Developments and Trends

Notes

The material in this document is based on information available to **1 June** unless otherwise indicated.

The phrase “major banks” in Canada refers to the six largest Canadian commercial banks by asset size: the Bank of Montreal, CIBC, National Bank, RBC Financial Group, Scotiabank, and TD Bank Financial Group.

Assessing Risks to the Stability of the Canadian Financial System

The *Financial System Review* is one vehicle that the Bank of Canada uses to contribute to the strength of the Canadian financial system. The Developments and Trends section of the *Review* aims to provide analysis and discussion of current developments and trends in the Canadian financial sector.

The first part of the Developments and Trends section presents an assessment of the risks, originating from both international and domestic sources, that could affect the stability of the Canadian financial system. Key risk factors and vulnerabilities are discussed in terms of any potential implications for the system's overall soundness. The second part of this section examines structural developments affecting the Canadian financial system, its safety, and its efficiency, such as developments in legislation, regulation, or financial practices.

The current infrastructure, which includes financial legislation, the legal system, financial practices, the framework of regulation and supervision, and the macroeconomic policy framework, significantly influences the way in which shocks are transmitted in the financial system and in the macroeconomy, and thus affects our assessment of risks.

Our risk assessment is focused on the vulnerabilities of the overall financial system, and not on those of individual institutions, firms, or households. We therefore concentrate on risk factors and vulnerabilities that could have systemic repercussions—those that may lead to substantial problems for the entire financial system and, ultimately, for the economy. In examining these risk factors and vulnerabilities, we consider both the likelihood that they will occur and their potential impact.

Particular attention is paid to the deposit-taking institutions sector, because of its key role in facilitating financial transactions, including payments, and its interaction with so many other participants in the financial system. For instance, these institutions assume credit risks with respect to borrowers such as households and non-financial firms. Thus, from time to time, we assess the potential impact that changes to the macrofinancial environment may have on the ability of households and non-financial firms to service their debts.

Risk factors and vulnerabilities related to market risks are also examined. The potential for developments in financial markets to seriously affect the financial position of various sectors of the economy and, ultimately, to disrupt the stability of the Canadian financial system is assessed.

Financial System Risk Assessment

This section of the Review *presents an assessment of the risks arising from both international and domestic sources bearing on the stability of the Canadian financial system. The objective is to highlight key risk factors and vulnerabilities in the financial system and to discuss any potential implications for the system's overall soundness.*

Key Points

- The likelihood that a shock would have a significant adverse impact on the Canadian financial system remains small.
- The Canadian financial, non-financial corporate, and household sectors are healthy and in a good position to withstand shocks.
- The possibility of a significant price reversal in riskier assets remains, although markets have so far been resilient in the face of negative shocks.
- There continues to be a small risk that the adjustment of global imbalances could slow the growth of the global economy appreciably and increase volatility in financial markets significantly. This risk may, however, be lower than previously thought.
- Issues raised by a possible influenza pandemic have received considerable attention domestically and internationally in recent months.

Overall Assessment

In general, households, businesses, and financial institutions are in good financial shape. This is partly the result of a very favourable macroeconomic environment. It is also the result of improved risk-management practices at financial institutions and of prudent financial behaviour by non-financial corporations.

The macroeconomic situation has been particularly favourable for the past several years, with robust global growth, high commodity prices, and strong profits. On the whole, the Canadian economy has adjusted remarkably well to large relative price changes, including a significant appreciation of the Canadian dollar, although that appreciation and heightened global competition continue to pose challenges for a number of firms.

Volatility in financial markets has been extraordinarily low in recent years, and this has contributed to a reduction in risk premiums to a very low level. In May, however, volatility suddenly increased in commodity, foreign exchange, and equity markets against a background of increased uncertainty about the strength of the global economy and future inflation in the United States. There was also some limited correction in the prices of riskier assets. Nonetheless, both volatility and spreads remain at historically low levels. There is thus a possibility that a more pronounced increase in market volatility could still trigger a significant repricing of risk. An important question is how resilient world markets would be to such repricing.

One area of concern is growing global current account imbalances. These imbalances primarily reflect mismatches of savings and investment in major regions of the globe, with large precautionary savings in Asia and low savings in the

United States. The base-case scenario presented by the Bank of Canada in its April *Monetary Policy Report* assumes that these imbalances will gradually diminish as public and private savings in the United States rise and domestic demand picks up in the rest of the world.

There is, however, a risk that the adjustment could involve considerable volatility in markets and large movements in exchange rates, which would spill into the real economy, partly through weaker consumer and investor confidence and, perhaps, through protectionist measures. This would result in a pronounced slowdown in global economic growth and lower commodity prices. The larger the global current account imbalances become, the larger the adjustment to reduce them will need to be. And the more impediments there are to a market adjustment of these imbalances, the greater the risk that the adjustment will be disorderly.

Although these imbalances have continued to grow recently, there have been some tentative signs of policy shifts that could contribute to an orderly adjustment. Moreover, global economic growth is becoming more broadly based with the strengthening of Japan's economy and, to a lesser extent, that of Europe. On balance, it appears that the risk of a disorderly adjustment may be lower than was previously judged.

What are the implications of these risks for Canada?

A slowing of the world economy, together with a sharp upward movement in the Canadian dollar, could imply lower export volumes for Canada and weaker commodity prices, which could impair the profits of Canadian companies and strain the ability of households to service their debts. Repricing of risky assets internationally would likely affect the prices of risky assets in Canada, as well as the balance sheets of any Canadian entities holding risky assets abroad.

Canadian financial situation

Canadian financial institutions are currently in a good position to withstand shocks. Major banks have been profitable, are well capitalized, and are using sophisticated risk-management models. Market-based indicators suggest that markets consider the major Canadian banks to be healthy.

Box 1

The Risk of a Pandemic

Issues raised by the risk of an influenza pandemic have been discussed recently at a number of international meetings, including the Joint Forum and the Financial Stability Forum. There is considerable uncertainty about the timing and severity of such a pandemic. From an economic point of view, the key factors would be increased absenteeism related to illness, disruption of the supply chain, and the possible effect on confidence. The extent of any economic disruption would depend partly on how well prepared firms were to continue operations if they were faced with extensive absenteeism.

Financial institutions would likely experience an increase in non-performing loans to households and corporations affected by the pandemic, while higher mortality rates would increase payments by life insurance companies.

The International Monetary Fund (IMF) has been active in raising awareness of the possible economic and financial consequences of a pandemic.[1] It has also encouraged co-operation among countries in preparing contingency plans to deal with absenteeism in their financial sectors and in developing best practices.

The Government of Canada has put in place a Canadian Pandemic Influenza Plan, and in the May 2006 budget allocated $1 billion over 5 years to further improve Canada's preparedness to deal with a pandemic. The Office of the Superintendent of Financial Institutions is working with financial institutions to understand the challenges associated with a possible pandemic and best practices to respond to such an occurrence.

1. See <http://www.imf.org>.

Chart 1 Evolution of Consensus Estimates for Global Economic Growth*

* This estimate covers 46 countries.
Source: Consensus Economics Inc.

The behaviour of non-financial corporations in Canada seems to have been prudent at a point in the cycle when risk taking can often lead to vulnerabilities that can cause problems when the macroeconomic environment becomes less favourable. Many non-financial companies are earning substantial profits and are using these profits to reduce debt-to-equity ratios and to accumulate liquid assets. A number of sectors are, however, suffering from the appreciation of the dollar, high input costs, and increased competition in international markets.

One sector of the economy that has seen a substantial increase in debt is the household sector, as growth in household credit has risen to around 11 per cent. Despite growing debt and recent increases in interest rates, debt-servicing ratios remain low, partly because of a substitution of home-equity lines of credit for other forms of personal credit. Analysis of the market for condominiums supports the assessment in the December 2005 *Financial System Review* (FSR) that the risk of a marked reversal in housing prices in major Canadian markets appears limited. Since December 2005, there has been a significant escalation in the prices of houses, but the movement was largely limited to cities in Western Canada. Our assessment continues to be that the household sector poses a low risk to the financial system. If economic prospects were less positive, however, or if interest rates were to rise significantly, the finances of some households would, undoubtedly, be heavily strained.

The Macrofinancial Environment

The global economy has continued to expand at a solid pace in recent months. Indicators of real activity and financial health remain strong, and the global economic outlook is somewhat better than expected in the last FSR. However, it appears that inflation pressures may be building in the United States. As a result, there has been some net increase in bond yields and increased volatility in commodity, exchange rate, and equity markets.

The international environment

Despite higher oil prices, expectations for global economic growth in 2006 have generally been revised upwards since the December 2005 FSR

(Chart 1), owing mainly to a stronger outlook for Asia, including Japan, and, to a lesser extent, for Europe. Expectations for 2007 point to a slight moderation in global economic activity, partly reflecting some monetary tightening undertaken to balance aggregate supply and demand.

Healthy corporate profits and favourable financing conditions continue to be reflected in various indicators of financial distress, such as default rates. According to Standard & Poor's, the global corporate default rate for speculative-grade bonds fell to 1.1 per cent in the 12 months ending in April 2006, the lowest level in more than two decades (Chart 2).

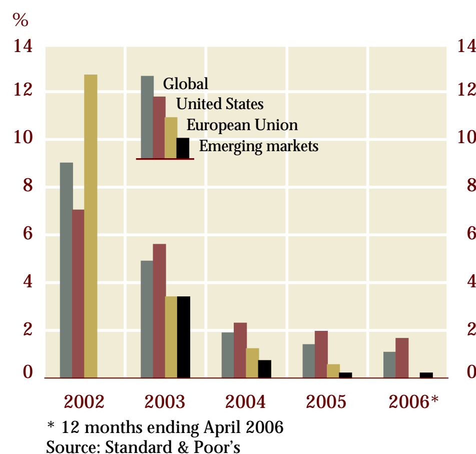
United States

Attention in the United States continues to focus on the housing market, which has been slowing since mid-2005. Price declines have been modest and orderly so far, with the median prices of new and existing homes falling by less than 5 per cent from their recent highs (Chart 3). Since their peak last summer, sales of existing homes have declined by 5 per cent and sales of new homes have fallen by 12 per cent, although the latter are a much smaller segment of the market. The average inventory of unsold new homes available so far in 2006 exceeds five months' worth of sales—much higher than the previous five-year average of 4.1 months. Applications for conventional mortgages have fallen by about 40 per cent since the middle of 2005.

The current housing boom has featured significant increases in lending to "subprime" borrowers. Non-traditional mortgages, such as adjustable-rate mortgages, hybrids, and simultaneous second mortgages and home-equity credit lines, are now commonly offered along with interest-only introductory periods and no requirements for documentation. These practices raise home ownership rates and lower consumer debt payments, but they also increase default risks and expose more homeowners to rising interest rates. Subprime mortgages, second mortgages, and equity-based lines of credit have higher delinquency rates than conventional fixed-rate mortgages and appear more sensitive to economic conditions (Chart 4). These developments need not pose difficulties for banks as long as these new types of mortgages are correctly priced.

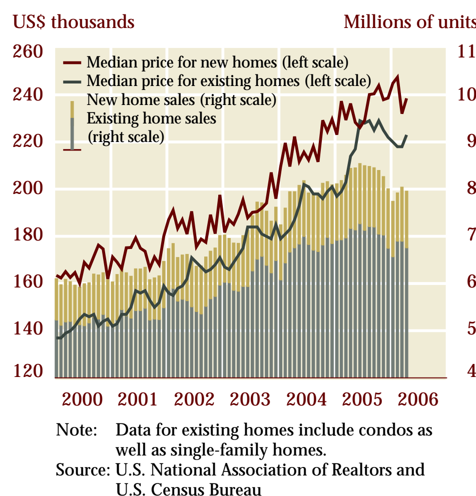
To ensure adequate management of potential risks, the Federal Reserve tightened regulations on home-equity loans and non-traditional

Chart 2 Default Rates on Speculative-Grade Bonds



* 12 months ending April 2006
Source: Standard & Poor's

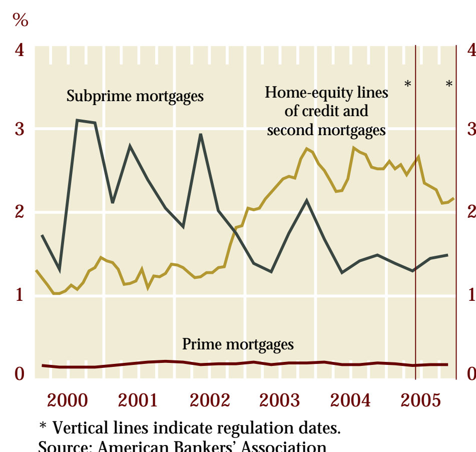
Chart 3 United States: Market Selling Price and Units Sold, New and Existing Homes



Note: Data for existing homes include condos as well as single-family homes.
Source: U.S. National Association of Realtors and U.S. Census Bureau

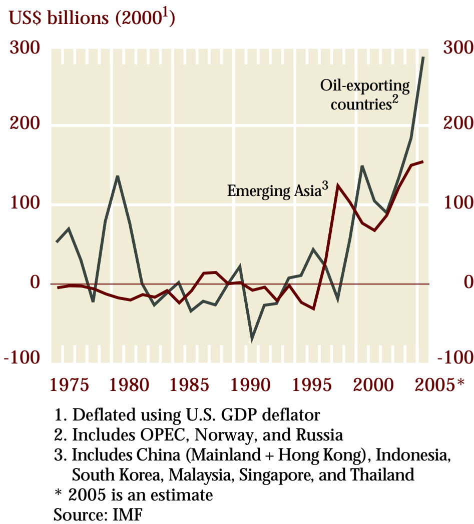
Chart 4 United States: Delinquency Rates

Not seasonally adjusted



* Vertical lines indicate regulation dates.
Source: American Bankers' Association

Chart 5 Current Account Surpluses

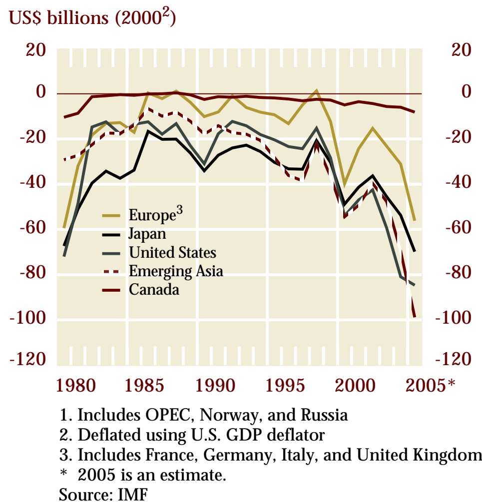


1. Deflated using U.S. GDP deflator
2. Includes OPEC, Norway, and Russia
3. Includes China (Mainland + Hong Kong), Indonesia, South Korea, Malaysia, Singapore, and Thailand

* 2005 is an estimate

Source: IMF

Chart 6 Trade Balances with Oil-Exporting Countries[1]

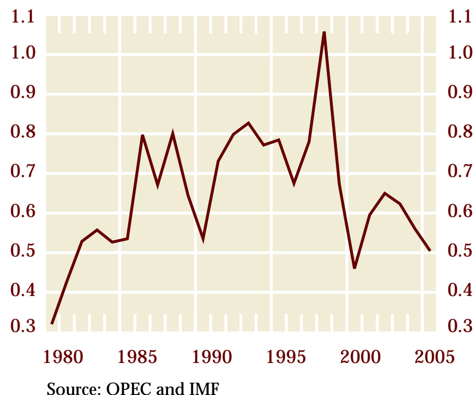


1. Includes OPEC, Norway, and Russia
2. Deflated using U.S. GDP deflator
3. Includes France, Germany, Italy, and United Kingdom

* 2005 is an estimate.

Source: IMF

Chart 7 Ratio of Imports to Oil Exports: Oil-Exporting Countries



Source: OPEC and IMF

mortgages in 2005. Most lenders have also recognized the potential risks posed by non-traditional mortgages. In the January Senior Loan Officer Opinion Survey, 40 per cent of respondents expected the quality of their non-traditional mortgages to decline in 2006. Accordingly, banks have increased loan-loss reserves.

Developments in the U.S. housing market to date appear to be broadly in line with consensus forecasts calling for a moderation in house prices over 2006, but a large price reversal remains a concern. Since Canadian financial institutions have very little direct exposure to the U.S. housing market, they are unlikely to be seriously affected by further adjustments to U.S. house prices. Canada would be affected indirectly, however, by the broader consequences of such adjustments on U.S. household spending and on U.S. economic activity.

Highlighted Issue

Petrodollar recycling and Canadian financial stability

Prepared by Robert Lavigne

The rise in oil prices since 2002 has produced significant windfall revenues for fuel-exporting countries. According to IMF estimates, revenues from international oil sales reached US$800 billion in 2005, a figure that has propelled the current account surpluses of major oil-exporting countries past those of Emerging Asia (Chart 5), making them the world's largest surplus-generating region.[1] The sources of this positive trade balance are divided among surpluses with the United States, Europe, and Asia (Chart 6). Canada, a net oil exporter, has only a small deficit with this group of countries.

These export earnings are recycled into the global economy either through imports of goods and services from oil-importing countries or through purchases of their assets. Chart 7 shows import growth in oil-exporting countries lagging the expansion of oil revenues by a considerable margin. There are several reasons for this

1. In this article, "oil exporters" are defined as OPEC, Norway, and Russia (the IMF definition also includes a number of smaller exporters). Emerging Asia comprises China, Hong Kong, Indonesia, South Korea, Malaysia, Singapore, and Thailand.

increased propensity to save, including uncertainty with respect to oil prices, the highly concentrated ownership of oil resources in many countries, limited immediate investment opportunities in local economies, and the constraints imposed by heavily managed exchange rate regimes on the conversion of petrodollars into domestic currencies.

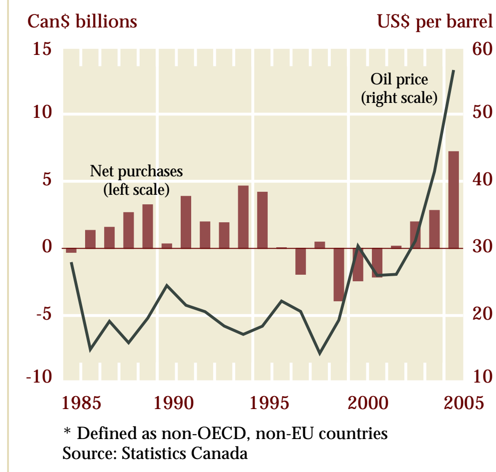
Although some of these savings are being used to pay down external debt, most petrodollars are invested abroad. In contrast to earlier periods of high oil prices, when petrodollars were stored mainly in international reserves or recycled via deposits in a few multinational banks, oil revenues are now allocated in a much more diversified manner, with a focus on portfolio investments.

Impact on Canada

Recycled petrodollars can enter the Canadian financial system through several channels. The most direct is through the purchase of Canadian securities. The extent of such inflows is difficult to assess, however, because most petrodollars move through international financial centres, which masks their origins in bilateral statistics.[2] Matters are further complicated by a lack of transparency in the investment policies of many oil exporters, an issue that may become a growing source of uncertainty if high oil prices are sustained.

With this in mind, it is interesting to note that net purchases of Canadian equities and long-term bonds by non-OECD and non-EU countries rose markedly in 2005 to an all-time high of over $6 billion (Chart 8).[3] While specific data on oil exporters are not available, the strong positive correlation between the price of oil and the net portfolio purchases from the aforementioned group suggests that petrodollars may be increasingly entering Canada. These inflows accounted for a sizable portion of net foreign

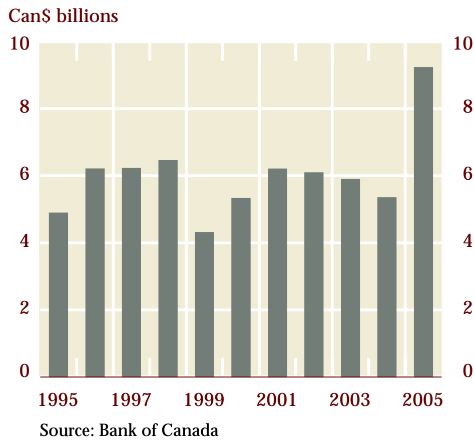
Chart 8 Net Purchases of Canadian Stocks and Bonds by Developing Countries*



* Defined as non-OECD, non-EU countries
Source: Statistics Canada

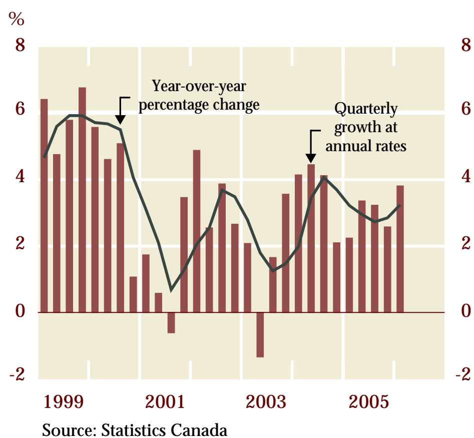
2. An extensive BIS study found that only 30 per cent of petrodollar investments could be tracked to a country destination.
3. The closest proxy for oil exporters in Statistics Canada data on non-resident purchasers of Canadian stocks and bonds (excluding money market instruments) is the category of non-OECD, non-EU countries. Because this data set includes the net purchases of other regions with current account surpluses, such as Emerging Asia, it reflects more than just petrodollar inflows.

Chart 9 Deposits of Oil-Exporting Countries in Canadian Banks



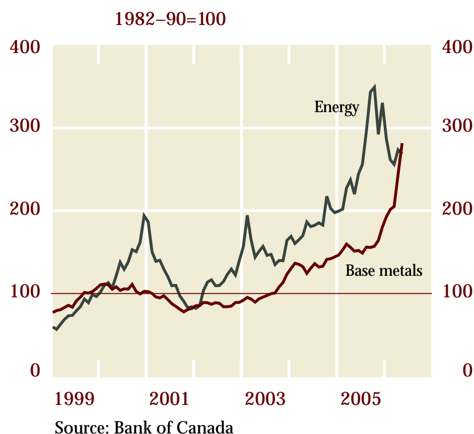
Source: Bank of Canada

Chart 10 Real GDP Growth: Canada



Source: Statistics Canada

Chart 11 Bank of Canada Commodity Price Index



Source: Bank of Canada

purchases of Canadian securities in 2005. Nevertheless, the magnitude of these flows remains small in relation to the average size of total foreign net purchases in recent years and to the overall stock of foreign-held Canadian securities (about $700 billion).

Petrodollars can also enter the Canadian financial system through deposits in Canadian banks. Indeed, there was a significant increase in deposits from oil-exporting countries in 2005, with the amount outstanding at branches and subsidiaries of Canadian banks worldwide nearly doubling to about $9 billion by the end of 2005 (Chart 9). This still represents only about 2 per cent of the total deposits of foreigners at Canadian banks worldwide.

Foreign direct investment in Canada by oil-exporting countries remains limited.

Overall, the relatively modest (though increasing) petrodollar inflows suggested by the available data are unlikely to significantly affect the Canadian financial system. Of potentially greater consequence for Canada is the impact of petrodollar recycling on global imbalances. Clearly, higher oil prices are serving to widen the U.S. current account deficit (net petroleum imports now account for 25 per cent of the deficit). However, petrodollars are increasingly being invested in a diversified, profit-oriented manner, which encourages a market-led resolution of imbalances.

Canadian developments

Canadian economy

Canada's real GDP grew at an average annual rate of just over 3 per cent in the second half of 2005 and the first quarter of 2006 (Chart 10). In the April 2006 *Monetary Policy Report*, the Bank judged that the Canadian economy was operating at, or just above, its production capacity in early 2006. Growth in final domestic demand is expected to remain the key driver of economic expansion in Canada through 2008. Net exports will likely exert a small drag on GDP growth for some time.

The Canadian economy is adjusting to the appreciation of the Canadian dollar, higher energy prices, and enhanced competition from Asian countries. Oil and metals prices have recently, been very volatile (Chart 11). Although the high prices for these commodities are largely related to the strong growth of world economic activity,

the current level raises questions about whether these prices will be sustained.

Corporate sector

The overall financial position of the Canadian non-financial corporate sector remained healthy in early 2006 (Chart 12). Profitability has been very strong in recent years. Many corporations used this opportunity to reduce their debts. As a result, the ratio of debt to equity has declined. The high level of profits has also allowed non-financial corporations to fund their investment spending from internally generated revenues and has made them net suppliers of funds to the rest of the economy. This contrasts with their traditional position as net borrowers (Tomas 2006). Furthermore, as companies endeavoured to find additional opportunities for profitable investment, they increased their holdings of cash and liquid assets, which amounted to 9 per cent of their total assets at the end of March 2006. The improvement in their balance sheets would make it easier for firms to deal with the financial consequences of adverse shocks.

In late 2005 and early 2006, profitability remained buoyant in most sectors with a low exposure to international trade, as well as in oil and gas extraction and mining (Chart 13). On the other hand, overall profitability for other industries with a high exposure to international competition continued to be relatively weak. Many companies in these industries were restructuring their operations because of such factors as the past appreciation of the Canadian dollar, the high level of energy costs, and increasing competition from emerging markets.

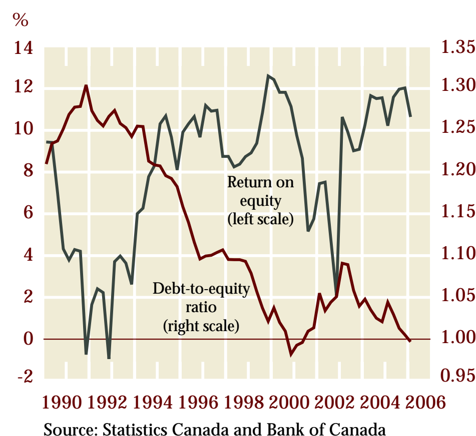
With the favourable macroeconomic environment and prudent behaviour by companies, business bankruptcies, as a per cent of total establishments, have continued to fall, corporate bond defaults have been virtually non-existent, and corporate bond spreads are still at a very low level.

While some indicators suggest that credit quality may start to deteriorate, this deterioration is expected to be confined to a few sectors, and is unlikely to pose a significant risk for the Canadian financial system (Box 2).

Industry

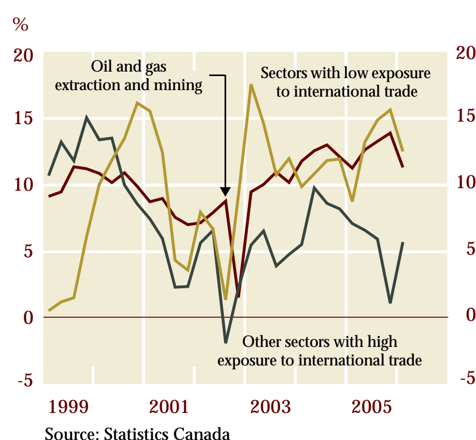
A limited number of industries, such as auto manufacturing, wood and paper products, and computer and electronics manufacturing, have

Chart 12 Financial Position of the Canadian Non-Financial Corporate Sector



Source: Statistics Canada and Bank of Canada

Chart 13 Rate of Return on Equity for Selected Sectors



Source: Statistics Canada

Box 2

Corporate Credit Quality in Canada: Assessment and Outlook

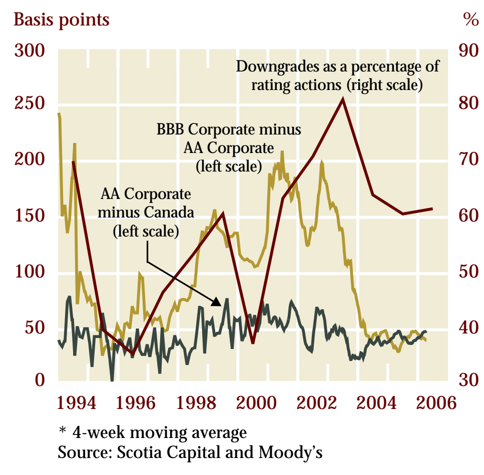
Favourable macroeconomic conditions in recent years have resulted in record profits for the non-financial corporate sector. A number of market-based indicators suggest that corporate credit quality is very high. Corporate bond spreads—for both high-rated bonds compared with government issues, and low-rated bonds compared with high-rated bonds—are at a very low level. The ratio of downgrades to upgrades has flattened after a few years of decreases (Chart 1). The quality of Canadian corporate credit is very strong, and default rates are very low.

However, there are some indications that credit quality might weaken. According to Moody's Investors Service, the corporate default rate in Canada is expected to increase in 2006 in tandem with the global default rate. The main driving factors are rising interest rates and slightly lower average credit ratings among speculative-grade issuers. Two potential leading indicators of credit risk in the aggregate non-financial sector developed at the Bank of Canada also suggest that credit quality may start to deteriorate from its current strong level.

One of these indicators uses the contingent claims approach (CCA), combining information on the market value of equity, debt, and market uncertainty to derive a measure of credit risk in the non-financial corporate sector. The second uses company-level financial accounts ratios (microdata) to make this assessment.[1] Both indicators show a recent increase in risk (Chart 2). The CCA measure of risk in the non-financial corporate sector started to increase in late 2005. The asset-based microdata indicator also increased in 2005.[2]

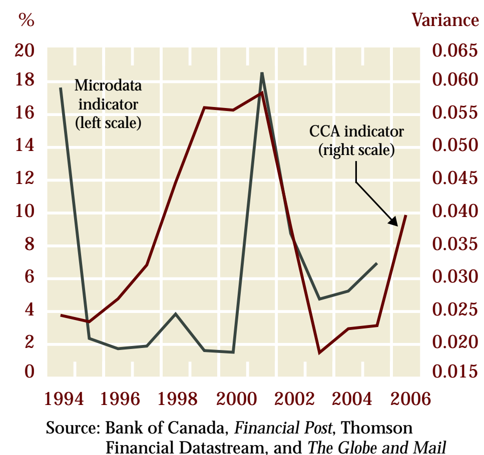
Preliminary work suggests that both measures may have leading-indicator properties, which may hint at deteriorating corporate credit quality in the future. However, the deterioration is expected to be confined to a few industries. Given the current strength of balance sheets in the non-financial corporate sector, this is unlikely to present a significant risk for the Canadian financial system in the near to medium term.

Chart 1 Bond Yield Spreads* and Ratings Actions



* 4-week moving average
Source: Scotia Capital and Moody's

Chart 2 Microdata and CCA Indicators



Source: Bank of Canada, *Financial Post*, Thomson Financial Datastream, and *The Globe and Mail*

1. The contingent claims approach is explained in this issue of the *Financial System Review* (Kozak, Aaron, and Gauthier 2006). The report on the microdata indicator was published in the December 2005 issue of the FSR (pp. 37–42). Briefly, this indicator is calculated for publicly traded companies as the percentage of assets held by companies that fall in the vulnerable tails of three financial ratios used as measures of financial vulnerability: profitability, liquidity, and leverage.
2. Both the microdata and the CCA indicators are based, at the moment, on the limited sample of balance-sheet data for 2005 available as of 2 May 2006. For the microdata indicator, only 47 per cent of companies had reported 2005 balance-sheet information. For the CCA indicator, all market information as of 2 May is included, and about 50 per cent of companies had reported 2005 balance-sheet information.

experienced particular financial stress since 2001. These sectors represent about 12 per cent of the banking sector's total loans to non-financial enterprises.

Canada's auto manufacturing industry experienced a substantial loss in the fourth quarter of 2005, partly reflecting writedowns, as a number of firms began major restructuring in response to the loss of market share by General Motors and Ford in recent years (Chart 14). Profitability did, however, recover markedly in the first quarter of 2006. Many auto parts companies in Canada (and the United States) are continuing to make difficult adjustments in an environment of high input costs and intensifying foreign competition.[4]

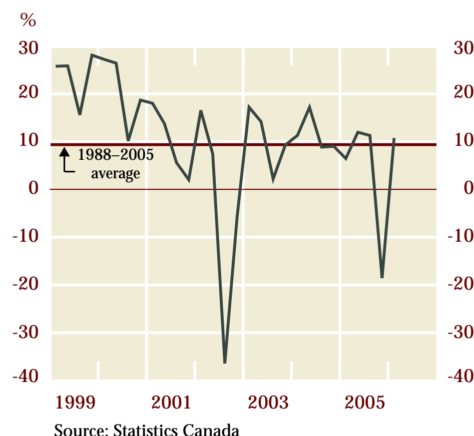
In addition, the wood and paper products industry experienced a loss in the fourth quarter, partly reflecting writeoffs, as a number of pulp and paper producers announced rationalizations of their operations (Chart 15). Factors such as the high value of the Canadian dollar, high energy costs, and rising wood fibre costs in Eastern Canada have all contributed to downward pressure on profitability. As a result, a number of Canadian companies saw their debt ratings/outlooks reduced towards the end of 2005. In the first quarter of 2006, profitability remained low. On the positive side, the Canada-U.S. Agreement Ending the Softwood Lumber Dispute should lead to an improvement in the financial position of lumber producers, chiefly as a result of the revoking of duties and the return of at least 80 per cent of duties paid since 2002.

Rates of return in the electronics and computer manufacturing industry remained quite low in 2005 and early 2006 (Chart 16). The industry continues to face intense competitive pressures from firms in emerging economies, even though sales volumes have continued to grow strongly. Consolidation is under way in the global telecom equipment industry, which might lead to a further restructuring of operations in the Canadian segment of this industry.

Grains producers have been adversely affected by weakness in world prices until very recently, as well as by the appreciation of the Canadian

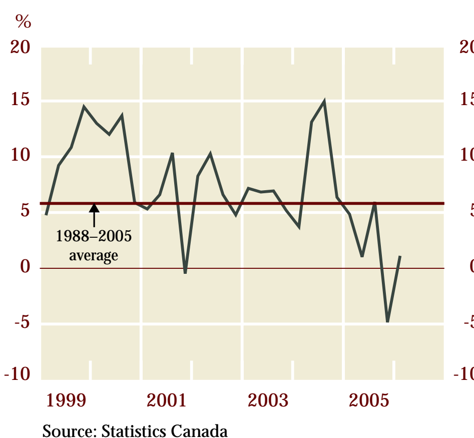
4. With a major U.S. auto parts company, Delphi, asking to repeal a number of labour agreements, there is a heightened risk of labour disruptions over the near term. This would contribute to even greater financial stress in the North American auto industry.

Chart 14 Return on Equity: Automotive Manufacturing



Source: Statistics Canada

Chart 15 Return on Equity: Wood and Paper Manufacturing



Source: Statistics Canada

Chart 16 Return on Equity: Electronics and Computer Manufacturing

Source: Statistics Canada

Chart 17 Household Credit

Year-over-year rate of growth

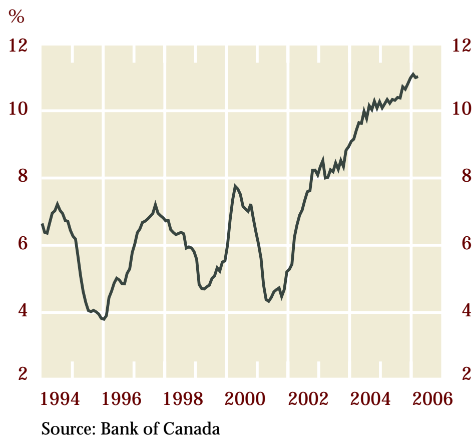


Chart 18 Financial Situation of Canadian Households

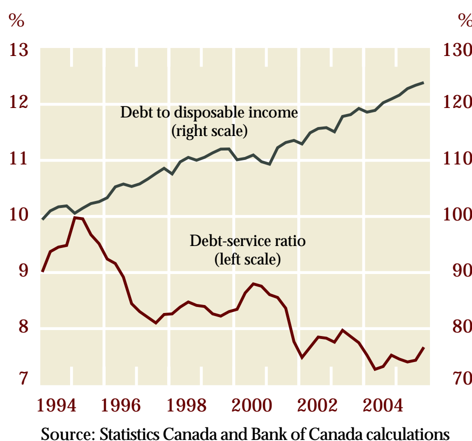
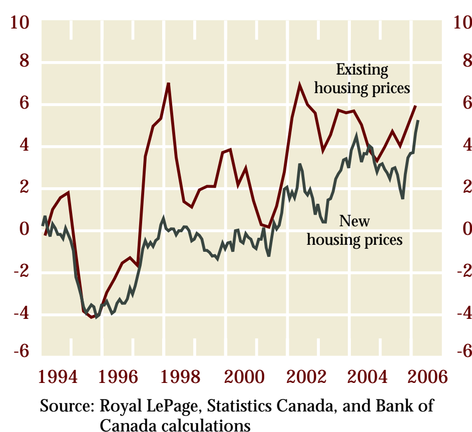


Chart 19 Developments in Real House Prices

Year-over-year percentage change



dollar and rising input costs. At the same time, despite further improvements in sales volumes, a sharp rise in fuel costs dampened the profitability of the Canadian air transport industry in late 2005 and early 2006.

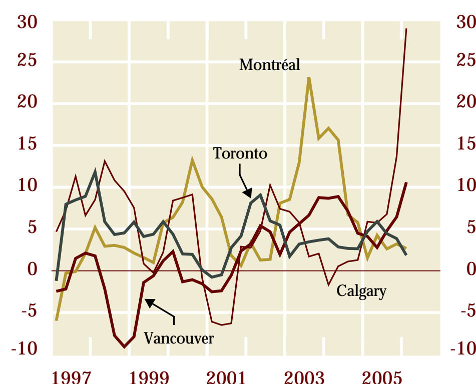
The problems in all of these sectors could have severe consequences for a number of firms in the affected industries. However, it is unlikely that such problems would severely impair the Canadian financial sector. In addition, many of these firms are currently undertaking significant adjustments in their operations to improve their financial situations over the longer term.

Households

Expenditures on housing and consumption were strong in 2005 and the first quarter of 2006, partly financed through the continued growth of credit (Chart 17). As a result, there has been a further rise in the ratio of household debt to disposable income. Even with this increase in debt and higher interest rates, the debt-service ratio of households remains at a very low level (Chart 18). The continued solid growth in employment and income currently projected should help households to service their debt. However, as discussed in the December 2005 FSR, if the overnight rate were to rise significantly above the current level, the aggregate debt-service ratio could rise above the average level for the 1980–2004 period. And if economic prospects for employment and income were less favourable than projected, a number of heavily indebted households would undoubtedly be strained financially.

Housing prices increased at a faster rate in late 2005 and the first quarter of 2006 after a period of moderation (Chart 19). This aggregate measure, however, hides significant differences among regions. While the pace of increase in housing prices in Central Canada (e.g., Montréal and Toronto) has been slowing gradually, prices in cities in Western Canada have accelerated significantly, particularly in Alberta (Chart 20), reflecting the economic boom in that region. There are few signs of excess supply at the aggregate level despite strong building activity, as illustrated by the gradual decrease in the number of recently completed but unoccupied dwellings. Taken together, these factors support the view that a significant reversal in housing prices is unlikely. However, there is a possibility of imbalances in certain areas or segments of the housing market.

A more detailed analysis of the condominium market appears below. This analysis suggests that the risk to the Canadian financial sector from this market is relatively small, both because the exposure of financial institutions to the market is limited and because a widespread reduction in condominium prices appears unlikely.



Highlighted Issue

An analysis of condominium prices

Prepared by Virginie Traclet

In the past few years, condominium prices have increased faster than prices for single homes in a number of cities and as fast as prices for single homes in the Greater Toronto Area and Calgary.

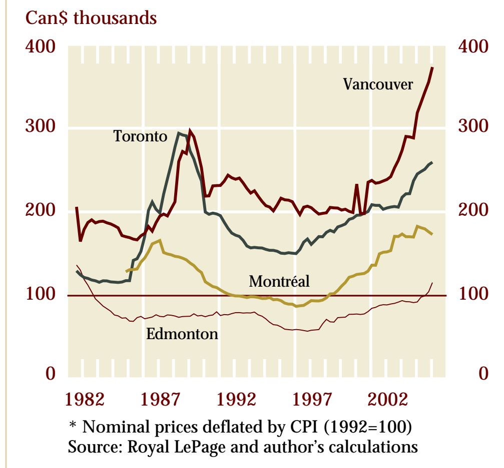
Exposure of financial institutions to condominium markets

Mortgage loans for condominium purchases have increased significantly in the past few years (by 46 per cent between 2000Q1 and 2006Q1). However, the share of mortgage loans for condominiums in total residential mortgage loans outstanding at commercial banks has remained stable, at slightly below 10 per cent. More than 40 per cent of mortgage loans for condominium purchases are currently insured and thus pose little risk for financial institutions.[5] Financial institutions generally require larger down payments for the purchase of rental condominiums than for the purchase of owner-occupied units.[6] Thus, the exposure of financial institutions to condominium markets is rather limited.

Loans from commercial banks to builders and developers for residential purposes have also increased markedly in the past two years (by 45 per cent between 2003Q4 and 2005Q4).[7]

5. Mortgage insurance, which is required when the down payment is less than 25 per cent of the value of the property, is provided by either CMHC or Genworth Financial Canada. The obligations of both CMHC and Genworth carry an explicit government guarantee.
6. Mortgage insurance is also available for rental condominiums, e.g., through CMHC multi-unit mortgage loan insurance, although with different eligibility criteria.
7. These loans include both condominium and rental projects.

Chart 21 Real Condominium Prices in Selected Cities*



* Nominal prices deflated by CPI (1992=100)
Source: Royal LePage and author's calculations

Table 1

Cycle of Real Condominium Prices in Local Markets

	Previous Condo Price "Boom"			Current Condo Price "Boom"		
	Period	Average annual increase %	Total increase %	Period[a]	Average annual increase %	Total increase %
Montréal	85Q4-88Q4	13	29	98Q4-05Q1	15	95
Greater Toronto Area	85Q4-89Q2	37	130	97Q3-06Q1	5	42
City of Toronto	86Q1-89Q2	46	151	97Q2-06Q1	8	68
Edmonton	86Q2-88Q3	5	11	99Q3-06Q1	11	71
Greater Vancouver	87Q1-90Q2	19	60	01Q3-06Q1	15	69
City of Vancouver	87Q3-90Q1	27	68	01Q3-06Q1	20	89
Ottawa	n.a.	n.a.	n.a.	00Q1-06Q1	12	73
Calgary[b]	n.a.	n.a.	n.a.	02Q1-06Q1	9	37

a. The starting point of the period is the date at which prices start rising again after having been flat in the 1990s. In Montréal, condominium prices reached their peak in 2005Q1 and have decreased slightly since then.
b. The condominium price measure cannot be calculated for Calgary over the whole period but only over the period starting in 2002Q1, because of changes in neighbourhood boundaries covered in the Royal LePage survey.

At $4.4 billion, however, they still account for a very small fraction of the loan portfolios of commercial banks, although some smaller institutions might be more heavily exposed.

While a correction in condominium prices would pose little risk to the stability of the financial system, it could have a negative impact on the household sector.

Developments in condominium prices

Condominiums accounted for 9 per cent of owner-occupied dwellings in 2001, up from 3 per cent in 1981.[8] They have performed strongly in the current housing cycle, accounting for about one-quarter of new home starts in 2005. Real condominium prices have increased in major Canadian cities in the past few years, after an extended period of flat prices in the 1990s (Chart 21 and Table 1).[9] Prices for condominiums have risen more than those for single houses in Montréal, Ottawa, Edmonton, and Greater Vancouver (Chart 22).[10]

A combination of structural and cyclical factors has contributed to the growing popularity and rising prices of condominiums. A shift towards smaller households and an aging population have increased the demand for condominiums, which require lower maintenance. Rising real disposable incomes since the mid-1990s, low interest rates, and tight rental markets in big cities have all made ownership attractive. At the same time, rising prices have put detached dwellings beyond the reach of many households, particularly first-time homebuyers (Royal LePage 2004, 2005). Finally, condominiums represent an affordable option for small investors who wish to include rental real estate in their portfolios. Tight rental markets in the second half of the 1990s, the poor performance

8. Not surprisingly, condominiums are more popular in big cities, where land is scarce and expensive. For instance, they accounted for 17 per cent of the owner-occupied housing stock in Vancouver, according to the 2001 census.
9. The condominium price measure used here is a quarterly resale price calculated using the Royal LePage *Survey of Canadian House Prices*.
10. This comparison must be used with caution, since it is done using a condominium price measure that is an unweighted average of prices in various neighbourhoods and a housing price measure that is a weighted average of prices in various neighbourhoods.

of equity markets in the early 2000s, and low interest rates in fixed-income markets all contributed to make rental condominiums an attractive investment. These factors suggest that at least some of the recent increases in condominium prices will be sustained.

Investment activity in condominium markets

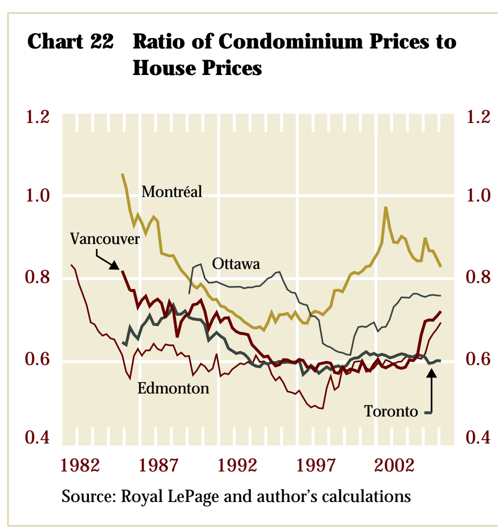
Investment in condominium markets falls into two categories: speculative investments, where the investor's objective is to "flip" the property to make a quick capital gain, and rental investments, where the objective is to rent out the condominium to generate cash flow over time. Contrary to the late 1980s, there are currently few signs of speculative activity in condominium markets in either Toronto or Vancouver.[11] In Vancouver, for example, only 12 per cent of the condominiums sold in the first eight months of 2005 had been purchased within the previous 12 months, compared with close to 30 per cent in 1989 and 50 per cent in 1981 (CMHC 2005a).

On the other hand, investment in rental real estate appears to have attracted a rising number of investors in the past couple of years (RE/MAX 2006). In Central Toronto, the number of rental condominium units rose by 21 per cent from 2001 to 2005; in the Greater Toronto Area as a whole, investor-held rental condominium apartments accounted for 19 per cent of the condominium market in 2005 (CMHC 2005b). Anecdotal evidence also suggests that rental condominiums are attracting an increasing number of small investors in Alberta.

Are there signs of excess supply?

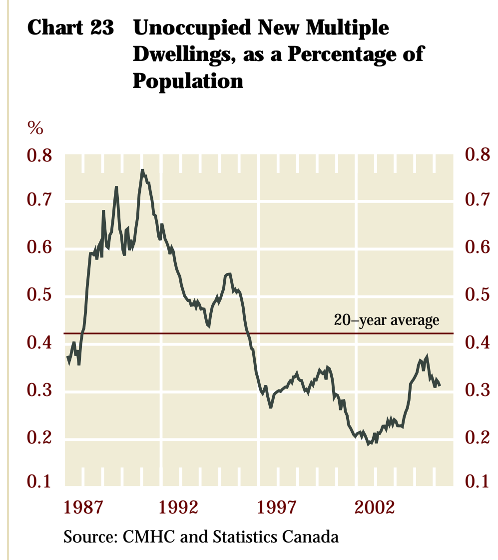
There seem to be few signs of excess supply at the aggregate level: the number of recently completed but unoccupied multiple dwellings relative to population is currently below its 20-year historical average (Chart 23).[12] Moreover, to avoid the buildup of excess supply, lenders typically

Chart 22 Ratio of Condominium Prices to House Prices



Source: Royal LePage and author's calculations

Chart 23 Unoccupied New Multiple Dwellings, as a Percentage of Population



Source: CMHC and Statistics Canada

11. Information about speculative investment in condominium markets is available only for Toronto and Vancouver.
12. It should be noted that unoccupied multiple dwellings include condominiums as well as apartments. More disaggregated data are not available. Because of data availability, we cannot calculate the ratio of unoccupied multiple dwellings to the stock of multiple dwellings. Instead, we use the population 15 years and older from the *Labour Force Survey.*

Table 2

Assessment of Excess Supply in Local Markets[a]

	Ratio of unoccupied multiple dwellings to population[b]	Relative price of renting versus owning	Rental vacancy rate
Montréal	Strong increase (above average)	Strong decrease	Strong increase
Edmonton	Increase[c] (above average)	Strong decrease	Increase
Ottawa	Stable (below average)	Decrease	Increase
Calgary	Decrease[d] (below average)	Strong decrease	Decrease
Toronto	Stable (below average)	Decrease	Stable
Vancouver	Strong decrease (below average)	Stable	Decrease

a. Changes in these indicators over the past three years
b. Comparison of the current value of this ratio to its 20-year average appears in brackets.
c. This ratio has decreased steadily from an historical high in March 2005, but currently remains above its 20-year average.
d. After having increased in the past three years, this ratio abruptly reversed in the autumn of 2005 and is currently below its historical average.

require developers to pre-sell a certain percentage of units—currently 60 to 70 per cent—before granting them the financing required to begin construction.[13] These factors suggest that a widespread reversal in condominium prices driven by excess supply is unlikely. The aggregate picture, however, conceals different situations in local markets.

Our assessment of excess supply in local markets is based on an analysis of the number of unoccupied dwellings (as a ratio of population), the rental vacancy rate, and the relative price of rented versus owned accommodation.[14] When the situation in rental markets improves for renters; i.e., when the rental vacancy rate increases and the relative price of rented accommodation decreases, a rise in the number of unoccupied dwellings is less likely to be absorbed by new first-time condominium buyers coming from the rental market. Thus, the combination of a growing number of unoccupied dwellings, a decreasing accommodation ratio, and a rising rental vacancy rate would point to emerging excess supply.

The results presented in Table 2 indicate that there are some disquieting signs in the Montréal and Edmonton markets. There is, however, no evidence of excess supply in Vancouver, Toronto, or Calgary, which together account for a very large share of the stock of condominiums in Canada. Evidence is mixed for Ottawa.

Thus, while there may be some risk of future downward pressure on prices in some condominium markets, overall, the risk of a broad reversal of condominium prices appears limited. Moreover, the exposure of financial institutions to condominium markets is itself limited. Thus, this presents no major risk for the Canadian financial system.

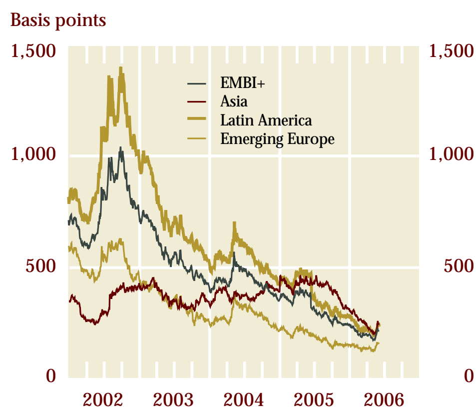
13. In the 1980s, it was common for projects to start with pre-sales well below 50 per cent.
14. This relative price, also known as the accommodation ratio, is the ratio of the rented-accommodation component of the CPI to the owned-accommodation component. It is not a perfect measure of the relative price of renting versus owning a condominium, since the CPI components include all types of dwellings, but it is the only proxy available.

The Financial System

Financial markets

Prices for risky assets, such as equities and emerging-market bonds, fell over a relatively brief period in May 2006 (Chart 24),[15] retracing most of their appreciation since the December FSR. This correction in the values of risky assets occurred in tandem with a general retrenchment in commodity prices, particularly prices for metals. As a result of these price movements, market volatility rose sharply in May (Chart 25). In addition, yields on bonds from major industrialized countries fell modestly in May, as investors sought to reduce portfolio risk. Nevertheless, these yields remain above those observed at the time of the December FSR by roughly 50 to 70 basis points.

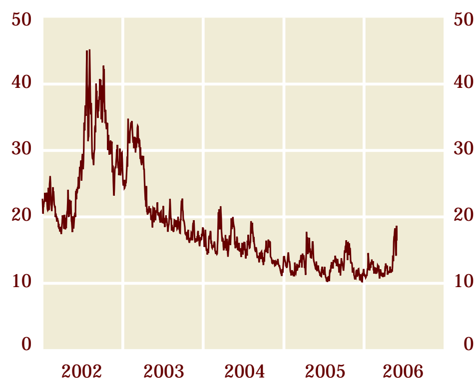
Chart 24 Yield Spreads on Emerging-Market Sovereign Bonds*



* Yield spreads between sovereign debt of emerging-market countries and U.S. Treasuries
Sources: JPMorgan Chase & Co., U.S. Federal Reserve, and Reuters

The recent declines in a broad array of asset prices appear to primarily represent a correction of the rapid escalation of asset prices vis-à-vis fundamentals since December, rather than a sharp increase in risk aversion. Since the prices of most risky assets are currently higher than at the time of the last FSR, and volatility, as measured by the VIX, still remains below its 10-year average, the concerns expressed in the December FSR that financial risks may be underpriced and that there is potential for further significant decreases in riskier asset prices remain despite the recent correction.

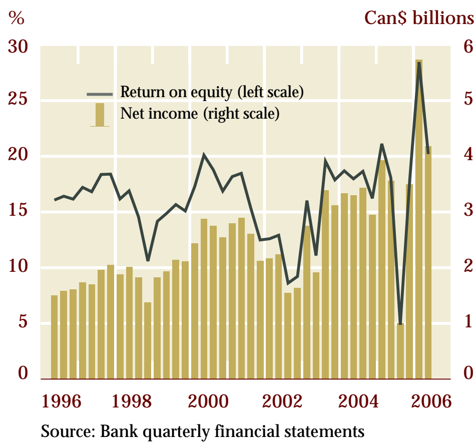
Chart 25 Implied Equity Volatility*

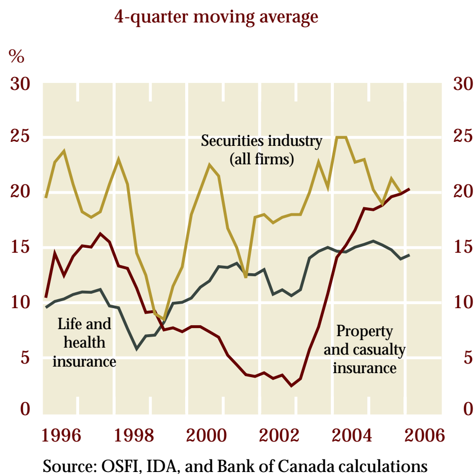


* VIX: Implied volatility on the S&P 100
Source: Bloomberg

The correction in the prices of risky assets appears to reflect a change in the perception of global growth fundamentals. There are mounting concerns among investors that stronger-than-anticipated global inflation, particularly in the United States, may bring forward and increase the degree of monetary policy tightening required among the G-3 beyond that which has already taken place. The European Central Bank and the U.S. Federal Reserve have raised their policy rates since December, while the Bank of Japan has recently announced the end of its quantitative easing policy. Investors seem to be increasingly concerned that the global reduction in monetary policy stimulus could lead to a

15. For example, the JPMorgan Emerging Market Bond Index (EMBI+), after reaching an all-time low of a 173-basis-point spread over U.S. Treasuries on 1 May, rose about 50 basis points. The TSX climbed by 10 per cent since December only to drop by about 8 per cent in mid-May.





decline in global growth. Accordingly, there has been a relatively large decline in the prices of assets that are particularly sensitive to the pace of global economic activity or to movements in commodity prices, such as emerging-market debt and shares of construction and materials companies. To date, markets have reacted to these changed perceptions of the underlying fundamentals of global growth in a relatively orderly way.

Financial institutions

The large Canadian banks continue to be very profitable and well capitalized, registering very strong profits through the first half of fiscal 2006 (Chart 26). Even excluding a $1.7 billion one-time gain by TD Bank in the first quarter on the sale of its U.S. brokerage operation, the average return on equity in the first half of 2006 was 20 per cent. Underlying profitability is firm, reflecting strength in personal and commercial sector business, strong revenues from trading and investment banking, and very high credit quality.

Market indicators support the view that Canadian banks are financially healthy. For example, a relatively new technique known as the contingent claims approach (CCA), based on the Merton model, uses both market and balance-sheet information to measure the riskiness of firms. A study applying this approach to the major Canadian banks suggests that their financial soundness has improved steadily in recent years and is currently very strong (Kozak, Aaron, and Gauthier 2006).

Canadian life and health companies have also enjoyed good profitability and strong capital positions through 2005 and early 2006. These companies have benefited from buoyant equity markets, which have boosted sales of segregated funds and other wealth-management products (Chart 27). Furthermore, sales of individual and group insurance products have been firm and credit losses very low. Profits have been strong in spite of the effect of the appreciation of the Canadian dollar on earnings derived from foreign operations and low yields earned on new fixed-income investments.

The Canadian securities industry reported its third straight year of record profits in 2005, boosted by a very robust fourth quarter (Chart 27). The

21 per cent increase in profits for the year reflected strength in all major categories of revenue.

The December 2005 FSR discussed the adverse impact of low global bond yields on the funding status of defined-benefit pension plans in Canada. The fall in yields over the past few years had raised the discounted present value of their pension plan liabilities (Tuer and Woodman 2005). However, the modest increase in yields since December has resulted in a decline in estimated pension obligations. The decrease in estimated pension fund liabilities, along with strong returns on pension fund assets, has generally resulted in an improvement in the funded ratio of pension plans. While the risks to the financial system related to the funding status of pension plans have declined since December, defined-benefit pension plans in Canada remain underfunded on balance. The 2006 federal government budget temporarily extended the period for funding the solvency deficits of federally regulated defined-benefit pension plans from 5 to 10 years, if plan sponsors meet certain conditions.

Important Financial System Developments

This section of Developments and Trends examines structural developments affecting the Canadian financial system and its safety and efficiency.

The Financial System

Financial markets

In January, the Canadian Accounting Standards Board (AcSB) ratified its strategic plan approving convergence with international reporting standards.[16] It has also adopted new accounting standards with regard to financial instruments. The standards, based on existing U.S. and international standards, will come into effect for public companies beginning on 1 October of this year.[17] They specify when a financial instrument should be recognized on a firm's balance sheet and how it should be measured once it is recognized. While the implementation of these standards may result in increased volatility in the value of key financial statement variables for firms whose assets and liabilities are not matched, it will also mean that users of financial statements will have better information on which to base decisions.

In March, the Canadian Securities Administrators (CSA) released a revised proposal on harmonized internal-control reporting requirements.[18] The new rules would require all publicly traded companies to report on the effectiveness of their internal controls on financial reporting but would not, as previously considered, require an external auditor's opinion. The CSA's decision is based on feedback from Canadian stakeholders and is consistent with international developments and experiences regarding financial reporting. In the United States, anecdotal and formal evidence of higher-than-expected compliance costs have led to calls for a similar reduction in the requirements for reporting on internal controls under the Sarbanes-Oxley Act, particularly for smaller public companies.

Another area in which recent U.S. initiatives have been important is the credit derivatives market. The rapid growth of this market over the past several years has not been matched by the growth of the supporting infrastructure for processing and settlement. Box 3 discusses recent industry initiatives to address this issue.

Canadian mortgage market

Two recent developments in mortgage insurance should provide further support to the Canadian housing market. These are offers to increase the amortization period of insured mortgages and to increase access to mortgage insurance for non-prime customers.

Canada Mortgage and Housing Corporation (CMHC) and Genworth Financial Canada recently announced an increase in the maximum amortization period allowed for insured mortgages, from the traditional 25-year amortization period to 30 years for CMHC and to 30 to 35 years

16. See Box 3 in the December 2005 FSR for a discussion of the international convergence of accounting standards.
17. Three new sections were added to the Canadian Institute of Chartered Accountants Handbook in January 2005: Section 3855—Financial Instruments, Recognition and Measurement; Section 3865—Hedges; and Section 1530—Comprehensive Income.
18. For more discussion on internal controls, see the Highlighted Issue, "Corporate financial reporting: The regulatory response in the United States and Canada," in the June 2005 issue of the FSR.

for Genworth Financial.[19] A premium surcharge will be added to the normal premium for mortgages with these longer amortization periods. Eligibility criteria for mortgage insurance are the same for mortgage loans with longer amortization periods as for traditional (25-year) mortgage loans (Traclet 2005). Since a longer amortization period will translate into lower monthly mortgage payments, a number of additional borrowers will become eligible for mortgage insurance.[20,21]

Genworth Financial has introduced two mortgage insurance products specially designed for non-prime/subprime borrowers. One is designed for customers who have experienced a credit setback and have started to rehabilitate their credit profile. The second is designed for self-employed people, who are traditionally considered low-documentation borrowers.

Highlighted Issue

Recent developments in the income trust market

Prepared by Stacey Anderson

Over the past few years, the income trust market has grown rapidly. It currently represents about 10 per cent of the total market capitalization of the TSX, up from around 2 per cent in 2002.[22] This rapid growth, which appears to be unique to Canada, has been influenced by the favourable tax treatment of the income trust structure, particularly from the point of view of tax-

19. For CMHC, it is a four-month pilot project conducted with FirstLine Mortgages from 3 March to the end of June 2006. CMHC will then assess the results of the pilot project and determine whether this will become a permanent program.
20. For a mortgage with a 5 per cent down payment and a 6 per cent interest rate, monthly payments would be 7 per cent lower with a 30-year amortization period than with a 25-year amortization, after factoring in a higher insurance premium.
21. Recall that the main eligibility criterion is that mortgage debt payments (and total debt payments) should not exceed a certain percentage of household income.
22. Source: TSX "Income Trusts on Toronto Stock Exchange." Data as of 30 September 2005. For a description of the characteristics of an income trust, see King (2003a,b).

Box 3

Measures to Reduce Operational Risk in the Credit Derivatives Market

Rapid growth in the credit derivatives industry over the past five years, primarily in the United States and the United Kingdom, has overwhelmed the infrastructure for processing and settlement, leading to delays and backlogs in trade confirmations. Deficient operational practices have resulted in uncertainties regarding counterparty risks and credit exposures of the major global bank-dealers that play a leading role in credit derivatives markets. In addition, a high proportion of non-bank involvement in credit derivatives trading, including hedge funds, has meant that the operational capabilities of some players are not supervised to the same degree as those of others.[1]

A private industry group, Counterparty Risk Management Policy Group II, was convened to study the issue, and its July 2005 report outlined recommendations for improving credit risk management, disclosure, and financial infrastructure. Further to that point, the Federal Reserve Bank of New York brought stakeholders together last autumn to discuss the issues and to encourage the industry to create and implement its own solutions.

This resulted in a public commitment last October by 14 major international bank-dealers to improve the infrastructure supporting the credit derivatives market. By February 2006, the number of trade confirmation backlogs had been reduced, a new industry protocol had been adopted (prohibiting the assignment of trades without consent), and the automation of trade processing had increased. In March, the 14 major dealers outlined further targets for action, including

- an additional reduction in confirmation backlogs;
- the creation of a largely electronic marketplace based on an industry-accepted platform;
- the creation of a central trade information database and support infrastructure;
- the development and implementation, by November 2006, of industrywide processing standards for trades, including those that cannot be confirmed electronically; and
- progress on a new framework for settlement of contracts following a credit event.

International supervisors and regulators, including Canadian authorities, have expressed satisfaction with the co-operation to date and are hopeful of continued progress towards an efficient and robust operational infrastructure for credit derivatives.

1. For a discussion of the impact of credit default swaps on financial stability in Canada, as well as internationally, see Reid (2005).

exempt and non-resident investors.[23] Strong demand from retail investors for income-producing investments has also contributed to the growth. A number of recent developments are likely to increase the involvement of institutional investors in the income trust market. First, income trusts have been included in the S&P/TSX Composite and MSCI (Morgan Stanley Capital International) indexes as of 17 March and the end of May, respectively. Second, five provinces (Alberta, British Columbia, Manitoba, Ontario, and Quebec) now offer limited liability protection to income trust investors.[24]

The following discussion examines the development of the income trust market over the past several years, reviews some evidence on the possible implications of the income trust structure for financial market completeness, and looks at some of the risks related to investing in income trusts.[25]

Changing characteristics of income trusts

The characteristics of firms adopting an income trust structure have broadened since energy and real estate firms first used them as funding vehicles. The past five years have seen a substantial increase in the percentage of trusts that belong to the industrial and consumer sectors and a decline in the proportion but not in the number of energy, real estate, and utility trusts (Chart 28).[26] At the same time, income trusts have emerged in the financial services, telecommunications, and health care sectors.

The growth in the relative number of these non-traditional trusts (henceforth, business trusts) has been accompanied by a decrease in the average size of income trusts. Most business trusts would be classified as mid-cap or small-cap. The average market capitalization of business trusts is $400 million, compared with $1.8 billion for energy, $800 million for utilities, and $650 million for real estate investment trusts (REITs).[27] Newer trusts also tend to be smaller than more established trusts. An examination of the initial public offerings (IPOs) of income trusts between 2001 and 2005 shows a steady decrease in median IPO size from $155 million in 2001 to $75 million in 2005 (Chart 29).[28]

Payout ratios, broadly defined as the amount of funds distributed to unitholders as a proportion of distributable cash, vary substantially by firm and by industry (Chart 30).[29] Firms with more variable cash flows and those with large capital expenditure requirements, such as energy trusts, tend to have lower payout ratios. Firms with the opposite characteristics, such as utilities, can support higher payout ratios. In some instances, however, cash flows can be too volatile to allow for sustainable distributions. Indeed, over the past few years, a number of income trusts have had to suspend or cut distributions. As of the end of 2005, 26 business trusts (or about 20 per cent of all business trusts) had cut or suspended distributions at least once since their creation. The reason most often cited was a decrease in demand for the trust's products, followed closely by the impact of the value of the Canadian

23. An income trust is a "flow-through" vehicle that allows income to flow through it and be taxed only at the investor level. For tax purposes, distributions are considered to be a combination of interest, dividends, and a return of capital. In its 2006 budget, the federal government increased the gross-up and dividend tax credit to eliminate the double taxation of dividends from large corporations at the federal level. This change in tax policy does not affect tax-exempt or non-resident investors, however. Since they do not pay taxes, they are not eligible for the gross-up and dividend tax credit and thus cannot recover taxes paid at the corporate level. They would thus have a preference for the income trust structure.
24. This legislation, which brings the treatment of trust unitholders in line with that of corporate shareholders, protects investors from being held personally liable for losses of the trust beyond their initial investment.
25. While this article presents some evidence on the impact of the income trust structure on market completeness, it makes no attempt to draw conclusions regarding the overall impact of income trusts on market or economic efficiency.
26. Sectors are defined according to Standard & Poor's Global Industry Classification Standard (GICS) methodology; the Consumer Discretionary and Consumer Staples sectors have been combined.
27. As of 7 February 2006.
28. This discussion is based on an analysis of data from the FPinfomart.ca New Issues database.
29. The definition of payout ratio used here is based on funds from operations (FFOs), which does not take capital spending into account. This would tend to bias the ratios downwards. The calculation of distributable cash, and thus the payout ratio, is subject to debate. (See the discussion on accounting later in this Highlighted Issue.)

dollar. Also frequently cited were risks related to the prices of raw materials and commodities (Blackmont Capital 2005, 2006). The incidence of cuts in business trust distributions over the period 2002 to the present has been broadly similar to that of dividend-paying stocks (Scotia Capital 2006).

Do income trusts enhance market completeness?

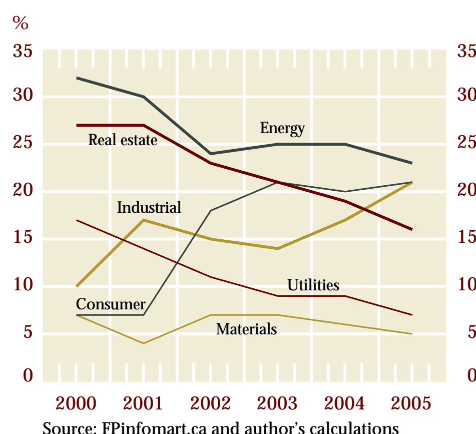
Income trusts exhibit characteristics different from those of common stocks. Limited evidence suggests that income trusts may enhance market completeness by providing diversification benefits to investors and a source of financing to firms that might not otherwise have had access to markets.

One reason for their recent popularity is that income trusts provide retail investors with a higher level of current income than dividend-paying stocks. Cleary and MacKinnon (2006) analyze the returns of an equally weighted portfolio of 59 trusts over the period 1995 to 2004. Their decomposition of trust returns into independent stock and bond return factors reveals that trusts are more similar to stocks than to bonds, but that income trusts have risk-return characteristics sufficiently different from either public equities or bonds to allow investors to achieve portfolio risk-return combinations not otherwise available.

The income trust structure may also have improved the access of certain firms to market financing. Carpentier, Kooli, and Suret (2003) note that primary equity issuance has been far less in Canada than in the United States and that capital raised is appreciably less after standardization by GDP. This trend in equity issuance may have shifted in recent years with the large number of income trust IPOs (Chart 31). Over two-thirds of business trust listings have been the result of either private firms going public or large public firms spinning off non-core parts of their operations through IPOs. These IPOs have been considerably larger than the average Canadian equity IPO, with average gross proceeds of \$129 million, compared with \$31 million for traditional equities.[30]

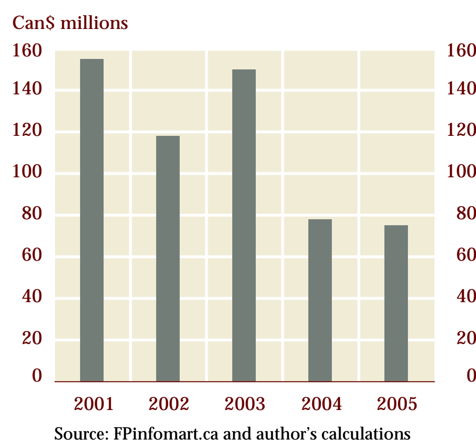
30. These averages are for different time periods. The income trust average is for 2001–2005. The traditional equity average is for the 1991–2000 period (source: Carpentier, Kooli, and Suret 2003).

Chart 28 Distribution of Income Trusts by Sector



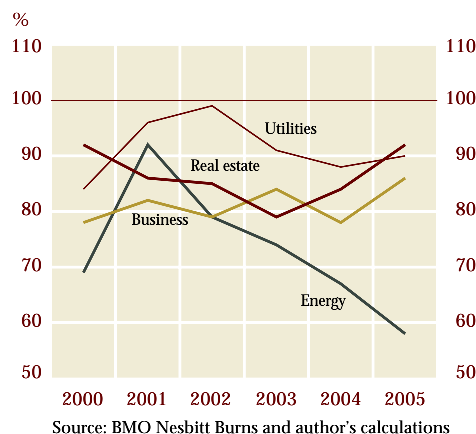
Source: FPinfomart.ca and author's calculations

Chart 29 Median Size of Income Trust IPOs

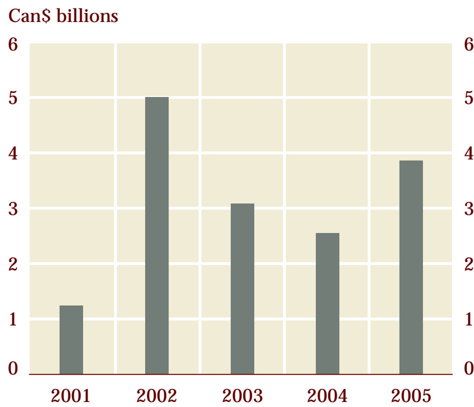


Source: FPinfomart.ca and author's calculations

Chart 30 Average Payout Ratio



Source: BMO Nesbitt Burns and author's calculations



Issues related to investing in income trusts

While the income trust market has matured over the past several years, there are still some areas where standards for trusts are not equivalent to those for corporations; in particular, two areas related to accounting and corporate governance.

The quality of income trust accounting has been questioned recently. In particular, distributable cash, a measure that is crucial to the financial analysis of income trusts, is not defined under Generally Accepted Accounting Principles (GAAP) but is left to the discretion of trust managers. This means that reported cash available for distribution is often overestimated, which may cause investors to make incorrect conclusions about the sustainability of distributions (Charbon and Hibbert 2006). A lack of transparency may obscure the fact that a firm is not reinvesting enough to remain a going concern. Various entities, acknowledging the need for improvement, have provided guidelines regarding the calculation of distributable cash.[31]

Because they are not corporations, income trusts are not covered under the Canada Business Corporations Act (CBCA) or equivalent provincial legislation. As a result, unitholder rights, which are defined in the declaration of trust, are somewhat different for each trust. While unitholders have most of the protection afforded to shareholders of a corporation, all of the same legal remedies are not available to them.[32] The Uniform Law Conference of Canada

31. These entities include the Accounting Standards Board (AcSB), the Canadian Securities Administrators (CSA), Standard & Poor's, and the Canadian Association of Income Funds (CAIF). In the case of REITs, the Real Property Association of Canada (REALpac) has published standards for calculating funds from operations.
32. For example, income trust investors cannot table shareholder proposals for a vote at annual meetings. For a fuller discussion of corporate governance issues related to income trusts, see King (2003a).

is currently working on a project to develop new harmonized provincial legislation that will address these issues.[33]

Conclusion

The continued growth and maturation of income trusts as an asset class has resulted in a market that is increasingly diverse in terms of sector, size, and risk characteristics. While there are areas where improvements can be made—in particular, increased clarity with respect to the calculation of distributable cash and corporate governance—available evidence suggests that income trusts may enhance financial market completeness.

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33. The Uniform Law Conference of Canada is an independent organization comprising two sections: Criminal and Civil. The Civil section considers areas in which provincial and territorial laws would benefit from harmonization. Delegates from each province and territory (as well as representatives from the federal government, private sector lawyers, academics, and law reformers) meet annually to develop nonbinding recommendations for the various levels of government.

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