Domestic Stability Buffer Council

Communiqué

May 15, 2024

Steady as She Goes – For Now: Council Recommends Holding Domestic Stability Buffer at 3.5 percent

Second Meeting of the C.D. Howe Institute Domestic Stability Buffer Council

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

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.

At their meeting on April 30, Council members stressed upfront the importance of understanding the different scenarios for increasing or decreasing the DSB. The DSB is meant to act as a countercyclical capital buffer for domestic systemically important banks (D-SIBs). As such, it is expanded in good economic times when vulnerabilities are on the rise. It can then be reduced or released when bad economic times hit, giving the banks more room in terms of capital to absorb or provision for losses without restricting lending, which could further exacerbate economic conditions. The DSB can also be reduced in good economic times if vulnerabilities are lessening.

Members noted that OSFI kept the DSB at 3.5 percent at its last decision in December. OFSI's announcement at the time highlighted its view that while system vulnerabilities remained elevated, and near-term risks to D-SIBs were increasing – albeit from low levels – their capital ratios exceeded required levels. These financial institutions were holding Common Equity Tier 1 (CET1) regulatory capital ratios above 12 percent, in excess of the 11.5 percent regulatory requirement (with the DSB accounting for 3.5 percent). OSFI's announcement focused on concerns over residential mortgage market susceptibility to higher interest rates, commercial real estate vulnerabilities, and increased geopolitical conflicts, all of which were causing banks to increase provisions for credit losses.

At present, at a high level, members judged that while vulnerabilities are rising, the economy is weakening, threatening a retrenchment in lending. Bearing that context in mind, Council members unanimously voted to leave the buffer unchanged at 3.5 percent.

Members argued that many of the risks OSFI highlighted at its previous setting – real estate markets, geopolitical tensions – have increased since December. Furthermore, the economic outlook has worsened, with, among other things, the unemployment rate increasing to 6.1 percent in March, compared with 5.8 percent in December, and real GDP growth slowing in February, and set to remain flat in March. With D-SIBs posting capital ratios in excess of 12.8 percent, there is space to address future risks.

Members highlighted that while OSFI did not increase the DSB to the top end of its 0-4 percent range at its last meeting, the buffer remains near the high end of the range.

Members noted that OSFI's decision on the level of the DSB must consider risks that arise on the domestic front as well as internationally. Members judged that geopolitical risks have increased since OSFI's last meeting, as the wars in the Middle East and Ukraine rage on. Moreover, members were concerned about the outsized role the US election may have on risks over the medium term.

D-SIB provisions for credit losses have risen since the last meeting, indicating banks continue to see increased risks on the horizon and are preparing accordingly. Increased provisions provide an additional layer of protection for bank capital. The average Common Equity Tier 1(CET1) regulatory ratio for Canada's D-SIBs increased in 2024 Q1 from the quarter before. Indeed, 2024 Q1 saw the fourth consecutive increase in the average D-SIB CET1 regulatory ratio. At 13.4 percent, it sits nearly 200 basis points above the required 11.5 percent. All D-SIBs were more than 100 basis points above the required 11.5 percent, with CET1 ratios ranging from 12.8 to 14.9 percent.

Members highlighted the distinction between risk stemming from residential housing markets and commercial real estate markets. On the former, debt servicing ratios have risen as the Bank of Canada tightened monetary policy. However, to date, consumers have largely been resilient to this effect, drawing down on savings from generous government transfers during the pandemic. Commercial real estate concerns stem from uncertainty as to the likely steady state working model involving hybrid work that society lands on over the longer term. Members also mentioned that as the Bank of Canada starts to loosen monetary policy, the terminal or neutral rate, reflecting an economy operating at potential and stable inflation at the 2 percent target, will likely be higher than originally anticipated, and the speed of the reduction in rates is likely to be slower than many people had expected. This might act as a drag on economic growth with deleterious effects on the credit quality of bank lending activities.

With the DSB near the top end of the range, and the economy potentially entering a slowdown, members argued that there was insufficient justification to increase the DSB. Instead, they highlighted the conditions they would want to see before reducing the buffer. Broadly speaking, the two scenarios are: 1) when banks are, or seem set to, cut back on lending activity; or 2) when there are clear indications that current risks and vulnerabilities are on the wane. Although a scenario may emerge where the supply of credit begins to contract or lending conditions tighten unduly, members felt that neither of those conditions were imminent.

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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