CONSULTATION PAPER

PREMIUM ASSESSMENT BASE
CALCULATION OF TOTAL INSURED DEPOSITS

JUNE 2007

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I. INTRODUCTION

The Canada Deposit Insurance Corporation (CDIC) assesses and collects premiums from its members based on two distinct processes. The first classifies each member institution into one of four differential premiums categories ascertaining the premium rate to be paid by the member. Through the second process – the Return of Insured Deposits (RID) – members determine the amount of insured deposits on which the payment of premiums is calculated.

Some CDIC member institutions have indicated that considerable resources are assigned annually to the RID process. Using insured deposits as the premium assessment base has been identified as the most significant contributing factor to this.

CDIC has been exploring possible modifications to certain aspects of the RID process with a view to reducing the burden while ensuring CDIC continues to have access to valuable information on its exposure and can effect, when necessary, timely deposit insurance payments. CDIC is seeking views on some potential options and a number of related matters.

This paper is not intended to be exhaustive. CDIC would welcome additional suggestions that would assist it in identifying other possible changes.

Please direct your confidential written comments or suggestions by September 30, 2007 to:

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II. LEGISLATION

Calculation of premiums is based on insured deposits as at April 30th each year. This has remained unchanged since the establishment of CDIC in 1967. Identifying what deposit liabilities are eligible for deposit insurance is not a straight forward exercise. The aggregation of depositor accounts and the application of depositor limits among the various insurance categories significantly increase the effort involved in calculating total insured deposits.

From 1967 until quite recently, the *Canada Deposit Insurance Corporation Act* (CDIC Act) stipulated that for premium purposes "a member institution may use any method approved by the Corporation to determine the aggregate amount of its deposits that are considered to be insured by the Corporation."[1] On March 29, 2007 *An Act to amend the law governing financial institutions and to provide for related and consequential matters* changed the CDIC Act allowing CDIC to approve a method to "determine or estimate" the amount of insured deposits.[2] This amendment provides greater flexibility for CDIC to consider methods to estimate insured deposits.

Past and current legislation all stipulate that the premium assessment base must be, or be closely linked to, insured deposits. The new language does not allow the use of a different premium assessment base such as total deposits, or total insurable deposits, unless it can be demonstrated that such are good estimates of insured deposits.

Moving to an estimate of insured deposits for premium purposes would in no way jeopardize a depositor's insurance coverage since the payment of premiums does not affect the insurability of deposits. While a member institution that fails to pay premiums could face severe consequences (e.g. termination of deposit insurance), this failure would not affect the insurance coverage of its depositors, which is a matter of law. As long as the institution is a member of CDIC, its depositors are afforded deposit insurance coverage.

III. PREMIUM ASSESSMENT BASE: Total Insured Deposits

(i) Computation

Each member first calculates its insurable deposits by deducting from its total deposit liabilities those that are not insurable by CDIC, such as foreign currency deposits or deposits with terms greater than five years. The next step in the RID process is to separate the insurable deposits into the six deposit insurance categories (basic coverage, in joint accounts, in trust accounts, in registered retirement savings plans (RRSPs), in

[1] Subsection 21(5) of the *CDIC Act* pre March 29, 2007
[2] S.C. 2007, c. 6, Section 406

registered retirement income funds (RRIFs) and in realty tax accounts). The deposits must then be aggregated by depositor to determine the amount of insured deposits. Each depositor is insured up to $100,000 (principal and interest) in each of the deposit insurance categories. Once the institution has aggregated the deposits of each depositor in each of these six insurance categories, it then deducts any amounts in excess of the maximum coverage. The result is the amount of insured deposits used to calculate premiums.

(ii) Issues

CDIC has been advised by some members that the process of determining total insured deposits for premium purposes can be quite intensive. Members report two main problems.

The first relates to the fact that the data used to determine insured deposits is not readily available from members' main systems or the systems used to capture the financial information needed to complete their regulatory filings – Financial Information Committee (FIC) forms. Member institutions develop and maintain additional information systems and processes specifically to compute insured deposit data as at each April 30th.

Query:
- Does the information used to compute insured deposits reside on member institutions main banking systems or is it kept or maintained separately on another system?
- Is the fact that it may be on a separate system a significant issue?
- If separate systems are a significant issue, what are the impediments to creating an integrated system?

The second problem arises from the complexity of computing total insured deposits. Contributing factors to this include:

> ***Aggregation:*** Aggregation procedures can be very complex, particularly when dealing with the deemed separate coverage applicable to trust accounts, RRSPs, RRIFs and joint accounts. Aggregating balances across multiple accounts by depositor may not be fully automated requiring some manual linking.
>
> ***Trust deposits***: CDIC has been advised that accounting for insurable deposits in trust accounts is by far the most troublesome and labour-intensive activity associated with the RID process. In order for the beneficiaries of trust deposits to enjoy deemed separate coverage under the CDIC Act[3], the trustee (depositor) is required to report certain information (name and address of beneficiary) to the member. Where there are multiple beneficiaries of the trust, the interest (amount

[3] Coverage is dependent upon the existence of a valid trust properly disclosed on the records of the member

or percentage) in the trust deposit balance attributable to each beneficiary must also be reported to the member and updated annually. In the event that the same beneficiary holds two or more distinct interests in the balance, these amounts must be aggregated.[4] This information must be reconciled and any amounts attributable to a beneficiary that is over the $100,000 limit identified.

Query:
- To what extent is the work done manually?

Items in transit and suspense accounts: Member institutions review each of these items to determine if they are deposits eligible for insurance and, if so, trace them back to, and aggregate them with, a depositor's other insurable deposit balances. Much of this work is done manually. Some members tell us that the time involved in such an exercise is not worth the effort, and they simply report the full amount as insurable.

Query:
How much work is actually involved in this part of the process?
Provide:
- the number of accounts reviewed;
- whether "deposits" in the accounts/items in transit are readily identifiable;
- the relationship between the amount actually insurable and the amount reported?

Index-linked deposits: These are term deposit products that pay returns fixed in retrospect, at maturity, by reference to historic movements in stock market or like indices. Since the CDIC Act insures interest "accrued or payable", CDIC developed a method of calculation to be used to estimate a notional yield accrued on such a deposit as at April 30th of each year for premium purposes. This requires an examination of each index-linked deposit of record.

Understandably, the question asked most frequently by member institutions is whether there is an alternative method available to calculate insured deposits that could alleviate some, if not all, of the issues mentioned above.

Query:
- Provide suggestions to CDIC with respect to other areas within the RID process where an estimation of insured deposits could be used.

[4] This could occur in a lawyer's trust account for example where a lawyer's client has placed with the lawyer numerous sums to be used for distinct purposes. They would be recorded as distinct beneficiaries within the trust account, but for purposes of CDIC insurance, would need to be aggregated.

IV. PARAMETERS FOR MODIFICATIONS

While CDIC is prepared to entertain the possibility of making modifications to the assessment base, there are certain parameters within which CDIC must work:

- CDIC's ability to rapidly determine the amount of insured deposits at a member institution is crucial to resolving member institution failures in a manner that best serves the interests of depositors. Unique identifiers for depositors, and deposit data by insurance category, must continue to be maintained such that in a payment of insured deposits, the aggregation by depositor can be rapidly performed in the various insurance categories, e.g. joint and trust accounts, RRSPs, RRIFs, etc. Members presently maintain these data fields in order to, among others, compute insured deposits. Notwithstanding possible changes to the premium assessment base, members would be required to maintain these data fields.[5]

- The process must fit within CDIC's legislative framework. In this regard, the method chosen must either determine or estimate insured deposits. Therefore, any new method should produce results that have a fairly strong correlation to members' total insured deposits, tested against historical data. Given the limited RID data with the $100,000 limit (only two years of data to date) and the absence of data on the stratification of deposits (e.g., deposits between $60,000 and $100,000), a statistically significant correlation to total insured deposits cannot be established at this time (see discussion under Section V);

- A modified premium assessment base would have to rely on readily available deposit data or reduce data requirements and manipulation involved in the current RID process; and

- The result of any change should be revenue neutral to CDIC and fair to all member institutions.

[5] The U.S. FDIC premium assessment base is total deposits. Its institutions do not calculate insured deposits. The FDIC recently issued an advance notice of proposed rulemaking titled Large-bank Deposit Insurance Determination Modernization Proposal. It is concerned that in the event of a large bank failure where in excess of 250,000 depositor accounts would be involved, it may not have in place the processes needed to make timely and accurate deposit insurance coverage calculations. The proposal calls for the largest (and more complex) of these institutions to identify the owners of each account by a unique identifier to facilitate aggregation of insurable deposits and all of the identified institutions to provide and maintain FDIC standard data frameworks and data structure to allow the FDIC to rapidly compute insured deposit balances. It also encourages institutions to know the insurance status for each new account opened and/or notify the customer of its status. The FDIC proposal demonstrates how crucial it is for the deposit insurer to have members maintain systems specifically supporting the calculation of insured deposits in order to support timely insurance payments to depositors in the event of failure.

V. POTENTIAL OPTIONS

The above limitations and in particular the lack of detailed deposit data seriously limit the options available.

(i) Estimation of Total Insured Deposits – Proxy

Throughout 2003 and into 2004, CDIC conducted research into whether it could make modifications to its assessment base and come up with a "proxy" as a way to estimate insured deposits. Total insurable deposits (as filed in the RID) were found not to be a good estimate of insured deposits.[6] At the time, the coverage limit was $60,000 and CDIC had access to numerous years of data on which to base its quantitative analysis. Using readily available FIC information, a statistically significant correlation factor between insured deposits and total Canadian currency deposits from individuals was computed to be 0.82[7]. However, this factor was found not to be stable as it trended downward from 1996 to 2004. The validity and significance of this relationship would have needed to be periodically reassessed to determine whether, based on future trending, adjustments needed to be made to reinforce the correlation to insured deposits. Members would have been required to maintain their RID system and periodically report insured deposits, e.g. every three or five years.

With the increase in the coverage limit to $100,000 beginning with the 2005 premium year, CDIC has only two years of data on which to base a similar proxy, which is insufficient to establish a statistically significant correlation between the FIC data (Canadian currency deposits from individuals) and the RID data (total insured deposits). CDIC would need significantly more data on insured deposits at the increased coverage level before being able to compute a new proxy on the same basis.

Alternatively, member institutions could provide historical stratified FIC data (Canadian currency deposits from individuals by size of deposit) that would enable CDIC to compute a new proxy based on the $100,000 coverage limit (See Appendix). Going forward, members would be required to periodically compute and file insured deposits together with the stratified deposit data to adjust the "proxy" if it does not appropriately reflect the average annual growth or reduction in insured deposits over the period chosen.

While providing the historical stratified data may impose some burden, once in place this option could provide some burden relief in that the current RID process would only need to be completed periodically. Providing stratified deposit data on an ongoing basis would

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6 As at April 30th, 2006, total insured deposits were approximately 57% of total insurable deposits but this percentage varied considerably from one member to another, i.e. from less than 1% to 100.0%.

7 Deposit liabilities information found in the FIC Monthly Consolidated Balance Sheet (M4) was examined to determine whether a significant and stable relationship existed between the various classes of deposit liabilities and total insured deposits. Concentrating on individuals Canadian currency deposits (ICC deposits) since this included most of the smaller deposits and the vast majority of insurable deposits, a strong correlation existed between total insured deposits identified on RID filings and ICC deposits. A "proxy" of 82% of ICC deposits was identified as providing the closest correlation to historical RID data on a member-by-member basis resulting in slightly lower premiums for most members.

also assist in evaluating the need for and impact of changes to deposit insurance limits. Further, members would continue to maintain the required deposit data by insurance categories.

> Query:
> - For the years 1998 to 2004, could insured deposits be calculated assuming a coverage limit of $100,000?
> - For the years 1998 to 2004, could the Canadian currency deposits from individuals that are in an amount between $60,000 and $100,000 be provided?
> - Would historical stratified data as set out in the Appendix be available for the period 1998 to 2007?
> - How much effort would be involved to comply with a proposed filing requirement that Canadian currency deposits from individuals be stratified at least annually as set out in the Appendix?

(ii) Focused Modifications

Another approach is to focus on those aspects of the existing RID process that are more burdensome on members such as trust accounts, items in transit or suspense accounts, and index-linked term deposits. It is possible that certain estimations within the aggregation process could be applied to alleviate some of the work identified as resource intensive. The challenge for CDIC in each of the potential areas for modification is a lack of sufficient data to assess whether the proposed change would have a material impact on insured deposits.

The advantages of this type of approach are that:

(i) it is targeted at areas of most concern to members,
(ii) there is no change to the overall RID process; and
(iii) there may not be an increase in the volume of data to be filed going forward.

However, any change would likely require members to make some systems changes albeit likely minor. A further drawback would be that going forward CDIC would not obtain accurate data on insured deposits.

> Query:
> In assessing each of the following focused modifications set out in (a), (b) and (c) below, members are asked to
> - Determine whether providing the data on a one-off basis would be possible
> - Determine whether the proposal would in the long run effectively reduce burden
> - Assess the extent of systems changes needed to implement the changes
> - Provide information on the optimum timing for introduction of change

(a) Trust accounts:

Aggregation related to trust accounts can be quite complex. The Schedule to the CDIC Act provides that, for purposes of coverage, where a person acting as a trustee deposits money in trust for the benefit of another (the beneficiary), the deposit is treated as separate from the deposits of that trustee acting in his/her own right, i.e. treated as a separate depositor. This occurs only if the trustee has disclosed the trust on the records of the member institution, has identified by name and address the beneficiary of the trust, and in the case of multiple beneficiaries, has disclosed the interest of each beneficiary in the deposit and annually updated all beneficiary information.[8] If the depositor trustee has not disclosed the necessary information, the deposit will be treated as a deposit of the trustee acting in his/her own right and aggregated with other deposits of the trustee. If the trust is properly disclosed, the interest of the beneficiary in the deposit is eligible for separate coverage. The beneficiary's interest is not aggregated with other deposits by the beneficiary made in his/her own right nor with other trust deposits of which he/she is the beneficiary. However, in the event that the same beneficiary holds two or more distinct interests in the trust deposit, these interests must be aggregated.

Member institutions must first identify the trust account, identify the individual beneficiaries and their interest in the total deposit, and aggregate the interests of the same beneficiary in the trust deposit. The member then identifies any beneficiary's interest in the trust deposit that exceeds the separate coverage limit of $100,000 and identifies these amounts as uninsured deposit liabilities. CDIC has no data on the amount of uninsured deposits resulting from this aggregation. Further, there is no FIC data related specifically to trust accounts.

Query:
- Would the amount of uninsured deposits identified post aggregation be available historically – for the years 1998 to 2007?
- Would these amounts be available by some, or all, deposit insurance categories (basic, joint accounts, trust accounts, RRSPs, RRIFs and mortgage tax accounts)?
- Once the aggregation process has been concluded, can members isolate and provide by deposit insurance category the amount of insurable deposits and insured deposits?

In looking at members' processes for trust accounts with multiple beneficiaries, CDIC can identify components of the process where modifications might be considered:

> <u>Aggregation of a beneficiary's interest</u>: Although it has no data, CDIC suspects that there are very few instances of a single beneficiary having more than one interest in a trust account. Furthermore, it is also unlikely that, even if a beneficiary has more than one interest in a trust account, once aggregated the total of the interests exceeds the coverage limit. If this is shown to be the case, CDIC could consider waiving the necessity of conducting this aggregation for purposes

[8] See Schedule to CDIC Act, Subsections 3(1) to (3) and CDIC Joint and Trust Account Disclosure By-law

of calculating insured deposits for premium purposes. This may lead to a small overestimation of insured deposits that could be offset by the savings in time and resources needed to conduct the aggregation exercise.

Query:
- Is there data on the number of accounts where aggregation of beneficial interests is required? What proportion of the total number of trust accounts would these represent?

Determination of "over $100,000": Another modification that could alleviate the burden associated with the trust account calculation would be to eliminate the determination of deposits in excess of $100,000. Members would either include all trust deposits as insured – thereby overestimating insured deposits and overpaying premiums – or perhaps a factor could be determined by which members could decrease their total insurable trust deposits to arrive at an estimate of insured trust deposits. CDIC would require information on the amount of trust deposits that are uninsured (at least five years of historical data).

Query:
- What is the amount of trust deposits deemed uninsurable due to exceeding the coverage limit for the years 1998 to 2007?
- For 1998 to 2007, relative to total number of trust accounts/trust deposits, what is the proportion of trust accounts/trust deposits that held uninsurable deposits due to exceeding the coverage limit?
- Could this information be provided going forward?

Similar aggregation rules apply to deposits held in RRSPs or RRIFs.[9] CDIC could consider modifications on receipt of sufficient information.

Query:
- Is a breakdown of total insurable deposit and total insured deposits by deposit insurance category for the years 1998 to 2007 available?
- Could this information be provided going forward?

(b) Items in transit/suspense accounts:

In April of 1999, CDIC issued an Information Bulletin clarifying its expectations in calculating specific sections of the RID. With respect to items in transit, CDIC stated: "A member institution must review each of these items and include in its return those which constitute deposits under the CDIC Act. While member institutions are permitted

[9] Subsections 3(5) and (6) of the Schedule to the CDIC Act

to make those adjusting entries required to complete the booking of transactions that were fully completed as at April 30, estimates for items in transit are not acceptable."

CDIC would consider looking at some relief in this area if it can be demonstrated that the impact of excluding items in transit that are deposits from total insured deposits is minimal. The information that CDIC currently has available is insufficient to draw any conclusion.[10]

Query:
- What is the relative amount of insurable items in transit to total insurable deposits as of April 30th?
- Can this amount be provided historically?
- When aggregated with other insurable deposits by the same depositor, would records be available to determine how often the coverage limit was exceeded by the depositor?

(c) Accrued Interest on Index-linked Term Deposits:

As mentioned earlier, the Schedule to the CDIC Act provides that a deposit includes interest that is payable or accrued. Term deposits that provide for interest tied to the movement of an index often pay all interest at the end of the term. In many cases, as well, the interest is not calculable until the end of the term. However, it has been determined that the interest does nonetheless accrue throughout the term. In the circumstances, for premium purposes CDIC has provided members with a method to calculate accrued interest on these types of term deposits.
Since 2002 members have been reporting the total amount of accrued interest included in total deposit liabilities on their RID. No more than 20% of members in any given year have reported any accrued interest, meaning that 80% of our members do not offer these types of products. The average amount of reported accrued interest as a percentage of total insured deposits was 0.6% at April 30, 2006, ranging from less than 0.1% to 6.5%.

Given the potential for accrued interest to amount to over 6% of total insured deposits, a complete exclusion from the calculation of insured deposits for all members is not possible. However, CDIC could consider choosing a certain threshold (% of total of index-linked term deposit liabilities to total insurable deposit liabilities) below which members would be relieved of the necessity of calculating accrued interest for these products. To determine the threshold, CDIC would require some historical information on the total amount of index linked deposit liabilities for the period 2002 to 2007 as

[10] Members report net Cheques and Other Items in Transit on the M4. A debit net result is reported as an asset whereas a net credit is reported as a liability. On the RID reconciliation, members report Cheques and Other Items in Transit on a net basis, but only those that are not deposit liabilities. The difference between the M4 report and the RID report, since we are dealing with netted amounts, does not result in deposit liabilities as there could be an equal amount owed by the institution as is owed to the institution. Also the reported amounts are calculated on a consolidated basis and CDIC has no way of knowing how much is attributable to non-members, nor any way of concluding with respect to uninsured amounts.

members do not report this amount at this time. This example may be an effective way of dealing with a burdensome area without the need for significant additional data.

Query:
- Can historical information on the amount of index-linked term deposits included in Canadian currency deposits from individuals, as well as in total insurable deposits, be provided?
- How much of the reported interest on index-linked term deposits is included in insurable deposits?

VI. CONCLUSION

CDIC recognizes that the RID process can be burdensome for certain members and is willing to consider some modifications. However:

- Any modifications must fit within the legislative framework;
- CDIC's ability to make insurance payments in a timely and effective manner cannot be compromised; and
- CDIC will need additional data to further consider any such modifications.

CDIC would appreciate receiving comment on the possible modifications outlined in this paper, as well as on any other focused modifications that could reduce the effort involved in the RID process. In addition, CDIC seeks your views on the matters surrounding additional data and directs your attention to the Appendix as well as to each of the queries throughout the paper.

Comments should be provided to CDIC by September 30, 2007. By the end of the calendar year, CDIC will publicly respond to the material received and will outline its next steps at that time.

APPENDIX

DATA / INFORMATION

Estimation of Insured Deposits - Proxy:

- Stratified data breaking down Canadian currency deposit liabilities of individuals by outstanding amount per account/depositor.

Canadian Currency Deposits of Individuals			
Deposit Amount	Total (in thousands)	Non-registered (in thousands)	Registered (in thousands)
$ 60,000 - $100,000			
$100,001 - $150,000			
$150,001 - $200,000			
$200,001 - $250,000			
Over $250,000			
TOTAL			