Letter from the President

Global Credit Markets at a Crossroads: Implications for Canada

Thoughts and perspective from the ICMA Annual Meeting and Conference

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As President and CEO of the Investment Industry Association of Canada (IIAC) and Chairman of the International Council of Securities Associations (ICSA), I am honoured and proud to promote and raise awareness of Canada's securities industry and our capital markets internationally.

In my roles, I also take every opportunity to urge greater regulatory cooperation and coordination across jurisdictions to facilitate cross-border transactions and to improve market liquidity and depth.

On June 4-5, 2015, I participated in the International Capital Market Association (ICMA) Annual General Meeting and Conference in Amsterdam—perhaps the foremost venue to understand the leading edge trends in global and European credit markets and the direction of regulatory reform.

The initial impression from presentations and informal discussion at the ICMA event was that market and economic conditions have not changed much over the past few years. A large number of developed economies still find themselves in a liquidity trap, with low interest rates unable to spur investment or consumption. Presenters at the conference noted that the primary market for investment-grade corporate bonds has been robust for several years as corporates make use of comparatively low rates to raise debt for refinancing and acquisitions. On the other hand, secondary markets activity—where investors purchase securities and assets from other investors rather than from issuing companies (and designated primary dealers provide continuous bid and offer prices to execute reasonably sized transactions)—has remained correspondingly weak. This reflects several factors, with increased capital and leverage requirements on market-makers being the more important.

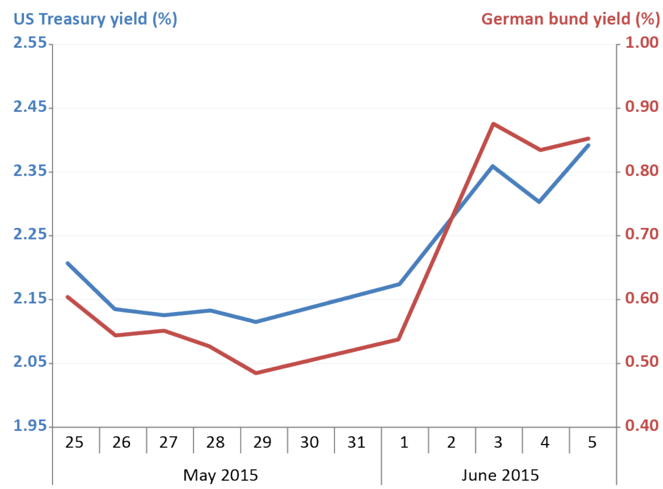
But first impressions do not always tell the entire story. As the conference program unfolded over a day-and-a-half, new insights emerged from the discussions.

Global credit markets are at an important crossroads, with investors and intermediaries sensing imminent economic and financial adjustment. The concern among market participants is the magnitude of the shocks could be significant and the follow-on impact on capital markets substantial, given the thin veneer of liquidity.

First, the pronounced ascent in long-term bond yields (the 10-year German bund yield has soared and North American 10-year yields have also risen sharply) is evidence of jittery markets and more upbeat economic data. This increased volatility became evident in the late spring and is expected to continue into the foreseeable future.

Soaring Bond Yields

10Y Treasury and German bund yields



Source: Bloomberg

Second, the global economic recovery remains uneven, opening up gaps in economic performance and subsequent differences in the stance of monetary policy. Widening interest rate differentials will spur more volatile currency markets.

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Third, risk of a Greek default and exit from the eurozone and a bevy of geo-political concerns from a renewed Cold War with Russia, chaos in the Middle East and tensions in the South China Sea, have added to uncertainty.

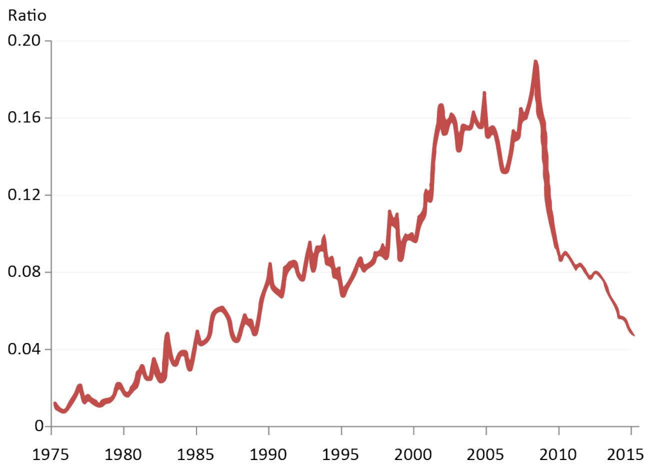
Finally, the Chinese economy is facing significant challenges. There remains pervasive uncertainty, leaving opinion divided between a mild pickup in growth, or continued insipid economic performance. For the rest of the world, how China fares is important for commodity demand and global savings.

Thinned-out credit market liquidity

The increased interest rate volatility and greater uncertainty about the outlook for markets and the global economy has put further pressure on liquidity in credit markets. Consistently available bid and offer prices for reasonable transactions are generally limited to large investment grade credits.

Evaporating Liquidity in the Bond Market

Treasuries held by dealers to total marketable treasuries



Source: Deutsche Bank

The direction of further planned reforms in credit markets will likely aggravate the liquidity problem in secondary markets. Even though much reform has taken place, most has been directed to improving the soundness and stability of the banking system, with tougher rules for capital, increased liquidity requirements and restrictions on leverage. The banking system is now more resilient to financial and economic shocks than six years ago. Reforms have also increased investor protection, with institutions directed to provide greater disclosure and transparency in products and fees charged, and implementation of rules governing the standard of conduct between advisors and their clients.

Regulatory initiatives: Will they further reduce liquidity?

Canadian regulators have moved in lockstep with the European and US regulators. The focus has been on implementing the Basel III requirements and extensive regulations related to the Client Relationship Model (CRM). Canadian regulators have also tightened rules governing registration and professional standards in the capital markets.

Canadian regulators and their global counterparts have also imposed a new rule framework for trading and clearing over-the-counter (OTC) derivatives, and have satisfied G20 commitments in respect to trade repositories to monitor derivatives trading activity. This reform effort has been notable for its lack of effective coordination in building a harmonized rulebook consistent with the global focus of OTC derivatives trading.

The regulatory community, however, has only now begun to tackle the institutional credit markets. These reforms run considerable risk of further debilitating already weak market liquidity, signaling that rule making should proceed with great care and in close consultation and responsiveness to suggestions from practitioners.

Transparency, that is providing more information on bond transactions to institutional and retail investors alike, will have priority in the reform agenda. In the EU, bond transparency is part of the ongoing consultations on Market in Financial Instruments Directive II (MiFID II), with Canadian regulators likely to follow the direction set by the EU and US regulators. The US regulators propose to expand the existing TRACE bond transparency system (which gives all investors access to trade data, including the price, yield and size of all bond transactions) to include transaction information on asset-backed securities, and consultations are underway on a proposal to begin disseminating information on transactions in securities backed by residential and commercial mortgages, as well as collateralized debt, bond and loan obligations.

The regulators clearly understand the trade-off between the need for greater transparency of pre-trade and post-trade information, and potential adverse consequences of exposing market-maker inventory positions. In recognizing the risks at stake, regulators will likely direct increased transparency requirements to liquid debt securities. While this approach may work in theory, the EU regulators have already found it difficult to settle on an effective definition of liquidity, and to design practical rules that rely on groupings of securities deemed as liquid for increased transparency purposes.

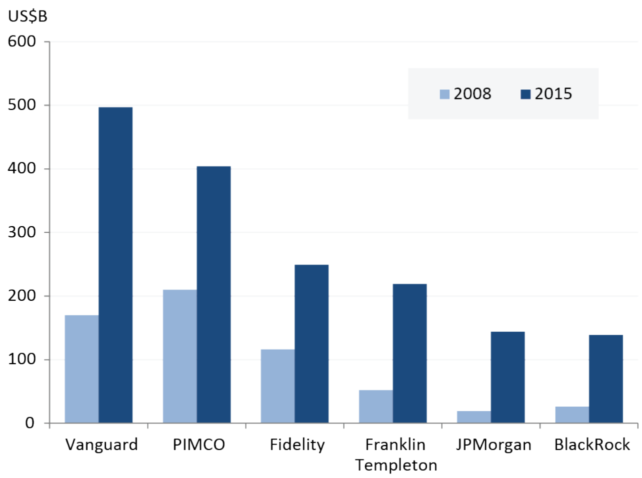
The second initiative is the Fair and Effective Markets Review which published its Final Report on June 10, 2015. It sets out 21 recommendations to help restore trust in the wholesale fixed income, currency and commodity (FICC) markets. The Review was established by the Chancellor of the Exchequer and Governor of the Bank of England in June 2014 to help to restore trust in those markets in the wake of a number of recent high profile abuses. The Review calls for the development of a set of globally endorsed common standards for trading practices in FICC markets, the extension of UK criminal sanctions for market abuse for individuals and firms to a wider range of FICC instruments, and the creation of a new FICC Market Standards Board with participation from a broad cross-section of global and domestic firms and end-users involving regular dialogue with the authorities. The Board will scan the horizon and report on emerging risks where market standards could be strengthened;

address areas of uncertainty in specific trading practices; promote adherence to standards, including by sharing and promoting good practices on control and governance structures around FICC business lines; and contribute to international convergence of standards.

The third initiative is the unbundling of charges for services to clients, such as research advice, embedded in the traded bid-offer spreads. In the EU, this requirement will be part of the MiFID II obligations, while in Canada it is embedded in the CRM requirements. The unbundling of costs related to fixed-income dealing will entail significant compliance costs.

These forthcoming regulatory initiatives have the potential to reduce market-making and further erode already thin liquidity in traded debt markets. Weak secondary markets will likely amplify swings in bond yields once evidence points to either strengthening growth and rising inflation rates, or deteriorating growth and building deflationary pressures. Interest rate shocks could spread rapidly across asset classes, notably bond ETFs, and reinforce further downward rate adjustments as selling pressure builds. The consequences for credit markets could be severe.

Largest Bond Mutual Funds
AUM 2008 and 2015



Source: Morningstar

Non-bank financial institutions: dealing with their system risks
Reforms have certainly left the banking system more resilient to market shocks, but concerns remain about potential systemic risk from the non-bank financial institutions, notably large managed investment funds, including large hedge funds and private equity funds, sovereign wealth funds, mutual funds and pension funds. Several managed funds got into trouble in the last financial crisis, with smaller hedge funds and private equity funds going bust and larger funds seeking assistance. To the extent overall asset size is relatively small, the selling impact on financial markets and bankruptcy effects would be limited, precluding systemic implications. On the other hand, large managed funds could have a serious systemic impact on capital markets in the event of a massive and swift collapse in asset prices, correlated across asset classes. Large mutual funds, even in an agency capacity, could have systemic impact on the markets, depending on the extent of asset price collapse and pressure for client withdrawal of funds.

The Financial Stability Board (FSB) is examining the systemic implications of non-bank financial institutions and appropriate regulatory safeguards. Canada will likely follow the lead of the FSB and other jurisdictions to implement additional regulations on large buy-side institutions that are considered systemically important.

The EU's Capital Market Union: lessons for Canada?
Policy makers in Europe are looking for new ways to unlock the continent's potential. At the heart of the European malaise is a lack of a diversified pool of capital for small and medium-sized enterprises (SMEs) to tap into—particularly innovative and high growth start-ups. Additionally, there are specific impediments to the financing of long-term infrastructure projects which are crucial to maintaining Europe's competitiveness.

It has become apparent that Europe's economy is over-reliant on banks for finance and that stronger and more diverse financing of the real economy is needed. The Capital Markets Union aims to cut the cost of raising capital and reduce the high dependence on bank funding in all 28 EU member states. Of course, regulations are still necessary for a market-based financial system that allocates capital efficiently.

It will be interesting to watch the evolution of this initiative to see if there are any lessons for Canada to develop a high-yield market. The main focus in Europe is on the standardization of offered securities to facilitate the securitization of bonds issued by individual SMEs. While these bonds would have a limited market, if issued on their own, as part of a securitized package with the benefit of diversification, these securitized instruments could find a receptive market.

The requirement for standardization could limit the securitized market to smaller issuers as larger enterprise may not be prepared to sacrifice flexibility of borrowing terms and conditions (and not have the need to do so) to issue new securities.

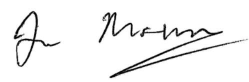
Conclusion: Regulators – proceed with caution
Regulators in many G20 countries have made considerable progress in introducing reforms to strengthen the resilience and integrity of the financial system. Efforts have focused mainly on increasing capital, liquidity and leverage standards to better withstand financial shocks to the system and mitigate systemic risk. In the EU, reforms have included measures to develop a single rulebook, to consolidate supervision through the European Central Bank (ECB), and to have resolution plans in the event of a banking crisis. While the banking system is in much better shape, regulators are now turning their attention to large managed funds, including hedge funds, private equity and mutual funds, sovereign wealth funds and pension funds. There has been much consolidation in the asset management sector, resulting in very large-sized funds such as BlackRock ($4 trillion in assets).

It is hard to believe these large funds could not have a significant impact on the financial system in the event of a crisis, particularly in terms of balance sheet adjustments on the financial markets and feedback effects from market participants. This is especially the case given asset prices are often correlated in a market downdraft. The FSB is examining the merits and the additional regulation needed to ensure the “shadow” banking system, targeted at the largest asset managers, will not cause systemic problems in the event of another financial crisis.

Regulators in all jurisdictions having reformed the OTC derivatives markets (the epicenter of the 2008 financial crisis) with new rules governing trading, clearing and settlement and mandatory reporting of all OTC derivative trades to trade repositories, and regulators in Europe, the US and Canada having intervened in the retail wealth management business, have now set their sights on reforming the institutional debt markets aimed at improving transactional transparency of the OTC markets, as well as on improving market conduct through strengthened governance and accountability, and on implementing new rules and improved standards and practices for professional conduct and enhanced proficiency.

These reforms in credit markets are rolling out just as the credit markets are undergoing an unprecedented collapse in liquidity. It is critical that regulators in the EU, the US and Canada in contemplating new rules, first step back and undertake a full regulatory review of the cumulative effect of post-crisis capital, liquidity, trading rules as well as an analysis of the impact of CRM requirements in Canada. It is also important that they proceed with utmost care to avoid further damage to market liquidity and the vulnerability of credit and derivative markets to sharp adjustments in interest rates and asset prices.

Yours sincerely,



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