing the mortgage industry closely, the German report makes a startling number of false conclusions, some of which are as follows:

■ The German report makes several statements indicating that private lenders are "not subject to statutory AML oversight." It accordingly suggests extending AML legislation to certain classes of unregulated lenders, such as mortgage investment corporations. Fact check: Private mortgage lenders which capital raise under securities legislation, such as mortgage investment corporations, are required to comply with mandatory AML reporting requirements as securities dealers.

■ The German report finds mortgages discharged within a year as suspicious, as homeowners usually "take many years to repay a mortgage." If a mortgage is quickly repaid, it "suggests that the borrower has access to significant capital and/or cash flow and may be an indication that they withheld funds from their purchase by choice." Fact check: As the industry is well aware, it is standard practice for private mortgage lenders to require borrowers to have an exit plan so that they do not hold the mortgage long term. Mortgage brokers are experts in finding exit strategies for private mortgage borrowers – this is part of their job, and hardly suspicious.

■ In one footnote, the German report states: "FICOM regulates brokers, not borrowers or lenders (unless they are credit unions, insurers or trust companies)." Fact check: This statement is patently wrong. The Registrar of Mortgage Brokers, housed in FICOM, licenses mortgage lenders under the Mortgage Brokers Act. In fact, in B.C. not only are mortgage lending entities required to obtain mortgage broker registration, but so too are all employees who perform lending activities on behalf of the entity. In this regard, B.C. has more stringent licensing requirements for private mortgage lenders than other provinces.

■ The German report states, "Private lenders, including MICs ... are not subject to the same regulations as banks and credit unions (including market conduct regulations and AML reporting)." Fact check: As stated above, private lenders and employees who engage in mortgage lending, administration and brokering actives must be licensed under the Mortgage Brokers Act. Licensing programs are by their very nature market conduct regulation. Licensees must undertake education qualification, be subject to suitability reviews and abide by a set of statutory prohibitions and requirements. Those licensees who fail to follow market conduct rules potentially face discipline by their regulator. There is transparency in the discipline process of mortgage brokers and lenders as allegations against them in the form of notices of hearing and final adjudications in the form of orders are published for all to see. Mortgage lenders who engage in capital-raising activities also require additional licensing as securities dealers – not a light licensing regime by any industry standard.

The German Report's incessant use of the term "unregulated lenders" to describe private mortgage lenders and its view that banks are subject to superior market conduct oversight demonstrates a lack of understanding of the mortgage industry.

Whereas mortgage brokers are regulated by provincial legislation, banks are regulated by federal legislation. Accordingly, they are held to different regulatory standards in many respects, such as those concerning reporting, registering of employees and disclosure to the customer/client. In many respects (such as duty to the client and acceptable sales practices), individual mortgage brokers are regulated more strictly than are individual bank employees. In other respects (such as continuing financial viability), the entity of a bank is more strictly regulated than is the entity of a mortgage brokerage.

The German Report's incessant use of the term "unregulated lenders" to describe private mortgage lenders and its view that banks are subject to superior (rather than different) market conduct oversight demonstrates a lack of understanding of the mortgage industry and its regulation. In order to properly tackle money-laundering problems in the mortgage sector and make appropriate policy reforms, a solid understanding of the mortgage industry and its regulation is an absolute necessity.

Money laundering is a serious problem desired by neither government nor industry – understanding and collaboration will be the keys to success in tackling it.