The Bail-In: Or How You Could Lose Your Money in the Bank

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Buried in the Liberal Federal Budget that was introduced on March 22, 2016, under Chapter 8 – Tax Fairness and a Strong Financial Sector, was a section titled "Introducing a Bank Recapitalization 'Bail-in' Regime." Simply stated, in the unlikely event of a large bank failure, the Government proposed it would reinforce that bank shareholders and creditors are responsible for the bank's risks – not taxpayers.

What that means is that shareholders, bondholders and depositors, rather than taxpayers, are responsible for the bank's risks in the event of a failure. During the 2008 global financial crash, banks that were deemed "too-big-to-fail" were bailed out by the government, meaning the taxpayer footed the bill. None of the banks were Canadian banks, but it does need to be noted that Canadian banks received some $114 billion from Canada's federal government. This was against the background of Canadian banks being declared "the most sound banking system in the world." At the time, the government denied there was any bailout, preferring to use the term "liquidity support." To put the amount in perspective, $114 billion is roughly 7% of Canada's GDP.

The 2016 budget notes that in implementing a "bail-in" regime, it will strengthen the bank resolution toolkit in Canada and ensure Canadian banking practices are consistent with international best practices endorsed by the G20. Bail-in regimes are being instituted in the Western economies especially – in the EU, the USA, Japan, Australia and, of course, Canada. This isn't the first time that a bail-in has been introduced, as the previous government came forward with one in 2013, and in 2014 presented a consultation paper. Initially it was thought that depositors would be excluded.

Surprisingly, in the budget, depositors are not mentioned specifically. It should be noted, however, that depositors have paid a price in bail-ins that have already occurred in Cyprus and in Italy. So the risk to depositors cannot be ignored.

First of all let's dispel a myth surrounding bank accounts. Most Canadians hold their funds in chequing and savings accounts. These are known as "demand" deposits. Most people mistakenly believe that their monthly bank statements show them how much they own. Au contraire. They are in fact a statement of what the bank owes its clients.

Under Canada's fractional reserve system, the banks promise to keep some cash on hand in the event of withdrawals, but the reality is that they lend out the funds or use the funds to purchase assets or incorporate into their global trading operations. The funds on deposit are no longer the property of the depositor. Instead the depositor becomes an unsecured creditor or lender to the bank. Banks pay you interest, but their real purpose is to use your funds to earn a spread. They put your funds at risk in the global markets through lending, syndication and trading.

If things do go wrong, depositors get nervous and run to the bank to withdraw their funds. This is known as a "bank-run." A "bank holiday" could also be declared in the event of a massive bank-run. What happens, essentially, is that the bank closes its doors and the ATM machines. This happened during the Great Depression, and also happened most recently in Cyprus. Effectively what happens with a bank holiday is that the bank bails itself in. And even that was insufficient to save many banks in the Great Depression and in Cyprus.

Canada does have an insurance safety net to protect depositors from bank failures. In 1967 Parliament created the Canadian Deposit Insurance Corporation (CDIC). The CDIC is a federal crown corporation similar to the Federal Deposit Insurance Corporation (FDIC) in the US. The CDIC is charged with maintaining public confidence in Canada's financial system.

It pays to know which financial institutions are covered and which ones are not. Most Canadian banks, loan companies and trust companies are CDIC members. Some banks and credit unions, and foreign banks that have branches in Canada, are not covered. Check the CDIC's website if you are unsure www.cdic.ca.

The CDIC covers up to $100,000 in deposits. That could include individual accounts, joint accounts, trust accounts and bank savings in a registered retirement savings plan (RRSP), registered retirement income funds (RIFs) and savings to pay realty tax on mortgage payments. Diversifying accounts among financial institutions helps ensure as wide a coverage as possible.

Eligible products include chequing and savings accounts, guaranteed investment certificates (GICs) and term deposits that mature fewer than five years from date of purchase, money orders and drafts, certified cheques and traveler's cheques. It doesn't cover foreign currency accounts, GICs that mature more than five years from date of purchase, government bonds, treasury bills, mortgage backed securities (MBS), stocks, mutual funds and gold certificates issued by a Canadian bank. Note that it covers deposits only in Canadian dollars.

Canada does not have an extensive history of bank failures, not even during the Great Depression. Banks or financial institutions tend to be merged or taken over, even ones that could be on the verge of failure. The last failures were Northland Bank and Canadian Commercial Bank in 1985. Prior to that, the last one was Home Bank in 1923. Confederation Life Insurance Co. (CLIC) collapsed in 1994, but that was an insurance company.

Canadian banks are generally well rated, but they are not what one would call AAA. The following are the credit ratings of Canada's banks (Standard & Poor's):

Toronto-Dominion Bank (TD) – AA-
Royal Bank of Canada (RBC) – AA-
Bank of Nova Scotia (BNS) – A+
Canadian Imperial Bank of Commerce (CIBC) – A+
Bank of Montreal (BMO) – A+
National Bank of Canada (NBC) – A
Caisse centrale Desjardins (Caisse) – A+
Laurentian Bank of Canada (Laurentian) – BBB
Canada Western Bank (CWB) – Not rated

Canadian banks are regulated by the Office of the Superintendent of Financial Institutions (OSFI), which regulates and supervises not only banks but also trust and loan companies, insurance companies, cooperative

credit associations, fraternal benefit societies, and private pension plans. The OSFI does not regulate the securities industry or the mutual fund industry. The OSFI reports to Parliament through the Minister of Finance.

Those at risk of a bail-in in the event of a failure are subordinated debt holders, bondholders, preferred shareholders and any accounts in excess of $100,000 not covered by CDIC insurance. Their bonds, preferred shares, deposits etc. would be converted to capital to re-capitalize the banks. According to the financial statements of the CDIC, they insured some 30% of total deposit liabilities, or $684 billion, as of April 30, 2014. The remaining 70% not insured would primarily be large depositors, including both large and small businesses, and other banks and financial institutions.

Depositors can avoid problems in a bail-in regime, but to do so they must be aware of the rules and have taken steps to ensure the safety of their funds. The bail-in regime would only apply to eligible Canadian banks and financial institutions. As was noted, it would not cover brokerage accounts, pension funds and mutual funds.

Some steps that an investor might take: diversify savings across banks and even countries; look carefully at the health of your bank or financial institution; own assets outright and reduce or avoid risk to custodians and trustees; avoid investments where there is significant counterparty risk, such as exchange-traded funds (ETFs) or structured products; avoid banks with large derivative or mortgage books; and be aware of your bank's or financial institution's credit. Finally, it would be wise to own physical gold in fully allocated accounts where you are the owner. Gold, unlike banks, has no liability.

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