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The Boundaries of Bank Funding: The Case of Canadian Cash ETFs

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Abstract

Banking regulations set the boundaries of bank funding. They can also shape the asset-management landscape in an underappreciated way. We document that banking regulations push asset managers' liquid holdings away from bank savings accounts and toward money market assets.

The case of Canadian HISA ETFs illustrates the mechanism. Launched in 2013, these ETFs invested in high-interest savings accounts. When policy rates rose sharply after the pandemic, HISA ETFs became a surprisingly effective way for households and institutions to earn a deposit-like asset with competitive returns. Funds poured in.

Then, in late 2023, OSFI affirmed how banks under Basel III must treat deposits from ETFs like they treat those of other asset managers. The result is a clean quasi-experiment. Banks with HISA ETF deposits lowered their yields that they offer, and HISA ETFs responded by moving holdings toward money market securities.

We describe what HISA ETFs do, their quick expansion, the regulatory concerns behind OSFI's stance, and how regulations ultimately shifted HISA ETFs into holding money market securities. This episode highlights that banking regulations ensure the sound liquidity of banks, but it also highlights broader implications for the liquidity management decisions of other financial institutions.

Topics: Financial system - Financial institutions and intermediation; Financial markets and funds management - Funds management
JEL codes: G23, G28, G2, G18, G11, E44

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Résumé

Sujets : Système financier – Institutions financières et intermédiation financière; Marchés financiers et gestion de fonds – Gestion de fonds
Codes JEL : G23, G28, G2, G18, G11, E44

Introduction

In the span of just a few months, one of the fastest-growing investment products in Canada flipped from attracting billions in new cash to posting sustained outflows. High-interest savings account exchange-traded funds (HISA ETFs) grew rapidly in Canada after the pandemic, offering investors a straightforward way to hold cash-like assets that earned competitive yields in the most convenient way. By 2023, they had become a prominent share of ETF inflows, reflecting both abundant household savings and the sharp rise in interest rates. Their appeal was simple: they offered relatively high interest rates and, unlike retail savings accounts, HISA ETFs could be bought and sold on exchange at low cost, making them an efficient parking spot for cash.

That changed in late 2023 when the Office of the Superintendent of Financial Institutions (OSFI) clarified that deposits from HISA ETFs should be treated by banks as wholesale funding under Basel III liquidity rules. This adjustment had immediate consequences. Because banks would have to assume these deposits vanish entirely in a stress event, they became less attractive as a way to fund the profitable lending activities at the heart of banks' businesses. Banks lowered the interest rates offered on HISA ETF deposits, and the yield advantage that had driven investors' demand quickly eroded.

The timing and design of this policy shift are important beyond the story about one product. This shift offers a clear quasi-experiment in how a regulation designed to foster commercial banks' safety can reshape financial markets. With no change in investor preferences or interest rates, flows shifted sharply after the regulatory environment changed. Investors moved away from deposit-based ETFs toward money market and government bill funds, which offered comparable access and liquidity but now offered higher yields. Under the competitive pressure from these other funds, the HISA ETFs themselves then turned to holding less money market securities. HISA ETFs continue to exist to this day, but they now more closely resemble other money market mutual funds.

The divergence in assets under management before and after the rule change underscores how powerfully the regulatory design can redirect savings between banks and securities markets. Perhaps unsurprisingly, the evidence shows that banking regulations can be effective at safeguarding liquidity of the banking system. But the events also help understand why money market securities dominate the liquidity pool of asset managers, instead of banks deposits, even though securities are less liquid than deposits with banks. Ultimately, the banking regulations that are sound for banks have effects on the broader financial system.

This note traces the rise of HISA ETFs, explains why regulators stepped in, and shows how the episode illuminates the broader role of Basel III liquidity rules in shaping the

competition between traditional bank deposits and money market securities. In doing so, it highlights how a regulatory classification that enhances banks' safety can ripple through funding models and investment choices of asset managers.

The Rise of HISA ETFs in Canada

HISA ETFs blend features of a high-interest saving account (HISA) at a bank with the structure of exchange-traded funds (ETF). This made them a competitive investment vehicle. Investment flows toward this type of funds surged during 2021–23 and HISA ETFs captured an outsized share flows toward ETF (about 54% of inflows in 2022).[1]

Essentially, these ETF issued exchange-traded shares (or units) to investors and invested the funds into deposit accounts at Canadian banks. Investors receive monthly distributions of interest income, as well as any accrued interest when they sell the share. Investors can quickly access cash by offering and selling HISA ETF shares on exchange at any time during trading hours, or through most self-directed brokerage account. This means that cash sitting idle between investments can still earn relatively high interest rates. By contrast, retail HISA accounts and other close retail substitutes include term limits or penalty on withdrawing cash or offer interest rates that are not competitive with money market rates.

Transaction costs are low on the exchange, and, like other ETFs, the creation and redemption protocol in the primary market keeps the trading price of HISA ETF shares in line with the net asset value (NAV) of the underlying deposits. If the price rises above or falls below the deposit value, authorized participants can create new shares or redeem existing shares, so that deviations from the NAV are quickly arbitraged away[2]. In practice, the price of HISA ETF almost never moves more than a few cents away from their NAV. Even during the financial stress of March 2020, HISA ETF shares remained stable or even traded at a small premium.

Cyclical Rise in Saving Deposits

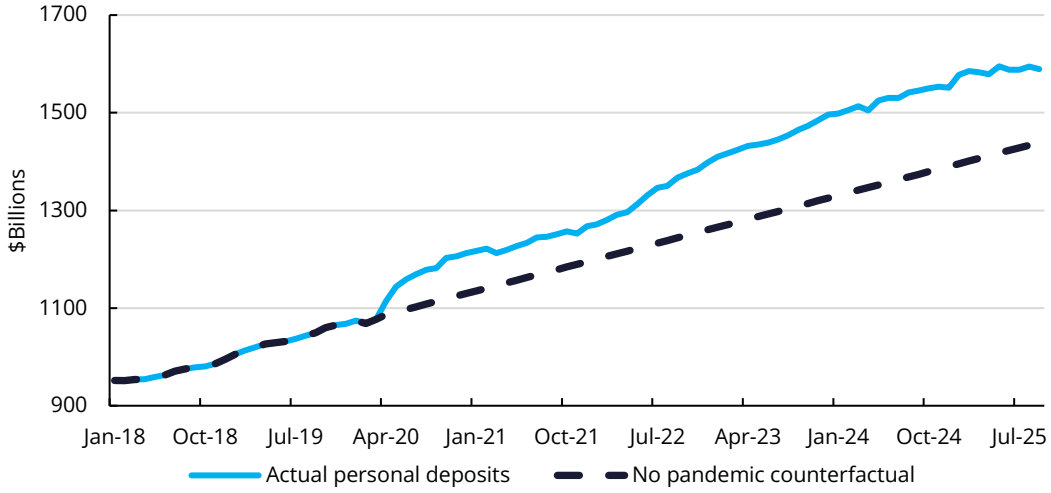
The economic backdrop was also contributing to the quick rise in popularity of HISA ETFs. Specifically, the combination of (i) households' surplus savings and (ii) rising interest rates lifted the demand for short-term deposits. First, domestic savings surged

[1] See IE Staff (2023) for details on HISA ETF flows during 2022.

[2] See Evolve Funds Group Inc. (2023) for details on the creation and redemption mechanism of HISA ETFs

during the pandemic (Chart 1), largely due to increased government transfers and reduced spending opportunities, and the level of savings shifted to a higher trend.[3] Second, the Bank of Canada target rate quickly rose from 0.25% early in 2022 to 5% by mid-2023, which lifted other interest rates that banks offered on savings account (Chart 2). As a result, the yields on HISA ETFs offered highly competitive rates that climbed to a peak near 6% compounded. Assets under management more than doubled to $15 billion during 2022.[4]

Chart 1: Canadian personal deposit balances (solid line) climbed well above the pre-2020 trend (dashed line) during the pandemic

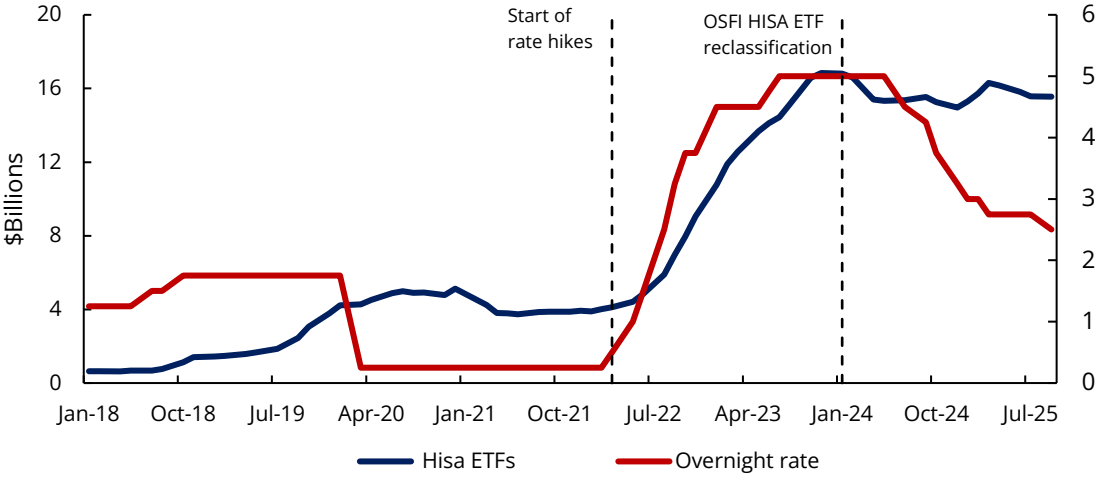


Source: Statistic Canada and Bank of Canada

Last observation: September 2025

Chart 2: HISA ETF's net asset grew quickly

Rate hikes drive HISA ETF growth before plateauing after reclassification



Source: Bank of Canada Calculation and Refinitive Workspace

Last observation: September 2025

[3] TD estimates that this resulted in households accumulating $300 billion more than in a non-pandemic counterfactual. Excess household savings (2021)

[4] See Mark Burgress (2023) for details on new regulatory requirements and HISA ETF asset growth during 2022-2023.

Benefits for Commercial Banks

HISA ETFs offered clear benefits to investors. However, why could HISA ETFs offer relatively high interest rates? The answer follows from the benefits that HISA ETFs offered to deposit-taking institutions, like banks.

We can break deposits into two broad buckets:

- **Retail deposits**. These include households' chequing and savings accounts. These are smaller, insured and relatively passive.
- **Wholesale deposits.** These include wholesale funding sources such as unsecured borrowings. These are larger, but not insured and can move quickly.

Retail deposits remain banks' favored funding source. In particular, the Basel III regulatory framework reinforces this effect through the regulatory Liquidity Coverage Ratio (LCR). The LCR requires banks to hold enough high-quality liquid assets (HQLA) to cover projected net cash outflows during a 30-day stress event:

$$\text{LCR} = \frac{\text{High quality liquid assets}}{\text{Projected Net Cash Outflows}}$$

A bank can improve its LCR ratio by raising stable retail deposits. These deposits are assigned a relatively low run-off rate over the stressed period (they are insured and considered stable). By contrast, wholesale deposits from financial institutions and asset managers like mutual funds are assigned a 100% projected run-off rate.

This means that the LCR pushes banks toward backing wholesale deposits by holding cash, GoC bills and bonds, but these assets pay a relatively low interest. By contrast, the LCR pushes banks toward using retail deposits (and other sources with relatively low projected run-off rate) to back holdings of assets with higher yields, but that are not HQLAs.

The key question is what is the run-off projections used for the deposit account of HISA ETFs. These ETFs do not rely on the same redemption mechanism as mutual funds, but they are not insured deposits like the households' accounts. They fell somewhere in the middle. Initially, some banks interpreted the regulations to mean that a favorable run-off assumption should apply.[5] As a result, HISA ETF balances combined some of the features of wholesale funding (large block deposits) with the regulatory advantage of retail funding (low assumed liquidity outflows), making them an attractive source to manage funding needs at the margin.

[5] See Mark Burgess (2023) to see details on how banks initially applied lower liquidity coverage ratio run-off rates to HISA ETF deposits, treating them more favorably than typical wholesale funding before OSFI's regulatory changes.

OSFI's Decision

OSFI launched a public consultation in May 2023 to review the regulatory treatment for HISA ETFs. The review drew more than 175 submissions from banks, ETF sponsors, and investors. On October 31, 2023, OSFI affirmed that deposits held by HISA ETF should be classified like unsecured wholesale deposits and assigned a 100% projected run-off for the purpose of the LCR ratio.[6] Banks were required to comply by January 31, 2024.

OSFI explained that its decision rested on three important concerns raised by stakeholders during the consultation:

1. **Aggregation.** Unlike traditional retail deposits dispersed across thousands of individuals, HISA ETF deposits are controlled by the fund's managers acting on behalf of investors. OSFI noted that a bank's relationships are with the ETF funds' managers, and not the underlying investors in the ETFs. OSFI argued that managers would "likely act swiftly" under stress to protect clients, meaning billions could be withdrawn all at once.
2. **Contagion.** The redemption protocol stipulates that funds are withdrawn from the ETF deposit accounts in proportion of the size of each account as a share of the total deposits. OSFI highlighted that stress at one bank could trigger proportional withdrawals from deposits at other banks. OSFI explicitly cautioned that "contagion is inherent in the product," since even healthy banks could suffer simultaneous outflows simply by the same depositor.
3. **Investor base.** While marketed to households, HISA ETFs trade on exchange and are available for trading by institutional investors, just like any other shares trading on exchange. OSFI stressed that "there is no way to effectively prevent" holdings of HISA ETF shares to retail investors and, given that the ETF deposits are not covered by CDIC insurance, OSFI assessed that they would be prone to higher run-off rates in stress.

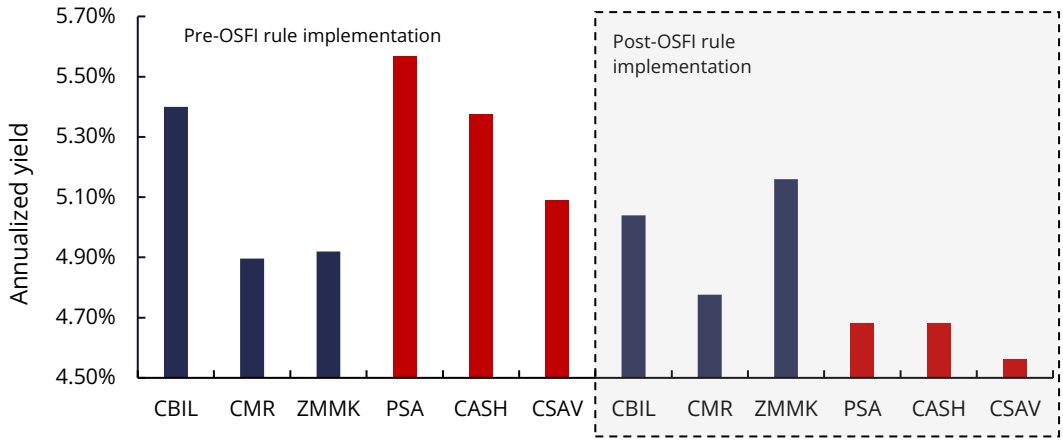
Implications

OSFI's decision reduced the incentive for banks to offer competitive rates on deposits held by HISA ETFs. As a result, the dividend yield offered by large Canadian HISA ETFs decreased significantly between OSFI decision on October 31st and the implementation deadline on January 31st. By contrast, the yields offered by other money-market or short-duration ETFs did not change as much during that period. The premium offered by HISA ETFs had disappeared (Chart 3).

[6] In the backdrop, several high-profile U.S. banks had failed in early 2024, most notably Silicon Valley Bank, which exemplified how quickly uninsured and concentrated deposits can flee.

Chart 3: HISA ETFs lost thier yield edge post-OSFI regulation

Money market ETFs preserve yield advantage after OSFI rule change



*"Pre" reflects the last dividend period under the old funding treatment (before October 31, 2023)
*"Post" reflects the first dividend period under the new funding treatment (after January 31, 2024)
Money market funds: CMR.TO, CBIL.TO, CMR.TO and ZMMK.TO
HISA Exchange traded funds: PSA.TO, CASH.TO and CSAV.TO

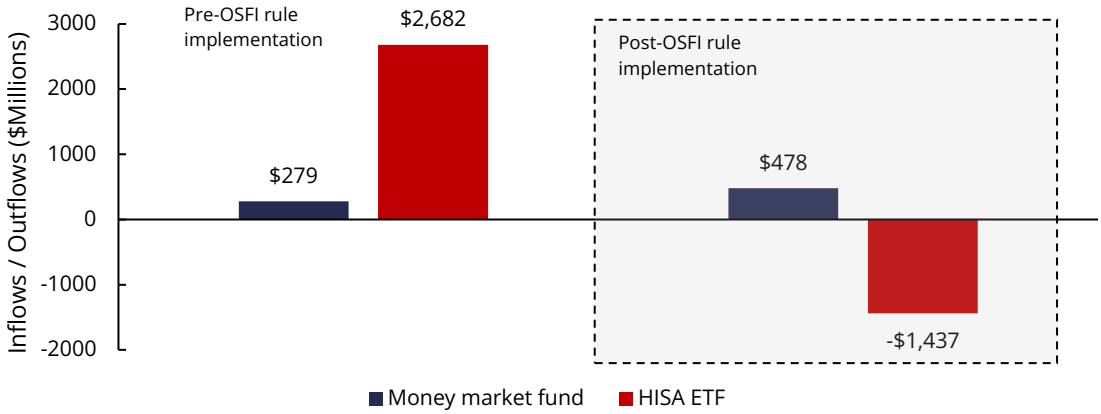
Source: Bloomberg

Averaging across funds suggests that the yield erosion was significant, around 50- 75 bps. As a result, that the stricter regulatory treatment lowered ETFs yields below that offered by T-bills and similar securities. This stifled the ETFs' demand for the HISA deposits. HISA ETFs recorded meaningful outflows during February 2024 (Chart 4), which marked the first full month of the new regime, and these outflows were larger than for money market funds that were just as easily accessed via self-directed brokerages.

Assets under management eventually stabilized (Chart 1). Going forward, because of the competitive pressures, the composition of asset held by the HISA ETFs is similar to the holdings of a money market mutual funds, and both asset manager types offer comparable rate of returns.

Chart 4: Shifting flows after OSFIs rule change

Money market funds attract steady inflows while HISA ETFs face sharp outflows



*"Pre" reflects the last dividend period under the old funding treatment (before October 31, 2023)
**"Post" reflects the first dividend period under the new funding treatment (after January 31, 2024)
Money market funds are an aggregate of CMR.TO, CBIL.TO, CMR.TO and ZMMK.TO
HISA ETFs are an aggregate of PSA.TO, CASH.TO and CSAV.TO

Source: Bloomberg

Conclusion

The HISA ETF episode clearly shows how Basel III liquidity rules can redirect savings between banks and market-based finance. Once OSFI classified HISA ETF deposits as wholesale funding, banks reduced the rates they were willing to pay, causing yields to fall and prompting HISA ETF to hold securities, and become more like money market funds, to remain competitive.

For central bankers, this demonstrates how liquidity regulation can strengthen the structure of banks' short-term funding, as intended. The results show that deposit pricing and funding models are clearly sensitive to run-off assumptions underlying the LCR.

At a higher level, the episode also provides clean evidence that the strict liquidity treatment of deposit can move asset managers away from bank deposits (again, as intended). However, the asset managers then turn toward less liquid money market securities. Ultimately, the banking regulations that are sound for banks unsurprisingly have other effects on the broader financial system. In this case, the regulatory shift led asset managers toward money market securities.