CHECK AGAINST DELIVERY

Deposit Insurance in the Digital Age

Speech by Peter Routledge, President and CEO, CDIC

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INTRODUCTION

Good morning,

It is my privilege to welcome you to this conference.

For those of you who are joining us from outside the Ottawa region, you may have heard this has been a record year of flooding.

But drawing on lessons from recent past floods, authorities here have done an exceptional job of supporting residents.

For example, they improved communications, training and coordination with volunteers and emergency staff. They improved models for forecasting precipitation and snow melt, and they monitor low-lying neighborhoods at risk so they can respond sooner to prevent property loss. And as the global climate continues to change, new approaches will be required for the inevitable challenges ahead.

Sound familiar?

There are clear lessons from these flood mitigation efforts for deposit insurers.

In that spirit, as we bring together leading experts from academia, industry, and both the public and private sectors, I hope we can also find new approaches for inevitable future challenges.

As I reflected on the title of this conference, I considered: "What are the expectations of a deposit insurer in the digital age?"

There was a time – not so long ago -- when deposit insurers could wait until a bank had reached the point of no return before they acted, and when depositors considered it normal to wait for weeks to be reimbursed. To go back to the flood analogy, that's like waiting for the water to come through the front door before acting.

I believe those days are behind us.

Digitization is a disruptor that brings two defining strengths to the financial system: blinding speed and precision.

If deposit insurance cannot adapt to this new environment, the quality of our product will decline, and it will lose its utility.

So today I would like to share with you how CDIC is investing in the quality of its product, and how we aim to keep pace in the digital age.

This includes:

1) investing in faster payments technology and public awareness
2) improving deposit data environments, and
3) taking faster and earlier resolution decisions.

1) INVESTING IN THE QUALITY OF OUR PRODUCT

Audacious goal

Last week, I read a very interesting article in *The Economist* magazine, titled "Tech's raid on the banks."

Digital disruption is coming to banking. Close to half of North Americans bank on their mobile telephones. Apple, Facebook and others are getting into the business. Around the world, new businesses are moving into the banking relationship space.

Younger people who trust tech firms are their natural customers – they are not wedded to the old banking model. They don't need branch banking. They want more control over their own data. They are used to instant payment and great customer care.

How do deposit insurers fit into this new world?

For one thing, we must be leaders in reimbursing depositors if their financial institution fails.

That's why CDIC has given itself an audacious goal: within five years, we aim to have the capability to reimburse depositors on the same day their financial institution fails. We call this T+0.

Today, we can reimburse most deposits within just a few business days of failure.

We do so by getting data extracts from the failed bank, loading cleaned data into our bespoke insurance calculation engines, producing payment files and sending a letter and cheque in the mail to the depositor. Or for very large dollar amounts, we may also send a wire transfer.

While the approach works, you can see that there are a lot of steps (and I have only given you the simplified version). Under this model, there are only a few payment methods, and a heavy reliance on physical mail delivery.

And a key dependency in this approach, or any payout approach for that matter, is having the right data and information to execute on a payout. Without having good quality data, we are unable to move to the next step to calculate insurance and prepare the payment.

In the age of the consumer, information immediacy, faster payments and big data, we are evolving so that we can have line of sight to the right data, at the right time.

And we need to empower depositors so that they feel in control during a time of uncertainty. We could do this by giving them the opportunity to select a preferred payment method, direct that payment, manage their contact information and view reimbursement details.

As you can imagine, a key objective to this vision will be to establish processes, complemented by technology, that allows us to get assurance that the deposit data will be "payout ready" at the time of failure. We are going to be exploring different options to achieve this, while recognizing that there are several factors that will need to be considered including:

- Getting visibility at the quality of the data **prior** to the bank failure, to allow sufficient time for the institution to rectify any anomalies

- The burden or effort on member institutions, trustees, and brokers required to produce the data for us, and
- Security and safeguarding of that sensitive data

We want to ensure that Canadians' trust in us is well-placed and that they can have access to their savings when they need it most, in a secure but also convenient manner.

Awareness

Of course, no matter how fast we reimburse deposits or how comprehensive the coverage regime, we will not be effective in promoting financial stability or preventing bank runs if depositors are not aware they are protected.

Investing in the quality of our product includes advertising its benefits.

For example, many of you may have seen our colorful purple ads on TV, online, on social media platforms and in public transit zones.

We are frequently asked why we advertise something that is free and automatic for depositors. This is a fair question.

We advertise because we have conducted behavioral research that demonstrates we can significantly reduce the risk of a bank run in Canada by making depositors aware their money is protected by CDIC.

A summary of this research is available at our website and the correlation between awareness and the risk of bank runs is quite strong. If depositors know that their money is safe, they won't be inclined to panic in the event of a bank failure.

The corollary is also true, with enormous potential costs. If depositors are not aware of this protection, they will behave as if there is no deposit insurance. And in the context of a bank in trouble, this can quickly snowball.

This is what occurred in the U.K. in 2007, when Northern Rock Bank suffered the first bank run in that country in close to 150 years. When depositors heard the bank was in trouble, they lined up at branches and withdrew all their funds and the bank had to be bailed out by the U.K. government for close to $80 billion Canadian.

Among the key reasons for the bank run was that depositors were not aware of the deposit insurance scheme in place at the time.

Today, the U.K. deposit insurer's ads, websites and other communications channels closely mirror those of CDIC – they should; we helped them start their awareness program. Some banks in the U.K. have failed in recent years, but they have not had bank runs.

Instead, we think that considering the awareness/confidence correlation I mentioned a moment ago, Canadians should ask why we aren't spending more, *particularly since our members – and not taxpayers – pay for ads like this.*

Indeed, our members could do more as well.

Our own survey research suggests that Canadians would be up to 65% more likely to buy financial products that display our purple lock logo, just as the Energy Star logo or the Intel logo help guide the buying decisions of appliance and computer shoppers.

That means we'd love to see our purple ads posted alongside the rainbow of colours used by our members in their own advertising – if it's factual and involves eligible deposit products!

After all, this is an investment in the quality of our product.

2) IMPROVING DATA ENVIRONMENTS

I have spoken about the investments that CDIC is making. But these are not enough on their own.

To ensure the quality of deposit insurance in the digital age, our members and other financial sector participants must also invest.

Since arriving at CDIC about six months ago, I have made it a priority to meet with the heads of all our member institutions and key stakeholders to encourage open communication between our organizations and to share some of CDIC's priorities for the next few years.

One of these priorities is brokered trust deposits. Let me explain why this is so important.

Many of you may deal with financial advisors who are affiliated with securities firms that broker financial products.

When these advisors purchase GICs or other deposit products from a CDIC member institution, they are acting as a nominee for their clients. We consider these deposits to be held in trust under our framework, and these financial advisors are considered nominee trustees. Their affiliated firms are nominee brokers.

For these trusts to benefit from the full protection of CDIC deposit insurance, the associated advisors and nominee brokers must take steps to transmit to our member institutions essential information about their clients, who are beneficiaries of CDIC deposit insurance. In turn, those member institutions must record that information and keep it current.

Following a member failure, CDIC would rely on beneficiary information provided by nominee brokers to member institutions to make prompt and accurate reimbursements of deposits held in trust. Therefore, nominee brokers must promptly transmit beneficiary information to our member institutions and keep it current.

Unfortunately, this is not the case for may brokered deposits right now. There are many brokers who are not providing our member institutions with the information about their client-beneficiaries that CDIC requires to calculate coverage accurately.

This could impact the amounts that CDIC can reimburse brokers for their clients.

Today, nominee brokered deposits represent about $80 billion or 32% of total deposit liabilities held as CDIC's non-DSIB members.
And we have approximately 14 of our 84 members for whom nominee brokered deposits represent 40% or more of their total deposit funding.

From my perspective, this represents an exposure risk to CDIC that cannot be ignored, and a clear stability risk if we cannot payout these deposits quickly and accurately.

Recent changes made to the CDIC Act will help ensure that CDIC can accurately calculate coverage for nominee brokered deposits if we are faced with the situation of having to liquidate one of these institutions and reimburse depositors.

It does so by setting out clearly in the law, the information that needs to flow between brokers, our member institutions and to CDIC to ensure that we can protect these deposits and reimburse brokers accurately on behalf of their clients.

The new rules enacted by the Government clarify the responsibilities that brokers and member institutions have for ensuring that the deposits they place for the clients are well protected by CDIC.

This includes hardwiring into the law, as a requirement of coverage, that brokers disclose unique client IDs each time they place a deposit for a client and be able to provide CDIC with the names and addresses of their clients, post-failure. This is complemented by requirements on our member institutions to correctly record this information and transmit it to CDIC when required.

The broker community and our members need to fully commit to implementing the new CDIC Act Requirements to ensure that broker clients' who place their funds in deposits get the full extent of protection under the CDIC Act.

CDIC is taking a proactive role in the implementation process and has established, in cooperation with key industry associations, an industry Brokered Deposit Advisory Group.

This Advisory Group will play a critical role in finding solutions to the inevitable challenges that brokers and CDIC members will face while implementing new requirements.

3) TAKING FASTER RESOLUTION DECISIONS

CDIC is fortunate to have a mandate as both deposit insurer and resolution authority for its members.

This authority provides us with the flexibility to pursue resolution strategies that minimize our exposure to loss, which includes taking early action to resolve institutions in trouble. In practice, this can be hard to do.

I think we need to do more to minimize the risk of acting too late. Policymakers must recognize *ex ante* that they operate in a "fog of war" during periods of instability, and that they are obliged by events to make decisions with only a fraction of the information they would like.

This fog tends to encourage inertia on the part of policymakers, for understandable reasons.

CDIC's own history is a good lesson on the costs of inertia and acting too late. Costs tend to rise as policymakers play for time, as occurred with the failures of Canadian Commercial Bank and Northlands Banks in the 1980s.

I believe policymakers should make conscious, concerted efforts to minimize the risk of acting too late and accept the risk of acting early.

A key element of acting early is understanding our own risk tolerance.

Let's consider a failure scenario where CDIC's expected resolution cost in liquidation is $2 billion, but in a worst case could be as high as $8 billion.

The option here is an assisted transaction with an expected resolution cost of $3 billion and a worst-case cost of $4 billion.

If we have a low-risk tolerance and are more concerned about the worst-case scenario, then we would choose an assisted transaction. This is the least cost under the worst-case scenario.

But, if we have high-risk tolerance, we would choose the liquidation in hoping that the worst-case scenario would not materialize, and our actual cost would be closer to $2 billion.

You can see why we view these considerations as being a trade-off between cost and risk.

So, we have developed probabilistic models to estimate risk when there is uncertainty. There is no one and only one deterministic value for the estimate. It is a probability distribution covering all possible values for uncertainty with their respective probabilities.

Another key element of acting early is choice of resolution method.

As CEO of CDIC, I ***have*** to promote financial stability, and I'm thus attracted to the capacity of certain resolutions to help us do exactly that.

Pursuing some targeted resolutions – which are always and everywhere de-stabilizing – helps us overcome this conflict in executing our financial stability mandate. For example, non-payout resolutions – a method advanced impressively by the FDIC since 2008 – have characteristics that align well with our financial stability objectives here in Canada.

However, this is something we must consider very carefully.

For example, were CDIC to commit the equity of its fund prior to the total exhaustion of equity capital at a member institution, we would tend to undermine long-term financial stability, notwithstanding the benefits to short-term financial stability.

This tradeoff is the very essence of moral hazard. And it is something we talk about regularly at CDIC, with colleagues at the Department of Finance, the Bank of Canada and OSFI, and with our counterparts around the world.

CONCLUSION

The three areas I have covered -- investing in the quality of our deposit insurance product, improving data environments and taking faster decisions – all have a common denominator. Digital data.

We need more of it, of better quality, and faster than ever before. Digitization is a disruptor, but it also provides unprecedented opportunities if we can keep pace with change.

Before I conclude, I would like to thank all those who have worked so hard to put this conference together – most notably Jesus Sierra Jiminez and his team.

And with that, I would be pleased to take your questions.

Thank you.