INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

Turbulent Markets Demand Major Changes

A Speech by

Ian Russell, President and CEO
Investment Industry Association of Canada

To the Halifax Chamber of Commerce

March 4, 2009

How do you turn around a faltering economy? That's the question all governments are asking themselves today. The Canadian government has taken several steps to deal with the after-effects of the credit crisis – primarily through the Budget. I want to talk about some of the things the Canadian government is doing – and some things it needs to do.

Before we look ahead, let's look back. Canada has done comparatively well in dealing with this global crisis. But its manifestations were actually felt here before they were felt anywhere else.

It all started with innovative financial instruments – or asset securitization. It had allowed investors to access assets, such as mortgages, that were previously restricted to financial institutions. A good example is asset-backed commercial paper, or ABCP. What happened is now well-known. In the early summer of 2007 investors found the packaged assets were not traditional assets such as mortgages and consumer card receivables. Instead, they included sub-prime mortgages and esoteric derivatives such as credit default swaps.

Difficulties related to the securitized commercial paper materialized here after it became known how shaky the packaged assets were, notably the subprime mortgages. The rising defaults on U.S. sub-prime mortgages quickly led to a loss of confidence in asset-backed securities in general.

In Canada, most non-bank ABCP trusts found themselves unable to access back-up bank lines when some of their paper became due and they lacked sufficient funds to repay investors. To prevent a complete breakdown in the non-bank ABCP market in Canada, major non-bank ABCP stakeholders agreed to freeze non-bank ABCP redemptions and work toward converting non-bank ABCP into longer-term tradable financial instruments. In December, consenting ABCP stakeholders, together with the federal government and several provincial governments, reached an agreement to provide a standstill or extension of maturity to institutional investors and a pay-out to retail investors.

Fortunately, ABCP was a small part of the Canadian financial market. But as it turned out, Canada was like the canary in the mineshaft. The ABCP problems we faced signaled the marked deterioration in credit standards in U.S. mortgage and corporate lending.

What impact will the credit crunch have – on the investment industry, on investors, and on the broader economy that provides most of Canada's jobs and economic growth, what we call the real economy?

Let's start by looking beyond our shores. The institutional landscape has already changed dramatically.

In the United States, there are few national banks left, although there are still a significant number of regional banks. The U.S. securities industry is starting to resemble Canada's – based on firms that are subsidiaries or affiliates of large financial institutions, as well as regional firms. No doubt the U.S. regulatory system will go through dramatic changes in light of a massive loss of public confidence.

What about Canada? How will we be affected?

First, let's look at the impact on investors. From mid-year until the end of October, the TSX fell 34 percent.

Investment banking has been on the rocks for some time. There has been minimal business in that field for over a year. There were no IPOs on the TSX in the second half of 2008. Equity financings were down 23 percent from 2007. The corporate advisory business in the second half of the year was almost non-existent. Investment banking revenues are down 32 percent from last year. The recent thaw in credit markets has enabled a few big names like Enbridge and Hydro One to raise funding through small, well-timed issues.

Retail business has fared relatively better, with a good performance in the first half of the year, and support from more stable advisory fee income, that has mitigated the revenue downturn. In fact, after the market collapse investors were more likely to reach out for advice, which is good both for them and the industry.

What's ahead for the investment industry in the short run? Small firms will be able to cope with the difficult conditions. They've achieved significant efficiencies in recent years. They've relied on outsourcing and introduced technological efficiencies. They have had a streak of profitable years, and built up their capital against an earnings collapse. As well, firms gear compensation to performance, generally based on bonuses, which reduces costs during weak economic conditions.

The question is: How long will these weak conditions last? The longer they do, the more likely it is that small firms will have to make adjustments, such as shutting down offices and laying off employees. As well, retail clients will be increasingly mobile in the search for security and competent advice, and many investors may migrate from mutual funds, opening some opportunities for small firms. The longer it lasts, the more likely we will see significant consolidation as small firms continue to come under pressure.

The stock market declines have prompted anxiety, at times a borderline sense of panic. But it is not the 1930s. The economic fundamentals are sound, and our financial institutions are in good shape. Unlike the 30s, Canadians still have confidence in our financial institutions. There has been no mass exodus from them, no long lines of depositors trying to get their cash out before it's gone.

While the collapse has been dramatic, the recovery is going to be a much slower process. Although there should be a correction in a market that was oversold, recovery is primarily tied to the fate of the real economy. And while the economic underpinnings of the Canadian economy are strong, the ability of Canadian companies to grow will be hampered by the state of the capital markets. Difficulties in accessing capital will constrain investment spending. Any rebound in consumer spending will depend on increased consumer confidence, dampened by the financial crisis, and an increasingly uncertain outlook.

The downturn in consumer confidence has reduced our exports to the United States, especially commodities. Obviously that's important here, as Nova Scotia sends 78 percent of its internationally marketed goods to the United States. At the same time, it's a good thing your province's economy has diversified significantly, with professional, scientific and technical services growing at a faster rate than other industries.

Across Canada, companies have retrenched. This is especially true of small companies, as access to capital has literally shut down. Expansion plans have been deferred. While construction is ramping up on the Deep Panuke Offshore Gas Development Project, many resource companies lack the financing to undertake major projects. Keltic Petrochemicals Inc.'s multi-billion dollar chemical plant and Maple LNG have both been taken off the fast track. Many natural resource companies are being forced to sell assets at deflated share prices.

Canadian firms need capital to compete. More than ever, we need to make sure it is available to them.

But investors are shell-shocked. Some look at the devastation in the capital markets and see under-priced buying opportunities. But many simply feel the pain of being burned.

We have to ask ourselves: How are Canadian companies and entrepreneurs going to raise the capital they need to create the products that will create wealth and jobs?

That is the toughest question we face. How did the federal budget respond to this crisis?

Let's start with the positive. The federal government's stimulus package will result in a $34 billion deficit for the next fiscal year and $30 billion for the following year. After the enormous effort it took to eliminate Canada's deficit, none of us is happy to see a return to red ink. But it is a temporary fiscal strategy to offset the impact of the global slowdown. And unlike similar deficits in the early 1990s, public finances are in far better shape to absorb the increased debt load.

What's more, the budget included several measures to improve the ability of capital markets to stimulate capital flows to the real economy. That includes an additional $50 billion to the Insured Mortgage Purchase Program, and the establishment of a credit facility to purchase asset-backed securities that will bolster liquidity and encourage increased lending.

The budget contained another measure that will benefit Canadian investors and businesses – a measure that has been debated in Canada for years – and that is a transition plan to a single Canadian Securities Regulator.

A single securities regulator has been recommended by a number of comprehensive studies. The most recent was the Expert Panel on Securities Regulation in early January.

Under a transition plan outlined in the Budget, the federal government announced its intention to move forward with willing provinces and territories to create a Canadian securities regulator. It will respect constitutional jurisdiction, and regional interests and expertise as recommended in the Expert Panel's Report.

The federal government made it clear it will provide the resources necessary to establish a Canadian securities regulator as quickly as possible. The budget promised to establish and fund a transition office. The office is expected to deliver a transition plan within a year, covering the necessary legislation, negotiations with the provinces, and infrastructure.

A single Canadian securities regulator is needed now more than ever. Aside from its impact on our economy, the turmoil in global financial markets points a spotlight at the magnitude and velocity of change in financial markets – the frenetic pace of financial innovation, the development of new investment products and trading practices, their rapid dissemination even when risks are misunderstood and underestimated, and the close linkages between leveraged financial instruments and developments in the real economy.

There are a great many questions coming out of this market meltdown, but about one thing there can be no doubt: Every country that has been affected is going to embark on a comprehensive review of its regulatory rules and structures to try to avoid the exact same problems cropping up in the future. Canada cannot be an exception to that.

Three trends create a clear need for improved regulatory coordination: Business lines carried out in different types of financial institutions are converging. Unregulated institutions such as hedge funds and private equity firms are growing. And global markets are integrating.

There is a need for greater coordination among domestic regulators, such as the Office of the Superintendent of Financial Institutions and the provincial securities regulators. And there is a need for closer global cooperation and coordination among national regulators and international institutions like the IMF and OECD.

There is also a need to re-examine our approach to regulation to make it match the changing nature of investment. Many of the functions traditionally carried out by banks are now conducted directly through financial markets. This has thrust upon securities regulators the need for a broadened market focus. That means they must have the mandate, the resources and the expertise to meet this need.

Regulators must be able to act quickly. Otherwise, Canada bears a significant opportunity cost: Foreign institutions have been reluctant to participate in our markets because of the sense of uncertainty.

As well, our regulators must be able to provide a perspective on national markets – rather than simply on transactions between local investors and local investment advisors. Given that investors are exposed to credit and liquidity risks inherent in new investment products and changes in global trading patterns, our regulatory system must be sufficiently centralized to focus on broad market developments. At the same time, it must be sufficiently localized to ensure the integrity of the investment process between investors and advisors. Remember the saying that was in vogue a few years ago “think local, act global?” When it comes to regulation, today we must be prepared to think and act local and global. Ultimately, there is only one investor.

Even though Canada has come out of this better than many countries – largely through the efforts of regulatory bodies – we cannot hope to avoid the demand for regulatory scrutiny and clarity that is growing in all countries.

We will have to ensure better coordination and collaboration between securities regulators and bank and insurance regulators, and better coordination between Canadian regulators and their counterparts in other countries. The current financial crisis drives home the need for Canadian regulators to closely monitor developments in global and national markets and make changes, when necessary.

For all of these reasons, the budget's measures to create a single securities regulator and to bolster the economy through tax relief for individual Canadians are welcome. So is the confirmation of previously announced cuts in corporate tax rates. But in some respects the Budget was disappointing. It failed to introduce needed reforms of the RRSP and RRIF programs to rebuild retirement savings devastated by the recent market collapse.

And it failed to cut the capital gains tax. That is one of the most important changes we can make in Canada. A cut in capital gains tax rates would get right to the psychology of the investor. It would make it clear if you invest, you will have the opportunity to keep more of your gains.

A cut in the capital gains tax is needed to repair the investment process in Canada. It would encourage risk-taking by investors, whose appetite for risk has been devastated by the collapse in financial markets. It would lower the cost of capital to encourage productive investment by business. It would make it easier for financial institutions to rebuild capital and enable non-financial companies to strengthen balance sheets and finance investments.

For many small companies, access to external capital means the difference between proceeding with planned investment projects or abandoning them. If projects don't go forward, future profits will not materialize, share prices will drop further, and business activity will contract. Many companies will face the prospect of winding up their operations or being acquired at depressed share prices, as has already begin with natural resource companies.

Just contrast our capital gains tax rate with the United States. Half of our capital gains are taxed as personal income, resulting in an effective rate of about 25 percent. And we make no distinction between long-term and short-term capital gains. In the United States long-term gains are subject to a 15 percent tax rate – nearly 10 percentage points lower than the Canadian rate. That's a good way to encourage the development of patient capital.

There are further measures that the government could take to improve financing prospects for small companies – measures that would have been great to have seen in the Budget. The government could allow the flow-through share concept to non-resource companies. This would allow depreciation expenses to flow from businesses to individual investors, improving after-tax returns. And government could extend the tax benefits that apply to Canadian-controlled private corporations to small Canadian public companies. That would allow small public companies to benefit from a lower federal corporate tax rate, tax credits for R&D spending, and the $750,000 capital gains tax exemption for original owners to divest common shares.

All that said, there is no doubt that regulators and governments have taken positive steps to limit the impact of the crisis here in Canada.

We’ve averted a crisis but we face a period of slow growth, uncertainty and adjustment – how long it will last and how deep it will go depends on the reforms that governments adopt on tax policy and regulatory policy. Recovery will turn on both judicious policy, especially on taxes, and on greater coordination to improve regulatory efficiency.

Canadians have built a strong economy over the past few decades. It exceeds anything the world has ever seen before. We can resume that path of progress. What we need are more incentives to invest, to take risks, to build wealth. That has been the key to growth in the past – and it can be the key to a prosperous future.

Thank you.