FISCAL POLICY TRENDS

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BANK RUNS CAN OCCUR IN UNCERTAIN TIMES, INCLUDING DURING A PANDEMIC, BUT THEY ARE NOT LIKELY—ESPECIALLY IN CANADA

In times of elevated uncertainty and stress, people tend to panic and engage in stockpiling, a behaviour that is amplified by the fear of missing out. Some rush to supermarkets to accumulate toilet paper and non-perishable items, while others rush to the bank and withdraw large amounts of cash. During economic downturns, some might lose faith in their financial institution, and this fear of losing savings can lead to a run on banks.

A bank run occurs when a large number of customers of a bank or other financial institution simultaneously withdraw their deposits over concerns that the financial institution may collapse.

Rumours, which can lead to a fear of losing savings, are a key precursor to bank runs. During economic downturns in particular, rumours about potential bank insolvency or illiquidity are adequate to trigger a bank run. Once individuals believe that their bank might be failing, panic withdrawals can lead to the collapse of their bank. For example, in 2017 a bank run occurred on Canada's Home Capital Group (HCG) upon rumours that it had been issuing 'liar loans.' Even fake social media rumours can lead to bank runs, as happened in the United Kingdom in 2019, when rumours about financial health led to a bank run and long queues at branches of Metro Bank.

Though driven by concerns of the bank collapsing, the bank run itself is what leads to the collapse of the bank. This is because banks keep a small fraction of deposits as reserves, using the rest to provide loans and purchase bonds. In Canada, most banks hold less than 1% of their deposits in reserve, meaning that they do not hold enough reserves to meet an instantaneous withdrawal of all deposits. In the event of a massive withdrawal of cash within a short time frame, banks have to look for other sources of cash, such as selling their bonds or borrowing from other banks or the Bank of Canada. However, during crisis times, these options may be insufficient, as bonds are sold at a discount and other financial institutions might be reluctant to lend to an institution in financial distress. This leads to the failure of the bank.

While bank failures were more frequent in Canada between 1980–1996—a period during which there were 41 bank failures—the last bank failure in Canada occurred 24 years ago, when the Security Home Mortgage Corporation collapsed in 1996. However, since 1967 Canadian deposits have been protected to some degree in the event of such bank failures to ensure depositor confidence in the banking system and to prevent bank runs.

The Canadian Deposit Insurance Corporation (CDIC) currently protects each chequing and savings account of up to $100,000. Additionally, CDIC separately protects deposits in six additional categories: RRSPs, RRIFs, TFSAs, trusts, Mortgage Property Tax accounts, and joint deposit accounts. In addition, an individual can be protected for up to $100,000 in each of these categories for a total of $700,000. This protection applies to each of the 86 CDIC-member financial institutions. On April 30, 2020, the coverage under some of these categories will expand to include deposits in foreign currencies.

Given the COVID-19 pandemic, should Canadians worry about a bank run?

In the age of electronic banking and social distancing due to COVID-19, people might actually withdraw less than they did in previous crises. Social distancing is discouraging some individuals from lining up outside a bank branch or an ATM to withdraw cash. Additionally, there is already a shift away from using physical forms of money due to concerns of spreading the virus. Many customers have already switched to online purchases using credit cards, while those who continue with in-person purchases often use contactless forms of payment. While physical distancing and reduced bank hours might restrict the withdrawal of physical forms of money, bank runs are still possible as individuals can withdraw money electronically. This puts some banks at risk.

What can we do to minimize the risk of bank runs?

Elevated uncertainty and fears about the state of the economy could trigger bank runs. To prevent this from happening, rumours should be dispelled by the government and economic policy groups, individuals should be informed of the benefits of banking with CDIC institutions, and the Bank of Canada should continue to provide short-term loans to banks. Finally, individuals can protect their savings—even those in excess of $100,000—by spreading funds across multiple bank accounts or banking with multiple CDIC institutions.

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