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# WEALTH *builder*

## GLOBAL PORTFOLIO EDGES UP

*By Gordon Pape, Editor and Publisher*

When you invest in a portfolio of ETFs, you're at the mercy of the markets. When they go up, you win. When they drop, you lose. There's no escape.

Our Global Portfolio, which invests entirely in mainstream ETFs, was hammered in the first part of 2022, as stock prices plunged in the face of high inflation and rapidly rising interest rates. We did better in the September-March period. The gain wasn't big, but at least it was on the plus side of the ledger.

This portfolio was launched in March 2012. It is designed to provide an international model for growth-oriented investors, with the diversification and low costs that ETFs offer. The target annual rate of return is 8-10%. The portfolio invests in eight domestic, American, and international ETFs, covering all parts of the globe. Investors should only track this portfolio if they are willing to accept stock market risk. As we've seen that risk has been significant recently.

On page 2 we'll look at how our ETFs have performed since the last update in September. Results are as of March 23.

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**iShares Core S&P/TSX Capped Composite Index ETF (TSX: XIC).**

This ETF tracks the performance of the S&P/TSX Composite Index. The TSX held its ground over the past six months, so we experienced a drop of only \$0.40 per unit. That was more than offset by three distributions for a total of \$0.759 per unit, so we came away with a slight gain for the period.

**iShares S&P/TSX Small Cap Index ETF (TSX: XCS).** This ETF tracks Canadian small cap stocks. This sector of the market was marginally higher in the recent period and the units gained \$0.48 — not a lot but on the plus side. Because of timing, we received three quarterly distributions that totaled \$0.224 per unit.

**iShares US Small Cap Index ETF (CAD-Hedged) (TSX: XSU).** US small cap stocks continued to retreat in the latest period. The units were down \$2.43 or 6.7%. We received a semi-annual distribution in December of \$0.293 per unit.

**iShares Core S&P 500 Index ETF (CAD-Hedged) (TSX: XSP).**

This ETF tracks the performance of the S&P 500. This ETF posted a small gain of \$0.18 during the period. We received a year-end distribution of \$0.325 per unit.

**BMO Nasdaq 100 Equity Hedged to CAD Index ETF (TSX: ZQQ).**

This fund provides exposure to the top 100 stocks on the Nasdaq exchange. After a terrible first half in 2022, this fund staged a modest rally, and the units are up \$4.91 (5.7%) since the last review. We received a year-end distribution of \$0.35 per unit.

**iShares MSCI EAFE Index ETF (CAD-Hedged) (TSX: XIN).** This ETF tracks markets in Europe, Australasia, and the Far East. Despite the problems in China, the stock markets in those countries posted positive returns during the period and these units gained \$2.09. We received a semi-annual distribution of \$0.102 per unit in December.

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**iShares MSCI Frontier 100 ETF (NYSE: FM).** This ETF holds major companies in Third World countries from Nigeria to Vietnam. These markets have been in a prolonged slump and the units are down US\$1.76 (6.6%) since the last review. We received a year-end distribution of US\$0.08 per unit in December.

**iShares MSCI Emerging Markets ETF (NYSE: EEM).** After a long losing streak, emerging markets managed a small gain of \$0.63 per unit in the latest six-month period. We received a nice year-end distribution of US\$0.584 per unit.

We received \$13.41 in interest from the cash balance in our Saven Financial high-interest savings account.

Here's a look at how the portfolio stood at day's end on March 23. The Canadian and US dollars are treated at par, and commissions are not considered. The percentage in the Gain/Loss column

represents the cumulative return since the portfolio was launched or since the security was added. The initial book value was \$20,002.30.

### IWB Global Portfolio (a/o March 23/23)

| Security  | Weight | Total Shares | Average Price | Book Value  | Current Price | Market Value | Retained Income | Gain/Loss % |
|-----------|--------|--------------|---------------|-------------|---------------|--------------|-----------------|-------------|
| XIC       | 19.4   | 290          | \$22.34       | \$6,479.95  | \$30.87       | \$8,952.30   | \$432.99        | +44.8       |
| XCS       | 6.4    | 165          | \$16.23       | \$2,677.90  | \$17.86       | \$2,946.90   | \$101.62        | +12.4       |
| XSU       | 13.6   | 185          | \$17.96       | \$3,527.35  | \$33.79       | \$6,251.15   | \$123.33        | +80.7       |
| XSP       | 20.9   | 230          | \$18.29       | \$4,206.10  | \$41.94       | \$9,646.20   | \$102.98        | +131.8      |
| ZQQ       | 21.7   | 110          | \$21.44       | \$2,358.40  | \$90.68       | \$9,974.80   | \$280.06        | +334.8      |
| XIN       | 11.0   | 170          | \$21.76       | \$3,698.75  | \$29.84       | \$5,072.80   | \$66.33         | +38.9       |
| FM        | 2.2    | 40           | \$35.18       | \$1,407.25  | \$24.84       | \$993.60     | \$35.88         | -26.5       |
| EEM       | 4.6    | 55           | \$43.29       | \$2,381.20  | \$38.77       | \$2,132.35   | \$73.50         | -7.4        |
| Cash      | 0.2    |              |               | \$73.38     |               | \$86.79      |                 |             |
| Total     | 100.0  |              |               | \$26,810.28 |               | \$46,056.89  | \$1,216.69      | +74.7       |
| Inception |        |              |               | \$20,002.30 |               |              |                 | +136.3      |

**Comments:** We experienced a modest recovery from the beating we took in the previous six-month period. The total value of the portfolio as of March 23 was \$47,273.58, up about 2% from the November review. Nasdaq (ZQQ) was our best performer during the period, with a 5.7% gain in the unit price.

As a result, our cumulative gain since inception improved to 136.3%. That works out to a compound average annual growth rate of 8.04%. That's at the bottom end of our original target range.

**Changes:** Despite weakness in world equity markets, this portfolio continues to offer excellent diversification and geographic coverage. We will not replace any components at this time.

We have a little money to reinvest so we'll add to two positions.

XIC – We will buy 10 units at \$30.87, for an outlay of \$308.70. We now own 300 units, with retained earnings of \$124.29.

XCS – We'll buy five units at \$17.89, for a cost of \$89.30. We now own 170 units, with \$12.32 left in the reserve fund.

All else remains the same.

We have cash and retained income of \$905.48. Several banks have high-yield interest offers right now, some quite complicated. The best we could find was 4.65% on a Scotiabank Momentum Plus savings account, so we'll put the money there. Here is the revised portfolio. I will review it again in September.

## IWB Global Portfolio (revised Mar. 23/23)

| Security  | Weight | Total Shares | Average Price | Book Value  | Current Price | Market Value | Retained Income |
|-----------|--------|--------------|---------------|-------------|---------------|--------------|-----------------|
| XIC       | 19.9   | 300          | \$22.63       | \$6,788.65  | \$30.87       | \$9,261.00   | \$124.29        |
| XCS       | 6.5    | 170          | \$16.28       | \$2,767.20  | \$17.86       | \$3,036.20   | \$12.32         |
| XSU       | 13.5   | 185          | \$17.96       | \$3,527.35  | \$33.79       | \$6,251.15   | \$123.33        |
| XSP       | 20.8   | 230          | \$18.29       | \$4,206.10  | \$41.94       | \$9,646.20   | \$102.98        |
| ZQQ       | 21.5   | 110          | \$21.44       | \$2,358.40  | \$90.68       | \$9,974.80   | \$280.06        |
| XIN       | 10.9   | 170          | \$21.76       | \$3,698.75  | \$29.84       | \$5,072.80   | \$66.33         |
| FM        | 2.1    | 40           | \$35.18       | \$1,407.25  | \$24.84       | \$993.60     | \$35.88         |
| EEM       | 4.6    | 55           | \$43.29       | \$2,381.20  | \$38.77       | \$2,132.35   | \$73.50         |
| Cash      | 0.2    |              |               | \$86.79     |               | \$86.79      |                 |
| Total     | 100.0  |              |               | \$27,221.69 |               | \$46,454.89  | \$818.69        |
| Inception |        |              |               | \$20,002.30 |               |              |                 |

# CANARIES IN THE COAL MINE

**By Richard N. Croft, Associate  
Publisher**

We all knew that aggressive interest rate hikes would eventually break something. The first shoe dropped on March 10-11, when the Federal Deposit Insurance Corporation (FDIC) took control of two insolvent commercial banks: Silicon Valley Bank (SVB) and Signature Bank (SBNY). These were the second and third largest bank failures since Washington Mutual collapsed in 2008.

The Silicon Valley Bank is a subsidiary of SVB Financial Group (NDQ: SIVB). SIVB is a financial services and bank holding company that operates through four main subsidiaries: Silicon Valley Bank (commercial lending), SVB Private (wealth management), SVB Capital (funds management), and SVB Securities (investment banking).

## Signature Bank

Signature Bank was founded in 2001 and catered to privately held businesses, their owners, and executive teams. It was a major lender to New York City apartment owners and clients included the Trump organization and Mr. Trump's son-in-law, Jerrod Kushner and his family. Ivanka Trump was a member of SBNY's board until her father ran for President in 2015. Another famous board member was Democratic congressman Barney Frank, who co-authored the 2010 Dodd-Frank Act that overhauled regulations across the banking industry.

SBNY was also the go-to bank for many crypto currency businesses and became the first FDIC insured bank to offer a blockchain-based digital payment system. In 2021, SBNY's deposit base expanded by 67%, with the bulk of new deposits coming from the crypto industry. When FTX crashed and eventually declared bankruptcy, SBNY began pulling away from the crypto space. In 2022 SBNY's deposit base shrank by US\$17 billion as crypto businesses sought alternative custodians such as Silverlake Capital that, in a twist of fate, also declared bankruptcy this month.

The failure of these institutions can be traced back to a misalignment of assets and liabilities during a period when central banks were raising interest rates at an unprecedented pace. Rule number one in the banking industry is to always match your assets (loan portfolio) to your liabilities (deposit base).

On a broader scale, these failures represent the unintended consequences of narrowly focused central bank policy. While the inflation reduction strategy is admirable, the aggressive approach may have gone too far too quickly. What seems clear is these failures signify a seminal moment, not only because of their size, but because they demonstrate that aggressive rate hikes are having the desired, albeit painful, effect on the financial system.

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The fallout is being felt most among US regional banks as contagion fears caused market values to plummet. Even the thirty largest US money centre financial institutions and the Big Six Canadian banks were not immune to the fear-induced sell-off.

Before letting fear guide your decision-making processes, take a moment to examine the timeline that created the perfect storm and weigh any potential macro-economic repercussions.

**The tech problem**

As central banks were aggressively raising interest rates, the pain was most acute among tech startups and crypto businesses that need to raise capital to finance their cash burns. SVB was a dominant lender for innovative disruptors.

The typical trajectory for a tech startup is to spend aggressively in search of customers who can provide a real-world beta test to validate the new technology. SVB, and other banks who understood this visionary spirit, would lend money to startups collateralized by the firm's private equity that, hopefully, would appreciate when the tech company went public via an initial public offering.

The business models began to fall apart when financing costs went ballistic. The surge in rates made it too costly for venture firms to add layers of capital and challenged the cost-benefit analysis for SVB. By mid-2022, SVB was no longer willing to capitalize startups through loans collateralized by the private equity

of an unprofitable company.

It was a similar story with SBNY, as loans it made to crypto businesses were no longer tenable given the higher cost of money. It was also more difficult to finance residential construction projects as real estate values were declining and cash flow metrics were more difficult to sustain.

The bank's core business relationships may have been the unstable TNT. What lit the fuse was their sizeable, albeit thin, deposit bases. As loans to their core clients became untenable, the banks decided to invest their deposits in a portfolio of available for sale (AFS) securities made up mostly of short-, mid-, and long-term US Treasuries that yielded less than prevailing rates. As rates began to rise, it caused the value of the AFS portfolios to decline. That is not a problem if the bank holds the portfolio to maturity. When depositors began to withdraw massive amounts of money, holding to maturity was no longer an option.

And so, the back end of the hurricane begins to take shape. With the lack of available funding from venture capital firms and the banks, tech startups and crypto businesses began withdrawing funds from their operating bank accounts (a significant portion of which was held at these institutions). SVB and SBNY had to sell their AFS portfolios at a discount to manage the liquidity crunch. It came to a head on Wednesday March 8 when SVB stated that it intended to raise capital by issuing US\$2.25 billion in common equity and convertible preferred shares to shore up its balance sheet.

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SVB CEO Gregory Becker urged clients to “stay calm” amid concerns about the bank’s financial position. Mr. Becker added that the bank had “ample liquidity to support our clients with one exception: If everyone is telling each other SVB is in trouble that would be a challenge.”

And therein lies the rub. At the time SIVB was experiencing losses across all its business units. Investment banking had ground to a halt, commercial lending to startups burning cash to support growth was untenable and concerned FSB depositors were demanding their money.

The “shore-up-the-balance-sheet” rhetoric lit the fuse that prompted many VC firms, notably Peter Thiel’s Founders Fund, to move money out of the bank while at the same time, encouraging other VCs to do the same. The resulting tsunami of withdrawals was the worst case that Mr. Becker was trying to avoid. That these institutions were unable to placate their deposit base was rooted in the position that a bank’s business model is predicated on trust and confidence, not on net interest margins.

As with all banks, deposit accounts are guaranteed up to US \$250,000 by the FDIC. The problem with SVB and SBNY is that an inordinate number of deposit accounts held more than the FDIC insured limits. That created the run on the bank as depositors demanded their money, which ultimately led to a similar run on SBNY.

The shares of both companies collapsed on Thursday March 9 and contagion fears

caused a rush to the exits across the entire banking sector. When the markets opened on Friday March 10, trading in SIVB and SBNY shares was halted. The FDIC took control shortly after.

Because neither bank is a systemically important financial institution (SIFI), the US Treasury Department made it clear it will not provide a bail out. A SIFI bank is one in which US federal regulators determine would pose serious risk to the economy and as such, is “too-big-to-fail.”

However, in an unprecedented move, the FDIC decided to guarantee the total value of all deposits held at SVB and SBNY. Considering that the bulk of deposits held at both institutions was well above the US\$250,000 FDIC insured limits, that was a significant decision that may have unintended consequences down the road. But in this case, it allowed tech startups and crypto businesses to meet payrolls and hopefully, calmed markets and prevented further bank runs.

**Contagion fears**

We’ve already seen one example of how failures in a couple of relatively small US banks can have an impact on the global financial system.

Credit Suisse (CS) was the poster child of a SIFI bank that was simply too big to fail. In the case of CS, the problems pre-dated the rising interest rate environment. CS was an aggressive bank by Swiss standards and over time was embroiled in fraud and mismanagement allegations that eventually caused a US style bank run.

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CS depositors were made whole after Swiss regulators arranged the sale of the bank's assets to Union Bank of Switzerland (UBS). The sale was consummated at pennies on the dollar, including a significant write down of the bank's bonds. That led to a class action lawsuit by CS bondholders. That will play out in time, but from our perspective, the unwinding of CS is the blueprint for how regulators will deal with the fallout should any contagion spread to SIFI banks.

The main question haunting investors is whether SVB and SBNY were unique outliers because their loan portfolio was concentrated in specific sectors and financed by an outsized uninsured deposit base. That's very different from traditional banking models, where loans are spread across many sectors and are financed by a large base of smaller deposits well below the US\$250,000 insured limit.

Notwithstanding the differences, contagion fears prompted a sell-off in the thirty SIFI banks, which caused Morgan Stanley analyst Manan Gosalia to issue a statement that "we (Morgan Stanley) do not believe there is a liquidity crunch facing the banking industry, and most banks in our coverage have ample access to liquidity." Gosalia added that the downward spiral in SVB and SBNY is "highly idiosyncratic and should not be viewed as a read-across to other banks."

My concern is that these comments sound a lot like what we heard from analysts after Bear Stearns collapsed in 2008. And being mindful of the trust and confidence

sentiment that permeates through the financial sector, I suspect that depositors – particularly large depositors – will re-examine their relationship with a smaller bank and many will opt to move their funds to a larger institution. I suspect that trend is underway, which is wreaking fallout across smaller regional banks. Feeling the sharp edge of the knife, First Republic Bank of San Francisco (FRC) was the first to start bleeding, losing 80% of its market value in a day. We also witnessed after-shocks impact other names such as PacWest Bancorp (a 30%+ decline) and a 50% sell-off in Western Alliance Bancorp.

Ten of the largest money centre banks have attempted to stem this tide of redemptions by adding US\$30 billion in liquidity to FRC rather than stepping up and buying the bank, as occurred during the financial crisis. Buying a weak bank has its own challenges.

In the aftermath of the financial crisis, the buyouts of Bear Stearns and Merrill Lynch took years to assimilate into JP Morgan's and Bank of America's risk models. So far, the results of the FRC liquidity infusion have been mixed and has resulted in an enhanced level of volatility across all sectors. Make no mistake, fear is a fickle emotion, and strategies that are meant to assuage anxiety can add to the problem.

Despite the initial selling, I think a broader contagion is unlikely, although smaller banks that are disproportionately tied to cash-strapped industries like tech and crypto will be challenged. I see little risk

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to the thirty largest SIFI banks and the Big Six Canadian banks as they are well capitalized – more than was the case during the financial crisis – and any significant threat to their business model is tied more to housing, which tends to be supported by long term mortgage commitments supported by a broad insured depositor base.

**The macro-impact**

Clearly these failures denote a watershed moment for tech startups. New business models will be difficult to finance, venture capital firms will be more reluctant to invest, and many tech companies on the bubble will fail. That means more job losses in Silicon Valley and New York, limited development of new disruptive technologies, and widespread carnage across the tech sector.

Tech giants (i.e., Microsoft, Apple, Amazon, Meta, Alphabet, and Netflix) should benefit from the carnage as they can make investments in new technology that can be easily assimilated into their business models. However, the investment thesis of the big names will be propelled by profitability, which is very different from the way venture capitalists empower startups.

On a macro-economic level, I think the fallout will have an impact on the future direction of interest rates. Last week, the US Federal Reserve raised rates again by 0.25%, but that may be the end. It's likely the Fed will pause after that hike, which is in stark contrast to pre-SVB projections. A pause may mark the beginning of a Fed pivot.

That is most likely why the financial markets, despite the volatility, have not collapsed, as traders weigh the impact of a Fed pause/pivot on the economy. It may be that the pain inflicted by SVB, SBNY, and the potential fallout from FRC will ameliorate the hawkish tone that has permeated the thinking of central bankers.

Time will tell!

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## MEMBERS' CORNER **Deposit insurance**

**Member comment:** Hear, hear! It's about time the limits were increased! In fact, beyond the time! What can an individual like me do to increase the chance of that happening? – Bill M., Vancouver, BC

**Response:** If there's no change in the upcoming budget, send an email or letter to your MP expressing your view. A copy to the Minister of Finance wouldn't hurt. – G.P.

# INVESTING IN A CHALLENGING MARKET

**By Richard N. Croft**

Getting to an appropriate investment thesis in the middle of so many cross currents is a challenge.

We will likely see continued pressure in the financial sector. I would not exit positions in Canadian banks or the US money centre banks. If anything, I suspect these institutions will get bigger and stronger, not weaker and at risk of a financial meltdown.

The Canadian banks that have a significant US presence (CIBC, TD, BMO) should benefit when the financial sector stabilizes. It is a question of when. Moreover, TD must decide whether to proceed with its delayed US\$13.4 billion acquisition of First Horizon Bank (NYSE: FHN), based in the US southeast. TD offered US\$25 a share for the regional bank but last week the shares dipped as low as US\$13.40 before closing on Friday at US\$16.76. As things stand right now, the deal will terminate if it doesn't close by late May.

Other Canadian banks may be in a position – much like they were after the financial crisis – to buy up smaller US regional banks at bargain basement prices should regulators need to find a white knight. But TD's experience with First Horizon will prompt them to look long and hard at any possible deal.

I expect negative sentiment will act as a drag on bank stocks until we have a clear signal of a Fed pivot, which some

suggest may have occurred at Wednesday's Federal Open Market Committee (FOMC) meeting. According to Fed Chair Jerome Powell, committee members saw some improvement on the inflation front although the impact across sectors has been disproportionate. Members noted a slowdown in the housing sector as a result of higher mortgage rates but saw no discernable impact in the service sectors, which represents 70% of the US consumption.

Coming full circle, I think we may have seen the beginning of the end of rate hikes. At a minimum, I suspect the Fed will pause at the next FOMC meeting. There are two reasons for this.

- Committee members will want to assess the impact of previous rate hikes in terms of its recessionary impact.
- The volatility in the financial sector is limiting the risk appetite for bank executives, which means less lending. That should slow economic expansion. If that is the end result, the Fed may be able to stand on the sidelines and let the invisible hand of capitalism take control of the economy.

It is probably too early to take aggressive new positions in money centre banks. If you are looking for an entry point, keep a close eye on the yield curve. When it begins to

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normalize, financials will spring to life. Make no mistake, when financials turn positive, they produce outsized gains for shareholders. Upside performance in the 80% to 120% range is not out of the question.

Another consideration in the current environment is to consider some of the FAANG names that have been out of favor for the better part of a year. High growth, well-capitalized technology companies should do well in a Fed pause scenario.

Many of the tech giants have already begun right-sizing their labor force, which should show in their bottom lines. They are also immune to interest rate increases because they have an inordinate amount of cash on their balance sheets. Also, they are in the best position to weather a deep recession. That's not my base case, but there is never anything wrong with having some insurance against catastrophes.

Returning to the banks, one strategy is to use limit orders to buy bank stocks at entry points below current prices. The challenge with this approach is that you could get a serious drawdown in equity valuations – an all too often occurrence in the current environment – which would cause your limit order to be executed. which limits your ability to time the purchase. There is also the possibility that the order never gets executed, which would leave you on the sidelines if the eventual rally unfolds later in the year or in 2024.

As an alternative, you could consider selling long-dated put options on a couple

of Canadian banks with significant US exposure. When you sell a put option, you are committing to buy shares of the underlying bank at the strike price of the put. Think of the put sale as a limit order that provides you a fee to compensate you for committing to the purchase. Another consideration is that the premium received when the put is sold can be used to reduce the cost of buying the shares if the put is eventually executed.

Here is a specific recommendation. Prices as of March 22.

## **Sell Toronto Dominion December 80 puts at \$6.20. Current price of TD: \$78.75**

The sale of one TD December 80 put obligates you to buy 100 shares of TD at \$80 per share until the option expires on December 15<sup>th</sup>, 2023. Of course, you can buy back the short put option at any time prior to expiration, which would eliminate the obligation.

At the Dec. 15, expiration, one of two scenarios will unfold:

- If TD is trading above \$80, the option expires worthless. You would retain the \$6.20 per share premium and the obligation would cease to exist.
- If TD is trading below the \$80 strike price at expiration, you would be required to buy 100 shares at the \$80 per share price. You retain the original premium received which reduces your out-of-pocket cost for the shares to \$73.80 (\$80 strike less \$6.20 premium = \$73.80) per share.

# YOUR VIEW: CDIC COVERAGE

As a follow-up to last week's column on deposit insurance, we asked my followers on social media what their views were on the subject.

This was an informal poll, so the results aren't statistically reliable. But they are a reflection of what some people are thinking.

The question was: Should CDIC coverage be raised from the current \$100,000 per eligible account?

Here are the responses.

- Yes, with no limit – 25.5%
- Yes, to \$250,000 – 52.9%
- No, keep as is – 13.7%
- No, it's not needed – 5.9%

I wasn't surprised by the fact that over 78% of respondents favoured an increase in the current maximum protection. What did surprise me was that almost 6% felt we don't need deposit insurance at all. What do you suppose would have happened after the failure of Silicon Valley Bank if there had been no insurance in the US? Believe me, it would not have been pretty. – G.P.

## PRO'S POSTS CDIC

**Pro's comment:** I read your article on CDIC insurance coverage. Great article and very timely as it's my understanding CDIC is exploring an increase to \$200,000 with its members.

Back in the day, I was the lead instigator of the last call for an increase in deposit insurance from the then \$60,000 to the present \$100,000.

One point to consider for your continuing research is that the CDIC returns a portion of the premiums if a bank is in good standing within a certain time period. In the case of a shortfall, CDIC has the capacity to call upon the government for substantial funding. Simplistically, that's because the government has the capacity to tax us all. – David Newman, FiscalAgents.com, Oakville ON

**Response:** I'd prefer an even higher threshold, but I'll take an increase to \$200,000 if it's offered. We'll see if there's anything in the budget. – G.P.