

C.D. Howe Institute

## **Crisis preparation in the time of COVID: protecting deposits and the financial system**

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Remarks by Peter Routledge, President and CEO

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CHECK AGAINST DELIVERY

### **Introduction**

Good morning and thank you, Bill, for that kind introduction. I'd also like to thank the C.D. Howe Institute for this opportunity to speak to the challenges that face us in these difficult times.

Let me begin by acknowledging that I am speaking to you today from the traditional, unceded territory of the Algonquin Anishnaabeg people. I thank all the generations who have taken care of this land.

### **COVID's challenge to financial stability**

It's a shame we are restricted to meeting today via computer screens. But we all need to do our part to avoid contributing to COVID contagion.

Now that word—**contagion**—is as alarming to me and my colleagues as it is to public health officials—for a different reason. At the Canada Deposit Insurance Corporation (CDIC), when we speak of "contagion," we're talking about financial panic that can spread as rapidly as a virus. For that reason, Parliament incorporated CDIC in 1967 and has adjusted the Corporation's powers over those 54 years to mitigate certain risks in the Canadian financial system.

While COVID has not triggered any financial contagion, it has placed an enormous burden on our economy and financial system. As the Bank of Canada noted in its policy-rate announcement on January 20, the post-holiday surge in COVID-19 cases is a serious setback. With elevated infection rates and stricter containment measures in many parts of the country, households and businesses are facing renewed strains. On the upside, the Bank notes that prospects for a strong, sustained recovery in the second half of 2021 and 2022 have improved with the arrival of effective vaccines.

Nevertheless, the costs of the pandemic have fallen and will fall unevenly – certainly across the economy and possibly across CDIC's membership. While the likelihood of a CDIC member institution failure has fallen considerably over the past half year, it has

not fallen to zero. Given that the economic recovery from the pandemic will likely remain volatile and unpredictable, CDIC must maintain its vigilance in the face of this uncertainty. That means we must be ready for a highly unlikely, but high severity, financial distress event within CDIC's membership.

Despite the damage to the economy caused by COVID, Canada's financial system remains strong and resilient in the face of market volatility. In CDIC's corner of financial markets, resilience to the failure of a CDIC member institution, and not its absence, is the mark of a sound financial system.

I believe Canada's financial system is far more resilient to a potential CDIC member institution failure, however remote that possibility, because of CDIC's extensive preparations since the financial crisis of 2008-9 and, more precisely, over the past two years. And I would like to take you inside CDIC so that you may understand how we think about sustaining resilience and minimizing the prospect of financial contagion. To reinforce your confidence in the deposit-taking system, I'd like to outline for you today:

- our responsibilities;
- the preparations we've made; and
- the tools we have to address institutions in trouble.

## CDIC's responsibilities

Let's start with our responsibilities. Although CDIC insures almost a trillion dollars of deposits in Canada, we are in the resolution business more than the insurance business.

Through the CDIC Act, Parliament has assigned CDIC the task of resolving troubled or non-viable financial institutions for the benefit of insured depositors and to promote financial stability.

Our Act gives us four objects, or key responsibilities, in this regard:

- To protect depositors within CDIC's deposit insurance limits (our deposit protection totals \$100k across seven different deposit categories at each CDIC member institution);
- To promote financial stability;
- To do those first two things in such a manner that minimizes CDIC's exposure to loss; and
- To act as resolution authority for our members.

There is an intended tension in our assigned responsibilities – the tension between protecting depositors and promoting financial stability on one hand and avoiding moral hazard on the other. Put differently, we risk moral hazard in our zeal to promote

financial stability and we risk financial instability if we focus too much on avoiding moral hazard.

Parliament asks that we balance our objects and thereby balance the tension between the avoidance of moral hazard and the promotion of financial stability. And CDIC's power in pursuing this balance is checked, as it should be given the immense powers in our Act, by our Board of Directors, our minister, the Governor-in-Council, and ultimately Parliament.

Put more succinctly, the principle of accountability is central to Canada's system of democratic governance and, so, CDIC is accountable for its decisions to Parliament through the Minister of Finance. Let me explain how a major CDIC action that could affect financial markets – e.g., the resolution of a member institution – would come to pass.

Assuming recovery efforts encouraged by the Office of the Superintendent of Financial Institutions failed to improve the condition of the institution, CDIC's management would consider its options and make a resolution recommendation to our Board of Directors. Our Board would then review and approve the recommendation, amending it as it sees fit. CDIC would then seek ministerial approval for the resolution approach from the Minister of Finance, or the Governor in Council in some cases.

I want to assure you again that our financial system is resilient and that while failures of financial institutions in Canada are rare, they can and have occurred. Since the establishment of CDIC in 1967, we have handled the failure of 43 members, affecting some 2 million Canadians. No one has lost a single dollar of deposits protected by CDIC.

## CDIC's tools

When a deposit-taking institution falls into financial distress, history shows that resolution authorities tend to both minimize losses and promote financial stability when they act early as opposed to late. But it is not quite that simple. There is a fine line to walk.

Acting too early can lead to moral hazard. Moral hazard is a situation in which one party engages in risky behaviour or fails to act in good faith because it knows the other party bears the economic consequences of their behaviour. ... Any time a party does not have to suffer the full economic consequences of a risk, moral hazard can occur. Therefore, we don't want our member institutions to take reckless risks in the belief CDIC will eventually bear the financial losses produced by that recklessness. A good rule of thumb is that shareholders and other loss-absorbing capital providers should lose everything before CDIC and other senior creditors lose a dollar.

Alternatively, responding too late to the deterioration in the financial condition of one of our member institutions could trigger contagion or a loss of public confidence, which could destabilize the financial system and result in much higher costs to CDIC.

Two sections of the *Canada Deposit Insurance Corporation Act* instruct us on how to manage this tension and give us the tools to do so.

Section 10 provides us with a bounded capacity to act before the point of non-viability. We have a wide array of tools available to us – including but not limited to guarantees, loans, recapitalization, and loss-sharing arrangements with the buyers of failing institutions.

We can deploy whatever tool we consider appropriate provided any action we take is in accord with our objects. Our four objects bind our use of these tools. And our Board on behalf of the Minister binds to a fidelity to our four objects.

Another section, 39.13, obligates us to intervene after the point of non-viability, a point determined by the Superintendent. The powers in this section are quite substantial. For example, we could:

- Reimburse all insured deposits immediately and afterwards liquidate the institution via the *Winding-Up and Restructuring Act*.
- Vest shares or assets of a non-viable institution to force a sale of the member institution.
- Establish a bridge bank into which we would transfer the failed institution's good assets and certain liabilities.
- For systemically important banks, convert capital and certain debt instruments – not deposits – into common equity and thereby recapitalize the bank.

As I mentioned, history teaches us that earlier actions tend to limit losses and the risk of financial instability. In our history, 24 of our 43 member failures have involved payouts & liquidations and those tended to be more expensive than other forms of resolution.

In the U.S., the Federal Deposit Insurance Corporation (FDIC) – has often made use of loss-sharing agreements to facilitate acquisitions of failing members by healthy members. Only 26 of FDIC's roughly 500 resolutions have involved post-failure payouts.

Between 2008 and 2013, FDIC payout resolutions led to median costs to FDIC of about 35 per cent of the failed institution's assets. Resolutions in which FDIC facilitated the sale of troubled assets were much cheaper: a median cost of about 20 per cent.

## CDIC's Preparations

So, our obligation is to construct resolution strategies to act early such that we minimize both moral hazard risk and financial stability risks. Preventative and preparatory habits are key to developing sound strategies. We have developed three critical habits and I'll list them according to their distance from non-viability.

First, resolution planning. Canada's six largest banks have developed detailed resolution plans in coordination and collaboration with CDIC. And over the last 18 months, we've turned our focus towards developing resolution plans with smaller institutions. But plans aren't enough. We must apply those plans in a real-world setting to truly understand their effectiveness. This is hard to do in a banking system that has not had a deposit-taking institution fail in 25 years.

So, secondly, do what other first-responders do - we simulate failures. In other words, we routinely conduct "war games" to play out potential financial crises in a safe environment so we can test our resolution plans and coordination. We hold a number of these each year, of differing size and complexity. So far, they've been either internal to CDIC, with our board of directors, or with our federal government financial safety net partners. Down the road, we will expand them to include our member financial institutions.

Third, we have the authority to seek early collaboration with troubled members. Since the mid-1980s, we have had the power to conduct in-depth examinations of the assets and deposit liabilities of member institutions whose financial condition would give a reasonable person charged with the responsibilities in CDIC's Act cause for concern. Through these exams, we can anticipate problems and respond sooner to a potential failure before too much value and capital are lost. Undertaking such a special examination has the unintended, though eloquent and unmistakable, consequence of sending a powerful message to the boards of these institutions.

## Conclusion

Since CDIC's establishment in 1967, we have handled failures affecting more than two million depositors and more than \$26 billion. And no one has lost a penny of the money that was insured by CDIC.

In this time of pandemic and financial uncertainty, Canadians can rest assured that CDIC has the strategies and toolkit to protect depositors and promote the confidence necessary to ensure our financial sector remains a key economic driver.

Thank you. I would be happy to answer your questions.