Council Recommends Keeping Stability Buffer at 3.5 Percent While Urging Major Banks to Stay Prepared

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

At its meeting on November 26th, 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 the domestic systemically important banks (D-SIBs)[1] at 3.5 percent at its next setting in December. The DSBC also emphasized the importance of D-SIBs preserving their strong capital positions.

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 Canada's financial system. The Council consists of Vivian Abdelmessih, Cathy Cranston, Jamey Hubbs, Peter Levitt, Duncan Munn, Mark Zelmer, and Chair Jeremy Kronick. Council members make recommendations for OSFI's upcoming DSB announcement. At this meeting, Cathy Cranston, Jamey Hubbs, Peter Levitt, Mark Zelmer, and Jeremy Kronick were in attendance.

Given the heightened uncertainties for Canada in the wake of the US election, there was a significant dispersion of views on several issues at this Council meeting compared to the previous two meetings. This led to more debate before reaching a consensus on the Council's final DSB recommendation.

The discussion began with a review of the risks that OSFI highlighted at its last announcement in June and how they have evolved since then. Among others, these risks include household indebtedness as mortgages renew, plus geopolitical risks in Ukraine and the Middle East and their potential impact on global growth and the future path of commodity prices.

Members commented that some concerns remain over mortgage renewals for households who took out mortgages in 2020 and 2021 at rates much lower than today's. But they acknowledged that these repricing concerns have dissipated somewhat with the reductions in the Bank of Canada overnight rate target – so far by 125 basis points.

1 D-SIBs refer to the six major banks in Canada: RBC, TD, Bank of Montreal, Scotiabank, CIBC, and National Bank.

Some members felt that relative to June, where OSFI left the DSB at 3.5 percent, there was not a significant increase in financial sector risks based on the evolution of the data we have available to us across the risks described above and given the performance of the economy and financial system more generally. Others felt that the problem with the publicly available data is they are often based on aggregate numbers that do not tell us the story at the tails – often where we find the most worrying risks. For example, while Canada's household sector debt service ratio was fairly stable between 2008 and the start of the pandemic in 2020, it has subsequently jumped from 12.6 percent to 15 percent with the rise in interest rates that accompanied the tightening of monetary policy after the pandemic. This increase may be challenging for those borrowers located in the more highly indebted tail of the distribution of those having to renew mortgages in 2025.

Geopolitical risk is another area where data averages might be hiding the relevant story for the Canadian economy. The geopolitical risk index[2] sits at a level today that does not differ much from where it was when the Council met prior to the June DSB announcement. However, for Canada, our risk is now concentrated on what will happen south of the border in 2025. In that respect, there is much to worry about. The group focused much of the discussion on the impacts of what a Trump presidency could mean for the Canadian and global economies, and what that would then imply for the financial sector and the countercyclical nature of the DSB.

More generally, the view from members was that even if we accepted the notion that risks to the financial sector had increased since June, the economy itself is sluggish, and any further restriction in lending that might result from an increase in the DSB could prove counterproductive. Unemployment has been on a mostly upward trend since the Bank of Canada started tightening monetary policy in March 2022. And while GDP growth has largely been positive during this period, GDP per capita has fallen in eight of the last nine quarters. While not a recession, it suggests a weak economy that has not kept pace with population growth – which is set to slow – and thus a weak starting point for increasing a buffer that is already close to its 4 percent maximum limit.

As mentioned, the group focused much of its attention on the risk stemming from President-elect Trump's stated plan to impose tariffs on all Canadian goods exported to the US – a plan that includes goods exported by some other countries as well. An increase in the price of Canadian goods that American consumers must pay would slow the latter's demand for our exports. Members noted that missing from our

2 See: Caldara, Dario and Matteo Iacoviello. 2022. "Measuring Geopolitical Risk," *American Economic Review*, 112(4), pp.1194-1225.

ability to assess the impact of these tariffs on the financial sector are data on the percent of assets carried by the D-SIBs that are exposed directly or indirectly to this proposed tax on Canadian goods. By the same token, the group lacks enough data to judge how exposed the D-SIBs would be to the economic shocks that would arise from a more global tariff war.

Some members expressed hope that given that trade is relatively balanced between our two countries, common sense would prevail. This relative balance in Canada's trade relationship differs from other countries that are much larger net exporters to the US – a situation President-elect Trump sees as a negative for American consumers and one of several reasons to impose tariffs. Other members cautioned that the incoming US Administration's tariff policies are designed to achieve a broader range of policy objectives. Thus, the price of avoiding tariffs may undermine the Canadian economy in other ways if Canada needs to commence much larger military spending or introduce more stringent border controls that impede the flow of goods and services between our two countries.

This leads to a broader point members emphasized: that there is both the bilateral impact of US tariffs on Canada and the global tit-for-tat tariff retaliations that will impact world trade, the world economy, and Canada's economy with it. Even if we withstand or avoid the worst of President-elect Trump's tariff threats in bilateral negotiations, the impact globally may affect our economy and financial sector.

Members concluded that the only options on the table were leaving the DSB at 3.5 percent or increasing it by either 25 or 50 basis points. The following summarizes the list of points in favour of increasing the DSB:

- Risks stemming from our largest trade partner's tariff threats are substantial and uncertain;
- Retaliation from other countries, most notably China, could have a significant effect on the global economy, and Canada will feel the ripples; and
- Tail risks might be fatter than averages would lead us to believe.

Similarly, the summary list of points in favour of leaving the buffer at 3.5 percent include:

- The buffer is already near its ceiling, and the major banks are comfortably above;
- The economy is at a weak starting point, and tightening policy runs the risk of unnecessarily slowing credit; and
- We've been through these trade fights in the past and came out the other side without a recession.

Members reached a consensus that the arguments in favour of leaving the buffer unchanged outweighed those in favour of an increase, given the buffer is already close to its maximum and that the risks may begin to crystallize fairly quickly after President Trump takes office in January 2025. But even if the buffer is left unchanged, all members agreed that the major banks should be encouraged to maintain their current strong capital positions to ensure that they are well-positioned to help Canadians and our businesses cope with the economic turbulence that may emerge from the US in the coming months.

Chair of the Council:

- **Jeremy Kronick**, Vice-President, Economic Analysis and Strategy, C.D. Howe Institute.

Members of the Council:

- **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,** Chair & CEO, Elevate Export Finance.
- **Mark Zelmer**, Senior Fellow, C.D. Howe Institute, Former Deputy Superintendent of Financial Institutions, OSFI.

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