From: Jeremy M. Kronick and Duncan T. Munn
To: Financial Sector Regulators
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Re: ENSURING CAPITAL FOR THE RECOVERY

The COVID-19 crisis has ravaged economies and damaged private sector balance sheets all around the world, Canada included. The Bank of Canada has seen its balance sheet more than triple in the last two months. With all that liquidity floating around, access to capital remains a potential problem. The C.D. Howe Institute’s Working Group on Monetary and Financial Measures recent communiqué addressed the issue and what can be done to ensure capital ends up in the hands of businesses critical for Canada’s economic recovery.

Despite massive fiscal and monetary stimulus, many companies won’t survive. As the economy reopens, some businesses and some business models will no longer be viable. Those that will, are going to need working capital and more patient capital to restructure their balance sheets to make the types of investment critical for survival and eventual growth.

Financial institutions might provide the short-term liquidity needed to replenish working capital but not necessarily at the breadth, depth, and time periods required. Lenders’ traditional risk measurements are going to show companies much riskier than they were pre-pandemic. And even before the pandemic, despite the important contributions of EDC, BDC, the Canadian Business Growth Fund, alongside our financial institutions, there were reasons to be concerned that Canada was underperforming when it came to business lending, in particular to SMEs.

The most recent OECD data suggests Canada ranks at or near the bottom in SME lending as a share of total business lending and as a percentage of GDP, and has one of the largest (and by some measures the largest) spread in interest rates charged to SMEs relative to those charged to large firms.

There are a variety of explanations, but many come down to incentives. And, the good thing is incentives can be changed. We focus on three.

First, in Canada, incentives are skewed towards household lending. Insured mortgage loans are risk-free, with a 100 percent CMHC guarantee, and the insurance premiums CMHC charges are a flat percentage based on loan-to-value. This should be changed so that the premiums also take into account the characteristics of individual borrowers. In other words, the premium should reflect the quality of the borrower and not just the quality of the collateral. As in every other form of lending, risk-based pricing ensures a more efficient allocation of capital, perhaps freeing up more lending for productivity-enhancing businesses.

The second issue is risk-weights more generally. With traditional risk metrics, and company balance sheets turned upside down by this pandemic, it is imperative that regulators and policymakers work to remove impediments to capital flowing to businesses critical to supporting the recovery.

One example and opportunity, focuses on life insurers. Life insurer regulations assign the same capital charge to all unrated debt investments regardless of their credit risk, allowing no incentive for lower risk investments. We could instead allow major life insurers to use their internal risk models to measure and capitalize risk the same way major banks are allowed to use their own models to measure and capitalize the risk in their lending activities. That would help facilitate greater institutional investor supply of capital.

Lastly, the issue of competition. This has been hotly debated for years in Canada’s financial services sector, and the Competition Bureau points specifically to the lending space as an area where barriers to entry are unnecessarily restricting competition.

One solution involves ensuring regulations blend the function being performed and the entity performing it. For example, though there are exemptions, peer-to-peer lenders, like traditional lenders, must file a prospectus for each loan where securities are sold to investors. The functions are the same, but the cost could be prohibitive to smaller less risky players, creating an unnecessary burden to increased competition.

The recovery from this crisis is going to be hard. Ensuring businesses have the capital they need to invest in the recovery is imperative. Canada has a tremendous track record of working together during crisis times, including this one. Now it’s time to work together to help build the future.

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