Intelligence MEMOS

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To: Canadian Deposit Insurance Regulators

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Re: **THE BIG QUESTIONS SURROUNDING THE FUTURE OF DEPOSIT INSURANCE**

More than 15 years have passed since the $100,000 deposit insurance limit for eligible deposits at the Big Six banks and a host of other smaller federally regulated deposit-taking institutions came into force.

The passage of time and resulting decline in the purchasing power of that limit suggests the time has come to raise it. But, before doing so, and in light of the ongoing challenges faced by some US regional banks, it is worthwhile unpacking some issues and flagging questions that need answering.

Canada has a fragmented deposit-insurance system. In addition to the federal deposit-insurance system managed by the Canada Deposit Insurance Corporation (CDIC), deposits of provincially incorporated institutions like most credit unions and caisses populaires are backed by their respective provincial deposit insurance corporations. Coverage limits in those systems range anywhere from $100,000 in Quebec to full coverage in the four western provinces.

The main argument in favour of deposit insurance is that it helps to reduce the risk of deposit-taking institutions failing due to a bank run. That helps smaller institutions compete against the Big Six banks because customers can confidently place deposits with them knowing their deposits are insured within the defined limits.

Deposit insurance coverage limits are set in most places to mitigate moral hazard concerns. We fully protect depositors below limits, often those who may not have the resources to assess the risks of different banks and take informed decisions about where to keep their money. Depositors above coverage limits are incentivized to more closely monitor the activities of their financial institutions to make sure it is not taking on undue risk. Correspondingly, banks avoid undue risks to keep their large depositors.

Recent events, however, have raised questions about whether deposit insurance truly reduces the risk of bank runs or deposit flight and whether there is a future for limited deposit insurance.

On the first, Canada has a remarkably disciplined financial sector, but not always. In 2017, Home Capital experienced a bank run when depositors – both uninsured and insured – withdrew their money after the bank was accused of misleading investors. Even fully insured depositors will run if they become concerned.

On the second, the swift US government response to SVB's collapse was to cover all of that bank's deposits, not just insured deposits, to stem contagion risk. But that undermines the concept of limited deposit insurance and introduces moral hazard. Deposit-taking institution managers may be more tempted to take bigger risks now, betting they'll be bailed out – after all, SVB wasn't even considered a systemically important bank. Investors may assume the same and limit their oversight, weakening market discipline.

Meanwhile, there have been calls to raise the CDIC $100,000 cap. This makes sense given the loss of purchasing power of a dollar over the last 18 years. But it also raises other issues.

None of Canada's deposit insurance entities, is fully-funded with a pool of assets readily available to cover all insured deposits. Far from it. So, if we increase the coverage maximums, we need to consider how large should those deposit funds be. Higher premiums represent capital that is not in use in the economy. At the same time, relying more on industry levies to pay for a failure after the fact could undermine the financial condition of surviving institutions at a time of stress and cause serious damage to the economy.

Smaller institutions benefit greatly from deposit insurance. This is partly because big banks pay more into the funds, while consumers gain more confidence leaving their money at smaller institutions. This is good from a competitiveness standpoint. However, recent US events are a reminder that those institutions can be systemically important as a group even if they are not individually. If limits are increased materially, which by definition increases moral hazard, should smaller institutions face more stringent capital and liquidity requirements, closer to those currently imposed on the six major banks? Does it make sense to require them to adopt the bail-in debt requirements imposed on major banks so that more of any resolution cost is imposed on wholesale debtholders of the failing institution rather than the rest of the industry or, worse, the public purse? Careful balancing is needed to ensure system stability without unduly affecting competition.

Finally, no discussion about deposit insurance limits is complete without noting the presence of full coverage for some provincially regulated credit unions. No doubt this makes them more competitive, which is good for consumer choice. But there is also no denying the moral hazard risks. Provinces may wish to consider whether some very large depositors should continue to be fully insured.

As US bank turmoil plays out, there are many lessons and questions that require a deep dive. Deposit insurance is a big one.

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