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Chair

Mr. Rob Merrifield

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• (1530)

[English]

The Chair (Mr. Rob Merrifield (Yellowhead, CPC)): I'd like to call the meeting to order. This is pursuant to a committee resolution that we had on April 2, 2008. These are briefings on the asset-backed commercial paper in Canada.

We have with us, from the Office of the Superintendent of Financial Institutions Canada, Julie Dickson, superintendent. We want to thank her for coming.

Ms. Dickson, the floor is yours.

[Translation]

Ms. Julie Dickson (Superintendent, Office of the Superintendent of Financial Institutions Canada): Thank you.

Mr. Chairman, members of the committee, I am pleased to appear before you today to discuss this very important issue. There were many factors at play that caused the problems which occurred in the asset-backed commercial paper, also called ABCT, market, and I believe a full discussion and review are vitally important.

[English]

Before I speak to some of the questions related to the ABCP issue, let me touch briefly on OSFI's role in the Canadian system.

The Office of the Superintendent of Financial Institutions Act notes that OSFI shall strive to

protect the rights and interests of depositors, policyholders and creditors of financial institutions, having due regard to the need to allow financial institutions to compete effectively and take reasonable risks

Institutions under OSFI's regulatory oversight include banks, federally registered trust and loan companies, property and casualty insurance companies, life insurance companies, and federally regulated private pension plans. Thus for banks, OSFI's primary role or job is to protect the interests of depositors. This is important, since banks hold the life savings of many Canadians.

Because OSFI was created to help contribute to public confidence in the financial system, some have assumed this means we are responsible for public confidence in the financial system. However, our act makes it clear that our role in contributing to public confidence in the financial system is concentrated on the banks' safety and soundness.

Today I would like to focus on what OSFI is doing as a result of the non-bank ABCP issue. Before doing that, I would like to reiterate a few key points regarding the non-bank ABCP market.

First, OSFI's capital rules are designed to help protect the safety and soundness of Canadian banks in the interest of depositors. The capital rules that apply to Canadian banks did not drive the widespread adoption of general market disruption liquidity lines by non-bank firms in Canada. This topic is covered at length in an OSFI backgrounder dated April 22, 2008, copies of which were provided to you on Friday.

Second, there was no consensus that the ABCP market posed a significant risk to investors. Indeed, the market had worked very well for the previous 17 years. Further, some developments had occurred and were reported on that were seen as being positive, such as DBRS's decision to change its rating methodology in January 2007.

Third, much more is known today than before about the factors that were important for investor safety. For example, after the events of last August, it became apparent that the strength of the sponsor—in other words, whether the conduit was set up by a bank or non-bank—was extremely important.

OSFI has taken a number of actions in response to the ABCP issue. First, we assessed early on the impact of the turmoil in the ABCP markets on all federally regulated institutions that we oversee. Very few of the institutions we oversee had material exposure to non-bank ABCP. It's important to note that financial institutions are considered to be sophisticated investors. The private pension plans that OSFI oversees had virtually no exposure.

We also began a review of guideline B-5, which requires Canadian banks to delineate their roles and responsibilities in creating ABCP vehicles, as well as capital requirements for loans to such vehicles. We are focusing on the roles and responsibilities of banks, especially when they deal with ABCP conduits created by unregulated entities like Coventree. We are looking at whether bank involvement with such conduits can create the impression that ABCP issued by unregulated entities is sponsored by banks.

Third, we are focusing on how banks determine which products they add to their approved product list for ultimate sale. Our focus is on risk that may result in large, unexpected payouts or losses by a bank. From our perspective, Canadian banks are at risk if they unexpectedly repurchase products they had sold to clients. We want to determine best practices in developing approved product lists, so that the likelihood of future losses is minimized.

Fourth, OSFI has been very involved in the work of the Financial Stability Forum to assess the causes of the turmoil and to formulate recommendations to enhance system resilience. I've worked with international colleagues to draft the FSF report on enhancing market and institutional resilience. The report includes more than 60 recommendations that have been accepted by G-7 finance ministers and covers key issues, such as capital and liquidity for banks, as well as the need for more transparency in ABCP conduits, and various changes that should be made by rating agencies.

This is the reason I have to leave at 4:30. There is an FSF working group meeting tomorrow in Europe.

Lastly, OSFI, as well as our international counterparts via the Basel Committee, are increasing capital charges for liquidity lines to support ABCP. This will further enhance bank safety and soundness.

The freezing of the non-bank ABCP market has rightfully led to a lot of questions, and it is important to identify and understand what happened. OSFI fully supports the efforts being made by all parties in this regard and will continue to provide input into these deliberations.

I would be pleased to take your questions.

• (1535)

The Chair: Thank you.

Mr. McCallum.

Hon. John McCallum (Markham—Unionville, Lib.): Thank you for your testimony. My first question has to do with the market disruption liquidity lines, which I gather have been terminated. Does that imply, at least with the benefit of hindsight, that it would have been better had they never existed?

Ms. Julie Dickson: The first thing to note, just so that everyone is clear, is that the general market disruption liquidity lines, B-5, which set out a zero capital requirement, did not apply to Coventree or the non-banks at the heart of this issue.

What we talked about in our background was that in 1988 or so, regulators around the world had set a zero capital charge for any type of liquidity line under one year. When OSFI saw securitization start to grow rapidly, we became very concerned about the fact that no capital was being—

Hon. John McCallum: Excuse me. I have read your document.

Would you agree with my proposition that with the benefit of hindsight it would have been better had those kinds of lines not existed?

Ms. Julie Dickson: That would not be true from a bank regulator's perspective. From a bank regulator's perspective, you have to have capital if you take risk. The banks were not taking much risk with those liquidity lines. When you look at what

happened globally, asset-backed commercial paper vehicles globally started to have a problem even with global lines.

From our perspective, the Canadian banking system is not having the kinds of problems that some other banking systems are having, because they were not taking risks without capital.

Hon. John McCallum: But isn't it true that you've recently adopted a broader risk management framework, which would look at banks in their capacity as investment dealers and reputation risk and things of that kind? In that broader context, is it not the case that those lines inappropriately transferred risk from institutions to individuals?

Ms. Julie Dickson: We have said we are going to revise guideline B-5. We are working on that now. We are going to our international colleagues and we're saying that a zero percent capital charge is inappropriate for any liquidity line. That is because we have seen that banks bought back or started to support their vehicles. If you are going to be supporting your vehicles, you must have capital.

The whole theory had been that risk was being transferred to investors. That was the theory around the world. But what we've seen in the last nine months is that the risk that banks thought they had transferred actually hasn't been transferred, because banks stepped in and bought the transferred product back.

While we had legal and accounting opinions that the risk had been transferred to investors, we began to realize, as did every other regulator, how important reputation risk was. Once transferred, they would bring it back. They will have to hold capital for any liquidity line going forward.

Hon. John McCallum: There have been rumours that one or more financial institutions regulated by OSFI may have had inside knowledge of declining asset quality and possibly ordered these assets to be sold without informing clients.

Is OSFI examining tapes or trading behaviour in the period leading up to the freeze in August of 2007?

Ms. Julie Dickson: That would be the responsibility of the Securities Commission and of the Investment Dealers Association.

Hon. John McCallum: Even if it involves chartered banks?

Ms. Julie Dickson: Yes. Most of the stuff was sold through dealers. Product was being sold by either the dealer, mostly the dealer, or by the bank directly. We are looking to the Securities Commissions and the IDA to do work. The IDA has indicated they are doing work.

• (1540)

Hon. John McCallum: It seems to me there were a number of red flags that went up that OSFI seems to have ignored. For example, only one domestic rating agency gave a rating and the larger international ones did not. One Canadian bank, the TD Bank, decided it wouldn't have anything to do with that kind of asset. The international standard was very different from the Canadian standard.

My question is, weren't there warning signs that occurred along the path that would have caused OSFI to take action faster than it did and play more of a leadership role in this fiasco?

Ms. Julie Dickson: I think when you look at the 17 years preceding August, this market had worked extremely well. We knew there was a debate, and that was a very public debate. We've seen the reports that various rating agencies prepared and issued. DBRS was issuing reports. Other reports were being done. Even the Bank of Canada did a very good report in June 2007, and they talked about the fact that we had a unique market. Then they talked a lot about other features of the market.

Because we had general market disruption liquidity lines, the credit enhancement was greater. For example, you'd put more assets into the vehicle than commercial paper issued. While the liquidity lines were not what you saw internationally, the structures were believed to be more robust, with more assets in the structures. From our perspective, this was known. We had sophisticated investors who are heavily involved in the market presumably knowing about those reports.

It's not a market that we oversee. We've spoken in the past about the kind of work we do, which is focused solely on bank safety and soundness. We would put investor alerts on our website if we saw someone saying it was a bank and taking money from Canadians when it's not really a bank. There would be an investor alert on that. But when you're talking about asset-backed commercial paper and the fact that the market was different from what existed elsewhere, we would look more to other agencies that have responsibility for investor protection.

We were out at conferences explaining that we were not telling banks what type of liquidity line to offer. It was something the market was deciding and investors were deciding.

Hon. John McCallum: But now you are telling banks.

The Chair: Your time is gone. We have to move on to other questioners.

Monsieur Crête.

[Translation]

Mr. Paul Crête (Montmagny—L'Islet—Kamouraska—Rivière-du-Loup, BQ): Thank you, Mr. Chairman.

Ms. Dickson, as far as asset-backed commercial paper in Canada is concerned, do you agree that, beyond the financial crisis, we came

close to a major economic catastrophe because of the lack of control at each stage of securitization? When securitization was created, a process whereby many financial products containing good and rotten apples are bundled together, this is what led to the major catastrophe we are experiencing today. How should the system be changed so that this type of situation does not happen again?

Let me give you a concrete example I am familiar with. A bank sells one of these products, knowing full well that this product is not reliable, to people who have short-term needs, but who, three days later, will have lost \$20 million.

What has to be done so this type of situation does not happen again? What has to be done at each stage of the process by the credit rating agencies, by your organization or others, including the Bank of Canada, so that does not happen again? What is your position on this?

• (1545)

[English]

Ms. Julie Dickson: I know the securities regulators across Canada are looking at the operation of the exempt market as it pertains to asset-backed commercial paper. The big issue here is that asset-backed commercial paper was sold without a prospectus because it was in the exempt market. The security regulators are looking at that and whether anything needs to change in that regard.

One of the issues in this market is that it evolved quickly over time. For a long time it stayed the same and the product stayed the same—the asset-backed commercial paper. Indeed, the asset-backed commercial paper vehicles that banks themselves set up tended to be plain vanilla. But the asset-backed commercial paper conduits that were being set up by the unregulated players tended to be much more complex and aggressive. I think you always have to be concerned if a product changes over time and you don't see it.

I noted that we were looking at the approved product list processes—

[Translation]

Mr. Paul Crête: In your opinion, did the credit rating agencies do their job well?

[English]

Ms. Julie Dickson: Are the rating agencies playing a role?

[Translation]

Mr. Paul Crête: Are they still doing their job well?

[English]

Ms. Julie Dickson: I think DBRS should talk about exactly what it did. I noted in all of my speeches and backgrounders that they believed the risks were balanced because they had a general market disruption liquidity line, but they had better enhancement in the vehicles. That's what they've said, but they could give you more information on that.

[*Translation*]

Mr. Paul Crête: In Canada, the banks generally have a good reputation in the eyes of the public. However, in this context, some banks offered a product which turned out to be of extremely bad quality. The ones who did so really put their credibility on the line.

Should there be better controls over banks selling this type of product?

[*English*]

Ms. Julie Dickson: There are a lot of things here. Not only banks sold the products; we know that. I don't know all the details here, but banks can act in different ways as fiduciaries, in which case they have an obligation, if they are giving advice, to know the product and the client. That is what the securities commissions and the IDA would be looking at.

Banks can also act as order desks. The phone rings, you pick it up, and someone says, "I want the product." Banks would have tapes, etc., of that.

It's hard to make generalizations. If anyone is giving advice to buy a product, there is a regulator involved. It's not me, but there is a regulator and they're looking at that.

[*Translation*]

Mr. Paul Crête: Within the framework of your role, and in light of what has happened and what is still happening, do you have any recommendations for us, or do you think you will have recommendations for us on how to improve, widen or change the scope of your mandate?

[*English*]

Ms. Julie Dickson: We need all the facts first before we talk about making my mandate broader, because other regulators are still doing their work. We need to see what the Investment Dealers Association, now IIROC, come up with. They said they will tell people what the findings are. We need to see what the securities commissions do with the exempt market and its definition. Once we have all of that, we will have more of a basis to see whether there was any regulatory gap at all.

[*Translation*]

Mr. Paul Crête: Has anyone received the mandate to conduct a global overview of the situation, or is everyone putting forth their own recommendations? No one seems to have received the mandate to compile all the recommendations which have been made to see what exactly needs to be changed. In your opinion, do you feel that each organization is currently working in a silo, including your own?

• (1550)

[*English*]

Ms. Julie Dickson: We do work together. We each have our own role, but we do meet together as a group. The Bank of Canada chairs meetings, and we meet with the securities commissions and the Department of Finance. We will, on occasion, invite the IDA, now IIROC, and talk about what each regulator is doing and how we're addressing these problems. And of course we do the same thing internationally, because this is not a unique problem to have. So a lot is being done.

The Chair: Thank you very much.

Mr. Menzies, the floor is yours for seven minutes.

Mr. Ted Menzies (MacLeod, CPC): Thank you, Mr. Chair.

I will try to get in a few quick questions and then pass the microphone to Mr. Del Mastro.

Thank you for coming, Ms. Dickson.

I think you will find this a very non-partisan issue around this table, unlike many others. Everyone is here trying to find out what went wrong. Our role, as parliamentarians, is to make sure our investors, both large and small, are protected.

I'm sure you're aware that we started out with some witnesses from a variety of sizes of investors who were frankly very critical of you and some of the others. I think they were looking at the role the Minister of Finance played in this, which was nothing other than encouraging everybody to sit down and get together.

But a lot of them suggested they didn't know what they were buying. That, to us, is very troubling. Maybe you can comment on that, whether or not you can play any role in that.

One accusation was that we've abandoned seniors, and that seniors were allowed to invest in these unprotected, which has hurt their future savings, if you will.

The other major accusation was that international banks should not be permitted to operate schemes in Canada that expose billions of Canadian dollars.

I don't know if that's your role, but can you comment on those accusations to at least get the record straight on that?

Ms. Julie Dickson: On the first one, concerning investors, in my role we're interested in depositors. If you put your money in a bank deposit—an RRSP, a GIC—and the institution is a member of CDIC, and all banks must be members, then you're protected up to \$100,000. That's where my role ends.

But it is obviously an important issue, particularly when unsophisticated people end up with something they perhaps shouldn't have. I think that is where the work that's being done now by the IDA to look at exactly how the product was sold and what might have been said is so important, and we won't have the answer until that work is done.

In terms of foreign banks, any company in Canada is free to seek out a foreign bank for loans or for services, and that is what we saw with the non-banks—Coventree, etc. We think they dealt primarily with foreign banks, which OSFI does not oversee. We think 90% of the liquidity lines were negotiated with foreign banks.

The way the legislation works is that if a foreign bank comes to Canada and wants to take your money and put it in a bank deposit here, then we oversee that. But if a corporation wants to borrow money, it can go anywhere. That is probably a good thing, that they're able to seek out a source of funding from any bank in the world.

Mr. Ted Menzies: Thank you.

Mr. Dean Del Mastro (Peterborough, CPC): Thank you, Ms. Dickson.

I have a couple of questions. To begin with, as Mr. Menzies indicated, some people came forward who were critical of OSFI's role. That said, I think that may be somewhat misdirected.

My greater concern is on Canada's patchwork system of securities regulatory bodies. I'm just curious, does OSFI have a position? I know it's been the position of our government that Canada needs a single or national securities regulator. Does OSFI have a position on that?

• (1555)

Ms. Julie Dickson: We usually don't go out and talk about that at great length. That's something a lot of parties obviously talk about. From where I sit, I usually just talk about my own experience.

Certainly I am one person sitting here, not 13 people. So I think there is probably more accountability with one regulator than with 13.

I also think that internationally, when we sit at the Basel table or in other forums, it's easier if you're dealing with one regulator. But that's been my experience.

I do work with the securities commissions on a regular basis, and it's easier with one.

Mr. Dean Del Mastro: Thank you.

We seem to stand alone in that regard, so I certainly would support your personal view on that. It seems to me that if there really is a major failure on this, certainly a single regulator would hold those accountable to the failure.

But if there's a failure on this, it comes back to the rating service. The DBRS basically rated this asset equivalent to T-bills, with a slightly higher yield. In fact, we had a number of witnesses who came forward and said that when they were buying this they were told that for this type of asset to fail, the banking system in Canada would have to fail, and that's because it was rated in that fashion.

Do you have any comment on how these were rated then versus how they will be rated in the future?

Ms. Julie Dickson: Well, internationally, this is not the only product that failed to perform. Many products that were rated by various rating agencies failed to perform. That's point number one.

Second, what I've certainly learned is that whenever you see rating agencies disagreeing, it's time to pay attention. If you have rating agencies with very different views...and in the last month I've seen another case of that with a different product, primarily in the U.S., where four rating agencies were involved. Two were agreeing on a high rating and two were saying it didn't deserve that high rating. It's

a huge red flag that I think, going forward, people need to pay more attention to.

So plenty of improvement is called for on a number of fronts, and rating agencies are the focus of a lot of review and study internationally. The SEC announced last week certain changes that it wants to see, and of course DBRS would be paying close attention to that.

Mr. Dean Del Mastro: Thank you.

I have nothing further, Mr. Chair.

The Chair: I appreciate that.

Mr. McKay, you have five minutes.

Hon. John McKay (Scarborough—Guildwood, Lib.): Thank you, Chair.

Thank you, Ms. Dickson.

You're charged with the safety and soundness of the banking system. Mr. Clark, who was formerly with the Department of Finance in a senior position, then president of Canada Trust, now president of TD Bank, and by all measures a pretty sophisticated individual, said that he didn't understand the priorities in the event of difficulties. And indeed, when others have tried to explain it, it's sort of like a "Where's Waldo?" cartoon. You go here, you go there, you go everywhere else, but if you try to follow the chain of priorities and liabilities, it's virtually impossible.

Is there anyone in your shop who actually has sat down and charted out the priorities in the event that these securities are called upon?

Ms. Julie Dickson: Could you elaborate on what you mean by priorities?

Hon. John McKay: It seems to me you determine the liquidity requirements of a bank based upon your analysis of the risk of the securities they present, and it seems to me that if you're charged with the safety and soundness of the banking system, if Bank X puts forward this \$100 million worth of securities, then there should be someone in your shop who says, "This is the risk analysis of this particular security."

The question is relatively simple. Is there someone in your shop who is charged with that? If so, what was their analysis of these kinds of securities?

• (1600)

Ms. Julie Dickson: We're talking about complex products in general and the fact that some banks didn't have these products and didn't have these problems—like TD?

Hon. John McKay: Well, we're talking about a complex product, and presumably at some point that complex product is presented to you for the purposes of its liquidity. You're charged with safety and soundness, and presumably you have to have an independent analysis of whether this is an asset that generates more or less liquidity.

Ms. Julie Dickson: The way it works is as follows.

We set the capital requirements and liquidity rules—but capital requirements primarily. If you're going to get involved in complex products, if you're going to be investing in complex products, the focus is capital. There was a lot of discussion, not only in Canada but around the world, about complex products, because these were evolving quite quickly. There were studies done internationally by regulators, and OSFI participated.

A number of questions were asked. Do investors understand what they're buying? Do banks understand what they're doing? Do rating agencies understand what they're doing? Do regulators understand what's going on?

So regulators had done a fair bit of work and had identified risks. We would have gone into all the institutions and talked to them about the risks that we were seeing, delving further and trying to see whether they had the staff who understand the risk because it's primarily their responsibility. We are not in there on a day-to-day basis to see what they're doing.

Hon. John McKay: But if you're in charge of safety and soundness, isn't it also your responsibility to know what happens to this particular product when there is a default? If a person like Mr. Clark is saying he doesn't understand this, I'm a little confused as to how OSFI could say, in full conscience, that it understood the product.

Ms. Julie Dickson: First of all, it's the institutions that have to say whether they're understanding it or not. One institution can say they don't understand it and another can say they understand it completely. But it is our prerogative. This is what institutions are doing around the world. We need to be able to compete. We would see the boards of directors, we would do reviews of what we were seeing, and we would be explaining to the boards that it is their responsibility to know what they're doing. And I think the record in Canada has been fairly good.

When you look at—

Hon. John McKay: Wouldn't you be able to say, if you want to invest in these products, you can do what you want, but for our purposes, our analysis as OSFI, you have to put up x capital for this, and if you have to go and borrow it from GICs and put it up, that's another thing?

Ms. Julie Dickson: Yes, and we set those rules internationally. Those capital rules were based on complexity, and they're going up again. That was in the backgrounder I issued in April. The Basel Accord is going to be amended again because as regulators we have seen there is still not enough capital for some of these complex products. As a result, that will be going up again.

Hon. John McKay: Thank you.

The Chair: Thank you very much.

Mr. Laforest.

[*Translation*]

Mr. Jean-Yves Laforest (Saint-Maurice—Champlain, BQ): Thank you, Mr. Chairman.

Good afternoon, Ms. Dickson. In your opening statement, you talked about the measures which the Office of the Superintendent of Financial Institutions is taking to determine which measures should

be implemented in the future. You listed three points. In the second point, you say: “there was no consensus that the ABCP market posed a significant risk to investors”.

Can you tell us who specifically did not reach a consensus? I imagine this involved several parties.

[*English*]

Ms. Julie Dickson: I was referring to the assessments that have been done of the market. The rating agencies had views, and there were others who commented on the market. We would be at conferences as well. Up until August, the market had been working well, with a lot of sophisticated investors willing to put money into it in significant amounts.

[*Translation*]

Mr. Jean-Yves Laforest: Would you, who work for the Office of the Superintendent of Financial Institutions, have an opinion on that at this point? You said that even the credit rating agencies had diverging views. Did your office have a position on the issue before August 2007?

• (1605)

[*English*]

Ms. Julie Dickson: What we were focused on was the exposure of banks to that marketplace. Whenever there is discussion about a market, whether it be real estate, telecom, you name it, what we're focused on primarily is banks' exposure to that market, because if something happens...it's often difficult to predict exactly what will happen. But if something does happen, you have to make sure that banks have solid capital and are able to withstand whatever may come their way.

If you look at the asset-backed commercial paper market, I think there were not as many signs there as there often are in other markets. You can look in the past at the dot-com bubble, for example.

[*Translation*]

Mr. Jean-Yves Laforest: I will ask you another question right away, because our time is limited. In your third point, on the same issue where you talk about measures, something surprised me a great deal. You say:

Third, much more is known today than before about factors that were important for investor safety. For example, after the events of last August, it became apparent that the strength of the sponsor [...] was extremely important.

I am surprised that you only recognize now that the strength of the sponsor is extremely important, whereas I thought it always was important. I don't understand. Does this mean that before, the strength of the sponsor was not important?

[English]

Ms. Julie Dickson: I can elaborate on that. My message was that when banks set up conduits, asset-backed commercial paper conduits, the theory was that they had transferred the risk completely to investors. When Coventree, an unregulated player, set up a conduit, the theory was that it had transferred risk completely to investors, so that the only thing investors had to look at was what was in the conduit, what mortgage loans or car loans were in the conduit. You didn't have to worry about who had set the conduit up. But what we've seen internationally is that if banks set up a conduit, you would be far better off if you had been investing in paper issued by a bank.

[Translation]

Mr. Jean-Yves Laforest: But the investors trusted the credibility of the guarantor and the credibility of the product they were buying. You are telling us that the buyers were assuming the risk, regardless of the credibility of the seller. And that is where people were had.

[English]

Ms. Julie Dickson: The investors who were investing in these products legally were relying on the conduit only. I think some of the ratings given to conduits may have implicitly taken account of the fact that the bank was a sponsor, but at the end of the day, perhaps not as much as it could have, because the paper issued by unregulated conduits was given the same kind of rating as paper issued by bank conduits.

What really mattered, at the end of the day, and what we saw, not only in Canada but around the world, was that if you were strong and were able to walk in and say, "Don't worry, I will look after you", the investor was better off.

[Translation]

Mr. Jean-Yves Laforest: Could you say that...

[English]

The Chair: Sorry, your time is gone, so we have to move on.

We'll go to Mr. Dykstra.

Mr. Rick Dykstra (St. Catharines, CPC): Thank you, Mr. Chair.

I have a couple of questions. First, the OFSI mandate, if you look at the second point, is to "[p]romptly advise institutions and plans in the event there are material deficiencies and take, or require management, boards or plan administrators to take, necessary corrective measures expeditiously".

How long did it take, from the day you realized that there were issues in terms of asset-backed paper to the day you actually recommended to banks...or at least recommended changes?

Ms. Julie Dickson: When did we recommend changes? It depends on what "changes" are.

This problem began to surface on Friday of a long weekend, so we were meeting on the long weekend with the Bank of Canada and others. I think immediately steps started to be taken to find out who owned this asset-backed commercial paper, particularly among the institutions and pension funds we oversee. Starting on Tuesday, we were collecting as much information as we could.

I don't have the chronology in front of me, but the market drove a lot of the change for a few weeks in August. By "the market", I mean investors and large banks, for example, which started to say that they were going to convert all the liquidity lines to global-style lines in an effort to ensure that everyone knew that investing in asset-backed commercial paper was okay. So some of it was market-driven.

We began last summer I think constantly talking to international regulators about the whole capital framework as it pertains to conduits and liquidity lines. I don't have the chronology in front of me, but it was there in such a big way that we were doing a lot, right from day one.

● (1610)

Mr. Rick Dykstra: One of the points you've made in your presentation—I'm trying to link these two together—is listed under "OSFI Actions", the things you've done. In the last sentence it says, "We are looking at whether bank involvement with such conduits can create the impression that ABCP issued by unregulated entities is sponsored by them."

I'm not so sure this is an action, so I wanted to know what you meant by that. Certainly, to me, you would look at that before you actually recommended an action. So I wondered why you thought it was so important to look at this issue without really taking any action on it.

Ms. Julie Dickson: Well, we are going to issue a revised B-5, and that's one of the issues we're going to deal with in B-5, which has been written. We'll put it out quickly. B-5 originally dealt with the kinds of roles banks play in setting up conduits. We read a few newspaper articles that suggested that certain conduits were bank-sponsored when they were not. So we felt we ought to go in and make it very clear that if you're involved in setting up conduits, you have to be very explicit about exactly what you're doing with them if you want to reduce the risk to your reputation.

Mr. Rick Dykstra: Despite the fact that you oversee the institutions and the pension funds, obviously your comments on these issues, your recommendations, your issues for action are going to be listened to by more folks than just those institutions or pension funds. Regardless of whether or not you report directly to them, would it not be a consideration that you make your reports rather public rather quickly, so that even those who aren't necessarily under your jurisdiction would be able, hopefully, to garner a lot of goodwill, or at least be able to take action as quickly as they can, based on what you provide?

Ms. Julie Dickson: Yes. Guideline B-5, as an example.... The market is not changing right now, in the sense that it's not growing and people aren't developing new products, etc. From that perspective, we didn't need to get that guideline out within two weeks of this crisis hitting. But for sure, all of our material goes on our website. We try not to keep any secrets.

The Chair: Thank you very much.

Your time has gone.

Mr. Mulcair, you have five minutes.

[Translation]

Mr. Thomas Mulcair (Outremont, NDP): Thank you for your indulgence, Mr. Chair. I appreciate it.

Ms. Dickson, I would like to come back to a statement you made earlier regarding an institution you referred to as being unregulated, namely Coventree.

Since these institutions are not regulated today, who should regulate them?

[English]

Ms. Julie Dickson: Well, it was an issuer of securities, so from that perspective it comes under the jurisdiction of securities commissions. When I say it's not regulated, I mean it's not regulated by us for solvency. No one is making sure that Coventree is regulated like a bank for safety and solvency, but all the securities that are issued are covered by securities laws.

•(1615)

[Translation]

Mr. Thomas Mulcair: There was an obvious problem which everyone can see today. Interest rates posted by the banks were so low that the banks' clients, including companies which sold the products of those banks, felt that it was in their interest to remove their money from a system which duly protected it, that is, a bank account, and to invest it into products sold by the banks or their subsidiaries. You saw that.

This is my question: What did you do when you saw this happening? Even if this not fall within your mandate, did you raise the alarm? Did you say that there obviously was a problem in the structure of these papers and that something had to be done quickly? Did you warn the government?

[English]

Ms. Julie Dickson: Around the world, it was clear that with low interest rates investors were searching out new products that offered higher yield. Again, this market worked well for 17 years in Canada, and I think as long as sophisticated investors continued to put money in it, as long as the securities were rated triple-A, it continued to drive the market and investors as well.

Mr. Thomas Mulcair: You mentioned around the world, but I'd like you to concentrate, if you wouldn't mind, Ms. Dickson, on you, on your role, on the agency we've confided in you. You're heading up a very important organization called the Office of the Superintendent of Financial Institutions in Canada. You have a role.

When you saw this happening, did you or did you not warn the government, the elected members, your minister? Did you sound the alarm? Did you say we have a problem, we have people who are covered when they're depositors, but they're not covered when they're investors, because they've moved it out of a savings account into this vehicle that the banks, which we regulate federally, are telling people is an asset-backed commercial paper, and doesn't that sound secure? But you know it's not. You have the sophisticated people on your staff to tell you that.

Did you tell anybody else, and if so, who and when?

Ms. Julie Dickson: People are covered. If you are an investor in a security in Canada, you are covered by the securities commissions.

My job is to look after banks and bank depositors. If you're an investor, you're covered by securities commissions.

Mr. Thomas Mulcair: The way you explain it, it's almost as if there were no problem, as though there were no individuals who haven't been put in a very precarious position by having invested in asset-backed commercial paper. But we all know that's not the case. We all know there are a lot of people who bought through banks or their affiliates something called "asset-backed", despite the fact that it's a misnomer and was clearly misleading.

Now you're telling us that not only did you not sound the alarm, but it is your view that it was not only not part of your job but was strictly a provincial matter. Is that the view you're putting here before this committee this afternoon?

Ms. Julie Dickson: Well, my job is to protect bank depositors. Those are life savings; I treat it quite seriously.

Mr. Thomas Mulcair: No one's suggesting you're not. But we're asking you specific questions and you're not answering them—you're skating. I'd like a clear answer.

Ms. Julie Dickson: I wanted to note that protecting bank depositors is a very important job, as is protecting investors. There are securities commissions whose job it is to protect investors. I think that is where my mandate ends and where theirs begins. I know they are taking it very seriously as well.

Mr. Thomas Mulcair: When you saw this happening, did you sound the alarm—yes or no?

Ms. Julie Dickson: There was no alarm to be sounded around the world or in Canada because the market was functioning. We did, as regulators, talk about the complexity we were seeing and the fact that triple-A-rated instruments were being created out of other things. We were questioning whether that was appropriate, but we were focusing on risk to banks. I think when it comes to the banking sector we have a good story to tell, compared to some other countries in terms of the solidity of banks.

Mr. Thomas Mulcair: You said you were questioning. When and with whom?

The Chair: I'll allow a quick answer there and that will be it.

Mr. Thomas Mulcair: It's a very clear question and it requires a quick answer, but it requires an answer.

Ms. Julie Dickson: Could you ask the question again?

Mr. Thomas Mulcair: You just said to us, "We were questioning...." When did you raise those questions and with whom?

Ms. Julie Dickson: In 2005 a report went out in great detail on issues with complex products. That was on every regulatory website in the world. I had a speech out in April, which is on our website, that talked about the complex products being bought and the fact that triple-A-rated securities were being created out of other products. It was primarily from the perspective of a bank regulator and the impact on bank solvency.

This is something that I certainly did talk about, as did other bank regulators. I can't say more about that than what I know from a bank regulator's perspective.

• (1620)

The Chair: Thank you.

I have a couple of quick questions.

You had mentioned the rating agencies earlier, talking about going forward and how perhaps we should be raising some alarm bells if one rating agency should rate a certain product but others refused to. Then you suggested in your testimony that this had happened here recently, where two had rated, but others refused to or hadn't rated the same way, and it raised alarm bells.

Going backwards over the 17 years, has there been a situation where we've had rating agencies rate to that extreme and not had any complications of any kind? Can you think of any others?

Ms. Julie Dickson: I'm not aware of any. I don't know if there are others.

The Chair: That would raise an alarm bell to me, if it's never been done before and you see rating agencies rate so differently.

Have there been other cases of it in the last year, other than that one?

Ms. Julie Dickson: I don't think in Canada, but in other markets, yes.

The Chair: Thank you.

I want to thank you for coming in. I know your time is tight.

There was nobody else on my list. There is a little time, if there are still questions.

Go ahead.

Ms. Martha Hall Findlay (Willowdale, Lib.): Thank you.

Thank you, Ms. Dickson, for being here.

You have recommended that the zero capital charges to market disruption liquidity lines be removed. That is obviously something in the right direction.

We've had discussions about this issue and the anomaly of Canada's not having that—and you talked also about making these global lines. Is it true that Canada was alone, or virtually alone, in not having that already in place, and that there was a distinction between what Canada was allowing and the rest of the world was not?

Ms. Julie Dickson: I would put it in a different way. The whole world agreed to zero for any liquidity line of less than one year. As a bank regulator, we started to get very worried about that. You have to have capital if you're taking risk. We went to our international colleagues and said that there must be capital; banks are taking risks in providing these liquidity lines without any restriction to conduits. Our international colleagues agreed. They said that, yes, there must be a capital charge.

Ms. Martha Hall Findlay: I'm sorry to interrupt, but I'm actually looking backwards at when this was happening, and the incentive to in fact move the Canadian approach as well to be all global lines.

We've had other conversations with people saying Canada was a bit of a target for this because of the situation in Canada being

different from that in other parts of the world. Can you comment on that?

Ms. Julie Dickson: Both regulatory organizations in Canada and the U.S. in 2004 implemented an additional capital charge because we saw a risk being taken, and that was for the global-style lines.

Our OSFI rules applied to our banks no matter where they operated. When they operated in the U.S., they offered global lines, because that was the only line that investors and rating agencies would accept in the U.S. I know one of the large banks had converted to global lines in Canada as well. They just decided to do it.

What we're trying to say is that our capital rules did not apply to Coventree. Our capital rules applied to Canadian banks, and when they operated in the U.S. or Europe, they offered global lines, not general market disruption. Again, that's because that's what investors demanded and that's what rating agencies demanded.

I think, if anything, from a capital perspective, the OSFI rules stand up to scrutiny. Other factors drove the marketplace.

• (1625)

Ms. Martha Hall Findlay: But if they do, then what was the reason for moving to global lines if in fact we were fine beforehand?

Ms. Julie Dickson: What we saw was that instead of transferring the risk to investors, banks stepped in and supported the conduits, and when you do that, you cannot justify a zero percent charge. The zero percent charge made sense when banks had transferred risk to investors. It did not make sense when banks, for the first time ever, stepped in to support these conduits.

Ms. Martha Hall Findlay: I would just like to solidify my understanding of this.

My understanding was that Canada was relatively alone, as a jurisdiction, in allowing banks to decline making emergency funding payments to commercial paper conduits should they seize up, and that was one of the reasons there was a focus on Canada as opposed to other jurisdictions. If you're moving in the right direction, well done; that's terrific. But I just want to have a better understanding of whether that was in fact the situation, that Canada was a bit of an anomaly that aggravated this situation.

Ms. Julie Dickson: Ninety percent of the banks we're talking about were foreign. Ninety percent of the banks—Coventree, etc., the non-banks—typically dealt with foreign banks that are not subject to my rules. It was those foreign banks that had the bulk of the liquidity lines. It was those foreign banks that declined to provide the bulk of liquidity, according to the agreements they had with Coventree, and Coventree was free to choose any liquidity line.

Ms. Martha Hall Findlay: Thank you.

The Chair: Thank you very much.

Your time has really gone.

Monsieur Crête, very quickly, I have only 30 seconds, and then I'm going to call this part done.

[*Translation*]

Mr. Paul Crête: Do you think that foreign banks should fall within your mandate and that you should monitor them?

[*English*]

Ms. Julie Dickson: When they take deposits here, yes, but if a car company, a grocery company, or a Coventree wants to deal with a foreign bank, I think they should be allowed to do so. Those foreign banks have regulators, and they are regulated for solvency.

The Chair: Thank you very much for your time, and for coming and presenting. We want to honour your time commitments as well, so we will suspend the meeting until we have the finance department come to the table.

Thank you very much, Ms. Dickson.

- _____ (Pause) _____
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The Chair: I appreciate that we have the Department of Finance with us.

We have Mr. Tiff Macklem.

Thank you for coming in. Do you have a presentation for the committee? I appreciate that.

The floor is yours. Proceed, please.

- (1630)

Mr. Tiff Macklem (Associate Deputy Minister and G7 Deputy for Canada, Department of Finance): Thank you, Mr. Chairman and members of the committee. The Department of Finance and the Minister of Finance welcome these important hearings on Canada's asset-backed commercial paper—ABCP—market, specifically the non-bank sector of this market that was subject to the Montreal Accord and a court-supervised restructuring under the Companies' Creditors Arrangement Act.

I am pleased to have the opportunity to appear before this committee on behalf of the Department of Finance.

The restructuring of the non-bank-sponsored ABCP market under the Montreal Accord has been a market-led initiative with no public money or government guarantees. The restructuring provides a good example of how the private sector can sort out a market issue, and its success has been admired internationally. This, however, does not detract from the reality that the process has been long, complex, and very difficult for everybody involved.

Before I take your questions, I'd like to share with you the Department of Finance's perspective on the ABCP market and events leading up to the freezing of the non-bank sector market, including the global context in which this happened, some of the lessons learned, and the response of policy-makers.

[*Translation*]

The regulation of securities markets in Canada is the responsibility of provincial securities commissions. The regulatory framework specifies, among other things, the level of disclosure required of

issuers and investment dealers selling securities to the public. In Canada, commercial paper, including ABCP, is sold under a short-term debt provincial securities regulations exemption. This exemption allows short-term debt maturing not more than one year from the date of issue and having an approved credit rating from an approved credit rating agency to be sold without the need for a prospectus.

In Canada, there are two distinct ABCP market segments: bank-sponsored conduits, representing about \$80 billion Canadian of outstanding ABCP as of last August, and non-bank-sponsored conduits, which accounted for around \$35 billion Canadian.

In all ABCP programs, there is an inherent mismatch between the term of the assets—normally several years—and the term of the ABCP—normally three months or less. ABCP conduits therefore require standing liquidity lines from financial institutions that can be accessed under conditions where the sale of new ABCP is difficult or impossible.

In most jurisdictions, ABCP programs are backed by “global style” liquidity lines that can be accessed under a wide variety of market circumstances, including a credit event. A unique feature of the Canadian market as it existed prior to August, was that most ABCP, including all conduits in the non-bank sector, were supported by “general market disruption” lines, which were only accessible to issuers when the inability to issue new ABCP relates to a general disruption in the Canadian ABCP market, rather than the deterioration of creditworthiness of the issuer or its assets. This left the Canadian ABCP market more exposed to risk, so that investors would be unwilling to roll their paper at maturity.

The Canadian marketplace, including investors and the rating agency, accepted “general market disruption” lines. This was not a decision made by regulators. The Superintendent of Financial Institutions has already addressed you on this issue.

- (1635)

[*English*]

The key trigger of the global turmoil was the rise in the default rate in U.S. subprime mortgages. This immediately affected structured assets that were backed by such mortgages. What is clear now is that in the rapidly growing U.S. subprime mortgage market, originators of loans had loosened their standards of lending considerably. This created a pool of questionable assets that found their way into structured finance products around the world through the process of securitization.

Investors' concern quickly spread to a broad range of complex products with potential exposure to subprime securities, owing to their complexity and to a general lack of transparency. This included structured securities rated highly by rating agencies. One example was the global market for ABCP.

Against this evolving global backdrop last summer, Canadian investors came to question the quality of the assets underlying Canadian ABCP. In mid-August, the non-bank market froze, as investors refused to roll their paper. Domestic banks, to their credit, supported their own ABCP programs, but for non-bank ABCP, liquidity providers did not provide funds for the most part. The failure of the non-bank conduits to meet their maturing commercial paper obligations raised the spectre of a fire sale of assets and significant losses of capital.

On August 16, a group representing major investors in non-bank-sponsored ABCP and the main international bank asset providers agreed to a standstill under the Montreal Accord. This accord laid the basis for a market-led restructuring of the non-bank ABCP market, with a view to preserving investors' money. The restructuring process, led by the Pan-Canadian Investors Committee under the leadership of Mr. Purdy Crawford, has been a market-led initiative.

Since the standstill began, the Department of Finance and the Bank of Canada have encouraged a market-led restructuring as a better course of action for investors, other participants, and capital markets than a fire sale of assets. We are not a member of the investors committee. However, we have monitored developments closely through an observer on the committee, and we have encouraged all parties to work constructively toward an orderly resolution. The Minister of Finance has issued statements supporting the restructuring process at key milestones.

On June 5, the Superior Court of Justice of Ontario approved the plan for restructuring asset-backed commercial paper, developed by the Pan-Canadian Investors Committee. This marks a decisive step in what has been a long and difficult process. Since last August, the Government of Canada has supported this market-led restructuring as a preferred course of action for investors and for the ongoing stability of the overall Canadian financial system. Small investors' interests have been accommodated in the final plan. Its successful resolution removes an overhang of uncertainty and should help restore greater stability in our money markets.

While the Montreal Accord is a good example of the market sorting out a market issue, there are clearly lessons to be learned for market participants and for policy-makers, both domestically and internationally. The Canadian market is already adjusting; investors are demanding greater transparency and disclosure from issuers and are stepping up their own due diligence. Since last August, all bank-sponsored ABCP programs have adopted global-style liquidity lines, and sponsors are making efforts to increase the transparency of the underlying assets of these programs. Financial institutions are also strengthening their risk management policies and practices.

Many of the lessons learned are global in nature, requiring a coordinated global response. In April, G-7 ministers and central bank governors endorsed a report of the Financial Stability Forum, which provides detailed recommendations to address the weaknesses that contributed to the global market turmoil and to enhance market and institutional resilience going forward. The Minister of Finance has indicated that Canada is fully committed to implementing these recommendations, which include specific timelines and priorities.

A number of these recommendations apply to the asset-backed commercial paper market. In particular, recommendations deal with

the need for improved transparency in the securitization process, changes to the role and quality of the ratings process, and the appropriate use of ratings by investors and regulators.

The FSF has made a number of other relevant recommendations related to improving accounting and valuation processes for complex products and enhanced disclosure for financial firms. The Department of Finance, the Office of the Superintendent of Financial Institutions, the Bank of Canada, securities regulators, market participants, and credit rating agencies are all engaged in these issues, as are international standard setters.

• (1640)

For example, within its purview, securities regulators are reviewing the conditions under which commercial paper backed by structured credit products may be sold to Canadian investors. Prudential regulators, including ours, for their part must assess the appropriate capital treatment and risk management policies and practices respecting structured credit products.

The FSF also called on countries to review and strengthen their financial regulatory frameworks. In Canada, the priority is a common securities regulator with a more principles-based regulatory framework.

The Minister of Finance announced in February 2008 the establishment of an expert panel on securities regulation to advise on enhancing the content, structure, and enforcement of securities regulation in Canada. Under the chairmanship of the Honourable Tom Hockin, the panel is currently consulting across Canada with a broad range of market participants, including investors and their representative groups. The panel will deliver to the Minister of Finance and provincial and territorial ministers responsible for securities regulation a final report by the end of 2008. The minister applauds this committee's decision to hold hearings on these matters. There are a number of important issues that you could usefully explore.

With those words of introduction, let me open it up to your questions.

Thank you.

The Chair: Thank you.

Mr. McCallum.

Hon. John McCallum: There was a bit of confusion about global-style liquidity versus general market disruption. You say near the beginning of your comments that Canada was virtually unique in having these general market disruption clauses. Then you say this was not a decision made by the regulators. I assume there were four reasons for this: (1) all parties wanted it that way; (2) the rating agency agreed, which perhaps was unique to Canada; (3) the investors liked it that way; and (4) OSFI permitted it. Is that a fair statement?

Mr. Tiff Macklem: The superintendent has been clear on OSFI's role. Her role is to protect depositors and to look at appropriate capital requirements. She's been through that, and all this is being looked at and revised. In the U.S., investors and rating agencies demanded global-style liquidity arrangements. This was not the situation in Canada.

Hon. John McCallum: But OSFI now requires global-style liquidity. Is that not correct?

Mr. Tiff Macklem: What is happening is that the market players have all moved to global-style liquidity. As the superintendent explained, there were different capital requirements for global-style versus general market, a disruption-style liquidity, and those are all being reviewed. She explained that the bank-sponsored conduits with general market disruption liquidity came in and, to the benefit of investors, backed their conduits and provided liquidity. Although legally they were separate and were under no obligation to do so, they did. What that has brought to the fore for the superintendent is reputational risk and the fact that they're likely to do this in any event. So the capital charge needs to reflect this.

Hon. John McCallum: That action has been taken recently. But if OSFI had decided earlier that it didn't want these general market disruption clauses, and one could have anticipated that banks would face this reputational risk, OSFI, at least in theory, could have made this new ruling many months ago. Then we would have had in Canada the global-style liquidity lines and not the made-in-Canada general market disruption clauses.

•(1645)

Mr. Tiff Macklem: As the superintendent indicated, her job is to protect depositors and figure out the appropriate capital charges. She is revising those.

Hon. John McCallum: Okay. I think I now understand it.

This will be my last question. Weren't there a number of what one might call red flags that popped up along the way and that should have served as a warning to somebody earlier? The fact that Canada was unique with these general market disruption clauses, the fact that only one of the rating agencies would rate the asset under these conditions, the fact that at least one major bank wouldn't participate—weren't these somewhat unusual developments that perhaps should have been noticed and acted upon earlier?

I know it's difficult—hindsight is 20/20—but it does seem to me that these are fairly self-evident warning signs that appeared along the way.

Mr. Tiff Macklem: Let me put this into the global context and then come back to the specific issue.

I think it's fair to say that in the global context, if you go back a year or a year and a half ago, many people saw that the risk spreads were very low. They seemed unsustainably low and needed to widen. I think it was recognized that there was even a possibility that this wouldn't be an entirely smooth process. But I think it's fair to say that nobody foresaw the kind of global financial turbulence we have been going through in the last 10 months. Nobody foresaw the potential for contagion from subprime mortgages into a whole broad spectrum of complex products. Nobody foresaw the contagion effects this could have in the money markets at the core of the financial system.

This has certainly precipitated a great deal of reflection, a great deal of work on what needs to be done to prevent this type of crisis from happening again. The reality is that credit cycles are not new. They're not going to go away. So we also have to be prepared to manage these situations in the future.

With respect to this specific market, as the superintendent indicated, this is not a new market. It's been around for some time. It had been working successfully. With respect to the issues around global or general market-style liquidity, this was known in the market. As the superintendent indicated, the bulk of the investors in this market were highly sophisticated and very big investors. These were contracts issued in the private sector between relatively sophisticated players, by and large.

In terms of the regulatory oversight of this, as I indicated, securities regulation is in the domain of the provincial securities commissions. This was issued in the exempt market because it was a short-term instrument with an accredited credit rating. The scope of the exempt market is something the provincial securities commissions are looking at.

The Chair: Thank you very much.

We'll now move to Mr. Crête.

[*Translation*]

Mr. Paul Crête: Mr. Macklem, perhaps I am not understanding you clearly. You give me the impression that all of this happened by coincidence and through market forces, when we know very well that people borrowed thinking they could make easy profits. Banks fell into the trap of easy profits and acted as if they did not need to examine the content of the financial products, because it was not their responsibility.

Rating agencies issued securities. I witnessed a horrible situation: an agency gave a positive rating to this type of three-day loan, and after three days, the person who had bought the asset with the bank's approval lost \$20 million out of the \$25 million paid for the asset.

Do you think, as a result of the soul-searching which is happening today concerning the impacts of securitization, that various stages of the process will be tightened? I am not saying that this type of investment vehicle should be banned, but that there should be a significant tightening of the control mechanisms.

Do you acknowledge that this crisis has resulted from a laissez-faire attitude at many levels?

•(1650)

Mr. Tiff Macklem: Financial markets now offer many new products. Securitization is playing a much more significant role in financial markets. It is important not to lose sight of the advantages of diversification of risks and access to capital by companies. However, we must draw important lessons from this experience.

Regarding the credit rating agencies, a significant number of complex products did not yield the expected results for several reasons. When the agencies reviewed high risk mortgage loans and mortgages in general, they thought that diversification would minimize risks, but they did not anticipate that housing prices in the United States would fall to the extent that they did. As a result, diversification did not work as well as expected.

[English]

If you have a rating that's triple-A for a traditional single-name corporate, it has turned out that the behaviour of a triple-A complex product in situations of a lot of stress has tended to be different from a single-name corporate A. One of the recommendations of the Financial Stability Forum along with the IOSCO body is that rating agencies differentiate the ratings between structured and traditional products to provide investors with more information about the fact that their behaviour may be different even if their probabilities of default are the same.

[Translation]

Mr. Paul Crête: Do you know of a country which managed to control the value of its securities during that period and which as a consequence avoided the current crisis?

Mr. Tiff Macklem: Could you be more specific?

Mr. Paul Crête: Among developed countries, was there one country which did better than everyone else because it had a system which threw up warning signs in time or which prevented its markets from sinking into this quagmire? Did the United States, England, Japan, any European country or other countries manage to avoid the crisis?

Mr. Tiff Macklem: Each country had to deal with its own set of problems. The United States are really at the root of the problem. This is especially because standards

[English]

for credit assessment and underwriting of mortgages clearly became lax on the back of a very long and sustained expansion. This was exacerbated by the fact that interest rates were low. There was a search for yields. Investors were looking for products, and issuers were only too willing to provide them.

I give you this as an example. In different countries I think there have been different areas where the focus for improvement needs to be...

[Translation]

Canada stands apart because it does not have a common securities regulator.

•(1655)

Mr. Paul Crête: Do other countries have a common securities regulator?

Mr. Tiff Macklem: Yes, that is the case for each of the other developed countries.

Mr. Paul Crête: But they could not avoid the crisis either.

Mr. Tiff Macklem: The set-up is different in every country. In the U.S....

Mr. Paul Crête: But other countries are having the same kind of problem, in spite of having a national securities commission.

Mr. Tiff Macklem: There are examples of financial upheaval everywhere. Canada is affected, but the situation here is quite good if we compare it to that of other countries. Our banks are well-capitalized and the gaps in the money market are not that big.

Mr. Paul Crête: It's because of the Montreal Accord.

[English]

The Chair: The time has gone.

We'll move on to Mr. Wallace.

Mr. Mike Wallace (Burlington, CPC): Thank you, Mr. Chairman.

And thank you for coming today.

I'll start from the back of your presentation, and this follows up on Monsieur Crête's question. You've mentioned a couple of times now the need for a common securities regulator, which a panel is currently reviewing. Will this issue of asset-backed paper be a case study for them? Is this the type of issue or problem they will be addressing in their recommendations, or how are they dealing with this? Do you have any concept of that?

Mr. Tiff Macklem: Well, I have spoken to the panel, but I haven't asked them about that. I have given them some of my views, but I haven't received back their views. They're working on that; they're in the process of consultation. I expect this is something they're hearing about as they go across the country.

I think, more generally, this broader situation really illustrates just how global the financial markets are. The events were triggered by increased defaults in subprime mortgages in the United States, and that's affecting global markets around the world. So I expect this broader issue is something they will be hearing about and it will be something they will be responding to.

Mr. Mike Wallace: As for your choice of words here, maybe I'm picking a little bit, but I'm very interested in them, and I highlighted them a bit: "the priority is a common securities regulator with a more principles-based regulatory framework". Are you telling me they're not principles-based, or what are you saying there? And what are you hoping to accomplish if they come back with a recommendation for a single regulator?

Mr. Tiff Macklem: There's a fairly active debate around the world about whether regulation should be more rules-based, as it is, for example, in the United States, or whether it should be more principles-based as, for example, the FSA, the Financial Services Authority in the United Kingdom, has pushed for. Now even under a principles-based system, you still need some rules. So I wouldn't want to make an overly stark comparison.

But I think the idea of a more principles-based system is that in a world where markets are evolving rapidly and the situation can change over time, it may be difficult to keep detailed rules up-to-date, whereas a more principles-based system—for example, with general principles around disclosure, as opposed to having detailed line-by-line rules—puts some responsibility on the industry players that they have certain principles they should have to live up to.

Mr. Mike Wallace: Another thing you talked about here is, and part of your recommendations deals with, the need for improved transparency. What do you mean by that? Is that more information to the actual investor, whether they're a sophisticated investor or even Ma and Pa? We've had a few of those folks here who put their life savings into these things, based on advice they had received and their triple-A rating, relying heavily on this for their decision.

What do you mean by transparency? What can investors expect from that change?

● (1700)

Mr. Tiff Macklem: I think it has a number of dimensions. With respect to the products themselves, it means having more transparency as to what is in them; who is senior to whom, if something goes wrong; and more information about the structure itself.

With respect to credit-rating agencies, for example, I think we need more transparency about the rating methodologies. I think issuers themselves need to be putting out more information to the public so that credit-rating agencies aren't relying only on the information they have, but that everybody has the same information. I think rating agencies need to take more responsibility for the information they're getting and to do appropriate due diligence.

The basic underlying premise here is that if everything is laid out, people can make fully informed decisions, and it also creates appropriate incentives to design things in ways that should be better.

Mr. Mike Wallace: When you talk about people making better decisions, are we hoping to have this in a structure that the average investor can understand, or are we still gearing this toward the sophisticated larger firms—pension funds—or whoever is buying the product that happens to be available at the time? Are we looking at growing it down so that my parents could buy it and understand what they are getting into? I have no money, so it would have to be my parents.

Mr. Tiff Macklem: We've talked about credit agencies and their responsibilities. I think an important lesson from this is that investors need to exercise appropriate due diligence as well. Ratings are a very useful tool, but they should be used as a tool. You probably shouldn't be buying things if your only metric is ratings.

Mr. Mike Wallace: I understand.

Thank you.

The Chair: Thank you very much.

We have two more. We'll move now to Mr. Pacetti, and then to Mr. Laforest.

Mr. Massimo Pacetti (Saint-Léonard—Saint-Michel, Lib.): Thank you, Mr. Chairman.

In most cases I've been hearing that we have to look to see what went wrong; we can't necessarily look to the past; and we have to look to the future to see how we can correct this. But in order to find a solution, we have to blame somebody—I don't know if I necessarily want to use the word “blame”.

I understand the complexity. I don't want to make it too simplistic, but we're going around in circles, in a sense. We have OSFI coming forward and saying they're here to protect depositors. You just said that investors should be more sophisticated and understand. But investors have advisers, and advisers didn't advise properly. The advisers rely on the credit agencies, and the credit agencies didn't do their job.

Then all of a sudden investors wanted a higher return. So the banks, or whoever bundled up these products, made it so the returns

would be higher. There was a market that was fulfilled and there were people willing to buy. Those were the forces. I don't think we can ever change that.

It's not a securities regulator issue, because they'll look at what happened prior to this. There is no mechanism to prevent this from happening in the future, because this has to be prevented prior to it ever happening.

In the end, I don't even know if anybody is going to report or say they're going to fix it, because it's not anybody's job. The securities regulators will look at their end. OSFI will look at its end. You'll look at your end. Mr. Purdy Crawford is only making sure the investors get their money—and that's a separate arrangement for what happened in the past. I feel like we're going around in circles.

The answer always seems to be that it's very complex. But people were involved who put these products together and invested. We see now that the little investors are probably being protected, whereas some of the investors who are more sophisticated, like TransAd, that have the proper individuals to analyze these products, didn't do it. Jean Coutu and numerous other corporations in Canada invested in these products. I'm not sure if they're going to be protected. They had the ability to look at this. They relied on somebody, and somebody relied on somebody else.

Is there an answer? Is there something we could do? Is there something that somebody could do?

● (1705)

Mr. Tiff Macklem: Hearings such as this are helpful, and I welcome the opportunity.

On the broader issue, there are a few more pieces that need to be completed. As the superintendent mentioned, IIROC is reviewing the behaviour of the firms that sold the products. The securities commissions are reviewing the scope of the exempt market. From our perspective, we've been very active. I mentioned the FSF report. We have also taken a number of other measures. For example, in the budget bill—

Mr. Massimo Pacetti: Sorry to interrupt, but will they be pieced together, or will they still be working in silos? Is there something that should be pieced together, or should more authoritative responsibilities or regulations be given to somebody?

I hate to compare ourselves on a global level. I'm not worried about what happened elsewhere in the world. It's great to blame everybody else, but Canada has its own house to deal with.

Mr. Tiff Macklem: We need to reflect on what went wrong and how to prevent this from happening again, and I think that is being done.

Mr. Massimo Pacetti: Is the Department of Finance going to piece any of it together?

Mr. Tiff Macklem: We have a broader stewardship role. We're dealing with OSFI and the Bank of Canada, and we interact with the securities commissions.

Mr. Massimo Pacetti: Is somebody afraid to put everything together because they're going to be ultimately responsible in the future?

Mr. Tiff Macklem: I think we are moving forward.

The Chair: I guess we'll have to find that out.

We're going to move to Monsieur Laforest.

[Translation]

Mr. Jean-Yves Laforest: Mr. Chairman, the colleague who spoke before me said that we should worry less about what happens in other countries and more about what we have to do here. I don't entirely share his opinion.

[English]

The Chair: Committee, there's too much noise here.

Okay, go ahead.

[Translation]

Mr. Jean-Yves Laforest: I don't entirely agree with the views of the person who spoke before me, who said that we should not necessarily consider what happened elsewhere, but rather focus on what's going on here, or what has happened here. I think that this is a worldwide phenomenon.

Mr. Crête asked you if things were better in other countries. Basically, even if some countries have national securities commissions, the crisis happened anyway.

What makes a difference here is that the Montreal Accord has made it possible to stabilize the situation quite quickly, and to see what we can now do. Not having a national securities commission has not prevented us from doing that. This is something which must be pointed out clearly.

That said, I am wondering about the Bank of Canada's role. Does the bank have the instruments it needs to prevent this sort of situation? Among other things, does it have the instruments to support the Montreal Agreement?

Mr. Tiff Macklem: You might have to put that question to the Bank of Canada.

The Bank of Canada's role on money markets is to establish monetary policy. It is responsible for keeping the short-term liquidity market running smoothly. That's how it implements its monetary policy. That's what it has committed to do ever since the crisis began.

• (1710)

[English]

They've provided more liquidity to the market and expanded the term over which they can provide liquidity. They've expanded collateral. As part of the budget bill, the statutes of the Bank of Canada are being expanded to give them the capacity to take broader types of collateral.

[Translation]

The Bank of Canada's mandate is to keep the system secure, but it is not responsible for the actions of individuals or companies.

Mr. Jean-Yves Laforest: Thank you.

[English]

The Chair: Thank you very much.

Mr. McKay.

Hon. John McKay: Thank you.

We don't allow a pharmaceutical to hit the market unless the Department of Health has signed off on it, yet we allow a security to hit the market based upon a rating produced by a company that is dependent upon the issuers of those securities for its revenues.

Does that strike you as a very serious flaw in our system?

Mr. Tiff Macklem: I take from your question an implication that there are some conflicts of interest here and that therefore this may not be entirely appropriate.

In terms of the rating agencies, certainly one of the lessons out of this global crisis, as reflected in the FSF report and the IOSCO code of conduct for credit rating agencies, which was published on May 28, is the need to resolve issues around potential conflicts. The main one is this issue about credit rating agencies advising companies and at the same time rating the subsequent issue. There are new rules that say that if you advise on the structure you cannot also be the rater.

There is a broader debate about conflicts in credit rating agencies; for example, about who should pay the credit ratings, the issuers or the investors. That's a difficult one, because there are issues on both side. If investors paid, for example, they might not be too thrilled to have a downgrade. As in any of this kind of oversight role, where there are payments being made there are issues, and the key is to manage those.

Hon. John McKay: Is there a role for the Department of Finance in its broader stewardship of fiscal and, to a lesser extent, monetary framework? Is there a role for the Department of Finance, if not to bring in-house, at least to take over, if you will, a supervisory regulatory role and in effect set ethical standards and probably regulatory standards for how you go about rating a security?

Mr. Tiff Macklem: As you know, the Department of Finance is not a regulator. I must say, I myself don't see making the department a regulator as the solution. I think what we want to do is make sure that the regulators we have are—

Hon. John McKay: But the department does take supervisory responsibility for OSFI and various other agencies. It doesn't do it itself, but—

Mr. Tiff Macklem: We have some broader stewardship and oversight responsibilities, absolutely.

With respect to the issue of credit rating agencies, I can tell you we have been talking to credit rating agencies. We've met with them. We have been discussing these issues with them. We have been discussing how they are themselves responding to this and how they plan to respond to the FSF and IOSCO code of conduct. We are engaged in these issues.

With respect to credit rating agencies themselves, this would fall more in the domain of the provincial securities commissions.

• (1715)

Hon. John McKay: It seems to me that when you've—

The Chair: I'll explain to you what I'm going to do.

I'll give you another quick question. Then we're going to go to one party for two quick questions, or two minutes at the most, and for two minutes to another. Then we're going to have 10 minutes for an in camera session at the end.

Go ahead.

Hon. John McKay: It seems to me that this crisis, for want of a better term, took in pretty well the most sophisticated investors in our country. Just go through the list of the people who were in on it: Barrick Gold, the University of Western Ontario, 401 International, Transat A.T. Inc., NextStart. It's a list of the who's who of Canada, and they were taken in on this product.

Yet, when you started to work out your Montreal Accord, what was curious about the list was that the big banks, mainly Toronto-based big banks, were not on the workout sheet. They may have been monitoring or following it, but they were not involved. The ones who actually signed were in many instances foreign-based banks. It's a curious kind of workout.

That led to its own anomaly, in that the initial proposition basically gave the back of the hand to smaller investors. But by good luck more than good management, the smaller investors have one vote, and there are far more of them than of the larger investors. That effectively forced you to redo Mr. Crawford's initial proposal.

The argument has been that the market worked, but really the market worked by accident more than by anything intentional. If in fact the vote had been weighted according to the size of their investment, those retail investors would have been out of luck.

The Chair: I'll allow a quick answer to that, and then we'll move on.

Mr. Tiff Macklem: I think all parties had a real incentive not to let this fall apart and force a fire sale of assets. I think in that respect that kept everybody at the table through a difficult negotiation process, working to a solution that nobody is happy about, but it's better than the alternatives and I think overall is a good solution.

The Chair: Thank you.

Mr. Menzies.

Mr. Ted Menzies: Thank you, Mr. Chair.

I know, Mr. Macklem, you may not be able to answer this, but we did hear some very troubling comments from some of the smaller investors—I don't like to use that term, but some of the private investors—who told us they didn't even know what they were buying, and some of them didn't know they owned this. It's not that they bought it; they didn't know they owned it. Those, I think, were some of the most troubling comments we heard. I know there's nothing you can do about that, but those are the sorts of things that we don't want to see happen again.

This isn't the first time. One of our other witnesses, Larry Elford, talked about other instances where financial advisers really have no constraints. They could promise the moon when they know full well they can't deliver the moon.

What do we put in place? Your last line here says, "There are a number of important issues that you could usefully explore." What do you mean by that? What can we do to make sure this doesn't happen to Canadians again?

Mr. Tiff Macklem: Maybe I could answer your question in two parts: what are some of the things we can do to protect investors, and then, what could this committee usefully do?

In terms of protecting investors, absolutely, that is a key interest of the federal government. Getting back to the Hockin panel, an important aspect of what they've been asked to do is to look at investor protection, and in particular how to enhance enforcement in this country of securities regulation.

Another thing I think we can do is try to enhance financial literacy in this country. In the last budget, the government provided some funding to the Financial Consumer Agency of Canada. The B.C. Securities Commission had created a very nice course for high school students on financial literacy, so the idea was for the FCAC to create a web-based product for all Canadians to try to improve financial literacy.

I think those are two examples: improving people's understanding, and then enhancing enforcement so that if people are not living up to the standards they should be, they will be prosecuted.

• (1720)

The Chair: Thank you.

I'll leave two quick minutes for Martha Hall Findlay.

Ms. Martha Hall Findlay: Thank you.

In your own submission here, you referred to:

A unique feature of the Canadian market as it existed prior to August was that most ABCP...were supported by "General Market Disruption" lines...rather than the deterioration of creditworthiness of the issuer or its assets. This left the Canadian ABCP market more exposed to the risk that investors would be unwilling to roll their paper at maturity.

We all understand that. My question to the superintendent earlier was left, I must say, somewhat unanswered, because this was indeed a unique feature of the Canadian market. It was recognized before August, or perhaps should have been recognized before August, and the answer that OSFI is only responsible for protecting deposits does not address, then, why it was OSFI that did the recommendation that the zero capital charges for market disruption liquidity lines be removed. If it was OSFI that after August made a point of recommending that we go to global liquidity lines, why is it not then arguable, at least, that OSFI had some responsibility to address or to at least understand the risk associated with the unique nature of the Canadian market?

Mr. Tiff Macklem: I thought I'd answered that question.

Really, all I can say is that what became apparent through this process, as the superintendent explained, is that just because a bank had only committed to general disruption liquidity lines and the conduits are legally separate entities, in the event, they decided—I assume, for largely reputational reasons and to the benefit of investors—they would back them.

This hadn't happened before. When it did happen, what it illustrated to the superintendent is that even though legally they were under no obligation to do so, they chose to do so, which suggests that in the future they would probably choose to do so again, and therefore the distinction between these two in terms of capital charges needed to be changed.

The Chair: Thank you very much.

Thank you, Mr. Macklem, for coming in and sharing with us. This isn't the last we're going to hear on the asset-backed commercial paper issue, I'm sure, but I certainly do appreciate you giving us your insight and for the questions.

With that, I'd like to suspend for a moment while we go in camera.

[Proceedings continue in camera]

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