Empire Club of Canada

Here comes the boom: Protecting deposits and the financial system during the post-pandemic recovery

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CHECK AGAINST DELIVERY

Introduction

Good morning and thank you, Antoinette, for that kind introduction. I'd also like to thank the Empire Club for this opportunity to discuss the post-pandemic challenges that lie ahead of us.

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.

I'll share with you CDIC's view of the economic landscape and the risks that we monitor that could affect our member financial institutions, notably the housing market. And I will also tell you about our role and tools for supporting financial stability in periods of uncertainty.

Recovery from the pandemic

Like all of you, I'm preparing to step into post-pandemic life. In fact, I am quite eager to do so as evidenced by my attire this morning.

More people are vaccinated every day. The Bank of Canada expects Canadian real GDP growth to be positive and healthy in the first quarter of 2021. That said, new, more transmissible variants of COVID-19 are a present danger and we in Canada are taking special measures to combat them while we also increase vaccinations. Although near-term uncertainty remains elevated, the medium-term outlook is fairly robust with some prognosticators positing a robust economic recovery in North America.

Over the past 6-9 months, some of those prognosticators have articulated that viewpoint of elevated exuberance in Canada's residential real estate market, prompting understandable concern about the housing market. This is not a new challenge for Canadian regulators and policymakers. In fact, the story of Canada's residential housing finance system is a story of a successful interplay between the productive spirits of a marketplace and disciplined, measured, and ultimately effective prudential boundary-setting by policymakers and regulators.

Policymakers and regulatory authorities have so engaged more than three dozen times since 2007, by my count, with the end goal of a healthy, robust housing finance system that has moved Canada closer to the vision of every Canadian having a home that they can afford that meets their needs.

Last week, the Superintendent announced another measured, intelligent response to the productive spirits of the housing finance marketplace – a proposal for the qualifying interest rate for uninsured mortgages. The minimum qualifying interest rate, or stress test, adds a margin of safety that ensures borrowers will have the ability to make mortgage payments in the event of a change in circumstances, such as the reduction of income or a rise in mortgage interest rates. In my view, this proposal will reinforce sound residential mortgage underwriting and thereby bolster the safety and stability of Canadian financial institutions.

You may be asking yourself, how does CDIC factor into this housing discussion and why are we paying such close attention? I'll explain.

Our job at CDIC is to protect one critical component of the Canadian financial system: deposit-taking. We insure $1 trillion in deposits from individuals across 85 member banks, federally regulated credit unions, or loan and trust companies. Our job is to be ready for a highly unlikely, but high-severity, financial distress event within our membership.

We know that the economic recovery from the pandemic will be volatile and unpredictable. Indeed, the marked ebullience in the Canadian housing market of late is an example of that. And we know, from prior experience, that the costs of volatility may fall unevenly across the financial institutions whose deposits CDIC insures. So we have an interest in housing market developments because they could have an effect on our member institutions and, therefore, our risk exposure as deposit insurer.

So how do we manage this risk and also protect deposit-taking in Canada?

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

1. To reimburse depositors within CDIC's deposit insurance limits;
2. To promote financial stability;
3. To do those first two things in such a manner that protects depositors and minimizes CDIC's exposure to loss; and
4. 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. Parliament asks that we balance our objects and thereby balance the tension between the avoidance of moral hazard and the promotion of financial stability.

Timing is critical in these events. When a deposit-taking institution falls into financial distress, we can minimize losses and promote financial stability when we act early as opposed to late. But it is not quite that simple. There is a fine line to walk.

First of all, we prefer to let the market do its job. If a private sector solution occurs, such as the purchase of the troubled bank by another, then CDIC need not get involved.

We prefer to let the market do its job because acting too early can lead to moral hazard. 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 that CDIC will eventually bear the financial losses produced by that recklessness. A good rule of thumb is that shareholders and other capital providers should suffer losses before CDIC and other senior creditors.

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.

As I said earlier, there is a profound tension at the heart of resolution preparedness for deposit-taking institutions. Parliament has granted to CDIC two sets of tools to manage this tension.

One set of tools provides CDIC 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.

Another set of tools enables CDIC to intervene after the point of non-viability, a point determined by the Superintendent. These powers 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 – <u>not</u> deposits – into common equity and thereby recapitalize the bank.

To maximize the value of these tools, we must have sound, preparatory practices in place. We have developed three such critical practices and I'll list them according to their distance from failure.

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.

So how do we do that? We 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 gives us 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

The COVID pandemic has stressed to the maximum every element of our economy and financial system. And the recovery will present new and unpredictable challenges. Yet Canada's financial system remains strong and resilient. If one of CDIC's member institutions does fall into distress, Canadians can rest assured that we have the strategies and toolkit to protect depositors and prevent the spread of financial contagion.

Since CDIC was established in 1967, it has handled 43 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 us.

Thank you. I am looking forward to your questions.