Domestic Stability Buffer Council

Communiqué

November 15, 2023

Inaugural Meeting of the C.D. Howe Institute Domestic Stability Buffer Council – Council Recommends Holding Domestic Stability Buffer at 3.5 percent

At its inaugural meeting, the C.D. Howe Institute's Domestic Stability Buffer Council (DSBC) recommended that the Office of the Superintendent of Financial Institutions (OSFI) maintain its Domestic Stability Buffer (DSB) at 3.5 percent at its next setting in December.

The DSBC provides OSFI, industry participants, and key economic policy voices with an independent assessment of the appropriate size of the buffer in pursuit of OSFI's mandate of contributing to public confidence in the Canadian financial system. The Council consists of Vivian Abdelmessih, Cathy Cranston, Jamey Hubbs, Peter Levitt, Duncan Munn, Mark Zelmer, and Jeremy Kronick who is Chair. Council members make recommendations for OSFI's upcoming DSB announcement.

Council members first emphasized the importance of clarifying the purpose of the DSB. As a relatively new feature of the financial system (introduced is 2018), the DSB would benefit from increased public education about its purpose and role, in the view of Council members. By definition, the DSB is a publicly announced capital buffer that the big six Canadian Domestic Systemically Important Banks (D-SIBs) must set aside to cover potential losses during periods of financial stress. OSFI has announced a range for the buffer of 0 to 4 percent, and it is currently set at 3.5 percent. While it is part of the Common Equity Tier 1 (CET1) capital requirements for the big banks,[1] the Domestic Stability Buffer plays a different, more countercyclical role. According to OSFI: "OSFI raises the level of the buffer "in good times" when the economy is growing strongly, and when vulnerabilities to losses may be growing. A reserve cushion of up to 4 percent is built up to protect against those possible vulnerabilities. OSFI then lowers the buffer during "bad times" or times of economic stress when risks appear." By lowering the capital buffer in bad times, banks will have more room from a capital perspective to absorb or provision for losses without restricting activity and lending. Without this buffer, the six major banks would be under greater pressure to preserve regulatory capital and restrict activity and lending, thereby amplifying economic downturns.

Council members stressed that the DSB is meant to be countercyclical in this way. However, missing from that definition is a scenario where the economy is growing but vulnerabilities are falling, implying that regulatory capital carried for DSB purposes could be safely reduced. This is not a situation we find ourselves in today, but Council members noted it was a possibility requiring OSFI's consideration.

1 These include, in addition to the DSB, the 4.5 percent minimum capital requirements, the 2.5 capital conservation buffer, and the 1 percent D-SIB surcharge.

With that definition in mind, members highlighted that a recommendation on the DSB required an analysis of data along two lines: first, the change in risks, and how and when those risks are likely to manifest themselves on bank balance sheets, and second, the state of the underlying economy, and its potential impact on bank operations.

OSFI highlighted in its June announcement, in which the buffer was increased to 3.5 percent, that risks had grown in a number of key areas, including household and corporate debt levels, higher debt costs as a result of the Bank of Canada's tightening campaign, and more global uncertainty around fiscal and monetary policy.

Members felt that these risks have continued to worsen since June. The Bank has raised its overnight rate target by 50 basis points since June, further adding to concerns over the affordability of mortgages and other forms of debt carried by households and businesses. Members noted in particular that there still remain a substantial number of households who have not renewed/re-negotiated their mortgages during the Bank of Canada's tightening campaign. As a result, many households are now renewing mortgages at rates beyond the "stress test" rate at origination, and this presents a risk for the banks. Provisions for all forms of credit losses (PCLs) at the D-SIBs have increased substantially, hitting $3.54 billion as of July 31st 2023, far above the $1.54 billion registered in the same period in 2022.

Members also highlighted the increasing riskiness of the international arena since June, most notably geopolitical uncertainty stemming from, among other things, the war in the Middle East and Ukraine. This could have both a direct and indirect effect on bank balance sheets. While risks have increased, members also acknowledged that bank models are designed to be reflective of forward-looking risk assessments and have, indeed, been directionally appropriate, and that current provisions are meant to reflect each bank's unique assessment of underlying risks to their balance sheets. The implication would then be that many of these risks have already been accounted for.

On economic activity, members felt strongly that indicators were pointing towards an economy currently in a recession or headed toward one. Second quarter GDP was negative and with July and August GDP flat, early signs were that the third quarter would be too. The sharp increase in the Bank of Canada's overnight rate over the last 18 months is clearly working its way through to economic activity. With economic activity leading inflation, the Bank may be approaching the end of its tightening cycle. Members noted, however, that a higher level of interest rates might persist if inflation is slow to return to the 2 percent target. This would act as a drag on economic activity and could make things more challenging for Canada's highly indebted households and businesses – impacts that worsen the longer interest rates remain elevated.

All things considered, there was a consensus that risks to D-SIB balance sheets have increased since June. However, there was also consensus that economic activity has taken a turn for the worse. Members debated the weight to be given to each, but concluded that, at present, the window has likely closed to raise the DSB buffer further and that doing so could be counterproductive. With risks beginning to crystallize, and PCLs increasing accordingly, members also discussed the case for lowering the DSB. On balance however, the Council decided that this would be premature, given the potential for continued worsening as identified risks work their way through the economy and ultimately bank financial statements.

Members also commented on the importance of signalling DSB changes as early as possible, so banks can meet changes through profit retention unless circumstances are exceptional such that they require moving more rapidly.

With the downturn now beginning to emerge, members concluded that the buffer should be left at its current 3.5 percent level despite the increase in risks. With 3.5 percent near the DSB's top end of 4 percent, there remains significant room to release the buffer as appropriate so that banks are less likely to amplify a situation in which conditions have worsened.

Members of the Council:

- **Jeremy Kronick**, Associate Vice President, Director of the Centre on Financial and Monetary Policy, C.D. Howe Institute.
- **Vivian Abdelmessih**, Chair of the Board at Export Development Canada.
- **Cathy Cranston**, Former Treasurer at BMO Financial Group.
- **Jamey Hubbs**, Senior Fellow, C.D. Howe Institute, Former Vice Superintendent, OSFI.
- **Peter Levitt**, Corporate and Philanthropic Director, Former EVP, Treasury and Taxation, CIBC.
- **Duncan Munn**, President, C.D. Howe Institute.
- **Mark Zelmer**, Senior Fellow, C.D. Howe Institute, Former Deputy Superintendent of Financial Institutions, OSFI.

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