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

Resilience of Canada's Financial Institutions and Markets

A Competitive Advantage to Build From Crisis

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Even in the toughest economic times, Canadians should remember there are good reasons the Chinese use the same symbol for “crisis” as for “opportunity.” In the midst of the current economic contraction, there are opportunities for Canada. But it is up to Canadians to take advantage of them.

Our capital markets and financial system have come through the global crisis in far better shape than the United States, or any other major advanced economy. Our comparative strength is an asset that can be leveraged to stimulate economic growth.

But before I start to talk about our opportunities, I want to discuss some of the challenges we face. Let’s not kid ourselves, there are plenty of them.

For a while it seemed some Canadians were hoping the current economic crisis would just pass over us. But the global economy is too interdependent and the Canadian economy is too open for that.

The problem may have started in the U.S. subprime market. But it certainly hasn’t ended there. In the past year Canada has weathered a global financial crisis – better by far than most countries. But the financial crisis has morphed into a global recession; Canada, as a small, open economy, has very much been affected by the global economic contraction.

The Characteristics of the Crisis

The economic problems we face in the real economy were prompted by a collapse in the financial markets, the likes of which we have not seen in at least a half-century.

As of last month, the equity markets were down 35 percent over the previous year. Credit spreads have widened as corporate debt increased dramatically.

Both retail and institutional investors are more risk averse. Over the past 18 months they have reduced their participation in both corporate debt and equities markets. We can see that in reduced trading in debt securities, declining mutual fund sales and reduced new offerings of debt and equities securities.

The slowdown in the real economy is making it more difficult for the markets to recover, creating a vicious circle.

Unlike previous economic slowdowns, this one is not picking favourites. It is hammering industries and regions across Canada. That includes natural resources here in the west, aerospace in Quebec, and the auto industry in Ontario.

Aside from the breadth of the economic downturn, another alarming characteristic has been the pace. In the fourth quarter of last year Canadian GDP

declined at the fastest pace since 1991, according to Statistics Canada. We are in for further GDP declines this year.

Unemployment rates are at multi-year highs and trending higher.

Meanwhile, real estate values are in the early stages of following downward global trends. Lower retail transaction values could force further write-downs on institutional portfolios and reinforce cautious investment behaviour.

Impact on Investment Industry

As I mentioned, these economic problems originated in the financial sector.

The steep declines in stock and bond prices through much of last year decimated financial portfolios. Portfolio values have declined 20 percent, with equity investments down 30 to 40 percent. Turbulent and collapsing financial markets have resulted in declining financial advisory fees as participants have drawn in their horns. The fall-off in financial transactions has hit firms hard.

Independent firms in the wealth management sector are struggling to control costs as retail revenues decline; operating profits have dropped 60 percent this year. Profit declines at institutional firms nearly matched the retail declines, down 50 percent at year-end, led by the collapse in investment banking. Industry profits will fall another 50 percent this year if current trends continue.

The impact on portfolios, and on the value of pension funds, has created new levels of anxiety. What we are seeing is a decline in public confidence, unlike anything we have experienced in decades. The investment industry is based on helping people build for their future. But people find it hard to think about building for tomorrow when they feel like they are hanging on for their lives today.

People are staying away from investments, shifting to cash.

Clients have developed dissatisfaction with their financial advisors. We're seeing more mobility among clients, a greater willingness to migrate to competing advisors in different firms.

Firms are attracting quality brokers and weeding out low-performers to secure their client base. They're adapting to new technologies to improve efficiencies and reduce costs. For example, Investment Advisor Portfolio Management Platforms have become more common in the industry to achieve cost-efficiencies for clients and firms, reducing fees and tightly integrating client transactions with compliance oversight in real time.

We will see more and more firms expanding into portfolio management, as well as financial planning and estate planning activities. We are going to see more full-service wealth management firms, and fewer specialized ones. The industry will see continued growth in client assets-under-management. In the past five

years the retail brokerage industry's assets under management have grown 27 percent to peak out at $900 billion.

On the institutional side of the industry we have seen a collapse in investment banking and merger and acquisition activity. This weakness has been pronounced in the falloff in traded securities and new issues of junior financings in the resource sector. The exception has been a spate of common financings in the gold sector, providing some breathing room for small firms.

Large firms will have an advantage over smaller boutique firms in competing for investment banking business, given their dominance in corporate debt origination and trading. We have seen a rebound in corporate bond financings. Canadian companies have been selling bonds at the fastest pace in a year. In the five weeks since the start of March there were 13 corporate bond offerings, totaling $5.7 billion. These were not just ultra-safe companies and troubled financial firms, but solid companies such as Thomson Reuters, Shaw Communications, and RioCan Real Estate Investment Trust – reflecting a more positive attitude about corporate borrowers in the recessionary environment.

Small, specialized firms in both the retail and institutional sectors are cutting costs, reluctantly reducing staff through attrition or layoffs, starting with administrative staff and moving to skilled brokers, investment bankers and operational specialists as circumstances warrant. Many firms will seek mergers

to achieve business synergies and global alliances to expand trading and financing opportunities. Many small firms will seek to be bought by larger firms. Some small firms will not survive. And new firms will continue to spring up to seek niche opportunities.

Firms will also seek to purchase assets from failing competitors, and will make it a priority to attract quality sales people, as an alternative to the more costly option of buying a firm.

There were 78 firms in Canada with revenue of less than $5 million in 2008. Their struggle to survive is part of the process of creative destruction in the securities industry, with the potential to lead to a competitive renaissance. Some firms adjust, positioning themselves to grow in the economic upturn. Others are swallowed or disappear, allowing newly-constituted competitors to target their client base and human resources.

As firms compete aggressively to survive and grow, it is important to resist the temptation to over-regulate as we embark on regulatory reform. Regulators in Canada have responded to the financial crisis with positive actions to strengthen the framework for capital markets. We must not veer off that course, and turn regulation into a barrier to renewal.

Regulators should refrain from actions that will only make it harder for investment firms to compete. We need to be mindful of the risks of imposing unnecessary regulatory burdens, creating unintended consequences, and prompting excessive compliance procedures. Change offers the opportunity for growth. We must not suffocate it.

Canada's Positioning

When you look at the recession through a global lens, Canada is doing relatively well.

The Bank of Canada, regulators and governments responded quickly to the crisis and subsequent economic downturn. The Canadian banking system has held up well. According to the World Economic Forum – host of the annual Davos meetings – Canada's banks are the soundest in the world. Ours is one of the few banking systems to sustain relatively small losses in the current downturn – and one of the few systems not to see a single bank go under.

In fact, Canada is the only G-7 country whose banks did not receive a government bailout – and whose banks have been able to access public markets.

Since November, the Big Five have bolstered their balance sheets by raising $9 billion in common equity and preferred shares. There are seven banks in the world that still carry a Moody's AAA rating – two are Canadian.

Many are asking: How has Canada avoided the excesses of the U.S. system? We've benefited from a cautious corporate culture that depends heavily on a vast and stable branch network, separation of investment from commercial banking in our banking groups, and strict capital controls on leverage. U.S. and European banks are generally leveraged at two or three times as high a rate as ours. Our largest investment dealers, subsidiaries of our banks, have similarly benefited from stringent capital rules and conservative management – including a commitment to providing clients with prudent management and advice, characterized by balanced portfolios and an aversion to exotic securities.

The relative success of Canada's financial system in avoiding the worst of the damage has drawn considerable notice south of the border. President Obama has called the Canadian performance "striking." In fact, he said: "Canada has shown itself to be a pretty good manager of the financial system in ways that we haven't always been here in the United States."

Canadian governments and the Bank of Canada have indeed managed the crisis well. They've responded promptly and effectively to improve trading and financing conditions in corporate credit markets, particularly in the securitized

marketplace. And unlike the United States and Hong Kong, the federal government and the securities industry found a private-sector solution to restructure the asset-backed commercial paper market, which included sub-prime mortgages and esoteric derivatives such as credit default swaps.

What's more, the federal government has been in the unique position of being able to provide stimulus from a position of fiscal strength, a very different situation from other countries.

Running surpluses for 12 consecutive budgets has given us the scope to support economic activity as private-sector investment has waned. It also provides a catalyst to promote recovery. Federal deficit spending in Canada is only 2 percent of GDP, even with stimulus spending. Compare that to the U.S., where the federal deficit is now about $2 trillion – more than 10 percent of GDP, and heading up.

The federal budget's stimulus was supplemented by provincial initiatives. That includes the B.C. budget, with $25 billion in infrastructure spending and other projects, accelerated reduction in the small business tax rate, and extension of the mining flow-through tax credit to the end of 2009. That's accompanied by extensive infrastructure investment for the Olympic Games, which will leave a legacy of increased productivity.

In addition to its stimulus provisions, the federal 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 a credit facility to purchase asset-backed securities to bolster liquidity and encourage increased lending.

But there were some steps the federal budget failed to include. For one thing, it failed to cut the capital gains tax.

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. 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.

The budget addressed illiquidity in banks and other federally regulated institutions, but more needs to be done to enhance liquidity in the capital markets.

One of the priorities has to be facilitating the efficient functioning of credit markets adversely affected by the financial crisis. It's especially vital to ensure robust securities lending markets, including the repo market in which bonds are lent out in return for short-term cash.

That's an important catalyst for healthy capital markets. We're encouraged that the Bank of Canada is addressing this issue by improving access to short-term financing through expanded collateral, and also encouraged by the government's creation of credit facilities to provide stimulus to the securitization market.

But many institutions and debt issuers are still standing on the sidelines, partly because of the short interval over which financing is provided and partly because of the short-term nature of the government's commitment to the program.

To meet the needs of borrowers, the financing facilities for insured mortgages and asset-backed securities should offer a longer financing term. This will demonstrate government commitment to the program – and attract greater interest among market participants.

At the same time, funding from the Canadian Secured Lenders Facility, created in the federal budget, should be made available quickly to a broad range of financing companies. The Facility should also provide greater flexibility as to which participants and assets are eligible, without compromising the program's integrity.

Dealers could also use relief in the “netting” or settlement process for repurchased transactions. While the marketplace is in the process of launching an enhanced netting utility for fixed-income securities, balance sheet relief from

accounting bodies and standard setters could also assist in increasing the availability of capital in the marketplace.

In the wake of the global financial crisis, it is also clear that buy-side market participants need to build internal capability to assess credit risk or obtain third-party credit research to supplement issuer-paid rating agency research. Policy makers need to continue to consult actively to shape new policies regarding the role and requirements for credit rating systems in the regulatory framework.

Building on Canada's Success

Canada's relative success at managing the crisis has earned considerable respect – for our regulatory system, our policy environment, our banking system and our financial services industry. Measures to stimulate liquidity and financings are starting to show results.

We have the opportunity to build on our success – and attract more business and investment to Canada.

We've done relatively well; we need to take advantage of that. We need to encourage global companies to come to Canada, and encourage Canadians to think globally. We need to attract international financial institutions, like hedge funds, to our capital markets.

We see a good example of that kind of initiative here in Vancouver. The International Financial Centre – leveraging tax advantages offered by the B.C. government – provides a unique magnet to attract financial businesses to Canada and British Columbia. Other provinces should examine the potential to emulate this strategy.

Canada has demonstrated that this is a good place to do business even in the toughest of times. Now, Canadian businesses and governments must attract investment to grow our economy and improve our standard of living in ALL times. We must turn this crisis into an opportunity.

Thank you.