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Reining in the Risks: Rethinking the Role of Crown Financial Corporations in Canada

The extent to which financial Crowns compete in private financial markets poses risks to the overall economy – and these risks seem to have grown. The Crowns' mandates should be clearly circumscribed, in some cases rolled back. In all cases, Crown financial corporations should be subject to the same capital standards and prudential regulation as are federally regulated private financial institutions.

Philippe Bergevin and Finn Poschmann

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A handwritten signature in black ink that reads 'Finn Poschmann'.

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THE STUDY IN BRIEF

Crown corporations are business enterprises owned by governments – having been established to achieve a range of public policy goals, they tend also to have revenue-generating objectives. In the financial sector, the Crowns typically had their origins in a perceived lack of credit – a credit market gap – for some consumers and businesses.

In this *Commentary*, we test the rationale for financial Crown corporations' continued existence, in the context of the mandate and activities of three federal Crown financial corporations: the Business Development Bank of Canada (BDC), Export Development Canada (EDC) and Farm Credit Canada (FCC).

We argue that the rationale for their continued existence is difficult to sustain, because the market failures they are intended to address are not well defined. The financial Crowns' intertwinement with domestic political and business institutions, however, makes their rapid unwinding unrealistic. The issues we address, therefore, are the extent to which they complement or displace private activity, and whether their access to low-cost capital leads these Crowns or their counterparties to take on excessive risks.

We find that all Crowns compete to some extent directly with private financial institutions, and hence operate beyond any potential market gap. FCC, whose share of total farm loans has grown from less than 15 percent in the 1990s to 29 percent in 2011, appears to operate the farthest removed from a complementary role. We also find that Crowns' operations pose risks to taxpayers and the overall economy – and that these risks seem to have grown in recent years. In particular, the FCC has grown alongside a rise in the level of farm indebtedness and a bidding-up in farm asset values, including supply-managed farm quotas.

We recommend policies limiting these Crowns' activities to better align them with their core mandates and economic rationales. The Crowns' mandates should be clearly circumscribed, and even rolled back. The Crowns' practices should be monitored consistently to ensure adherence to their mandates and to ensure they do not pose undue risks for taxpayers and the economy.

In particular,

- All Crown financial corporations should, in their governing legislation, have a clearly articulated mandate that focuses on the need to be complementary to private institutions;
- Recent mandate expansions and capital enhancements at the BDC and EDC, some of which were extended for another year in Budget 2012, should be wound down;
- All Crown financial corporations should be regulated by the Superintendent of Financial Institutions, so that they are subject to the same capital standards and related prudential regulations as those of the federally regulated private financial institutions. Budget 2012 introduced model legislation for doing so with respect to Canada Mortgage and Housing Corporation;
- Parliament should introduce sunset clauses to the Crowns' enabling legislation, as with the current *Bank Act*.

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Canada currently has 49 federal Crown corporations, involved in activities that range widely from operating commercial port facilities to providing mortgage insurance, from export finance to venture capital lending and funding film-making. Among these are several agent Crown corporations whose assets and liabilities, including borrowings, are the assets and liabilities of the Government of Canada.¹

In this *Commentary*, we briefly explore the rationale for Crown corporations' existence and test that rationale in the context of the mandate and activities of three Crown financial corporations: the Business Development Bank of Canada, Export Development Canada and Farm Credit Canada.

We examine the historical mandates of these corporations, whether these mandates are relevant today and the continuing economic rationale for their activities. Considering their economic impact, the key issues are the extent to which Crown financial corporations complement or displace private activity and whether their access to capital at a lower cost than available to their private competitors leads these Crowns or their counterparties to take on excessively risky activities. We conclude that while the rationale for the continued existence of these corporations is difficult to sustain, because the market failures they are intended to address are not well defined,

their intertwinement with domestic political and business institutions makes their rapid unwinding unrealistic. We, therefore, recommend policies that would limit their activities to more clearly align them with the institutions' core mandates and the defensible features of their economic rationales.

WHY DO WE HAVE CROWN FINANCIAL CORPORATIONS?

Crown corporations are business enterprises owned by government. In Canada, they are largely immune to income tax and other provincial and municipal taxes.² Although they are creatures of the state, in the sense that ultimate control rests with public authorities, they typically operate on a commercial or quasi-commercial basis and, to some extent, at arm's length (Prichard 1983). They usually are established to achieve a number of public policy goals, in addition to having revenue-generating objectives, making their existence a balancing act.

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- 1 In its 2007 budget, the federal government announced that it would meet all the borrowing needs of the Canada Mortgage and Housing Corporation, the Business Development Bank of Canada and Farm Credit Canada through its own domestic debt issuance.
- 2 Some Crown corporations are subject to taxes, under federal *Income Tax Act* Regulations. The Crown corporations that are the focus of this paper are not subject to taxes.

This balancing act, the defining feature of Crown corporations' existence, reflects an inherent paradox. On one hand, the corporations' public policy rationale most often rests on filling presumed market gaps. These gaps represent, in principle, socially beneficial market activities that may otherwise be ignored by for-profit private organizations. The presumptive reasons for this neglect is the existence of information asymmetries or market characteristics that make it impossible for for-profit private firms to pursue those beneficial activities economically.

On the other hand, because the public and government are usually unwilling to support a money-losing Crown corporation, many Crowns are expected to be financially self-supporting, even returning a "dividend" to the public purse. Accordingly, Crown corporations may also have revenue-generating objectives.

And therein lies the contradiction, or existential challenge, most Crown corporations face: the more profitable the corporation, other things being equal, the less convincing is the argument that private enterprise would fail to provide the same goods or services. Moreover, even where there may be market gaps, whether large, small, permanent or transient, the presence of a dominant Crown will deter competitive market entry and product and service innovation. From this perspective, the existence of a Crown tends to ensure the persistence of the market gap it might have been intended to fill.³

Nonetheless, the Crowns' prevalence in the Canadian economy, past and present, is dramatic. In the early 1960s, for example, Crown corporation revenues represented about 30 percent of all federal and provincial government revenues (Tupper and Doern 1981). The revenue share is smaller now, but

the Canada Mortgage and Housing Corporation, whose balance sheet backstops about 50 percent of all residential mortgages, is a good example of a Crown's economic clout. Its net income, which averages about \$1 billion annually, reduces significantly the federal deficit and accumulated deficit in the Public Accounts.

In short, Crown corporations matter. Yet, they have no clear public policy rationale. At the same time, private ownership within a market-oriented economy is usually considered the best way to ensure an efficient allocation of scarce resources. In other words, the private sector tends to be better than the government at running a business. The Canadian experience with successful privatization of Crown corporations – including, for example, Canair and Canadian National Railway – tends to support this perspective.

Among our concerns is that Crown financial corporations may be less efficient than private institutions at allocating funds among competing business projects or households. An inefficient allocation of funds may have important, negative implications for the economy as a whole: it will affect which projects are financed, which in turn could negatively affect overall productivity and economic output.

While Crowns may not meet the economic definition of market efficiency, their relative freedom from the profit imperative may make them effective in delivering particular public services. That observation, however, is not enough to sustain their existential case, because Crowns represent only one of many possible instruments for providing public services. Direct spending, regulation and taxation might achieve the same objectives.

3 Market gaps do sometimes exist, even if temporary. For example, when private insurers withdraw from a market because information asymmetries make it difficult to price policies, the uninsured may form co-ops to fill gaps, as they did among United Kingdom coastal shippers in the 18th and 19th centuries. Had governments instead occupied the gap, innovative pricing policies and institutions likely would not have formed (Kowtoski 2007a).

The criteria for analyzing Crown corporations' relevance fall into two categories. The first is the salience or merit of the public policy objective that underpins a given Crown corporation's existence. The second set of criteria involves whether a given corporation is the appropriate instrument for achieving those policy objectives. For example, can the objectives be achieved efficiently through tools other than the Crown? This involves a distinction between goals and instruments.

In the financial sector, the stated public policy objectives have typically had their origin in a lack of credit availability – perceived or real – for some consumers and businesses. To choose an emblematic example, the origins of Farm Credit Canada lay in the perception that farmers did not, in the early years of the last century, have adequate access to credit. Even that rationale, however, had its limits: as argued by financial institutions at the time, the perceived credit market gap was itself the result of restrictions related to mortgage lending, thereby limiting the supply of credit to farmers (Senate of Canada 1996).

Whatever the cause of a perceived credit market gap, it is conceivable that Crown financial corporations can prove an efficient policy instrument for delivering credit where markets do not. If so, two issues remain: given the political direction to which any Crown corporation is necessarily subject, will the Crowns' activities be sufficiently remote from political intervention to permit safe and prudent operation? And can their activities be limited to those appropriately complementary to private lenders, so that the scale and scope of the risks inherent to these activities is suitably limited?

Building on that context, we will examine the mandates and activities of selected financial Crown corporations and the extent to which they compete with private lenders and take on excessive risks. We then recommend steps to ensure that these Crowns adhere to a narrowly defined mandate, which is clearly understood, including supervisory oversight and disclosure.

THE CASES OF FCC, EDC AND THE BDC

We begin our examination by considering the mandate and goals of Farm Credit Canada (FCC), Export Development Canada (EDC) and the Business Development Bank of Canada (BDC).

Farm Credit Canada

Subsection 4 (1) of the *Farm Credit Canada Act* sets out FCC's mandate:

4. (1) The purpose of the Corporation is to enhance rural Canada by providing specialized and personalized business and financial services and products to farming operations, including family farms, and to those businesses in rural Canada, including small and medium-sized businesses, that are businesses related to farming. The primary focus of the activities of the Corporation shall be on farming operations, including family farms.

The *Act* also lists a number of powers available to FCC, including the ability to offer loans and services to all businesses related to farming, including firms that add “value to inputs to or outputs from farming operations.”

Historical Context

FCC's history traces to the late 1920s, with the establishment of the Canadian Farm Loan Board. The board was to address a perceived lack of credit availability for farmers, notably in Western Canada, and to offer farm mortgages. The Farm Credit Corporation replaced the Board in 1959, with the enactment of the *Farm Credit Act*, and did so with a broadened mandate that included, for example, providing consulting services to farmers. Whereas the former board operated mostly on a for-profit basis, the new *Act* set FCC's lending rate at 5 percent, well below what was needed for profitability and accordingly providing an interest rate subsidy to farmers. By the 1970s, as the corporation's losses mounted, interest rates were set

at “the cost of funds plus 1.25 per cent.” (Senate of Canada 1996.)

FCC’s scope and powers expanded again in 1993 with the adoption of the *Farm Credit Corporation Act*. The new *Act* allowed FCC to offer increased flexibility to finance farmer-owned, farm-related enterprises and larger-scale farms. That *Act* did not include any provisions – unlike the acts now governing the BDC and EDC – limiting FCC to activities complementary to those offered by the private sector. The two fundamental steps – the shift from a for-profit basis to being a source of subsidized farm credit and the expansion of activities to areas where there was no indication of private sector failure to provide such services – signalled a clear departure of FCC’s mandate as a response to market failure.

Amendments in 2001 allowed FCC to offer a broader range of financial and business management services, such as business planning and risk management. It also widened FCC’s potential clientele to include more farm-related businesses, including those that are not farmer-owned.⁴ As a result, FCC has seen tremendous growth since its mandate began to expand in 1993. Indeed, its share of outstanding farm debt has grown from about 14 percent in 1992 to 29 percent by the end of 2011 (Statistics Canada CANSIM Table 002-0008).

Current Activities

FCC currently provides financing and other services to more than 100,000 primary producers and others in the agricultural production chain through 100 primarily rural offices. Its loans receivable

stood at \$23.2 billion at the end of its 2012 fiscal year, divided among three business lines: primary production financing, FCC Alliances (point-of-sale financing), and agribusiness and agrifood financing. Primary production financing, or loans to primary producers, is FCC’s largest business line with \$19.1 billion in loans at the end of fiscal 2012.

Export Development Canada

Subsection 10(1) of the *Export Development Act* sets out its mandate:⁵

10. (1) The Corporation is established for the purposes of supporting and developing, directly or indirectly,
- (a) domestic trade and Canadian capacity to engage in that trade and to respond to domestic business opportunities; and
 - (b) Canada’s export trade and Canadian capacity to engage in that trade and to respond to international business opportunities.

The *Act* requires EDC to offer services that complement those offered by the private sector. More specifically, subsection 10 (1.01) states that:

- 10 (1.01) The Corporation shall carry out its purposes, with respect to domestic trade and domestic business, in a manner that complements the products and services available from commercial financial institutions and commercial insurance providers.

EDC’s main financial services are to insure accounts receivable with respect to exports, as well as providing direct financing facilities.

4 The *Act* defines a business related to farming as “a business that primarily produces, transports, stores, distributes, supplies, processes or adds value to inputs to or outputs from farming operations.”

5 The wording related to domestic trade has been enacted on a temporary basis. This measure was part of a broader package of temporary measures introduced by the federal government in 2009 to enhance the resources and scope of action available to EDC and the BDC.

Table 1: FCC Consolidated Income Statement and Balance Sheet, Selected Items

	2012	2011
Income Statement Items \$ millions		
Net interest income	797	750
Provision for credit losses	2	36
Other income	39	5
Administration expenses	283	274
Net income	565	457
Balance Sheet Items \$ millions		
Total Assets	23,829	21,871
Equity	3,108	2,681

Source: FCC Annual Report 2012.

Historical Context

Parliament established EDC in 1944 as the Export Credits Insurance Corporation to support Canadian exports to Europe in the midst of the Second World War (Senate of Canada 1996). As was the case with the BDC and FCC, EDC was created to address a perceived market gap. The *Act* aimed to redress increased or perceived export risks that resulted from the war, which were reflected in a potential lack of credit facilities available to Canadian exporters, as well as financing limits to foreign buyers of Canadian goods, owing in particular to a fractured European economy that had been a key Canadian export market.

The *Export Development Act* in 1969 broadened considerably the corporation's mandate. The new *Act*, responding partly to critiques that suggested the corporation was too conservative in its support of Canadian exports, expanded EDC's scope. Among other things, the *Act* allowed EDC to provide direct export financing and to insure investments abroad against political risks.

Subsequently, the most significant legislative changes to EDC came in 1993 when the corporation's powers were expanded to support and develop, directly and indirectly, Canada's both trade and business opportunities, at home and abroad, compared to the former, narrower mandate of facilitating only international trade. More recently, in response to the global recession and, to some extent, to financial market disruptions, the mandate of EDC was temporarily expanded in 2009 with its capital limit doubled to \$3 billion. This has allowed EDC to support financing and insurance in the domestic market and increased its contingent liability limit to \$45 billion (from \$17.5 billion).

Current Activities

EDC currently supplies financing, insurance and risk management to Canadian exporters as well as services in support of domestic trade. EDC's dominant business is insuring commercial risks: in 2011, its portfolio consisted of \$14.8 billion in credit risk insurance, \$9.7 billion in contract

Table 2: EDC Consolidated Income Statement and Balance Sheet, Selected Items

	2011	2010
Income Statement Items \$ millions		
Financing and investment revenue:		
Loan	1,009	1,004
Finance lease	7	8
Operating lease	21	32
Debt relief	4	25
Investment	46	47
Loan-guarantee fees	32	33
Insurance premiums and guarantee fees	238	210
Net income	645	1,475
Balance Sheet Items \$ millions		
Total Assets	33,596	31,882
Equity	8,256	7,961

Source: EDC Annual Report 2011.

insurance and bonding, \$1.8 billion in political risk insurance, as well as \$45 billion in financing commitments and guarantees. Lending receivables stood at \$29 billion at the end of the 2011 fiscal year, of which 31 percent were US exposures and 13 percent Canadian. Under the authority of the 2009 temporary budget measures mentioned above, EDC provided \$2.5 billion in support of domestic firms in 2009, and the federal government has since extended these measures through March 12, 2013.

The Business Development Bank

Section 4 of the *Business Development Bank of Canada Act* states:

4. (1) The purpose of the Bank is to support Canadian entrepreneurship by providing financial

and management services and by issuing securities or otherwise raising funds or capital in support of those services.

4. (2) In carrying out its activities, the Bank must give particular consideration to the needs of small and medium-sized enterprises.

The *Act* also sets out the conditions under which the BDC must conduct its activities. More specifically, subsection 14 (4) states that:

14. (4) The loans, investments and guarantees are to fill out or complete services available from commercial financial institutions.

The *Act* sets out the type of financial services the BDC can offer, which include loans, investments and guarantees, directly or in partnership with other financial institutions or through a syndicate. These

financial services are constrained by risk measures: the debt-to-equity ratio cannot exceed 12:1, and the value of the federal government's share capital cannot currently exceed \$3 billion.

Historical Context

The Government of Canada established the BDC in 1944 as the Industrial Development Bank to “promote the economic welfare of Canada by increasing the effectiveness of monetary action through assuring the availability of credit to industrial enterprises.”⁶ The bank was intended to help new and existing industrial firms convert their production from wartime materiel. The private financial sector was perceived as unable to fully support that transition, and the extent of collateral against which to secure lending was expected to be limited during the transition (Tupper and Doern 1988).

Over the years, legislative changes expanded the bank's scope of activities. Its focus expanded in 1961 to include all types of businesses, not only industrial enterprises. In 1975, the bank became the Federal Business Development Bank with a mandate as lender of last resort for the financing and management needs of small businesses (Senate of Canada 2010). The current *Act* governing the BDC, enacted in 1995, transformed the lender-of-last-resort role to one of a commercial financial institution that offers products and services complementary to those offered by traditional financial institutions. The reform also expanded the type of services the bank could offer, with an emphasis on increasing activity in smaller loans, higher-risk term lending and venture capital, and increasing activities in “patient capital” and working capital financing.

In the wake of the 2007–2009 financial crisis, BDC powers were temporarily broadened, doubling its capital limit to \$3 billion in conjunction with the establishment of the now-terminated Business Credit Availability Program, a joint lending program with EDC and other private financial institutions.

Current Activities

The BDC currently conducts five main business lines: financing; subordinate financing; venture capital; consulting; and securitization through 102 regional offices. Most of its portfolio is in direct loans to businesses. At the end of the 2012 fiscal year, BDC loans outstanding (net of allowance for credit losses) stood at \$14.7 billion, with total assets of \$17.2 billion. At the end of the same fiscal year, the BDC held about \$0.8 billion in asset-backed securities, down from the \$3.3 billion acquired through its temporary, but now expired Canadian Secured Credit Facility. The BDC's subordinate financing and venture capital investments were approximately \$0.5 and \$0.4 billion.

THE PROBLEM: UNBALANCED COMPETITION, CROWDING OUT AND FINANCIAL STABILITY

What are the implications of the presence and expansion of the role of Crown corporations in the financial sphere?

The Political Economy of Crown Financial Corporations

The historical backdrop we described above illustrates how the development paths of different financial Crowns tracked similar trajectories.⁷ Their

6 <http://www.bankofcanada.ca/en/archives/collections.html>.

7 The list of Crowns with similar paths is lengthy, notably including Canada Mortgage and Housing Corporation (Poschmann 2011).

Table 3: BDC Consolidated Income Statement and Balance Sheet, Selected Items

	2012	2011
Income Statement Items <i>\$ millions</i>		
Net Interest Income	852	828
Net Revenue	913	798
Impairment reversal (losses) on loans	38	(104)
Income before operating and administrative expenses	925	744
Net income	533	367
Balance Sheet Items <i>\$ millions</i>		
Total Assets	17,220	18,400
Equity	3,625	3,760
Source: BDC Annual Report 2012.		

evolution typically followed three stages (Senate of Canada 1996). First came creation, when the institutions were organized to address real or perceived market failures in the delivery of credit to households or businesses. Second, the corporations or their political masters were criticized for holding too conservative operating principles. They were urged to do more to help consumers and businesses, or otherwise better serve current markets, leading to an expansion of their mandates. In the third stage, “when . . . the credit market gap seems to be taken as an unstated given,” the Crowns tended to expand the scope of their activities as they explored the limits of their statutory powers (Senate of Canada 1996).

To this taxonomy, in the aftermath of the 2008 financial crisis, we are now able to add a fourth stage: event-driven mandate and activity expansions, as governments reach for available tools to respond to financial or economic crises. This occurred in the cases of EDC, the BDC and FCC, as we have noted and discuss further below, and has opened the question of whether mandate changes are likely to exhibit ratchet-like behaviour, moving only in the direction of expansion.⁸

The pervasiveness of Canadian Crown financial corporations has received periodic public attention: one encyclopedic report examined the rationale for government intervention in financial markets and concluded that “government intervention has

8 Budget 2012 arguably responds to this concern in the context of EDC: “The extension of EDC’s temporary domestic powers until March 2013 will support further assessment and consultation with stakeholders on EDC’s role in the domestic market” (Canada 2012).

almost always been aimed at achieving economic and social objectives that went well beyond the scope of financial markets” (Economic Council of Canada 1982).

Because the acts authorizing the BDC and EDC – unlike FCC – require legislative reviews every 10 years, those corporations’ mandates have received more parliamentary scrutiny. In the course of their reviews, the Standing Committee on Industry of the House of Commons in 1994 and the Standing Senate Committee on Banking, Trade and Commerce in 1996 analyzed the role of all financial Crowns. The Senate Report concluded:

[T]here is a strong consensus that public institutions should address gaps in the capital markets and should not compete with the private sector. ... [D]ata released by the Crown financial institutions do not permit an analysis of the businesses being served by those institutions, making any analyses of whether these institutions are filling capital market gaps impossible. ... (Senate of Canada 1996.)

The debate surrounding the role of financial Crown corporations – or state financial institutions (SFIs) as they are more commonly called abroad – is not unique to Canada. A recent World Bank report for example concludes that:

The inability to define their objectives is one of the main problems of State Financial Institutions. Most countries have great difficulty in justifying the presence of SFIs.... [T]o gain market share for their profitable businesses, SFIs offer rates below the market, which ends up not only crowding out the role of privately owned institutions, but creating large and fragile SFIs that are highly dependent on government support. (Rudolph 2009.)

What these observations convey is an economic commonplace: direct state involvement in providing financial services tends to be a mission whose support depends more on national or regional politics than on economic theory or empirical

rationale. The questions that follow naturally from the continued existence and expanded mandates of financial Crowns are: How important are these market gaps? And, are there alternatives that could limit the extent of state involvement and risk exposure in the financial sector?

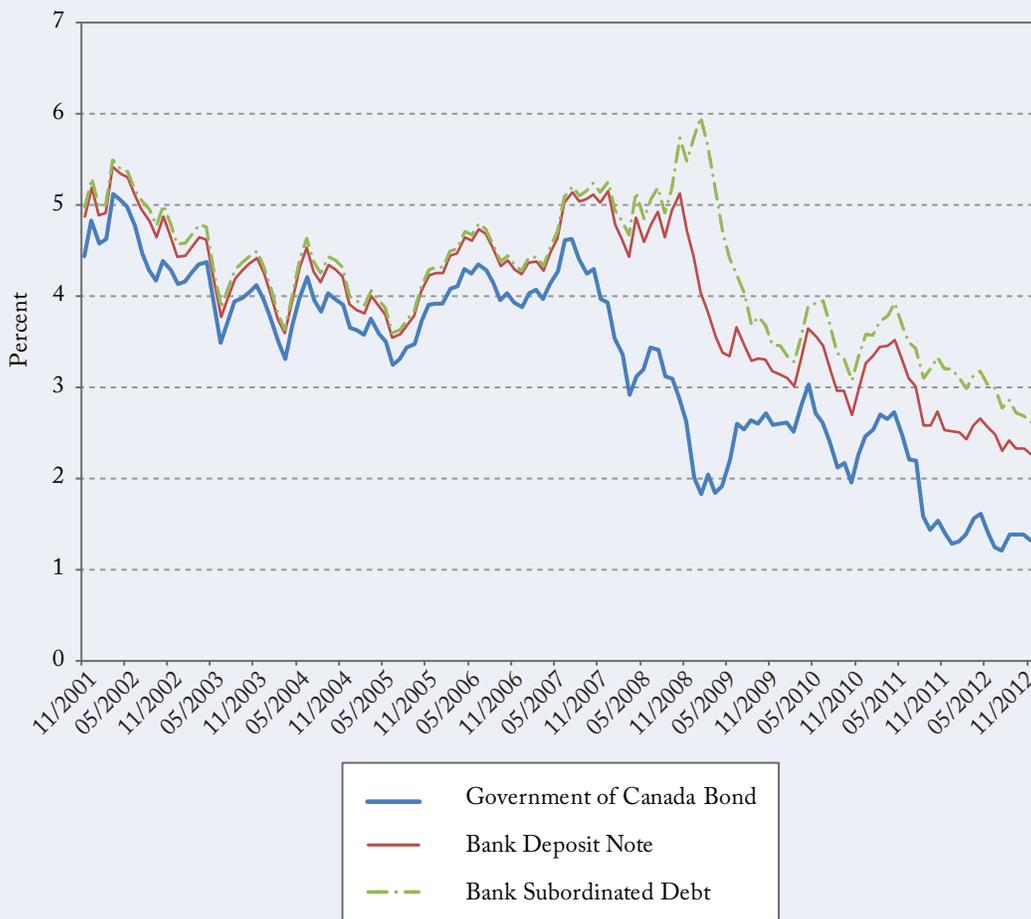
Competition and Crowding Out

Before turning to the financial Crown corporation mandates, we comment on the conditions that make it possible for Crowns to expand their activities in commercial markets, and the implications thereof.

Financial Crown corporations have a number of cost advantages relative to market competitors. For example, the fact that they are not exposed to the corporation income tax means they do not need to generate a market pre-tax return on equity that for-profit corporations must earn. The Crowns’ major advantage, in other words, is in the comparatively low cost of capital. They do not go to market for relatively expensive equity, but they may borrow, and do so very cheaply, either by issuing debt that is backed by the federal government or by borrowing directly from it at preferential rates. Their borrowing costs normally are 30 basis points to 50 basis points lower than what is available to private competitors. Private financial institutions normally must raise capital at the going rate for banks’ subordinated debt, while Crown corporations can borrow either at the same rate as those associated with government bonds or at a positive, small spread over such bonds (see Figure 1). In the wake of the 2007 financial shock, however, that spread, or capital cost advantage, increased to as much as 300 basis points.

The Crowns’ cost advantage clearly provides an edge over their competitors in selling financial products and services. To illustrate, if the BDC were to face funding costs similar to private institutions – approximated here by a 75-basis-point-increase – it would experience a significant decline in net

Figure 1: Crown Corporation Cost of Funds
 (Yields on Five-Year Government of Canada Bond, Bank Deposit Note and Bank Subordinated Debenture, monthly average)



Source: BMO Capital Markets.

income, dropping to a 8.4 percent return on equity, compared to 14 percent in its 2012 budget year.⁹

Under that scenario, if the BDC were to operate as a private institution and aim for returns on equity of 15 percent – consistent with those observed for private financial institutions¹⁰ – it would have

to substantially increase the interest return on its loan portfolio. We calculate that for its 2012 budget year, the BDC would have to increase the rate on its loans by 1.4 percentage points – a 25 percent increase – to generate a 15 percent return. Recognizing that these numbers are indicative and

9 We assume here a 30 percent tax rate.

10 According to the Canadian Bankers Association, the eight largest federally regulated banks had a return on equity equal to 18.75 percent for the quarter ending July 2012 and 14.74 percent for the same quarter in 2011.

hold many other factors constant, it is nonetheless clear that interest rate increases of this magnitude would affect the ability of any corporation to sell financial products and compete in the marketplace.

The Crowns' cost advantage can also affect the riskiness of the activities they are likely to finance because, even on a risk-adjusted basis, the expected return on a loan, minus funding costs, is higher for a Crown corporation than it would be for a private competitor. Having lower capital costs therefore means that the aggregate portfolio of investments that the Crown undertakes can be riskier than the privately financed portfolio, even when selected from the same pool of investment (lending) opportunities because a Crown's lending spread will be higher, even on a risk-adjusted basis. Unsurprisingly, according to stakeholder interviews, the assets of Crown lenders are likely to comprise loans that have higher loan-to-value ratios than others, and that tends to lead to higher rates of default or loan loss.

The Recent Impact of Expanding Mandates

In what follows, we present simple indicators of the expanded activities of the three Crown financials under examination and highlight some of the competitive implications for private lenders and risks for taxpayers and the broader economy.

Farm Credit Canada

The simplest measure of FCC's scope of activities is its holdings of farm debt, which have grown in dollar terms in the past two decades and, markedly, in percentage share over the past decade. Twenty years ago, FCC's share of farm debt was less than 15 percent; in 2011, it was 29 percent (see

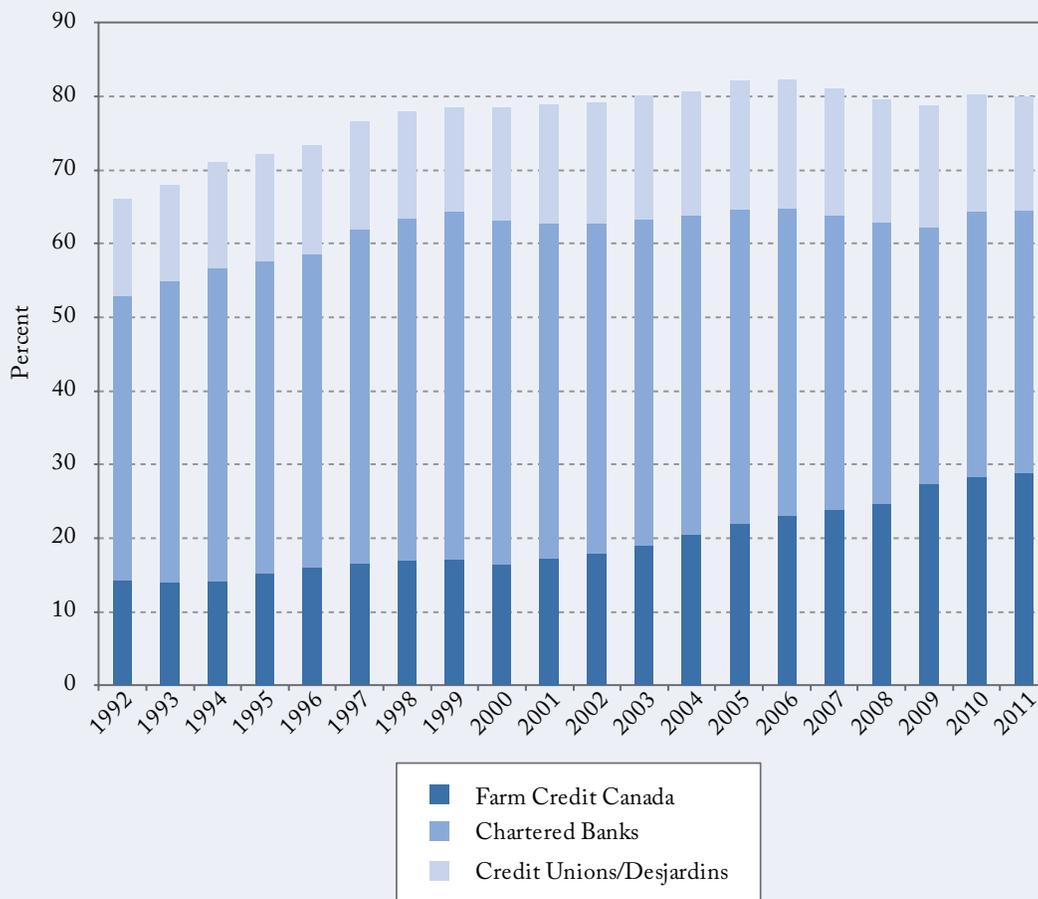
Figure 2). Presumably, this growth is related largely to FCC mandate expansion in 1993 and 2001. Farm debt held by FCC has, in the past decade, grown sharply faster than the total farm debt market and, accordingly, far faster than farm debt issuance by banks and credit unions. FCC's 29 percent share of all farm debt outstanding in 2011 stands against that of all chartered banks, 36 percent, and all credit unions with another 16 percent (Figure 2). The dynamic at play is not only the fact that FCC was permitted to expand its activities and enlarge its capital base to do so, but that it was able to build its lending share in a market where private sector competitors, primarily chartered banks and credit unions, historically have been very active.

Clearly, FCC been successful in building its market share because of the institution's low capital costs, as just discussed. Its capital has in part been provided directly by government and, again, as an agent Crown corporation it is able to borrow directly from the federal government on terms that reflect Ottawa's credit quality. It does not face the same regulatory capital requirements as financial institutions and, as mentioned earlier, it does not pay corporate income tax.

When it comes to specific FCC practices, interviews with stakeholders raise concerns about the impact of its lending criteria on the level of debt farmers take on and, ultimately, on financial stability. For instance, FCC loans tend to have long amortization periods, higher loan-to-value ratios, and the corporation stands ready to lend against supply management quotas and to offer interest-only loans. Other practices that could encourage excessive debt build-up or inflate farm asset values include quota values¹¹ and other FCC offerings, as listed in FCC's 2010 Annual Report:

11 Quota value is the market price of the right to produce supply-managed agricultural products, such as dairy and poultry products, under the federal provincial agricultural supply management system (Busby and Robson, 2010).

Figure 2: Percentage of Farm Debt Outstanding by Type of Lender



Note: Data for the Farm Credit Canada include farm debt from the BDC and Veterans Affairs Canada, but these amounts are negligible.
 Sources: Statistics Canada, CANSIM Table 002-0008, and authors' calculations.

- The 1-2-3 Grow Loan, which allows interest-only payments until projects generate returns;
 - The Cash Flow Optimizer Loan, which allows interest-only payments while reinvesting funds into other operations;
 - Construction Loans, which defer principal payments during expansions, with interim financing for up to 18 months on construction projects;
 - The Enviro-Loan, which defers loan payments on projects intended to “improve your environmental stewardship;”
 - The Start Now – Pay Later Loan, a cash-management arrangement that provides working capital;
 - The Transition Loan, which enables land purchases with low or zero down payment and a delayed repayment plan; and
 - The Capacity Builder Loan, which finances quota purchases or breeding livestock acquisition, with the option of capitalizing interest.
- None of these products is inherently inappropriate – what they are is risky, in much the same way

that so-called sub-prime mortgage lending is risky. Loans characterized by low down payments or that have high loan-to-value ratios, or that capitalize early accumulations of interest due, or which involve balloon or variable future payments have, keeping everything else constant, a higher default rate than more traditional loans. By definition, lending under these risky conditions carries an interest rate premium. For small business lending, and in particular to those businesses that have been in operation for a relatively short period of time, a typical risk premium is on the order of 300 basis points above the prime business lending rate.

This offers an hypothesis: if FCC competes for business on loan prices and terms without the same risk premium that the market would demand, its market share will grow as its mandate and capital expands, and lending in the sector in general will be riskier. Indeed, Figure 2 reflects FCC's growing market share relative to private competitors – impaired loans as of 2012 are 1.2 percent of loans receivable.¹² Evidence that risks have grown with FCC's portfolio and market share lays in the fact that farm debt has been growing, in real terms and relative to income (see Figure 3).

The implications of this expanded activity are simple but serious: FCC competes with private sector lenders in offering financing services to farmers and others active in the agrifood sector; its market share has been growing without any regulatory capital constraint; and farm lending has

grown relative to farm income, an indicator of rising risk in the sector.

The increased financial risks associated with farm-related activities are also apparent on the asset side of farms' balance sheet. In particular, the values of farms and buildings, as well as farm quota values, have been subject to large increases in recent years in per acre terms and as a percentage of farms' total assets (see Figure 4).¹³

Meanwhile, credit expansion's role in asset boom and bust cycles in various sectors is well documented (see, for example, Reinhart and Rogoff 2009). Excessive credit growth tends to be associated with increases in asset prices followed by potentially sharp adjustments in the value of those assets. For the farm credit market currently, there are clear signals that it is subject to excessive growth, as documented above, and this, coupled with FCC's aggressive growth strategies, warrants closer examination by regulators.

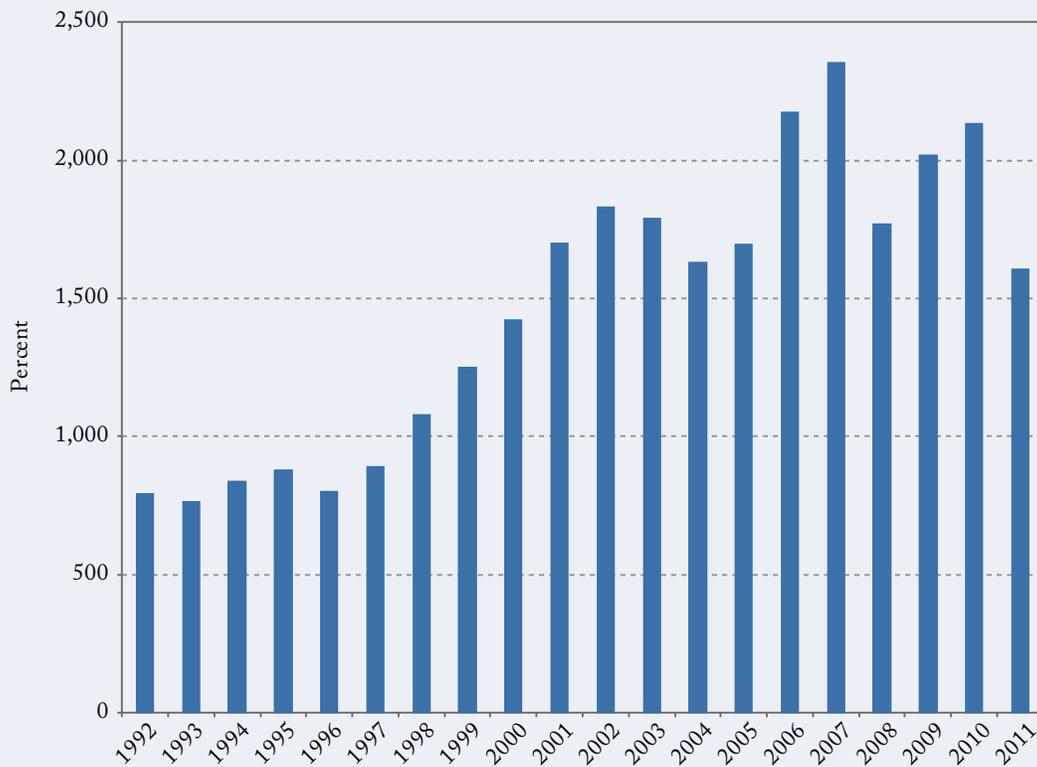
The potential impacts are not only related to potential losses for FCC and, ultimately, taxpayers. Private lenders could also be affected as they adjust their own lending standards to remain competitive.¹⁴ Farmers also lose from excessive credit growth to the extent that it subjects their assets to swings in value. Given the risks involved for FCC, farmers and for the economy at large, it would be prudent for Canadian regulators to monitor the situation more closely. FCC, as is the case for the BDC and EDC, is not formally

12 This impaired loan ratio is higher than that of chartered banks, as discussed later. It should be noted that FCC qualifies impaired loans differently from most private banks in Canada, suggesting that the FCC ratio may, in relative terms, underreport impaired loans.

13 FCC's role in lending against quota also sets up a nightmarish political economy problem: FCC, and by extension the federal taxpayer, have become financially invested in the preservation of the cartelized, supply-managed agricultural sectors. A similar problem applies to the FCC Energy Loan program, which provides funds to eligible farmers to purchase and install on-farm renewable energy generation systems, making more difficult the eventual unwinding of unnecessary energy-related government programs.

14 For instance, according to the authors' interviews with stakeholders, FCC is able to secure a large portion of farm assets to use as collateral against some of its lending – presumably as a result of its competitive advantage due to its Crown corporation status – thereby forcing private lenders into unsecured and, typically, more risky lending.

Figure 3: Farm Debt as Percentage of Farm Net Income (five-year moving average)



Sources: Statistics Canada, CANSIM Tables 002-0008 and 002-0009, and authors' calculations.

subject to a prudential regulator. Subjecting its activities to such a regulator, which would aim to ensure the safety and soundness of FCC's lending portfolio, would be an important step in ensuring that taxpayers and shareholders are not exposed to undue risks.

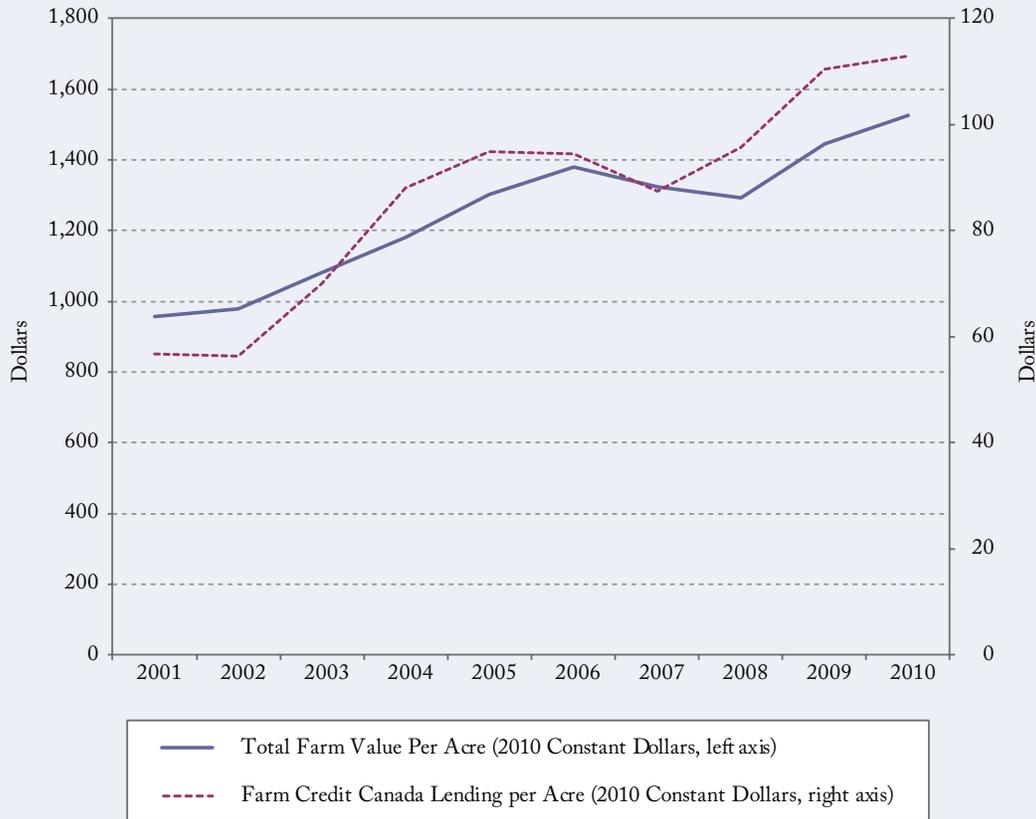
Export Development Canada

EDC's activities under what is called the Canada Account provide explicit government backing to exports considered in the national interest. Historically, wheat and aircraft sales as well as support of CANDU reactor exports were major examples of EDC backing and, while sometimes politically controversial, these are activities that

private financial markets can be reluctant to serve. In other words, this EDC support can be seen as complementary to the market.

The same, however, does not necessarily apply to other EDC activities in the credit insurance market, where private competitors exist and offer products on market terms. Internationally, there exist many large private market participants that are active in the credit insurance market, including three with some activity in Canada – Euler Hermes, Atradius and Coface – and a collection of smaller insurers (see Table 4). Private market participants have notably developed an appetite for short-term credit risks, and this portion of the credit insurance market is particularly well developed globally (Kotowski 2007b). Perhaps because of its capital

Figure 4: Expanding Value of Farmlands, Building and Quotas
Panel A: Real Farm Values and Real FCC Lending Per Acre



Note: Farmland and buildings values and FCC lending have been deflated with the Farm Product Price Index.
 Sources: Statistics Canada’s Farm Financial Survey and authors’ calculations.

cost advantages, EDC has become the dominant provider of credit insurance products in Canada and its market share, historically 60 percent to 70 percent and more recently growing, offers evidence that this insurance function is provided on a non-commercial basis (Table 4).

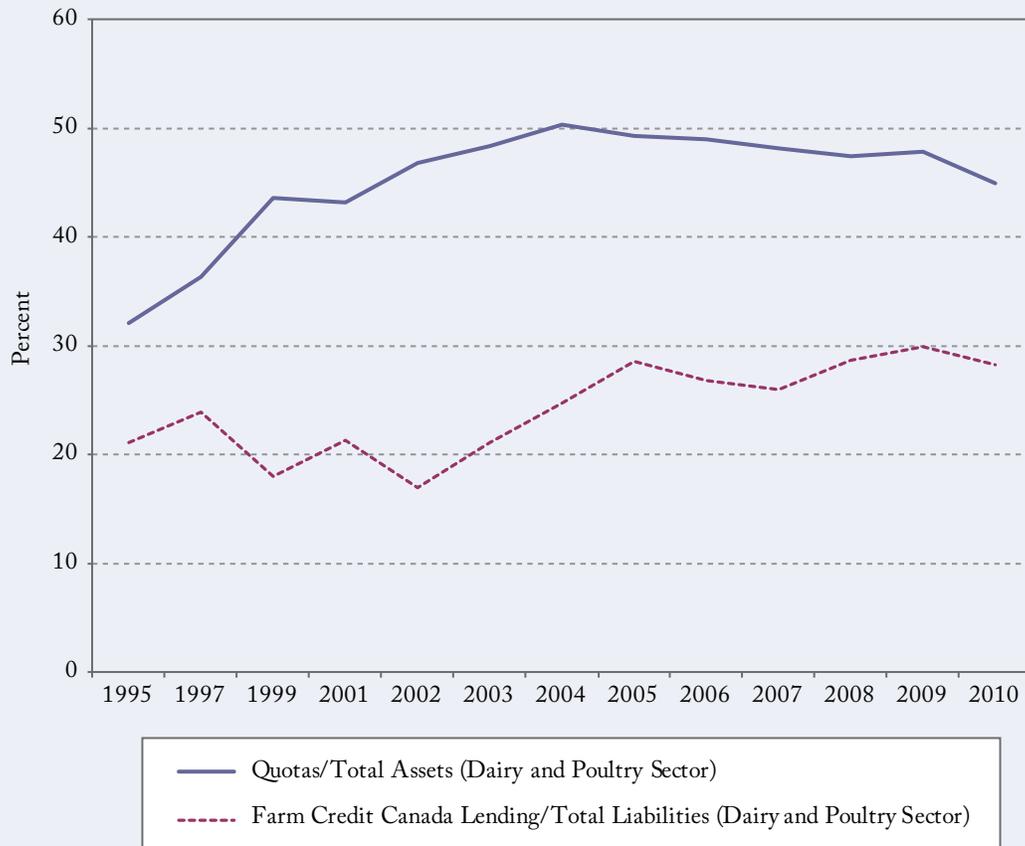
Meanwhile, the share of total exports insured by EDC has also been growing (see Figure 5). The corporation’s range of activities and market dominance in them are unusual among OECD countries (Kotowski 2007b), and this has contributed to trade friction and long disputes, as between Canada and Brazil over aircraft financing terms.

A major 2008 consultant’s study of EDC’s mandate and activities, conducted as part of the statutory review process, drew clear conclusions on these issues:

There can be no doubt that EDC operates outside any “market gap,” however defined... In addition, there can be no doubt that EDC actively competes with private insurers for export credit insurance business. (International Financial Consulting 2008.)

In other words, while EDC has made moves toward making its guarantee offerings on terms more similar to those available from financial institutions, it is clearly a competitor in this product line.

Figure 4: Expanding Value of Farmlands, Building and Quotas
Panel B: Values of Quotas and FCC Lending



Note: Farmland and buildings values and FCC lending have been deflated with the Farm Product Price Index. FCC lending in Panel B refers to long-term lending only.

Sources: Statistics Canada's Farm Financial Survey and authors' calculations.

The benefits of EDC's insurance activities include low-cost support for Canada's exports and for some domestic trade. The implications for financial system riskiness, or riskiness to taxpayers, are unclear. Among the costs is an underdeveloped private finance system and arguably less engagement with the international financial system. While not possible to quantify, narrowing EDC's mandate and insurance activities:

... would confer several benefits to Canadian exporters, EDC itself and to the Government of Canada. First, exporters would benefit from a more vibrant and competitive credit insurance market.

EDC's withdrawal from the field would remove a major disincentive currently faced by private insurers in developing their Canadian capacity. Second, with the market's development, Canadian exporters would benefit from the global scale of operations which these credit insurers enjoy. (Kotowski 2007b.)

Of secondary importance, but relevant to its scope of mandate and allowable capital, is EDC's direct financing and loan-guarantee activities. These activities have quite appropriately been declining over the course of the past decade as private credit supplies on good financial terms displaced the demand for government support (see Table 5).

Table 4: Canadian Market Share of Major Trade Credit Insurance Providers

Provider:	Market Size (Credit Insurance Premiums)			Market Share		
	2008	2009	2010	2008	2009	2010
	<i>\$ millions</i>			<i>percent</i>		
EDC	97.0	105.0	120.9	73.0	78.2	80.7
Euler Hermes	17.2	11.6	10.6	12.9	8.6	7.1
Coface	8.4	7.8	9.5	6.3	5.8	6.3
Chartis	3.5	4.8	3.7	2.6	3.6	2.5
Atradius	5.6	2.4	2.6	4.2	1.8	1.7
Executive Risk Insurance Services	0.9	2.3	2.2	0.7	1.7	1.5
Guarantee Company of North America	0.3	0.3	0.3	0.2	0.2	0.2
Total	132.9	134.2	149.8	100.0	100.0	100.0

Sources: Corporate annual reports, OSFI.

Then, two things happened that helped reverse this trend – the federal government decided to finance several particularly large export sales of Canadian-manufactured aircraft and the 2009 budget, discussed above, increased EDC’s lending authority, in large part to be delivered through the Canada Account.

The extent to which these government decisions are driven by political imperatives partly immunizes them from criticism on economic grounds. However, direct lending in support of business trade is exactly what credit markets evolved to do, and there is no question that existing financial institutions stand ready to serve the market on a commercial basis. In turn, the existence of a market gap, in the economic sense, is doubtful, and the case for EDC maintaining an expanded lending capacity in this area is correspondingly weak.

Business Development Bank of Canada

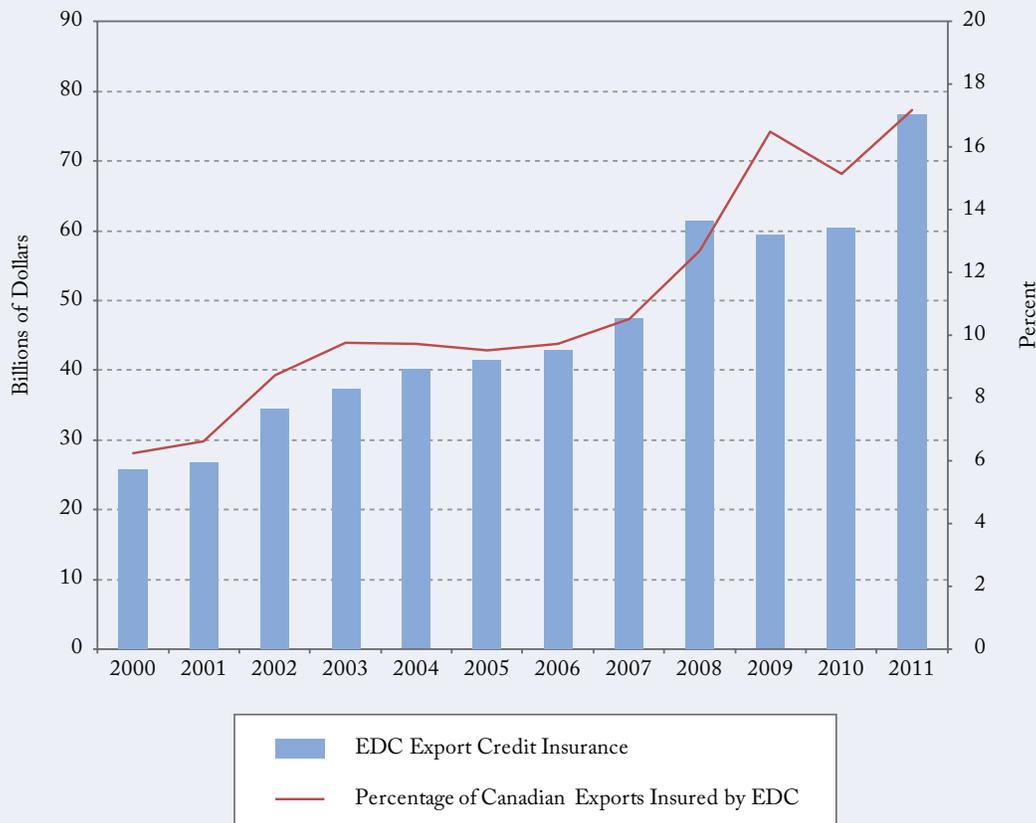
Concerns over the BDC’s lending practices and the extent to which they stand in competition with, as opposed to being complementary to,

private financial institutions’ lending are less well documented than in the cases of FCC. At a generic level, however, concerns over a lack of complementarity, or a less than clear market gap, parallel in most ways the preceding discussion of FCC.

Author interviews with stakeholders have highlighted instances where the BDC has apparently been in direct competition with private lenders. The level of concern associated with the BDC’s lack of complementarity was, however, much lower than in the case of FCC. Market participants reported a higher comfort level with the BDC’s interventions, but left room for improvement in ensuring these interventions did not displace private lenders.

In the case of the BDC, recent years have witnessed a growth in business lending – most markedly so in the wake of Budget 2009’s mandate and capital expansion. What stands out about the BDC, however, is that the expansion in dollar terms and as a share of total business lending has been large and rapid. While its financing portfolio has grown by about one-half in dollar terms since 2006,

Figure 5: EDC Insurance Business
(in dollar amounts and as a percentage of Canadian exports)



Sources: Statistics Canada, CANSIM Table 228-0003, various EDC annual reports and authors' calculations. EDC export credit insurance amounts correspond to relevant financial arrangements facilitated.

the BDC's business loan market share has risen by approximately one-third (see Figure 6).

Of course, the contributing factors to the BDC's expanded lending include the recent recession and the related slowdown in total business lending and associated tightening of lending standards, along with the policy choice to expand the BDC's capital to address that perceived difficulty in accessing credit.

However, there are reasons to be concerned about the impact on aggregate financial risks, as in the case of FCC. The expectation that the BDC serves as a complementary lender, to the extent that it is fulfilled, leads the bank to extend loans that

private lenders will not. Indeed, this behaviour is at the core of the bank's mandate. However, because it does so with a lower capital cost (and without the need to pay corporate income tax and without the private market's capital requirements), the risk premium it commands for its lending tends to be less than markets would otherwise generate.

As in the case of FCC, it would be normal for small business lending to be provided at the prime business rate plus a premium, typically on the order of 300 basis points. However, comments from stakeholders indicate that the BDC, in some instances at least, competes on loan pricing and terms that bring its lending rates much closer to the

Table 5: EDC Direct Financing and Facilitated Insurance Arrangements

	Direct Financing	Insurance	Direct Lending Activity Relative to Insurance
	<i>\$ millions</i>		<i>percent</i>
2009	26,131	71,488	37
2008	14,086	71,733	20
2007	12,611	57,438	22
2006	13,623	56,113	24
2005	5,740	52,353	11
2004	7,139	48,751	15
2003	7,148	45,922	16
2002	7,908	43,865	18
2001	8,554	35,944	24
2000	7,695	33,436	23

Note: Includes arrangements from the Corporate Account and the Canada Account.

Source: EDC Annual Report 2009.

prime rate, pricing other financial institutions out of the market. Evidence is anecdotal:

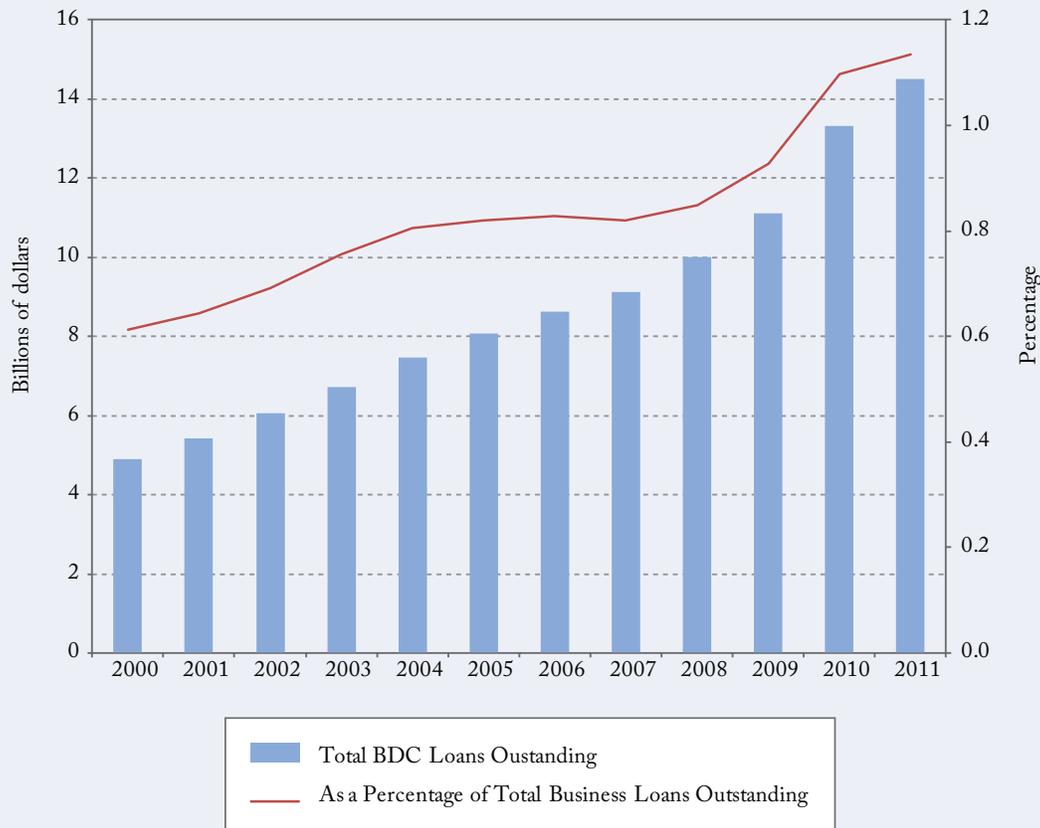
“We are hearing increasing reports from credit unions about aggressive lending on the part of [the] BDC in direct competition with credit unions. This is a matter of concern because such lending would be in direct contravention of BDC’s mandate.”
(Credit Union Central of Canada 2011.)

As of March 2012, the BDC’s impaired loans stood at about 3.6 percent of total loans outstanding, while the equivalent ratio for the main federally regulated private banks was about 0.8 percent of loans outstanding (see Table 6). The inherent riskiness in the BDC’s balance sheet that results from its lending is also reflected in loan provisioning: the bank’s “allowance for credit losses rate is at least five times greater than that of private

sector financial institutions.” (BDC 2010 Annual Report.) To the extent that expected losses are properly provisioned for, the BDC’s balance sheet is protected from expected losses, and taxpayers are thereby protected from unanticipated losses.

However, that does not mean the lending itself does not increase aggregate financial risks. As a matter of arithmetic, the larger the BDC’s share in total business lending, the larger the expected share of impaired loans in the economy. And as is the case with any lender, provisions, in some unforeseen circumstances, may not be enough to absorb losses. Further, the BDC is not subject to the same prudential regulation as federally regulated private counterparts through the Office of the Superintendent of Financial Institutions (OSFI), thereby reducing analysts’ comfort levels with

Figure 6: BDC Loans Outstanding
(in dollar amounts and as a percentage of total loans outstanding)



Sources: Statistics Canada, CANSIM Table 176-0023, various BDC annual reports and authors' calculations.

the extent to which it could appropriately absorb unexpected losses.¹⁵

On this point, the federal government in its 2012 budget introduced amendments to the legislative framework governing the Canada Mortgage and Housing Corporation (CMHC) so as to require OSFI to oversee its activities. The objective of the federal government was to “strengthen oversight of CMHC and to ensure its commercial activities are

managed in a manner that promotes the stability of the financial system.” There is no reason why the BDC, as well as EDC and FCC, should not be subject to the same oversight, given that all these Crown corporations perform financial market functions that may expose taxpayers to large and unexpected losses and, ultimately, affect the stability of the financial system.

¹⁵ While the BDC is not regulated by OSFI, it is subject to Treasury Board of Canada Secretariat guidelines on its capital adequacy ratios. Treasury Board guidelines are not publicly available, but our interviews with stakeholders suggest that they are less stringent than those imposed on private financial institutions. And Treasury Board does not possess the same level of expertise as OSFI in overseeing large and complex financial institutions.

Table 6: Impaired Loans – BDC versus Average of Five Largest Banks (2012)

	Gross Loans	Impaired Loans	Impaired Loans as a Percentage of Gross Loans
	<i>\$ millions</i>		<i>percent</i>
BDC	15,349	551	3.6
Average of five largest banks	323,141	2,614	0.8

Note: Includes Acceptances. Data for the BDC are as of March 31, 2012 and April 30, 2012 for the five largest banks.
Sources: Individual institutions' annual reports and authors' calculations.

PULLING THE PIECES TOGETHER

Crown financial corporations necessarily live a conflicted or paradoxical life. They are expected to fill market gaps that are, in most cases, non-economic to fill. When they pursue economically viable financial opportunities, they crowd out private market participants. When they extend their services on terms that the private market would not serve, they increase financial risk, potentially in a systemic manner, and they expose taxpayers to larger risks than they would otherwise face.

If, however, Canadians wish to keep Crown corporations in roughly their present form, close attention to their mandates and sound prudential oversight of their lending activities seem the most likely course to produce a balanced outcome. Hence, for example:

“State Financial Institutions should complete markets, not act as a substitute for the role of private financiers. In this context, the mandates of SFIs should implicitly promote the participation of privately owned commercial banks. SFIs may support the market in various ways, for example by segmenting the market and servicing mainly clients that are not serviced by others...” (Rudolph 2009.)

As guiding principles, the Crown financials ought, therefore, to focus on profitable investments that

would fail if the market level of risk aversion always prevailed. Techniques to mitigate risks, such as the BDC has pursued in some of its portfolio lending, include participating on equal terms in syndicated lending or taking first-loss positions as part of a larger syndicate. These are details, however, compared to the importance of focusing on mandates.

Clear, Narrow Mandates

In what follows, we presume that the financial Crowns will continue largely in their present form, owing to longstanding political imperatives and the fact that business and institutional frameworks have evolved in partnership with them. In this context, we present a number of recommendations aimed at mitigating the scale and scope of the inherent risks associated with their activities.

- The temporary mandate and capital enhancements at the BDC and EDC, some of which were extended for another year in Budget 2012, should be wound down.
- All Crown financial corporations should, in their governing legislation, have a clearly articulated mandate that focuses on the need to be complementary to private institutions. This recommendation is particularly relevant to FCC, given that it has no legislative requirement whatsoever to be complementary.

- The traditional “lender-of-last resort” role that governed the BDC’s lending should be considered for all Crown financial corporations. This former legislative role encapsulated well the concept that Crowns should not compete with private lenders and insurers. This would not necessarily lower the risk of the Crown lenders’ portfolios, but it would limit their size and the extent to which they crowd out private market activity.
- The complementary mandates of all Crown financial corporations should also be better defined in guidelines and, more importantly, be better reflected in practice. An example would be to adopt a lending threshold of prime business rates plus 300 basis points, below which the Crowns would not offer financing. Management compensation and the selection of directors should also reflect the complementary role. While this recommendation applies to all Crown financial corporations, it applies more forcefully to FCC, given that its business practices appear the farthest removed from a complementary role.
- Regular statutory review should apply to FCC as it does to all other Crown financial corporations. The next review should explore the extent to which there exists a credit market gap that needs redressing. Statutory reviews should occur at more frequent, five-year intervals for all Crown financial corporations. Their annual reports should also disclose more information on the extent to which they are complementary to, and in particular how their operational criteria compare with, private institutions.
- FCC’s lending programs need careful examination by its current regulator, the federal government, as its current suite of offerings, on its face, increases market risks and seems to be supplying excessive credit to the farm sector.
- EDC should shrink and eventually eliminate its participation in the short-term trade credit insurance market, allowing private market participants to serve it.
- All Crown financial corporations should be regulated by OSFI, so that they are subject to

the same capital standards and related prudential regulations as those of the federally regulated private financial institutions. This would help ensure that these institutions do not present undue risks for taxpayers, as evidence presented earlier tends to suggest.

- Given concerns about Crown financial corporation mandates, Parliament should consider introducing sunset clauses to their legislation, such as is the case with the *Bank Act*. Requiring legislators to periodically take action to maintain the existence of Crown financial corporations would help ensure appropriate reviews of their mandates.

CONCLUSION

During its adolescence, Canada’s economy evolved in tandem with a range of Crown financial corporations. But the country has now grown up, and these Crowns often represent an economic contradiction that deserves continuous attention.

In our view, the extent to which the Crowns currently compete in, near or within the margins of private financial markets poses risks to the overall economy – and these risks seem to have grown rather than shrunk in recent years. At the same time, there seems to be little doubt that the private market today stands ready to serve many of the perceived market gaps that the Crowns were created to serve.

The central message is that the Crowns’ mandates should be clearly circumscribed, in some situations even rolled back. In all cases, however, the Crowns’ practices should be monitored consistently to ensure adherence to their mandates. Together, these changes will promote a more efficient allocation of credit and capital within the Canadian economy, with positive implications for productivity and standards of living.

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