Intelligence MEMOS

From: Mark Zelmer

To: Financial Sector Policy Makers and Prudential Regulators

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Re: **CHANGE IS AFOOT. PRUDENTIAL REGULATION MUST CHANGE**

Canada has not had a bank failure in over 30 years. But banking is changing, and so prudential regulation of deposit-taking institutions may need to change, too.

Bank runs can now cripple an institution in a matter of hours, not days. Deposit insurance can no longer be counted on to prevent such runs. And a very different regulatory environment has emerged in the wake of the global financial crisis. Last year's sudden collapse of Silicon Valley Bank in the US and the slower demise of Credit Suisse in Switzerland are examples of crises Canadian regulators might struggle to cope with if something similar happened here.

As banking evolves away from the system that existed in the last century, the risk of bank runs is likely to grow. Our current regulatory regime will likely struggle to remain fit for purpose. If we cannot prevent bank runs, we at least need to manage them so that an institution that has been hit and cannot recover on its own can be safely removed from the financial system without sending the whole economy into cardiac arrest. Allowing a deposit-taking institution more time to either weather a crisis or be safely removed is key. Options include making withdrawals from savings deposits subject to notice requirements that are routinely enforced and making it easier for stressed institutions to access emergency funds from the Bank of Canada in ways that don't stigmatize them.

The more confidence we have that stressed institutions won't cause serious collateral damage, the more we can tolerate future failures. That may open the door to placing more responsibility on boards of directors and management to run their institutions' own affairs.

There are several ways to move forward, ranging from minor adjustments, like raising deposit insurance limits or boosting liquidity requirements, to more radical options, such as separating the money creation and credit extension roles of our banks and credit unions. Funds they receive from deposits would have to be placed with the Bank of Canada or invested in government securities. To lend money to households and firms, they would have to borrow from financial markets.

Not surprisingly, trade-offs are involved. More radical options involving less intrusive regulation may well increase the cost of financial services as deposit-taking institutions would have to carry more liquid assets and rely on costlier sources of funds to support their lending. Less radical options, such as higher deposit insurance limits, would impose smaller costs on society but are less likely to prevent or help manage bank runs. They might even require more intrusive regulation, given the larger implicit government guarantees they would involve.

However we move forward, there are things regulators could do now to make it easier to manage institutions in distress. The Canada Deposit Insurance Corporation (CDIC) should make sure it can reimburse insured depositors quickly when a failing institution has to be closed. And the federal government, CDIC and OSFI should look at the resolution plans of the six major banks and consider whether structural changes to those institutions could make resolution more efficient. Credit Suisse's removal with government support was quite different from what had been envisioned in its resolution plan. Regulators also need to consider the implications for resolution when granting regulatory approvals and conducting day-to-day supervision of institutions.

Finally, policymakers should consider further reforms to the Bank of Canada's emergency liquidity facilities to make it easier for deposit-taking institutions to access them in times of stress.

Our financial system is undergoing profound changes. Institutional investors are extending credit and supplying equity capital to many firms. Households and firms are placing their savings in new types of investment funds. Open banking may accelerate this migration as fintech firms and other non-bank entities help Canadians conduct payments and manage their financial affairs outside the banking system.

It's certainly possible that the changes now taking place will result in a more resilient financial system that is less vulnerable to the destabilizing consequences of bank runs. But in case that doesn't happen, our regulatory agencies should pursue reforms that give them more time to deal with any financial institution that encounters trouble in the future. To paraphrase Machiavelli, the best time to prepare for war is in peacetime.

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