Letter from the President

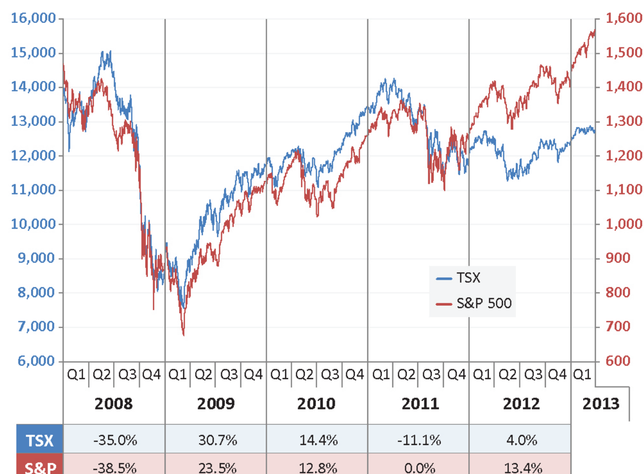
U.S. and Canadian Securities Industries: Why the Difference in Earnings Results?

Vol. 60

At first glance, the Canadian and U.S. securities industries look a lot alike. Both are divided between large, bank-owned, full-service dealers with a national scope, and a large contingent of small, specialized, and regionally diverse institutional and retail boutiques of varying size. Both have faced similar challenges stemming from the 2008 financial meltdown. And both have seen vigorous regulatory reform over the past few years.

However, a closer examination of both industries reveals significant differences – in performance, structure and operations, both among the large bank-owned firms and the specialized boutiques. Those differences explain the divergence in industry earnings.

TSX v. S&P



Source: S&P

For both the Canadian and U.S. industries the sudden collapse in financial markets in late 2008 triggered ensuing volatility and a dent in investor confidence, followed by a subsequent period of market recovery, with massive regulatory reform in the intervening years. While the market collapse eviscerated the investment banking and retail businesses in the securities industry on both sides of the border, earnings performance since then has been markedly different – reflecting indigenous market conditions and structural differences in the respective industries. Regulatory reform and tougher compliance standards have pulled down earnings. But here too, the impact has been different in both countries.

Canadian vs. U.S. Industry Earnings: Domestic Equity Market Performance is Key

Earnings in the Canadian industry recovered quickly in 2009-10, led by strengthening commodities markets and related financing and securities trading. Net profit for Canadian firms rebounded 53% in 2009, following a 32% profit setback in 2008. Both the integrated and the boutique firms shared in the profit rebound. Meanwhile, the U.S. industry continued to slide into progressively weaker profitability throughout this period. After collapsing by a dramatic 515% in 2008, net profits in the U.S. industry fell a further 50% in 2010-11. But then in 2012 the profit picture in the U.S. industry decisively reversed course while in Canada profits moved lower in 2011 and 2012.

Securities Industry Performance

	C$ Billions	2008	2009	2010	2011	2012e	08/07	09/08	10/09	11/10	12e/11
Canada	Revenue	14.6	16.3	15.9	16.1	15.1	*-15%*	*12%*	*-3%*	*2%*	*-7%*
	Expenses*	6.5	6.6	6.8	7.4	7.3	*4%*	*0%*	*4%*	*8%*	*-1%*
	Net Profit	1.9	2.9	2.4	2.0	2.1	*-32%*	*53%*	*-17%*	*-15%*	*2%*
	US$ Billions										
U.S.	Revenue	290.5	278.9	254.8	238.9	254.9	*-39%*	*-4%*	*-9%*	*-6%*	*7%*
	Expenses*	227.9	112.7	118.4	122.6	118.7	*-31%*	*-51%*	*5%*	*3%*	*-3%*
	Net Profit	-24.7	49.5	24.8	11.3	25.2	*-515%*	*300%*	*-50%*	*-55%*	*124%*

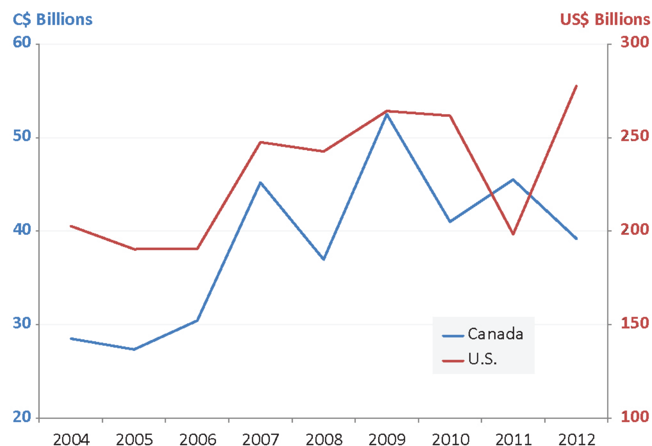
*excludes variable compensation

Source: SIFMA, IIAC

The marked difference in profit performance for the respective industries last year largely reflects the differing movement in domestic equity markets that drives institutional and retail business at the integrated and specialized firms. Canadian stock markets reflecting their heavy resource weighting rebounded strongly in 2009 and 2010. Canadian markets then tumbled in 2011 through 2012, taking down the performance of the Canadian industry. Operating profit at the retail boutiques disappeared last year, down from an average of $600 million in 2007. Profit for the institutional boutiques was sliced in half

from 2010 levels, one-third below profit in 2007. The integrated firms largely held their ground in 2011 and 2012.

U.S. equity markets skidded sideways through 2009-10, heavily influenced by the European crisis and political gridlock in dealing with the U.S. fiscal deficit. Earnings at the large U.S. dealers were also hampered by the drag of non-performing assets, the legacy of pre-crash derivative asset holdings, and greater business presence and exposure to difficult European markets. ROEs at the large U.S. bank-owned dealers tended to range between 5-10% in 2009-2011, half the ROEs of their Canadian counterparts. But by mid 2011 conditions reversed. U.S. equity markets began a sustained upward move, with the S&P Composite Index up 13% compared with a 4% increase in the S&P TSX Composite Index in 2012. Net profit for the U.S. securities industry rebounded dramatically last year, up 124%.



U.S. Regulatory Reforms More Sudden, Far Reaching

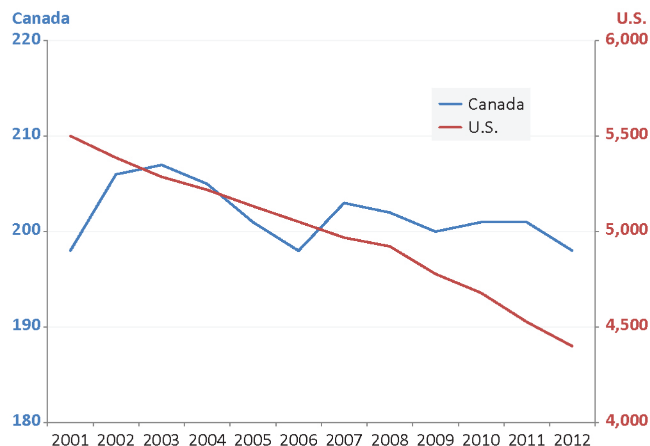
In the last four years the Canadian and U.S. securities industries have experienced widespread regulatory reform, in response to the 2008 financial meltdown and to structural change that swept equity markets in both countries. Here again, on closer examination, significant differences appear, exerting differing impact on firms in the respective industries. The reform process has been extensive in both countries, with new rules adding significantly to the cost burden of both industries.

The reforms in the U.S., however, have been more far-reaching. U.S. firms, especially the large bank-owned firms, have been forced to adapt to new rules to repair systemic weaknesses in the U.S. financial markets, revealed in the widespread bank and dealer bankruptcies and bailouts. This has meant structural changes in the regulatory framework, such as an oversight Resolution Authority and related rule framework, and rules to mitigate institutional risk, the most important being the Volcker Rule. Once finalized, the large U.S. dealers will be required to jettison their proprietary trading businesses. At the same time, the Dodd-Frank legislation has caused the SEC and the self-regulator FINRA to implement an extensive array of rules related to disclosure, capital and market conduct in both the cash and derivatives markets.

The pace of regulatory reform has not only been more widespread in the United States, reflecting the reverberation of the financial crash on U.S. institutions and markets, but has been concentrated within the four-year post-crisis period. In Canada, on the other hand, the Client Relationship Model, the comprehensive rule package governing the client-advisor relationship, as well as disclosure and compliance requirements of the OTC derivatives markets, began to take shape well before the 2008 financial crash, enabling a longer consultation period and more time to adapt to the new reforms.

U.S. Firms: Platform Efficiencies and Larger Average Accounts

Other factors have contributed to the difference in earning performance in recent years, especially the past year of surging profit at the U.S. firms. The small firm grouping in the United States has moved en masse to rely on carrying firm platforms reflecting the costs of self-clearing and the related escalation in capital charges and other regulatory requirements. However, in Canada, more than half of the small firms are still self-clearers. The retention of self-clearing is the result of historical precedent and effective clearing technology, but firms will likely evolve over time to platforms.

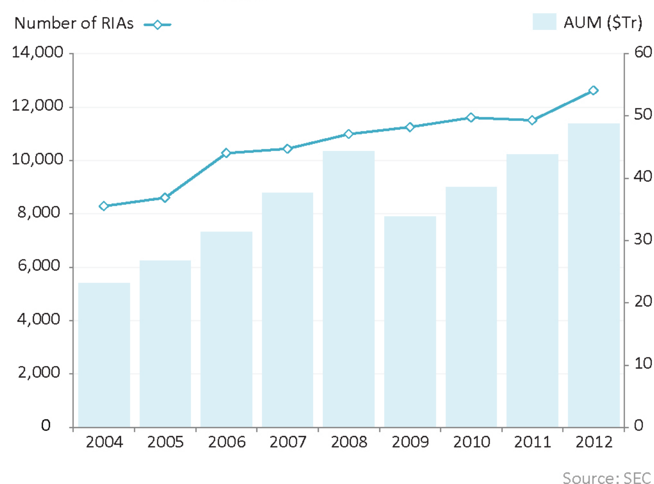


The carrying brokers in the United States – Schwab, Fidelity, Pershing, First Clearing, and TD Ameritrade – provide effective and comprehensive business and compliance support to the registered broker-dealers and RIAs, in terms of product, financial services and extensive compliance offerings, as well as other services such as advisor recruiting. The U.S. carrying firms are also prepared to take on the compliance burden for small firms, unlike their Canadian counterparts, and as well the U.S. regulatory system is more flexible, permitting the outsourcing of compliance. Further, for the retail broker-dealers and RIAs, average account size at $250K is more than double the Canadian average, resulting in higher net earnings. Similarly, assets under management per firm are about twice the average holdings at Canadian firms.

Finally, the U.S. industry has been well positioned to capitalize on the client preference shift towards discretionary managed accounts, given the large number of RIA firms specializing in this business complementing the traditional broker-dealers. The RIAs compete aggressively for this business through sophisticated technology platforms that offer a wide array of third-party managed funds and different custodial arrangements. Assets under management at RIA firms has vaulted by nearly one-third to $50 trillion in the five years ended 2012.

Canadian firms have also responded to growing client interest in discretionary managed accounts, offering a variety of options, from portfolios of pooled funds to customized discretionary accounts managed in-house or with third parties.

Growth of RIAs in the U.S.



Source: SEC

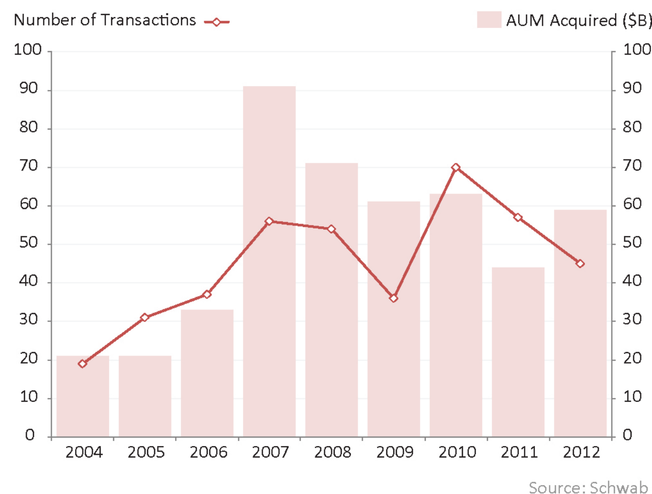
Structural Change in the U.S. and Canadian Securities Industries

The four-year period of collapsing earnings performance in the U.S. securities industry, combined with the ramp-up in fixed costs (mainly from the escalating regulatory burden), has triggered a rapid pace of consolidation among the 5,000 broker-dealers and 13,000 RIAs registered with the SEC. For example, SIFMA data indicate that roughly 500 firms (measured on a net basis adjusted for new entrants and resignations), about 10% of the total, closed operations in the past five years.

The acquirers of the U.S. firms have come from all segments of the market, large bank-owned dealers and many mid-sized independent RIA firms and broker-dealers. For example, firms like United Capital have acquired 42 small RIA firms alone in the past several years. Despite the rapid rate of consolidation, the aggregate number of RIAs has increased modestly reflecting new entrants and a shift of firms from the traditional broker-dealer model to the RIA channel. Most RIA firms rely on carrying brokers for business and compliance support.

Consolidation is also happening in an indirect way as larger firms in the U.S. bid aggressively for advisors. This recruitment effort pulls client assets from the small firms with a debilitating effect on critical mass and scale. The bidding for advisor talent has also forced up costs for small firms through higher payout ratios in an effort to retain brokers. A recent poll of broker-dealer executives has highlighted that broker recruitment by the larger firms is the biggest challenge confronting small firms. The improving market conditions in the past year may have come too late for many firms.

RIA Consolidation in the U.S.



Source: Schwab

In Canada, the pace of consolidation has been slower, with only two firms (1% of IIROC-registered dealers) on balance exiting the business in the past four years, compared to roughly 400 in the U.S. (8% of SEC-registered firms). Evidence also indicates that larger integrated firms have bid aggressively for top performing brokers, putting additional pressure on the small firms, similar to the practice in the U.S. Unless market conditions continue to improve, and corporate issuers and institutional and retail investors engage more actively in the markets boosting earnings performance, more acquisitions and firm closures are on the horizon.

Special recognition to Eon Song, Capital Markets Analyst, for analytical and technical support.

Yours sincerely,

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