Intelligence MEMOS

From: Jeremy M. Kronick and Duncan T. Munn

To: Financial Sector Regulators

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Re: **Six Banking Lessons From the Moment**

With the implosion of systemically important Credit Suisse, the reverberations from Silicon Valley Bank's failure continue to rattle regulators, investors, and Canadians alike.

What is the risk of further financial contagion, globally and for Canadians at home? What are the prospects for the innovation economy and start-up businesses? To answer these questions and analyze the consequences of this latest banking crisis, the C.D. Howe Institute convened a joint session of its **Financial Services Research Initiative** and **SME Working Group**, as well as former regulators and other industry experts. We see six big takeaways.

First, the SVB collapse highlights the importance of effective supervision. While the bank's failure can be attributed to a number of factors, inadequate supervision was at the top of the list. Regulators should have easily identified and mitigated the fundamental risk posed by the SVB balance sheet's dangerous duration mismatch: with high deposit flight risk due to large uninsured account balances set against long-term government bonds whose value was susceptible to interest rate fluctuations. This underscores the need for robust domestic supervision and more international collaboration and effort to ensure consistent regulatory practices worldwide.

Second, deposits matter and so too does deposit insurance. As we saw, a high percentage of uninsured, typically wholesale, deposits increases vulnerability in times of crisis since those funds can exit swiftly. This effect is worsened when the depositor base is as concentrated (by sector) as it was at SVB.

On the deposit insurance front, officials calmed markets by guaranteeing all SVB depositors – even those beyond insurance limits. But, making all depositors whole at a supposedly non-systemically important financial institution introduces significant moral hazard. Others will assume the same coverage will apply at their financial institution. As a result, the market discipline imposed by limited deposit insurance disappears. Canadians will need to reassess what we are trying to achieve with deposit insurance that balances depositor protection with market discipline.

Third, if one of the lessons from the Great Financial Crisis in 2008 was the need to focus on systemically important institutions, the clear lesson from 2023 is the need to pay closer attention to risks that can become systemically important to the entire system.

The rapid rise in interest rates was one such risk. It created duration mismatches across numerous non-systemically important banks and collectively kicked off a banking crisis that risks a broader financial crisis. Supervisors could consider publishing a risk register to bring more transparency to how they think of such issues.

Fourth, Canada's concentrated banking sector provides a buffer against global shocks. The country's Big Six systemically important banks, account for the large majority of banking assets in Canada. They are more tightly regulated than other banks. To wit, Canadian regulators would never permit a bank to operate without a chief risk officer, as SVB did for the better part of a year. And Canadian banks maintain higher capital ratios and rely less on wholesale deposits than their US counterparts.

Which leads us to the fifth takeaway. Despite this degree of protection, Canada will not walk away unscathed. Yes, there may be opportunities for our banks to capitalize on a flight to safety, as depositors look for more trustworthy institutions to park their money. But global credit spreads widen during periods of financial stress or uncertainty as everyone demands higher returns for loans they provide. This will increase the cost of borrowing to Canadians – a sideswipe to the economy, but an assist to the Bank of Canada in its fight against inflation.

Sixth, and lastly, SVB's collapse is a **$70 billion hole** that must be filled in global capital markets. SVB was a highly specialized financial institution that financed numerous tech firms and venture capitalists, and, given the dearth of alternatives – even more notable here in Canada – its absence will be felt in the innovation economy where Canada wants to be a player. While others may partially fill the void, their lending practices differ considerably. SVB was willing to lend to businesses based on their enterprise value, including cash on hand, not simply on the hard assets they were willing to pledge as collateral – something many early-stage businesses don't have. Regulators should learn from SVB's 40-year success and examine risk weights for appropriateness and adaptability. Policymakers will need to contribute as well, looking at alternative avenues to **encourage SME growth**.

The situation continues to evolve and has not yet stabilized. But, as we did during the Great Financial Crisis, Canadians can find solace in the resilience of our financial institutions. And, as always, stand ready to learn from a crisis – to better position ourselves for future ones and to promote our economic dynamism.

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This Memo was informed by a joint session of the C.D. Howe Institute's FSRI and SME working groups, which included market participants, industry experts and former public sector officials from OSFI, the OSC, and the Bank of Canada. However, it solely represents the views of the authors.