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Canada Deposit Insurance Corporation
Société d'assurance-dépôts du Canada

International Association of Deposit Insurers conference

# Realizing Reforms: What Has Changed in Deposit Insurance Systems Since the Crisis?

Istanbul, Turkey

October 10, 2019

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**Remarks by Peter Routledge, President and CEO**

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CHECK AGAINST DELIVERY

## INTRODUCTION

Good morning,

It's a pleasure to be with you today. While CDIC has a long history with IADI, this is my first presentation as its President and Chief Executive Officer, and I have been looking forward to meeting with all of you and learning from your experience.

It is also my first visit to this extraordinary city, which has borne witness to so many historic events over the centuries.

For all that time, and still today, Istanbul has been the meeting point of East and West and an important player in the global economy. As early as the $15^{th}$ century, lenders and brokers known as *sarrafs* were well-established in the Galata neighborhood not far from here.

Then, as now, speculation on global events shaped the buying and selling of money.

The global outlook – from the perspective of a deposit insurer – is the starting point of my remarks today. And then I would like to suggest how some lessons of history could help guide our actions in the coming period.

## GLOBAL OUTLOOK

The risks to the global economy are clear. Recent data point to slower momentum than anticipated in both China and the euro area, with the risk of a recession rising in Europe. The US economy continues to moderate but remains solid, while global trade tensions have not eased.

In fact, the volume of global trade has now shrunk for a third straight quarter. Growth in major economies is slowing as manufacturing output and business investment weaken. Economic growth is slowing down.

Financial markets continue to react to this weaker outlook, and some central banks have taken measures to ease monetary policy. Sovereign yield curves are inverted in many countries and in other countries negative yielding debt totals US$15 trillion.

As a reminder, an inverted yield curve has predicted eight of the last six recessions. While far from perfect, that's a pretty good track record for an indicator.

So far, Canada has performed rather well. The economy grew at a pace of 3.7% in the last quarter, better than forecast by our central bank. In its most recent Monetary Policy Report, however, the Bank of Canada forecasted real economic growth of 1.3% this year, 1.9% in 2020, and 2.0% in 2021.

## IMPACT ON CANADA AND OUR FINANCIAL SYSTEM

But as a small open economy with a high reliance on exports, developments on the global trade stage will affect Canada.

This impact will reverberate through the financial sector and we must be ready for whatever comes our way.

To give you some context, CDIC manages just over CDN $850 billion in credit risk in the form of insured deposits at our 85 member institutions. This amount breaks down into two parts: $720 billion for the deposits of domestic systemically important banks (or DSIBs); and the balance – about $130 billion – from non-DSIBS. Of this latter amount, 75% is in the form of deposits held by seven medium-sized deposit-taking institutions.

CDIC's exposure at default, therefore, is the $850 billion I just mentioned. This figure will grow to $1 trillion after foreign currency coverage comes into force in 2020.

CDIC has not experienced a member failure since 1996. Over the subsequent 23 years we have been living through an elongated period of stability and growth in Canada. As one of my favorite economists, Hyman Minsky reminds us:

> *"... over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system."*[i].

While Canada's financial system is resilient, medium-sized and smaller lenders who compete against larger banks deemed systemic might suffer because their business models are not as diverse as Canada's largest banks.

And the history of deposit insurance reminds us that resolution challenges don't come in a steady stream. They arrive in clusters. So we need to be prepared for many resolutions at once, from quiet to busy in a hurry.

Preparing for these multi-failure events means we need to consider a fundamental question:

> *What principles should guide authorities and deposit insurers when the financial cycle inevitably turns downward?*

## GUIDING PRINCIPLES FOR UNCERTAIN TIMES

Here is my top-line answer to this question.

Deposit insurers, in my view, need to minimize the risks of acting too late. Of course, we need to balance other risks, such as moral hazard, protecting shareholders, signaling and the potential impact on value.

We need to defend one of the most important pillar of financial stability, which is the hierarchy of claims.

And authorities – as well as deposit insurers – must endeavour to shape the narrative in times of financial crises.

Let me provide more details.

### *Minimize Risk of Acting Too Late*

First, the risk of acting too late.

At CDIC, we are guided in managing our portfolio of risks by the combination of *the Canada Deposit Insurance Corporation Act* and our bylaws.

We have four objectives in this regard:

1. to provide insurance against the loss of part or all of deposits;
2. to promote and otherwise contribute to the stability of the financial system in Canada;
3. to pursue these first two objectives for the benefit of persons having deposits with member institutions in ways that will minimize our exposure to loss; and
4. to act as the resolution authority for our members.

Authorities, including deposit insurers, must recognize *ex ante* that we operate in a "fog of war" during periods of instability or crisis, and are obliged by events to make decisions with only a fraction of the information we would like and with far less time to take a decision that we would prefer.

This fog tends to encourage inertia for understandable reasons. Think of events during and just after the worst of the global financial crisis in the fall of 2008.

Not acting quickly enough – or in some cases not acting at all – will be a key risk for authorities when they face the next period of intensified financial distress.

In fact, authorities in a fog of war tend to underestimate the costs of delayed actions and overestimate the risks of acting early when financial uncertainty intensifies. That's why, during periods of financial instability or crisis, I believe authorities should make conscious, concerted efforts to minimize the risk of acting too late and accept the risk of acting early.

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

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

I believe my predecessor, Michèle Bourque, addressed IADI about the need for deposit insurers to be more ambitious in our goals than reimbursing deposits in seven days. I agree with her.

Over the next five years, CDIC will work toward an objective of T+0 reimbursement, the ability to repay deposits in the same day as a failure occurs, provided Canada's payment system has advanced to the degree that permits same day clearance. This operability may not be there in five years, but we have set a five-year target so we can be ready if the pace of financial digitalization intensifies. The capacity to pay out quickly also provides us, as a resolution authority, greater negotiating leverage if we pursue non-payout resolutions.

In turn, pursuing targeted non-payout resolutions could help us overcome the tension within our mandate which calls on CDIC to support financial stability while minimizing the Corporation's exposure to loss.

However, this is something we have to consider very carefully.

For example, were CDIC to disburse from its insurance fund prior to the total exhaustion of equity capital at a member institution, we might 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 our federal Department of Finance, our central bank, our prudential regulatory authority, and with our counterparts around the world.

### *Defend Hierarchy of Claims*

In the last financial crisis, as with others, shareholder interests diverged dramatically from bondholder interests.

Indeed, during periods of financial distress, shareholders generally speaking have significant information asymmetries relative to creditors and, frequently, relative to authorities. Given their position in the hierarchy of claims, they have very little to lose and everything to gain when the institution's capital and / or liquidity are perceived, by market players, to be at risk.

Given the aforementioned information asymmetries and risks that financial institutions creditors, including deposit insurers, must bear, I believe authorities must, in a crisis, defend the hierarchy of claims as a first priority.

In future periods of volatility and instability – with violent retractions of liquidity that attend – creditors, investors, households and other players will seek pillars of certainty. One of the most important is hierarchy of claims.

Generally speaking, common shareholders should lose everything, or almost everything, before any creditor loses one dollar. And the holders of higher quality capital instruments should suffer losses before holders of lower quality capital instruments.

These plunges happen because, as I saw as an analyst, investors will not be able to assess the relative value of different instruments, and, in these circumstances, will evacuate their positions violently. This only exacerbates volatility and instability.

Again, we need to determine the right time to act in a balanced fashion.

### *Shape the Narrative*

Lastly, I think authorities – including deposit insurers – should take steps to shape the narrative when it comes to financial stability, stewardship and regulatory responses.

We've all seen countless examples of social media reflecting, indeed facilitating, some unusual behaviours among depositors and market participants.

And we've all seen a broad willingness among some people within the social media landscape to accept unchecked and unverified facts – often put out by conflicted parties with a vested

angle or interest – as pure truth. These unverified "facts" spread very quickly across digital platforms and physical boundaries, often reinforcing self-defeating and irrational panics.

For instance, these conflicted parties could spread exaggerated criticisms of our members on social media to promote their own interests.

In the spring of 2017, rumours spread on social media contributed to a deposit run at a mid-sized Canadian bank that nearly led to its failure. In the space of two weeks, we observed over 12 million references to this lender on Twitter, some of it false or misleading. Fortunately, the bank was able to recover but not without difficulty and at great cost.

But, as you may rightly ask in this digital day and age, who cares about factual details when anyone can simply tweet out anything they want with no recourse for being wrong? And at the click of a button, depositors can, or soon will be able to, cash in deposits and run to another destination.

I think some of the responsibility for mitigating this risk lies with deposit insurers.

We have a mandate to promote financial stability and to minimize our risk of loss. I think that fighting the spread of false rumours and mischief are an important contribution to the financial system.

Authorities must be prepared to use their pulpits to introduce and repeat actual facts to help inform and shape the narrative.

Who should say what, and when, is frequently unclear in fluid situations. But having a coordinated communications plan among authorities ***before*** any such crisis flares up is just as critical as acting and reacting in the moment it does.

In my view, the earlier the better when it comes to authorities talking about what's actually happening during periods of financial distress and about the potential spectrum of things that ***could*** happen. In so doing, we must be careful not to unintentionally stoke concerns. But, to the extent possible, we should proactively and affirmatively provide a calm voice of reason and trust before financial distress becomes contagious.

What do we have to do to make that happen?

We have to closely monitor our environment and be prepared to act quickly when the needs arise. And we have to adapt to the digital dialogue.

That is the responsive part of communicating with the public. But it is also important to be proactive – to get ahead of a crisis.

Many IADI members are now launching public awareness programs or you may be considering such measures. CDIC has a longstanding program, which includes advertising on TV and digital media, and many other channels.

Why do we advertise for something we hope never happens?

We do it because we know from experience and evidence-based behavioural research that we can significantly reduce the risk of a bank run in Canada by making depositors aware their money is protected by CDIC. The correlation here is strong and statistically valid.

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.

And a run might not stop with just one branch.

## CONCLUSION

As I said at the beginning, history has lessons for us.

Can we mitigate against all risks? No. And can we guarantee that one of our member banks won't fail. Also, no. History demonstrates that banks have failed for as long as there have been banks.

However, we can make our system more resilient to failure and that, in our minds, is a hallmark of financial stability. A stable financial system is not marked by an absence of failures, but rather by resilience in the face of failures.

Thank you.

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[i] Minsky, Hyman. 1992. *"The Financial Instability Hypothesis".* Working Paper No. 74. Levy Economics Institute of Bard College. http://www.levyinstitute.org/pubs/wp74.pdf