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

Overview: Review of CDIC *Ex Ante* Fund and Deposit Insurance Premium Framework

July 25, 2022

Canada

Summary

The Canada Deposit Insurance Corporation (CDIC) has undertaken a strategic review of its *ex ante* funding and deposit insurance premium frameworks.

CDIC's mandate, and the member institution operating and risk environment, have changed significantly over the last decade since CDIC's current funding and premium setting strategy was established, and the differential premium system was last reviewed.

This overview document sets out the findings from the review of the *ex ante* fund and premium setting strategy. In summary:

- CDIC will establish a near-term *ex ante* fund target to exceed 85 basis points (bps) of insured deposits by fiscal year 2026/2027;
- The near-term target will guide CDIC's annual premium rate setting and related communication to member institutions on forward premium levels; and
- CDIC will review the prudence of the near-term target in the context of prevailing risk factors at the earliest of either:
  — when the 85 bps target is exceeded; or
  — within five years.

In addition, CDIC has launched a 90-day consultation on proposed amendments to the differential premium system (DPS). The objective of this component of the review is to modernize and improve the effectiveness of the system and process which determines the risk-based premiums payable by members to CDIC on an annual basis. The DPS consultation document can be accessed **here**. Submissions are to be sent to **Siddarth Rajan — Director Insurance — consultation@cdic.ca** and are requested by **October 21, 2022.**

Background

The Canada Deposit Insurance Corporation (CDIC) was established in 1967 by the *Canada Deposit Insurance Corporation Act* (the Act). The Corporation is an agent of Her Majesty in right of Canada and is a Crown corporation named in Part I of Schedule III to the *Financial Administration Act* (FAA). The Corporation reports to Parliament through the Minister of Finance.

CDIC's mandate under the Act is to: provide insurance against the loss of part or all of deposits in the event of a member institution failure, act as the resolution authority for its members, and promote and otherwise contribute to the stability of the financial system in Canada. This work is pursued for the benefit of persons having deposits with member institutions and in such a manner as will minimize the exposure of CDIC to loss.

CDIC is statutorily required to maintain a fund (the *ex ante* fund) for the purpose of carrying out its mandate. An important principle underpinning this framework is that insurance losses arising from the failure of a member are ultimately borne by the membership through the assessment and collection of premiums.

CDIC's funding framework is composed of the following:

CDIC's *Ex ante* Fund

The purpose of CDIC's *ex ante* fund is to protect depositors and promote financial stability by funding the payout of depositors in the event of failure and / or supporting the timely resolution of a member institution.

The *ex ante* fund is composed of CDIC's provision for insurance losses (a point in time accounting estimate of potential losses) and its retained earnings. As at March 31st 2022, the *ex ante* fund represents $7 billion (or 71 bps of insured deposits) in loss absorbing capacity to pre-fund the cost of a member resolution to CDIC.

In addition to the *ex ante* fund, CDIC may borrow from the Government of Canada via the Consolidated Revenue Fund (CRF) or from private-sector capital markets in furtherance of its mandate.[1] For purposes of maintaining financial stability, CDIC may request additional borrowing via the CRF under the Financial Administration Act (FAA) (section 60.2).

1 The Act (section 10) outlines CDIC's borrowing authority calculation, which grows over time based on the annual expansion in membership insured deposits, and as at December 31st 2021 represented $30 billion of potential borrowing.

Premium Rates

The maximum annual premium chargeable to any institution is fixed under the Act (section 21) at a percentage of insured deposits not to exceed 1/3 of 1% (33 basis points) or such lower proportion as may be fixed by the Governor in Council. The classification of a member institution into a category under the DPS determines what percentage of the maximum an institution will pay in any given year. The differential premium rates are set out in CDIC's Differential Premiums By-law (DPB) as approved by the Minister of Finance, and as communicated through publication of the DPB and the release of the summary of CDIC's corporate plan each year on the corporation's website.

Differential Premium System (DPS)

Commencing with the 1999 premium year, each member institution has paid annual premiums at a rate dependent upon its classification into one of four premium categories under the DPB. Pursuant to the DPB, CDIC classifies members into premium categories based on qualitative and quantitative risk indicators. In doing so, the DPS fulfills its primary objective: to send an early warning signal — with financial consequences — to the management and board of directors of each member institution concerning the risk (i.e., likelihood of failure and resolvability risk) it poses to CDIC as deposit insurer and resolution authority.

Premium rate setting in respect of the setting of a base rate and calibration of differential premium system and the determination of an appropriate *ex ante* fund size by a target fiscal year have an impact on the size, timing and incidence of premiums paid by CDIC members.

Review Objectives

CDIC last conducted a comprehensive review of its *ex ante* fund size and premium setting strategy in 2011 following the global financial crisis. As a result of that review, CDIC took measures to ensure that it is well funded and minimize the need for procyclical premium rate increases through any future periods of stress and member failures. In particular, in 2011, CDIC established a long-range target fund size of 100 bps of insured deposits and corresponding premium rate increases aimed at hitting that target within a 10 to 15 year horizon. The premium rates were also calibrated to approximate a level that would have kept CDIC out of a deficit position during historical failure/resolution events.[2]

In its most recent review of the *ex ante* fund and premium rate strategy, CDIC was guided by the following objectives:

- Maintain public confidence in the safety of deposits in member institutions by ensuring that adequate funds are available to quickly reimburse depositors or support the use of resolution tools available to CDIC to protect depositors and promote financial stability.
- Incentivize sound risk management and mitigate moral hazard by employing a differential premium system that categorizes member institutions based on quantitative and qualitative indicators of risk.
- Support system fairness among member institutions by allocating the lowest premium rate to the least risky member institutions and ensuring that failed members contribute ex ante to the cost of reimbursing their insured depositors and/or resolving their failure.
- Avoid procyclical premium rate increases on surviving members during times of banking sector stress, which could further exacerbate a crisis or constrain an economic recovery.

Minimize regulatory burden on the membership in the administration of the regime.

2 CDIC was in a deficit position for 15 years from 1983 to 1998 and premium rates tended to increase in the period following member failures.

Operating and Risk Context

Since the global financial crisis, substantive regulatory framework enhancements have been implemented to improve the safety and soundness of member institutions, including:

- The finalization of Basel III regulatory requirements;
- The transition to International Financial Reporting Standards (IFRS);
- The designation of certain member institutions as domestic systemically important banks (DSIBs) and global systemically important banks (GSIBs); and
- The build-up of total loss absorbing capacity (TLAC) for Canada's DSIBs.

As a result, the financial and regulatory profile of CDIC's membership has changed since the time of the previous reviews of the *ex ante* fund and DPS.

During this time, the operating environment has also changed for CDIC; for example:

- The formalization of CDIC as the resolution authority for its members (2017);
- Strengthening of member institution resolution and recovery planning frameworks;
- Enhancements to CDIC's borrowing framework in cases of stability risks for the Canadian financial system (the FAA's section 60.2);
- The introduction of new tools to handle the resolution of systemically important banks (Enhanced Financial Institution Restructuring Powers, Bail-In); and
- Substantial improvements made to the way CDIC assesses the risk of its membership through updates to its risk assessment methodology (RAM).

Following these developments, the purpose of CDIC's *ex ante* fund has broadened to be a key source of funding for the restructuring and resolution of member institutions as required, in addition to funding for the payout of insured deposits in the event of a member institution failure.

The deposit base has also changed dramatically in recent years. In particular, the volume of insured deposits across CDIC members has experienced above-average growth over recent fiscal periods due to several factors, including:

- The Covid-19 pandemic and corresponding public health and fiscal measures have had a substantive impact on the savings habits of Canadians; and
- CDIC coverage has been expanded to include foreign currency balances, term deposits with maturity dates greater than 5 years, separate coverage for RESPs and RDSPs, as well as the deposit base of credit unions who have transitioned from the provincial to the federal framework.

These elevated levels of insured deposit growth have extended the timeframe by which the planned 100 bps target fund size is reached. As at March 31st, 2022, the 100 bps target is expected to be achieved by the 2029/2030 fiscal year.

Review Findings

In this context, in 2021/2022, CDIC undertook a strategic review of the *ex ante* fund's overall design, target size and time to achieve the target.

Fund target options were contemplated with due diligence to the purpose of the fund, CDIC's risk appetite, potential idiosyncratic and simultaneous member failure scenarios, borrowing and other ex post funding capacity as well as evolving international deposit insurer best practices.

The review confirmed that:

- The fund should continue to protect depositors and promote financial stability, and that it may be used for both loss absorbency and the rapid provision of liquidity in furtherance of CDIC's objects for a member resolution.
- The target does not need to pre-fund all potential severe but plausible losses given CDIC's statutory access to funding back-up (i.e. borrowing authority) and ex post premium mechanisms.
- The fund should provide a high degree of confidence across a range of severe but plausible stress scenarios and be subject to periodic review and calibration.

Continued fund growth in the near term at or over the growth in the volume of insured deposits is consistent with the fund objectives outlined above. The review also reaffirmed that CDIC's aggregate risk exposure generally scales with insured deposits (rather than a member's total deposits or total assets) and that a single fund approach remains appropriate to ensure flexibility across a range of failure resolution options.

Based on the review findings, and the volatility around deposit levels stemming from the Covid-19 pandemic, CDIC will no longer guide the annual premium setting strategy to a 100-bps target over an extended time horizon.

Consistent with the guiding objectives set out above, **CDIC will set a prudent and credible *ex ante* fund near-term target to exceed 85 basis points of insured deposits by fiscal year 2026/2027, and annual premium setting will be guided by this near-term target.**

This near-term target supports transparency and predictability for premium rate setting that is aligned to the current risk outlook, and the growth objective for the *ex ante* fund. Additionally, the setting of a near term horizon adds greater prudence and discipline for CDIC to regularly assess the achievement of *ex ante* fund and premium setting strategy objectives.

Forward Guidance on Premiums

The near-term target to exceed 85 bps of insured deposits by 2026/2027 will guide CDIC's annual premium rate setting and related communication to member institutions on forward premium levels.

Based on this target, current estimates for deposit growth, and current DPS rate assumptions, CDIC expects premium rate levels to remain stable in the near term.

CDIC will communicate annual premium rates setting to member institutions in the context of the progression to the near-term target through the summary corporate plan process, DPB publication and other communications.

The operating and risk environment may cause an acceleration or delay in CDIC's projected timeline to exceed the near-term 85 bps target. CDIC will review the prudence of this near-term objective in the context of prevailing risk factors at the earliest of either:

- when the 85 bps target is exceeded; or
- within five years.

Furthermore, CDIC intends to conduct a full review of the *ex ante* fund and premium setting strategy at least every five years going forward.

CDIC will continue regular engagement with member institutions and other stakeholders on the sound functioning of its funding framework for the continued protection of depositors and stability of the financial system.

Next Steps

The near-term *ex ante* fund target to exceed 85 bps by fiscal year 2026/2027 will come into effect during the second half of fiscal 2022/2023.

CDIC's 2023/2024 summary corporate plan (as published per the FAA), the DPB and other communications will reflect CDIC's assessment of progression to the target and communicate forward premium level expectations.

The feedback from the 90-day consultation on proposed amendments to the DPS will be integrated as appropriate into the *ex ante* funding and premium rate setting strategy following the conclusion of the consultation.