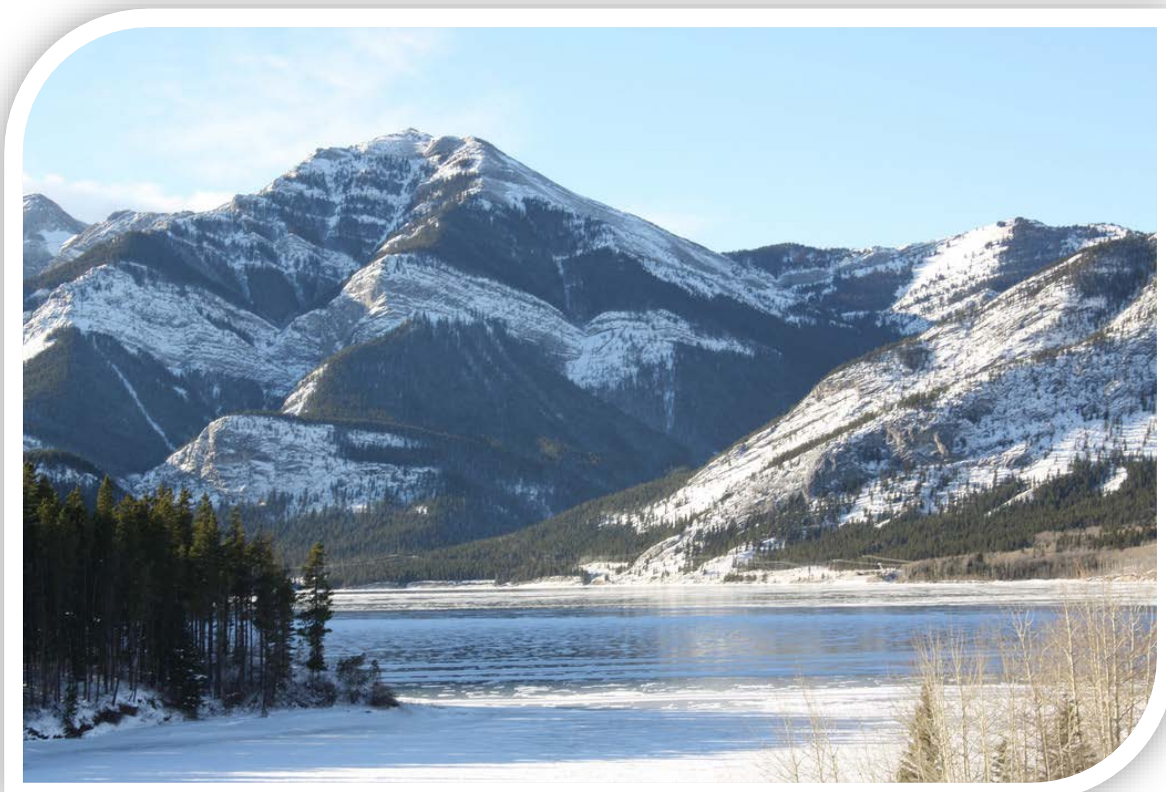
Alberta and BC Real Estate Foundations: Revenue Concept Paper



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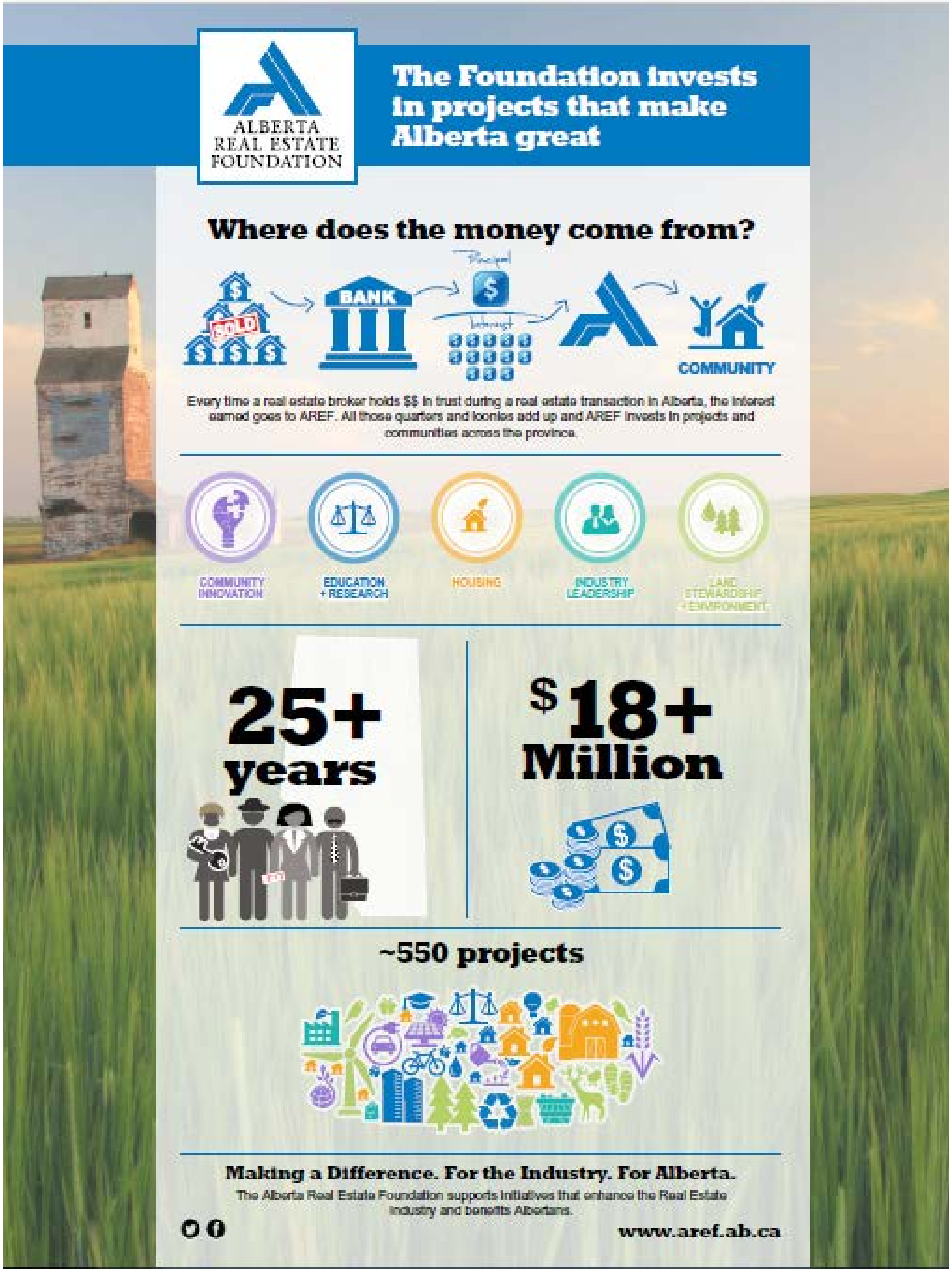
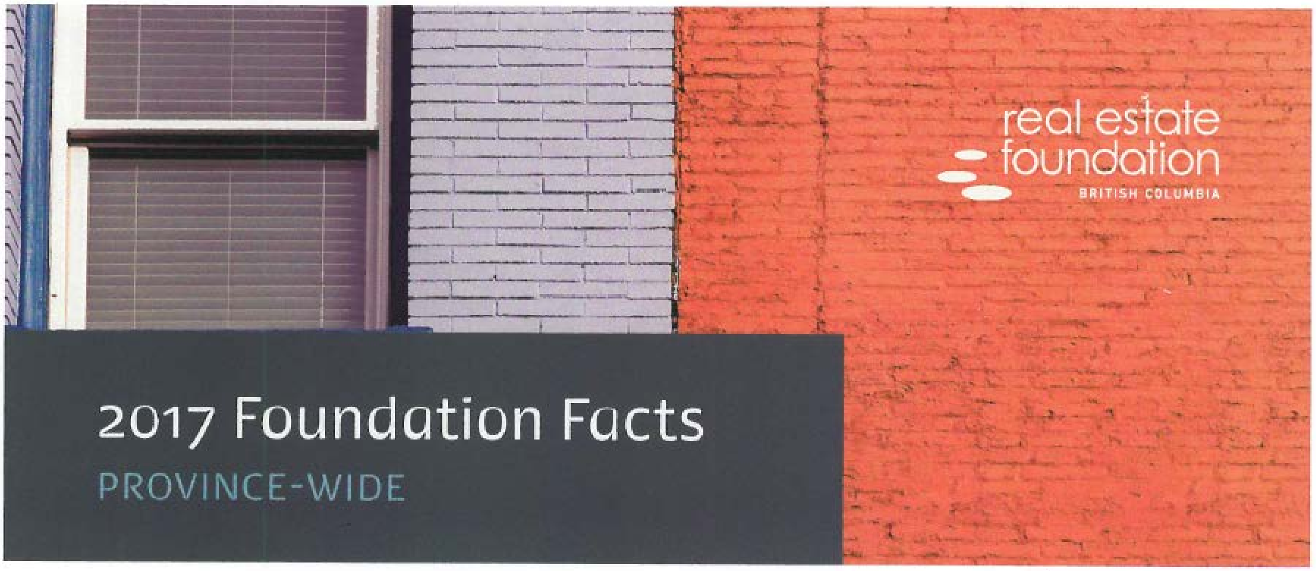

ALBERTA
REAL ESTATE
FOUNDATION
The Foundation invests in projects that make Alberta great
Where does the money come from?
SOLD
BANK
Principal
Interest
COMMUNITY
Every time a real estate broker holds $$ in trust during a real estate transaction in Alberta, the interest earned goes to AREF. All those quarters and loonies add up and AREF invests in projects and communities across the province.
COMMUNITY INNOVATION
EDUCATION + RESEARCH
HOUSING
INDUSTRY LEADERSHIP
LAND STEWARDSHIP + ENVIRONMENT
25+ years
$18+ Million
~550 projects
Making a Difference. For the Industry. For Alberta.
The Alberta Real Estate Foundation supports initiatives that enhance the Real Estate industry and benefits Albertans.
www.aref.ab.ca



2017 Foundation Facts

PROVINCE-WIDE

The Real Estate Foundation of BC

We're a philanthropic organization that helps advance sustainable land use in BC. We do this in two ways: by making grants to non-profit organizations working on land use and real estate projects, and by leading on initiatives that bring leaders together and fill knowledge gaps.

Our funding helps support research, education, and law and policy reform in the following areas:

- Sustainable Land Use
- Built Environment Sustainability
- Freshwater Sustainability
- Local & Sustainable Food Systems
- Professional Excellence in Real Estate

By supporting innovative and progressive projects, the Foundation's work contributes to resilient, healthy communities and natural environments.

2016 Grant Making

117
grant applications received

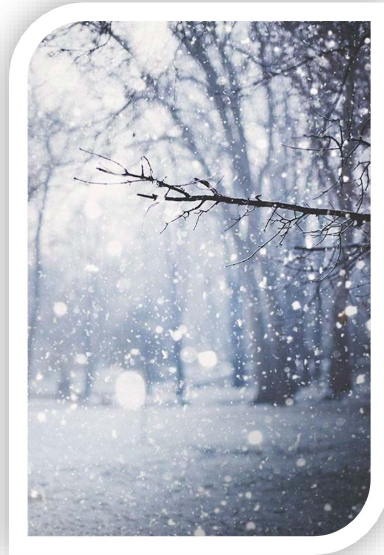
54
grant projects approved

>$3.5M
in funding disbursed

REFBC: Grants/Year ($)

Executive Summary

Real estate purchase agreements typically include a deposit held in trust until closing. Unique among the provinces, since 1985 and 1991 respectively, the interest earned on pooled trust account balances has been directed by provincial law to the BC and Alberta real estate foundations to distribute for the public good. **It's time to update workflows**.



Lower interest rates coupled with higher banking fees have compressed revenues for the foundations. Stakeholders expect efficient processes for making and archiving transactions. There is a compliance burden on industry to combat money laundering and terrorism financing and to reconcile principal, interest and fees on the deposits. Finally, changes in banking regulation have made short-term commercial deposits less attractive to financial institutions.

Based on initial stakeholder consultation, this paper proposes the collaborative development of a compliance and transaction hub. This fintech solution modernizes workflows for clients and professionals, implements regulatory best practice, and enhances foundation revenue.

Low Interest Rates

Compliance

Legacy Procedures

Bank Regulation

Contents

Stakeholders

The real estate industry is an important driver of economic activity and delivers a vital service for clients' personal, commercial, and financial lives. We begin by outlining the ecosystem of stakeholders.

1. Buyers and Sellers

The transaction is large and highly personal, and not repeated many times. Clients are increasingly "digital first", or can be coached by the Realtor.

2. Real estate professionals (Realtors)

Each side has a real estate professional that has a personal relationship with the client. Real estate professionals are keen adopters of technology and are client-focused. Realtors vary significantly in levels of activity (from 1 or 2 deals per year to dozens), sophistication, and resources (including say their own team of staff).

3. Real Estate brokerages

The brokerage office is responsible for handling the deposit and is regulated by the real estate council for compliance with FINTRAC and anti-terrorism financing regulation as well as practices for reconciliation of interest, fees, and principal transfers. Brokerages range significantly in size and sophistication. There are 990 brokerages registered in Alberta and 1700 in BC. Brokerages say they have anxiety over compliance expectations and costs. They say it can be challenging to ensure that the largely independent, entrepreneurial Realtors complete the required compliance items.

4. Lawyers and Notaries

To finalize the transaction, a lawyer or notary handles contracts and uses *another trust account* to collect and distribute cash from the buyer and buyer's lender to the seller and seller's lender. The law foundations operate similarly to the RE foundations, collecting interest on larger trust balances over shorter periods.

5. Trust account financial institutions

Trust accounts are usually at a bank or credit union (or ATB in Alberta). It is required that deposits be held in an interest-bearing account at a deposit-taking institution (DTI). Each DTI pools deposits into a consolidated account, and remits interest-less-fees to the real estate foundation. Therefore the foundations maintain relationships with about 40 institutions. This business is considered part of commercial banking and the rates are often set system-wide, not just for RE trust accounts. See the section on Basel III.

6. Mortgage providers and mortgage brokers

Not a big part of this paper. However, they may have similar compliance needs. The transaction quantities are larger and intermediated by lawyer/notary.

7. Regulators

RECA and BCREC are real estate councils that regulate brokerages by enforcing the Real Estate Act. They help to enforce requirements from FINTRAC and OSFI.

8. BC and Alberta Real Estate Foundations

The foundations use revenue and their accumulated investment portfolios to make grants across a variety of interest areas including land use, freshwater sustainability, industry leadership, and community innovation. REFBC granted $3.3 million per year over the past 5 years. Recipients are typically other foundations, societies or universities, including the Westman Center for Real Estate Studies at the Haskayne School.

Pain Points

- ❖ Deposit cheques are inconvenient and may be lost. Other transfers (to foundation, to lawyers, etc.) are similarly outdated.
- ❖ ID verification and "character assessment" are responsibility of brokerages, but performed by real estate professionals. Pain point is how to reliably enforce completion and documentation of these tasks.
- ❖ Buy-side brokerages and professionals have counterparty risk on their fees, because commission is first collected from the seller. There have been examples of brokerage bankruptcy. In fact, sell-side professionals face counterparty risk from their own brokerage too.
- ❖ Foundation has limited influence with banks to negotiate better rate and fees

The Principal-Agent Problem

The underlying economic concept that drives the current situation is the principal-agent problem. Brokerages choose their 'home bank' for their trust account for familiarity and to enhance their total client relationship. (More than one brokerage said that this choice is vital to facilitate easy transfers between the trust account and business account, but it's not clear what transfers they are talking about. Should they be transferring assets to their business account?) However, the economic value of interest-minus-fees belongs to the public via the foundation. The foundation would prefer long-term best service, interest rate, and lowest fees, whereas the actual decision falls to the brokerage without those incentives. The story here is not that the brokerage is negligent or inappropriate, but rather that they are not aligned to maximize foundation revenue.

Basel III and the Liquidity Coverage Ratio

Basel III is the latest set of global bank regulations interpretated and implemented locally by OSFI (Office of the Superintendant of Financial Institutions). Among other provisions, institutions must maintain a LCR (Liquidity Coverage Ratio) of over 100%. The LCR denominator is under 30-day liabilities such as demand deposits. The LCR numerator is unencumbered High Quality Liquid Assets (such as Canada bonds and NHA MBS). If trust account deposits count entirely as 30-day liabilities, then the bank must effectively hold low-yield/high-liquidity assets equal to the deposit, therefore cannot use the deposits to support lending. On the other hand, increased consolidation of the trust balances appears to help significantly because while individual deposits flow in and out in 3-6 weeks, the balance is perpetual. More work is required to understand the implementation of this regulation. Of particular interest is whether detailed cash flow forecasting (using contracted close dates attached to deposits) would help get better treatment under Basel III. Put another way, independent of Basel III, liquidity management matters to banks so these positive factors should matter generally.

Key questions: Does account consolidation help? Does detailed forecasting help?

Previous Efforts and Successes

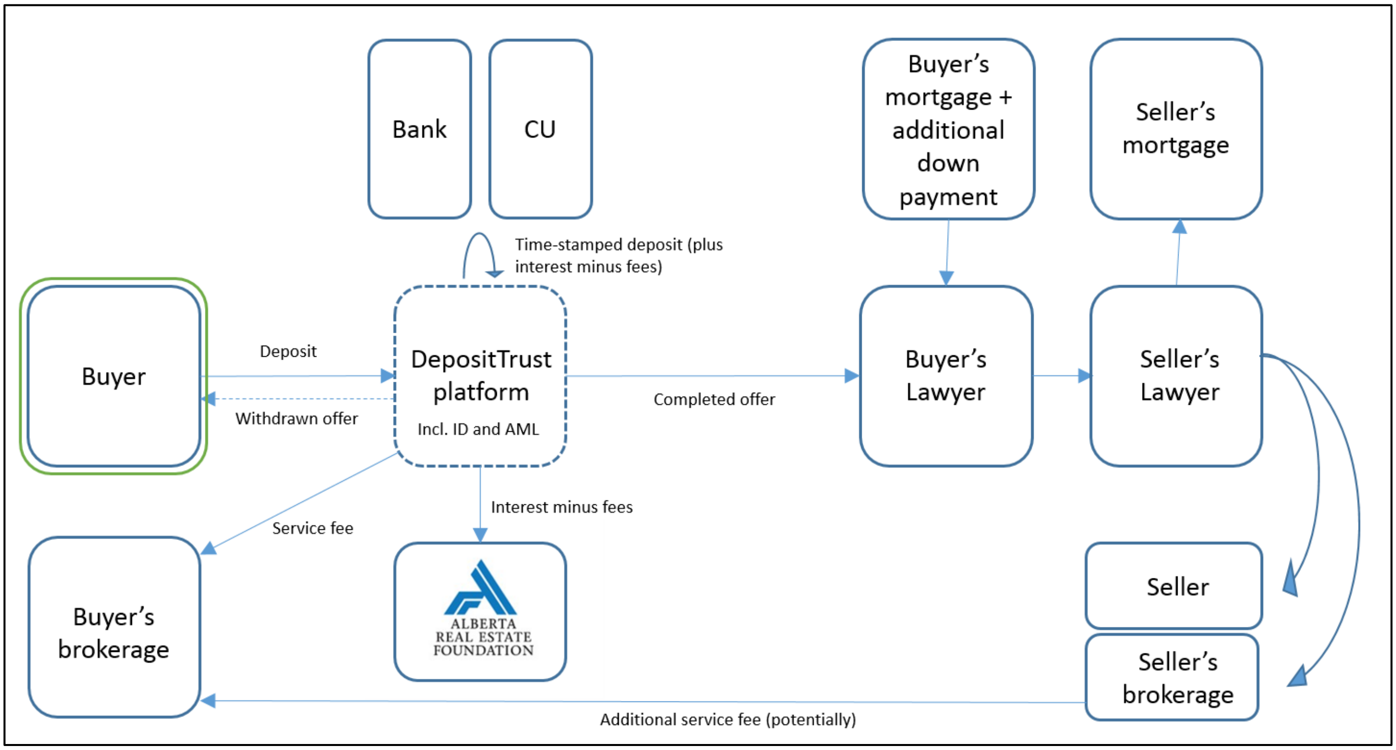
Minimum interest rates have been imposed or suggested by the province as a solution to low rates. Similarly the foundations have experimented with negotiating or publishing competitor rates. The provinces have used their influence to persuade banks to pay a better rate. These measures are likely not sustainable or desirable.

An example of a successful technology adoption is electronic signatures (such as Docusign) for offer agreements. Facilitated by real estate professionals and brokerages eager to streamline their practice, e-signatures are now accepted by industry and appreciated by clients. The security and authenticity is better than paper signatures and the paper trial is more complete.

Imagining a Solution

The real estate industry has an opportunity to show leadership by using technology to improve workflows, tighten up compliance documentation, reduce banking fees, and increase interest revenue to the foundations to support the public good. We imagine a fintech solution that captures and systematizes best practices of real estate professionals, brokerages and banks for client identification, documentation, money transfer, and liquidity management. We imagine a user experience so much better than existing workflows that brokerages voluntarily migrate. Then, we solve the principal-agent problem by consolidating accounts with one or two deposit-taking institutions at the choice of the foundation. The proposal is sketched in Figure 1 below.

Figure 1 – Concept diagram showing flows of funds. Shown to facilitate discussion.



Future Ready: Blockchain, Digital Identity, and Payments infrastructure

Blockchain is a promising emerging technology to systematize the concept of trust. It is potentially suited for the recording of events, identities, and transactions. At this stage large organizations and start-ups are experimenting with blockchain use cases, and the real estate transaction ecosystem appears to be in that wheelhouse. A key point is that blockchain technology does not replace a transaction and database infrastructure, but rather sits atop it to enhance trust. In other words, blockchain appears to be a new ketchup for hotdogs, not the advent of tofu dogs.

DIACC is the Canadian coalition developing the rails for next generation management of digital identity and authentication. We will soon be moving beyond username/password for electronic banking and other secure transactions and contracts. Again, the real estate transaction ecosystem appears to be right in the wheelhouse of this innovation, particularly the initial deposit. This is a nearer term implementation than blockchain, and will require business practice modernization.

Payments Canada is the trade name of the Canadian Payments Association which standardizes and facilitates the whole system of electronic transfers, cheques, wires, bill payments, Interac, and credit card payments. Canada has typically been a leader in adoption of payments innovation for example Interac and contactless point of sale systems. On the other hand, the main payments systems are lagging some international peers. The highest priority update is moving to the planning stage: the upgrade to ISO 20022. This standard bundles a payment with a message. To illustrate, think of the short text descriptions for each banking transaction that appear on a statement. These are limited to 140 characters in the current system often leaving them hard to understand. The ISO 20022 upgrade, already implemented elsewhere, would allow a longer, richer message connected to the payment, including identity information. This modernization could be important and timely for an enhanced implementation for real estate deposits.

Consultation and other Next Steps

This paper is a early draft and aims to encourage future consultation. Implementation steps will certainly include many more iterations of specification and a sequence of pilots.

With or without a significant fintech implementation, a structure with a single deposit-taking institution (bank or credit union) is worth more exploration. This means further conversations with potential DTIs and with brokerages. At this point, consultations indicate that many brokerages would find any change to be unwanted, so much more work is needed to understand their needs, and facilitate their processes to benefit from the change.

More work with the government of Alberta and BC will also be helpful at this stage.

Conclusion

Around 30 years ago, BC and Alberta demonstated characteristic western ingenuity by developing a unique industry-led solution, in collaboration with regulators and government, to ethically serve clients and the public good. This paper builds on that success by inviting the industry into continued leadership. Join the foundations to continue *getting it done* for the modern business environment characterised by low interest rates, high compliance demands, remarkable technology innovation, and client expectations shaped by Uber, Netflix, and Amazon.