



*The
Rough
with
the
Smooth*



Outlook for the Canadian Credit Cycle

**Presented to FEI & TMAC Regina
22 November 2005
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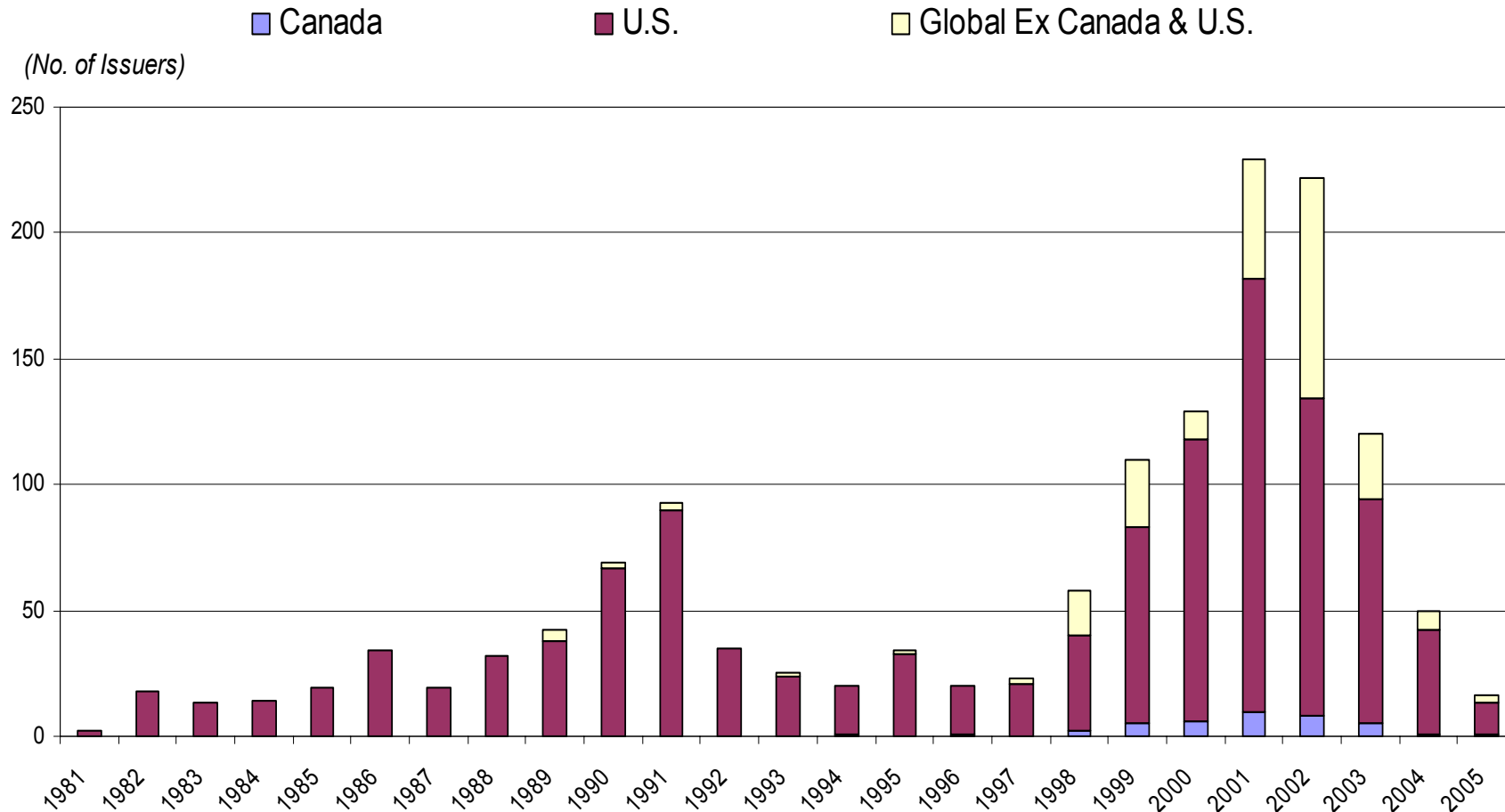
Presentation Overview

1. Recent Credit Trends and Outlook
2. Canadian Credit Outlook by Sector
3. Areas of Current Analytical Focus
 - Governance, Sarbanes-Oxley
 - Risk Management
 - Liquidity, Short-term Ratings
 - Canadian Bond Index
 - Pension Issues
 - Income Trusts

Risk Management Dreams



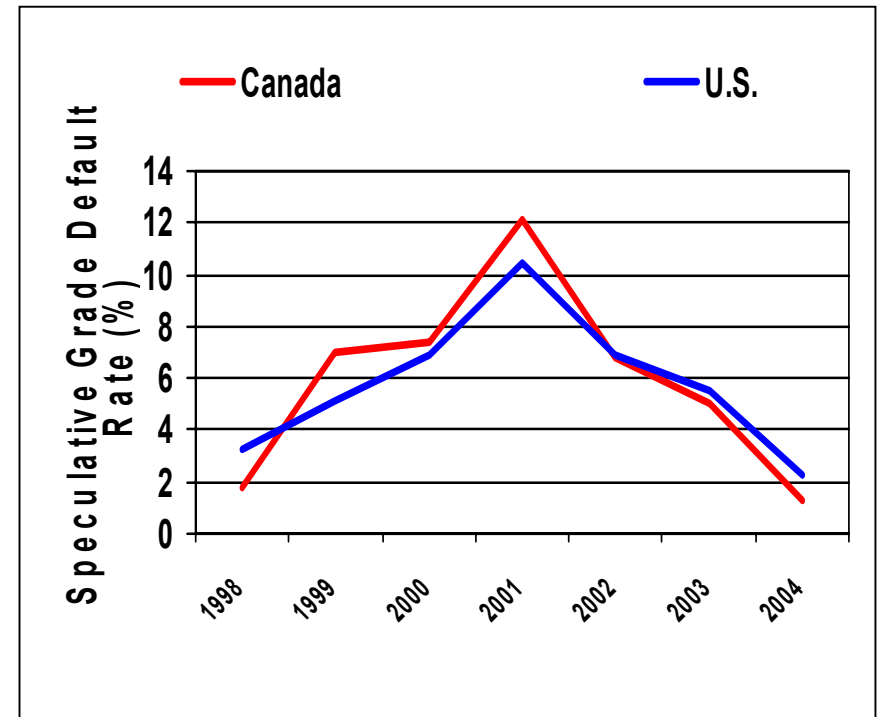
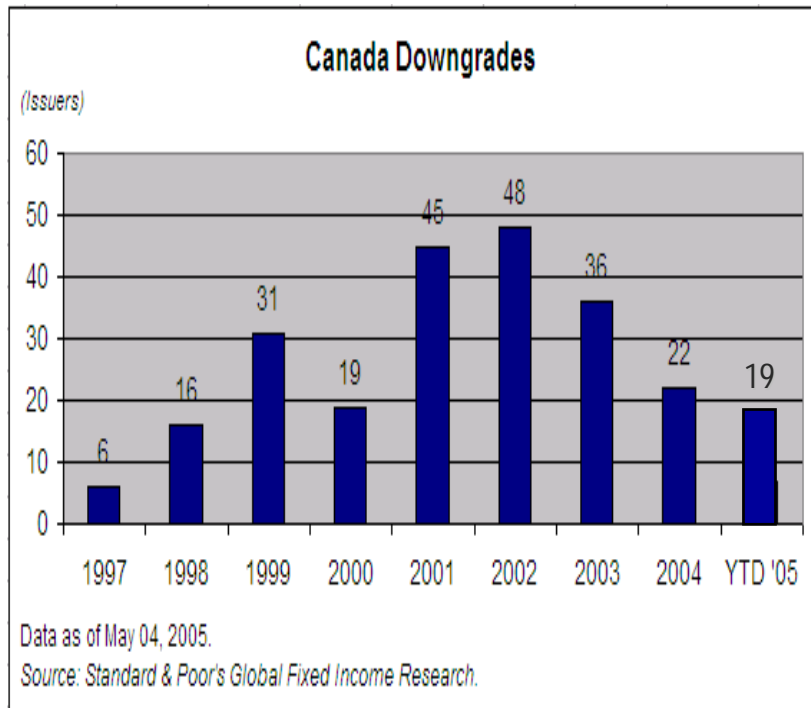
Annual Corporate Defaults by Number of Issuers



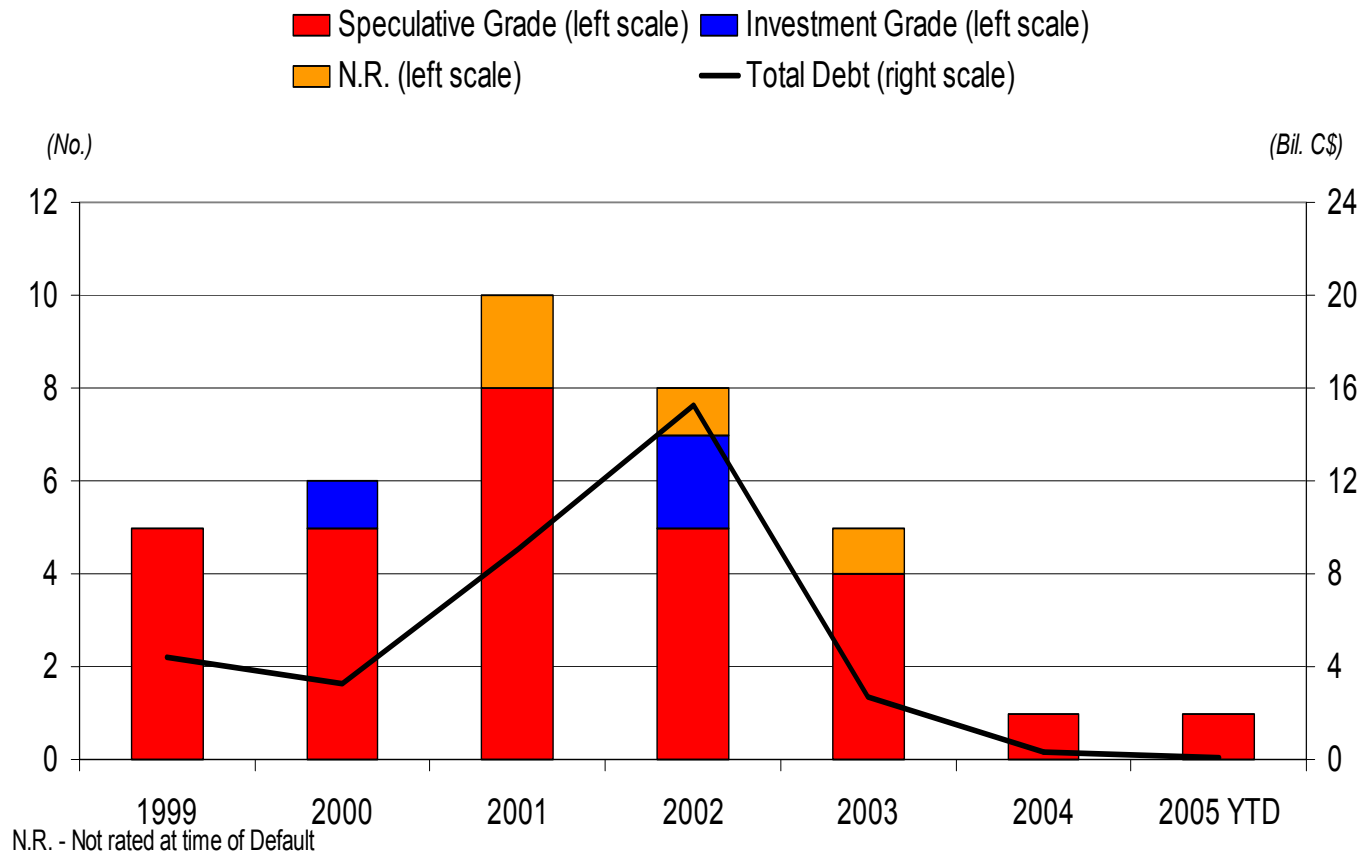
Note: Year-to-date 2005 data includes information to the end of June

Source: Standard & Poor's Global Fixed Income Research, Standard & Poor's CreditPro® 7.0

2005 Continues Emergence from an Extended Period of Downgrades



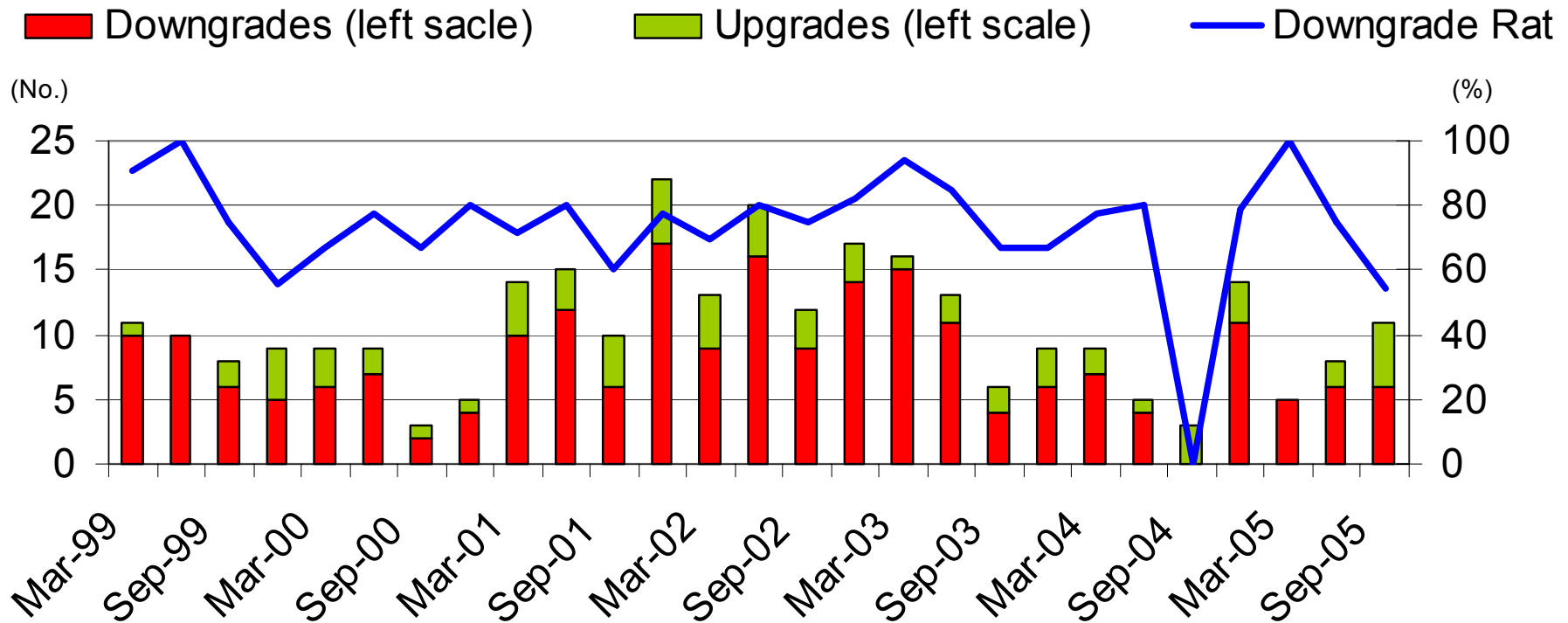
Canadian Corporate Defaults 1999 to 2005



Source: Standard & Poor's Global Fixed Income Research, Standard & Poor's CreditPro® 7.0

Rating Actions 1999 to 2005

Canadian Rating Actions



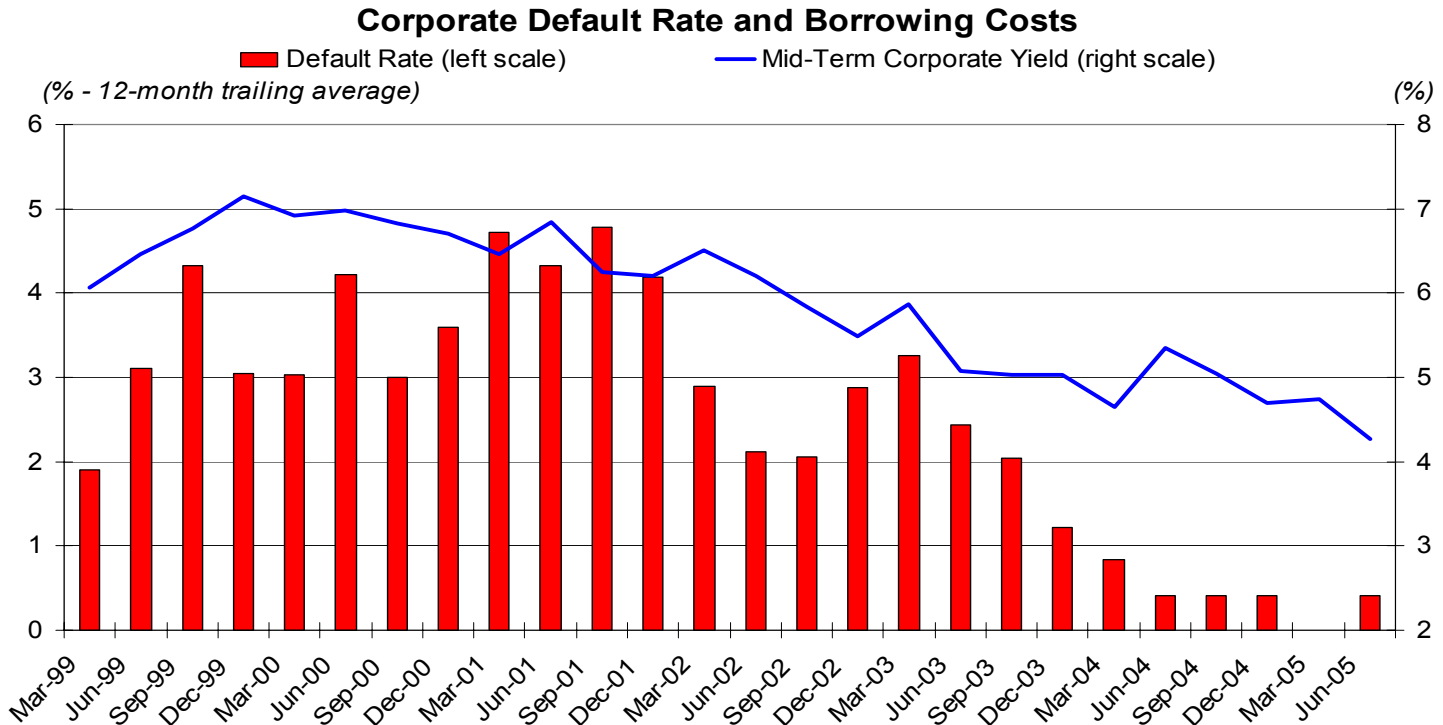
Source: Standard & Poor's Global Fixed Income Research



Recent Rating Actions 2005 Year-to-Date

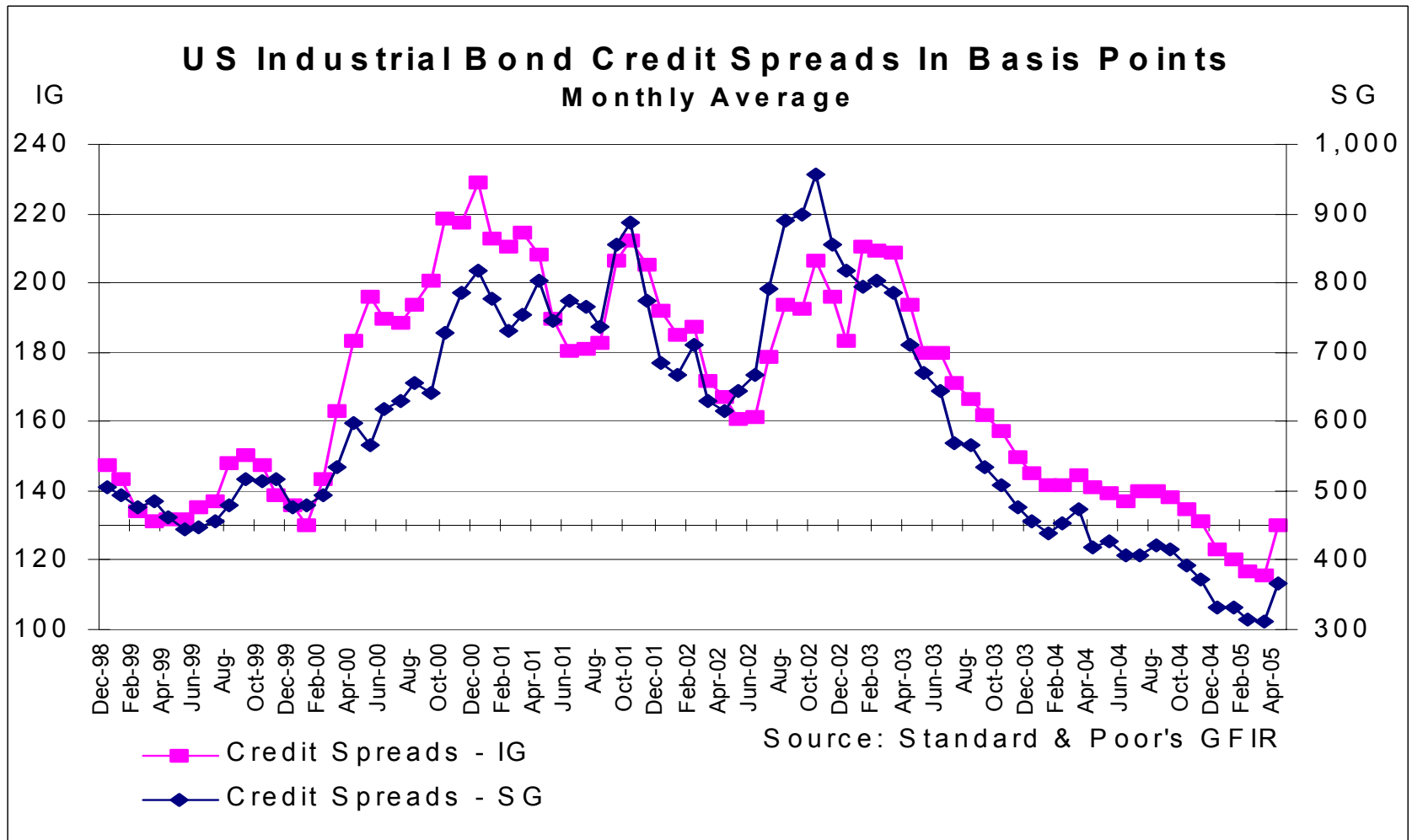
Upgrades	Downgrades
Cooperators Genl Insurance	SR Telecom
Bombardier Rec Products	N Am Energy Partners
CN Railway	Molson Coors
Ipsco	Hudson's Bay Co
Telus	Secunda International
	Paramount Resources
	Shell Canada
	Royal Group Technologies
	Domtar
	Alcan
	Metro Inc
	Persona Communications
	Sears Canada
	Tembec
	Quebecor World
	Jean Coutu
	Laurentian Bank

Corp Default Rate and Borrowing Costs

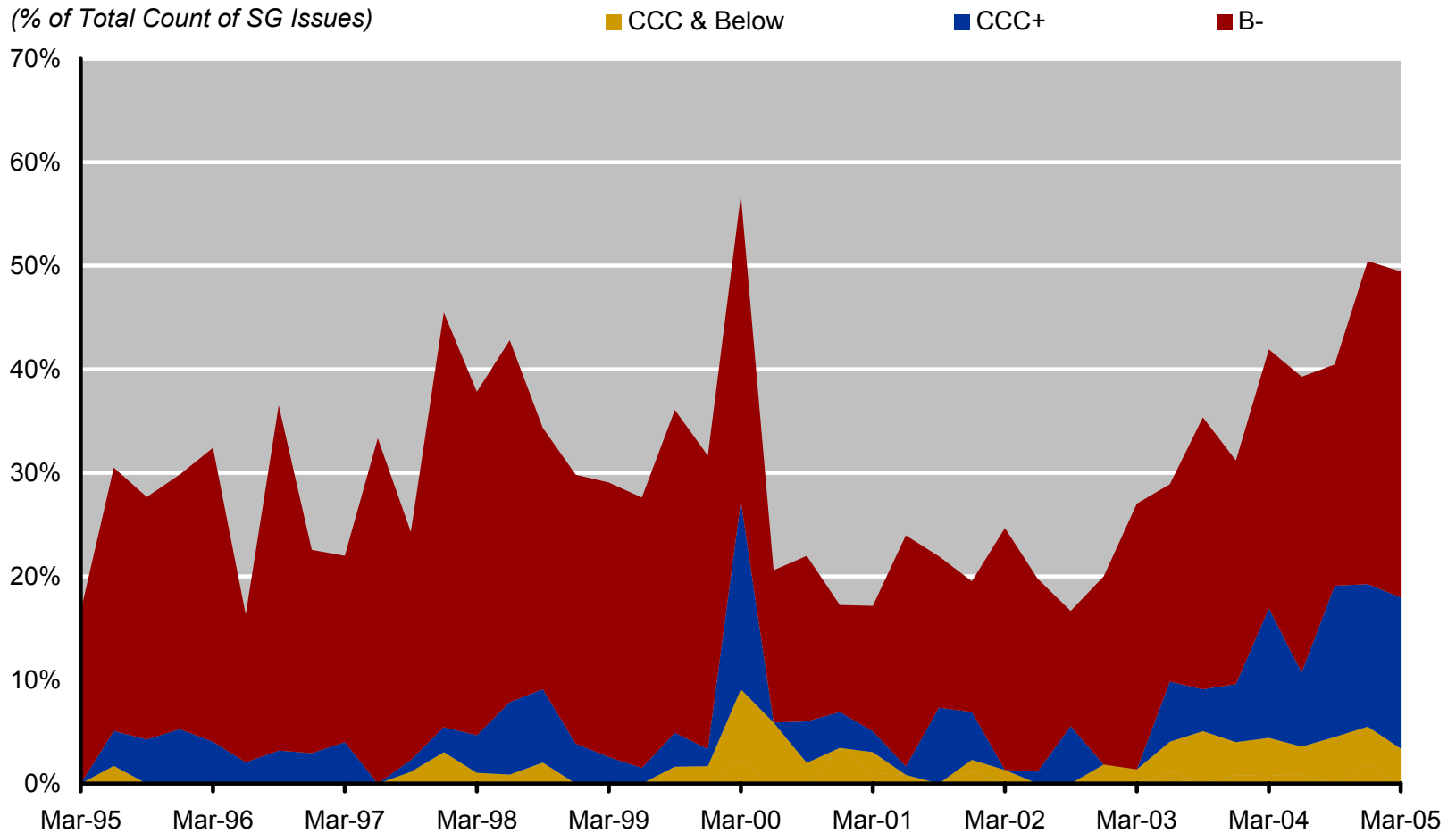


Source: Standard & Poor's Global Fixed Income Research

Current Liquidity Reflected in Narrow Spreads



Distribution of Speculative Grade New Issues by Rating



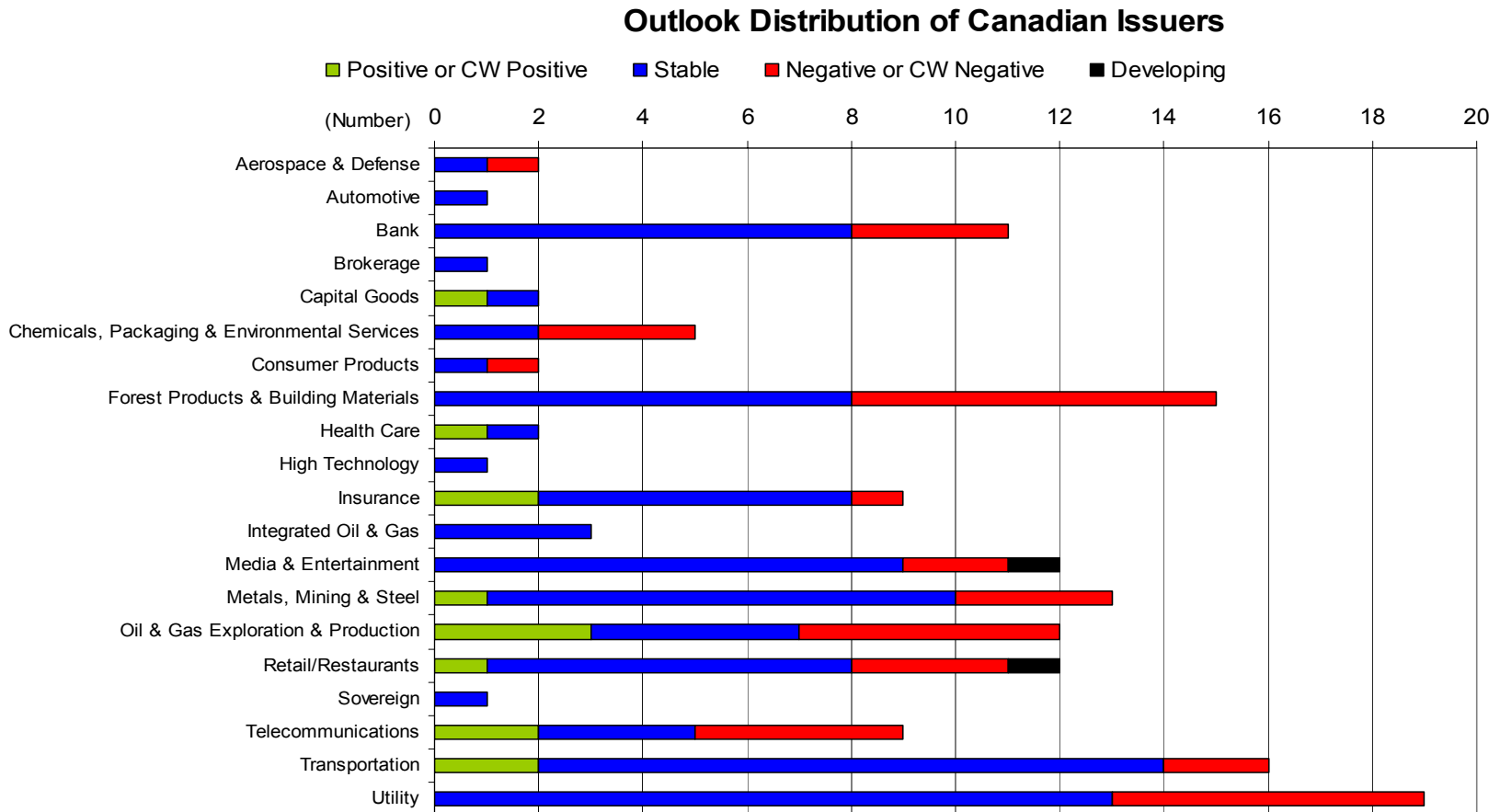
Source: Standard & Poor's Global Fixed Income Research; Thomson Financial



Riding the Credit Cycle

- **Currently at favourable point on the credit cycle**
- **Rating actions continue, reflecting wide array of credit pressures**
- **Credit spreads remain at or near historical lows**
- **Conditions of high market liquidity continue to prevail**
- **Analytical challenges ahead for credit managers**

Outlook Distribution of Canadian Issuers by Sector



Source: Standard & Poor's Global Fixed Income Research



Credit Outlook by Sector

- Corporates
- Banks & Insurance
- Governments



Corporate Issuers

- **Cable and Telecom** -- looming battle for the broadband home presents increased opportunities and challenges for the industry; wireless remains growth engine
- **Forest Products** -- C\$, energy, and fiber costs contributing to weak profitability; softwood refund would be helpful
- **Metals & Mining** -- exchange rates and energy contributing to higher cash costs, offset by stronger prices; development capex consuming operating cash flow; risk: demand (China) versus new capacity
- **Retail** -- Consolidation underway in food; department stores continue to lose share and relevance
- **Oil & Gas** -- Outlook reflects M&A activity and rising reserve replacement costs
- **Autos** -- Pressures on market share and profitability drive negative rating actions and outlooks for GM, Ford
- **Chemicals** -- Strong fundamentals; positive demand allows pass-through of increased costs
- **Utilities** -- Restructuring following gradual path in many jurisdictions; regulatory pressures remain a concern, but easing in some areas



Banks & Insurance

- **Banks**

- Operating earnings, asset quality, and capital adequacy are all strong. Will benefit from benign near-term credit environment.
- Bank of Nova Scotia upgraded to AA- in 2004
- Negative outlooks on Laurentian (operating performance) and Royal Bank, CIBC (Enron litigation)

- **Insurance**

- Lifeco operating earnings, asset quality, and capital adequacy are all very strong.
- Companies fortifying positions post-consolidation (GWL-Canada Life, Manulife-Hancock).
- P&C sector stability supported by favourable premium, claim, and investment performance



Government Issuers

- **Canada (AAA/Stable/A-1+)**

- Stability prevails given fiscal position, despite parliamentary paralysis

- **The Provinces**

- Stable outlooks for seven provinces; recent upgrade for BC (AA/stable), Saskatchewan (AA-/stable) and Nova Scotia (A/Stable)
- More federal dollars for healthcare well received, but further restructuring of delivery needed
- Atlantic Accord will improve credit profile for NFLD and Nova Scotia

- **Municipalities**

- Generally stable, although negative outlooks on Vancouver and MFABC
- Potential for new federal grant revenues depends on political outcomes in Ottawa
- Spending pressures linked to water, sewer, transit, and long-term care

Areas of Current Analytical Focus

- **Governance, Sarbanes-Oxley**
- **Risk Management**
- **Liquidity, Short-term Ratings**
- **Canadian Bond Index**
- **Pension Issues**
- **Income Trusts**
- **Recovery Analytics**



Sarbanes-Oxley S. 404

- **Recent market attention has been on SOX Section 404, requiring auditors to attest to the adequacy of an issuer's internal controls, initially affecting issuers reporting in Q1 2005**
- **Situation brings into focus combination of direct risks of inadequate controls, and consequential market reaction the next Y2K?**
- **Credit fallout to date has been moderate:**
 - **190 companies with adverse opinions, material weaknesses, or delays**
 - **14 downgrades, most by one notch; no "credit cliffs"**
 - **10 negative outlook or CreditWatch changes**
- **Greater lead-time for Canadian issuers (under both U.S. and proposed Canadian regulations) suggests widespread turmoil can be avoided**



Corporate Governance Evaluation Analytical Framework

Ownership Structure & External Influence

- Transparency of ownership structure
- Concentration and influence of ownership & external stakeholders

Transparency, Disclosure & Audit

- Content of public disclosure
- Timing of, and access to, public disclosure
- Audit process

Shareholder Rights and Stakeholders Relations

- Shareholder Meeting & Voting Procedures
- Ownership Rights & Takeover Defenses
- Stakeholder Relations

Board Structure and Effectiveness

- Board structure and independence
- Role & effectiveness of board
- Senior Executive & director compensation



Corporate Governance Evaluation

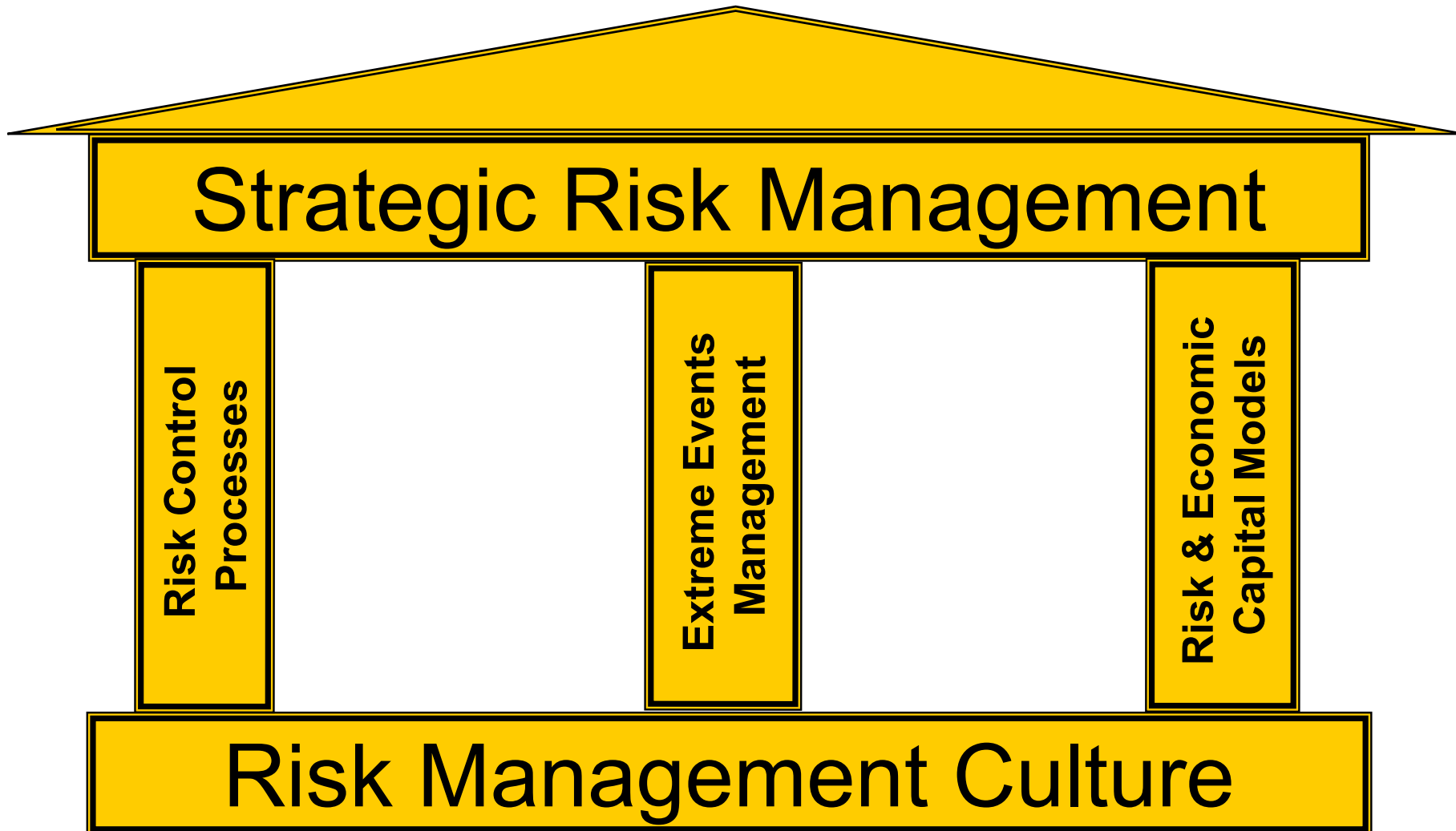
Red Flags

A combination of a number of the following factors suggests a need for heightened scrutiny of governance practices.

- **Aggressive pursuit of growth through acquisitions, and frequent shifts in strategy and business portfolio**
- **Organization obsession with share price appreciation**
- **Cult of CEO, with conspicuous concentration of influence and compensation; mgmt and board turnover**
- ***Making-the-numbers* trumps long-term vision**
- **Extensive involvement of lobbyists, litigators, spin-doctors; heavy-handed tactics with stakeholders**
- **Aggressive tax-driven strategies and use of leverage, and complex legal and financing structures**
- **Aggressive financial policies and propensity to issue restatements**



ERM Evaluation Components





Limitations of ERM

For an ERM program to truly manage risks, its limitations have to be recognized:

- system has to mesh with company and how it works**
- inherent limitations and risks of models need to be understood**
- *VAR vs Expected Shortfall vs Scenario Analysis***
- risk of over-reliance on one metric**
- adequacy of input data and timeframes**
- avoid temptation to take things to edge (moral hazard)**
- choose sensitivities sensibly**
- temper with common sense**
- real world doesn't have boundaries (Katrina impact 2.5x worst case for one company)**
- challenge of encompassing all risks and interdependencies (particularly in stress scenario)**

Focus on Liquidity

- Potential for market to react adversely to unexpected or adverse issuer disclosure, with negative implications for issuer market access
- May arise from:
 - Confidence-sensitive business models
 - Credit cliffs
 - Rating triggers
 - Refinancing pressure
 - Restatements, filing delays
- May be mitigated by
 - Careful liquidity management
 - Careful reputation management
 - Robust disclosure

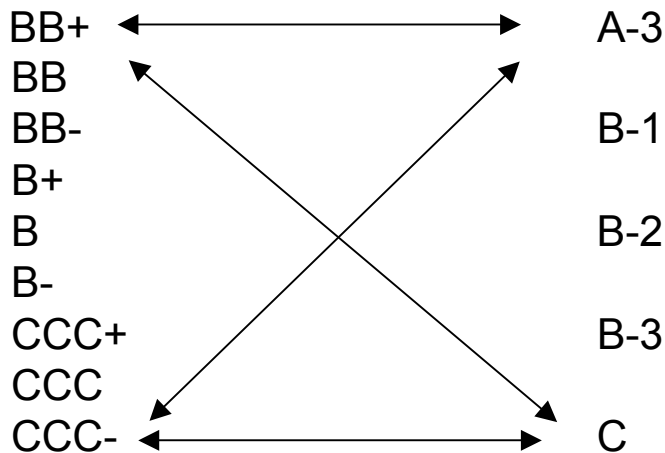
Areas of Current Analytical Focus

Short-term Ratings

Expanded short-term rating scale focuses on credit quality over next 12 months

- responds to active trading orientation, and near-term focus of high-yield investors
- provides additional focus on cash flow analytics, liquidity, covenants, and near-term business factors

Short-term rating scale incorporates expanded granularity



<u>Initial Ratings</u>	
Rogers Communications	BB / B-2
Novelis	BB- / B-2
Tembec	B / B-2
Nortel Networks	B- / B-3
GM	BB/B-1



S&P/TSX Canadian Bond Index

- **Launched on April 1st**
- **Developed in collaboration with CIBC, RBC, and TSX**
- **Encompasses over 900 issues, with market value of C\$600 billion**
- **Index management completely independent from trading or underwriting activities**
- **Index benefits from multi-dealer pricing for index-valuation purposes**
- **Likely to be leading objective measure of market performance**

