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Section 1. Introduction

As inflation rises and interest rates follow, the banking industry undergoes shifts. Little is written on this as the focus generally looks at the impacts on borrowers both individual and corporate so we are exploring the impact on Canadian lenders specifically banks. On the one hand, the faster repricing of assets enhances the profitability of banks. On the other hand, this positive aspect is hindered by a challenge: borrowers are under pressure to fulfill their debt obligations. Given the fact that Canadian Banks hold a significant portion of mortgages in their balance sheets, risk of defaults could potentially impact their revenue. Therefore, building on the previous report on the Canadian Housing Market, it is worthwhile to explore the financial stability of the Canadian Banks amid inflation, higher interest rates, and macroeconomic uncertainty.

[Note 1] Scope of this study is centered on the major banks that shape the Canadian Banking Industry: Royal Bank of Canada (RBC), Toronto-Dominion Bank (TD), Bank of Montreal (BMO), Bank of Nova Scotia (BNS), and Canadian Imperial Bank of Commerce (CIBC). Also known as the Big Five.

[Note 2] The "Big Five" (black lines and bars in Exhibits) refers to the market cap weighted average, calculated using the weights listed below.

	RBC	TD	BMO	BNS	CIBC
Market Cap (Billion)†	189.6	145.9	92.6	77.2	58.7
Weight	34%	26%	16%	14%	10%

† Market Cap: Retrieved from https://simplywall.st/stocks/ca/banks/market-cap-large, on Jan.10th.2024

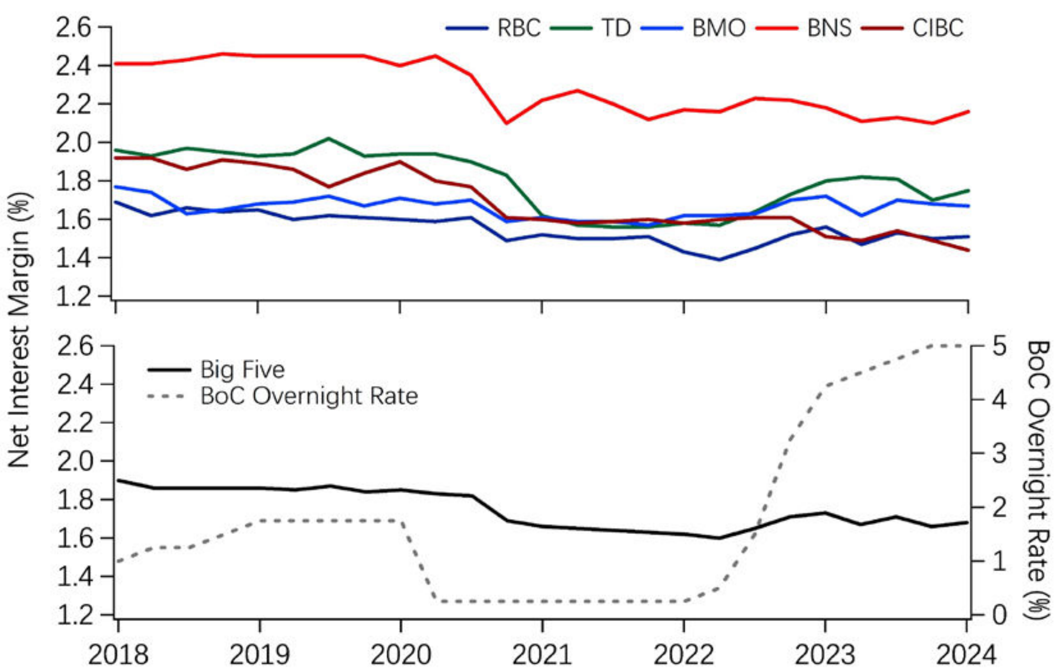
[Note 3] For more information on Office of the Superintendent of Financial Institutions (OSFI) and Basel Committee on Banking Supervision, please see Appendix.

Section 2. Financial Performance

2.1 Net Interest Margin (NIM)

The Big Five have recorded a collective rise in NIM. The upturn signals a recovery from the low point witnessed between 2021 and 2022, aligning with the gradual uptick in interest rates. Despite its rebound, NIM remains below the pre-pandemic levels observed before 2020.

Exhibit 1. Net Interest Margin for the Five Large Canadian Banks



Source: Company Documents

TD distinguishes itself as the most responsive to changes in interest rates, attributed to its significant portion of low-cost retail deposits and an expanding US loan book. Although the Big Five collectively experienced an 8 bps increase in NIM from the 2022 low of 1.60%, the figure remains 17 bps below the 2020 level. Despite the benefit of high interest rate on profitability, the expansion of NIM is expected to be modest due to (1) intensified price competition among financial institutions, (2) a decrease in mortgage sales influenced by housing market dynamics as well as tighter lending regulations, and (3) reduced demand for loans. The oscillating behavior of NIM starting from mid-2022 affirms these assumptions.

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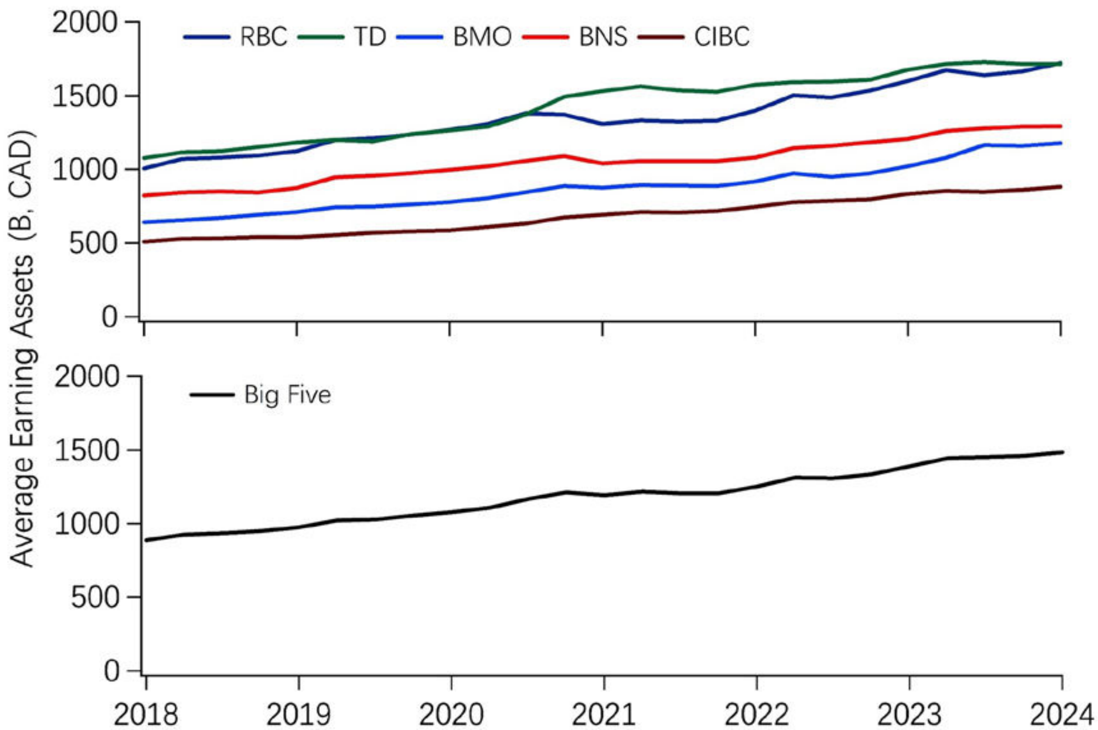
Positively, resistance is present, helping banks
o offset credit losses without invading their capital.

2.2 Average Earning Assets

The Big Five have experienced a collective 6.7% sector-wide Year-over-Year (YoY) growth in average earning assets, reaching $1,485 billion at the end of 2023.

Exhibit 2. Average Earning Assets for the Big Five Canadian Banks



Source: Company Documents

As previously stated, a decline in mortgage and other loan sales is expected. Adding to this challenge is the tightening of lending regulations by the Office of the Superintendent of Financial Institutions (OSFI) [1]. While the regulations aim to enhance financial stability of the banking system, they introduce an extra layer of complexity for banks, hence limiting their capacity to extend credit and affecting the growth of earning assets.

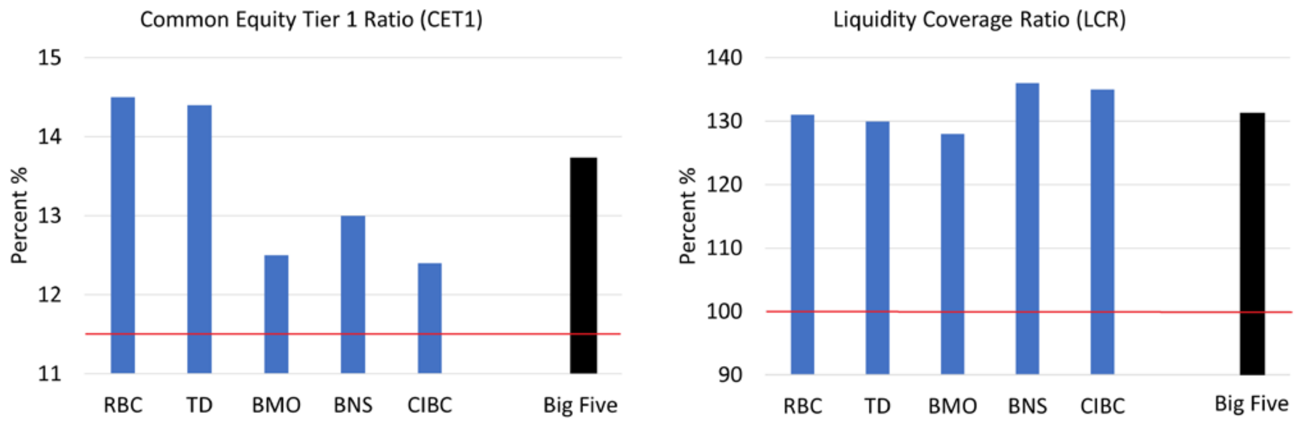
Nevertheless, customer deposits remain the primary funding source for the Big Five [2], underscoring their stability and customer trust. Data reveals a robust growth of nearly 11%

in deposits [3], surpassing the rates observed
in 2022. This optimistic growth again shows the resilience of the Big Five, positioning them safely in terms of interest income and income-generating assets.

Section 3. Financial Strength

TD is enhancing shareholder value by a share buyback initiative and broadening its market presence through new branch openings [4]. RBC is strengthening its international operations with the acquisition of HSBC Canada (CET1 Ratio of 13.8% as of Q3 2023), expected to be finalized in Q1 2024 [5]. In spite of these dynamic developments, the Big Five continued to maintain a sufficient capital cushion.

Exhibit 3. CET 1 and LCR for the Big Five Canadian Banks



The average Common Equity Tier 1 (CET1) ratio was 13.7% at Q4 2023, exceeding the new threshold levels (11.5%) set by OSFI [6]. Down 24 bps from Q4 2022, increased by nearly 200 bps since the pre-pandemic levels. The liquidity coverage ratio also maintained comfortably above regulatory minimum (100%) at the end of 2023 [7]. Up 4% from 2022 at 131 percent.

Moreover, the Total Loss Absorbing Capacity (TLAC) also comfortably exceeds the regulatory minimum, which was raised by 50 bps to 25%.

Table 1. Total Loss Absorbing Capacity (TLAC) Ratio as of Q4 2023

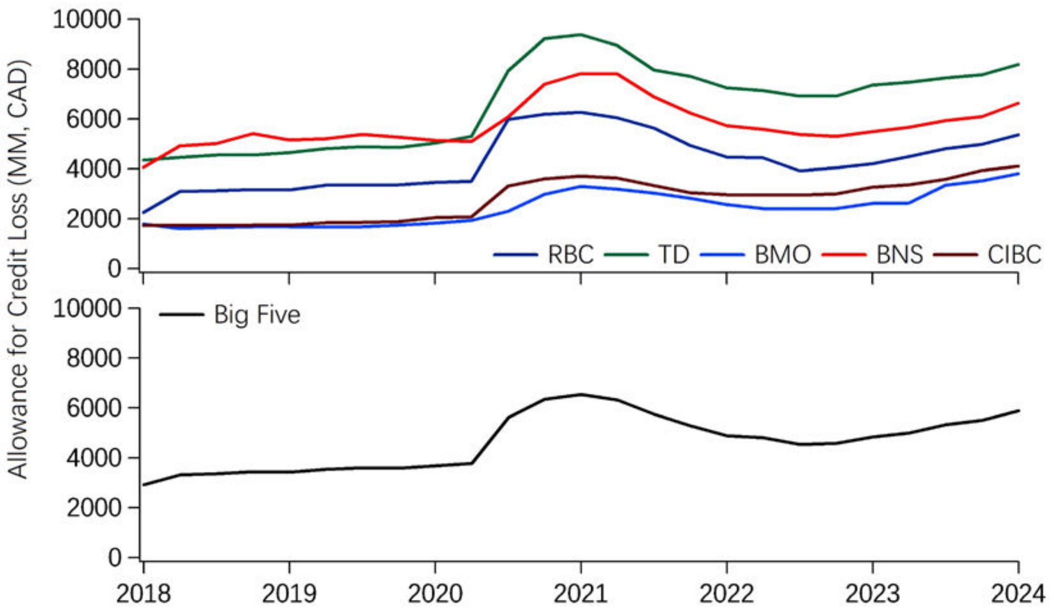
	RBC	TD	BMO	BNS	CIBC
TLAC Ratio	31%	32.7%	27%	30.6	30.7

Section. 4 Loan Portfolio Health

4.1 Increase of Allowance for Credit Loss

The Allowance for Credit Loss has gradually increased by 20% compared to the beginning of 2022, nearing the levels observed during the pandemic, which indicates banks' expectation of a higher probability of loan defaults. Concerns over an economic downturn, financial strain on borrowers from unemployment and high debt levels collectively prompt a cautious approach by banks, showcasing a proactive stance in handling credit risk.

Exhibit 4. Allowance for Credit Loss for the Big Five Canadian Banks

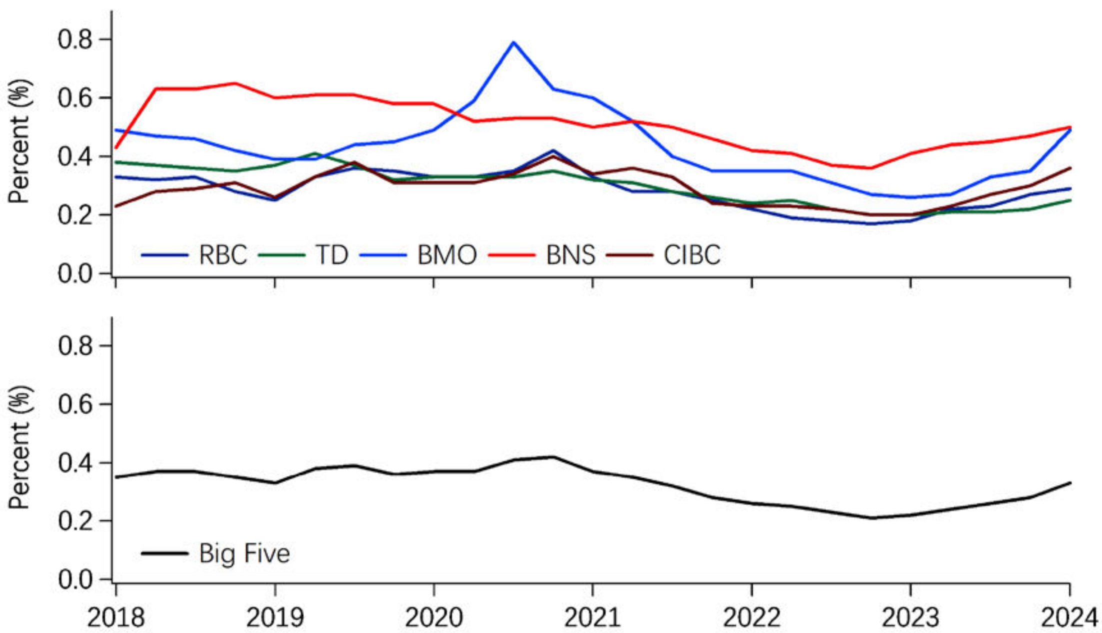


Source: Company Documents

4.2 Net Impaired Loans as Percentage of Loans and Acceptances

A rise of over 0.1% from the 2022 low point in the Net Impaired Loan to Net Loans and Acceptance Ratio signals challenges in the banks' loan portfolios, whether in repayment or credit quality. The recent upward acceleration, the fastest since 2018, surpasses the growth rate of the Allowance for Credit Loss [Exhibit 4], indicating the necessity for increased provisions by banks to mitigate potential losses. Since provisions can negatively impact bank earnings as they charge against income, the importance of vigilant risk management should be emphasized in the face of evolving credit challenges.

Exhibit 5. Net Impaired Loans over Net Loans and Acceptances



Source: Company Documents

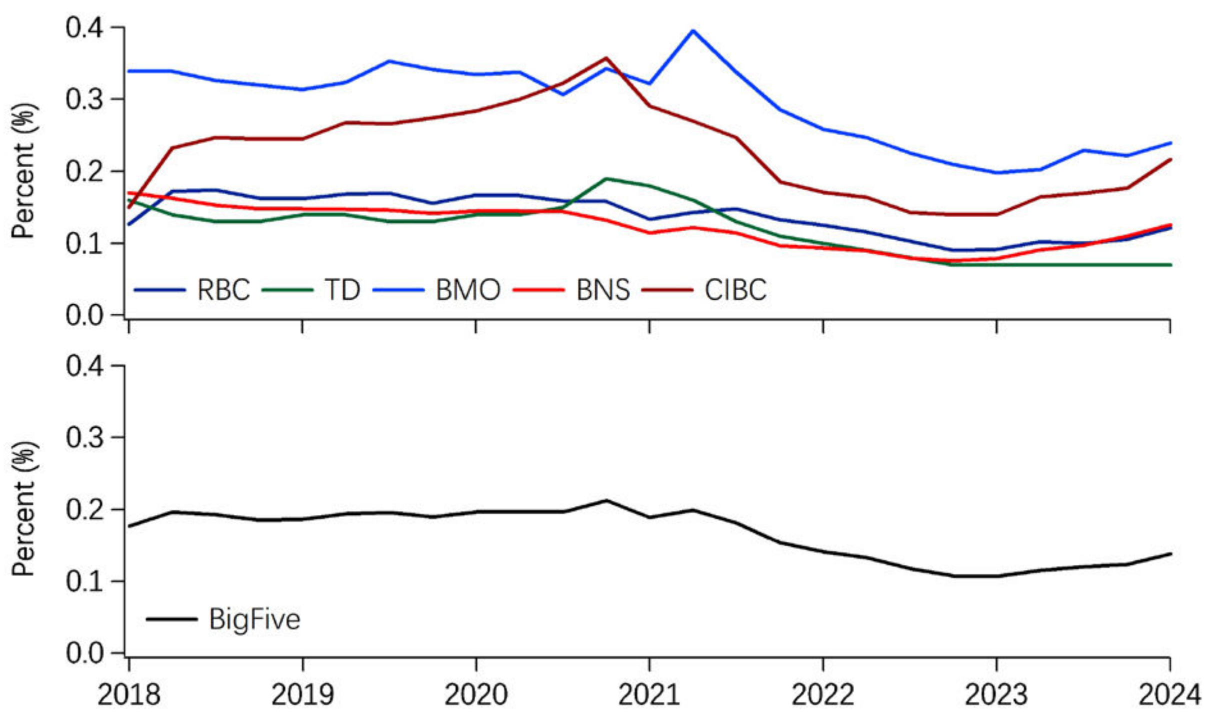
4.3 Loan Portfolio – Residential Mortgage

Among the Big Five, CIBC has the largest Canadian mortgage loan portfolio and the fastest-growing Gross Impaired Loan (GIL) to Gross Loans and Acceptance ratio. RBC, BMO, and BNS also contributed to the escalation. Only TD maintained stability. The close correlation between Exhibit 5 and 6 highlights the dominance of mortgage components in determining the overall portfolio health. However, all figures in Exhibit 6 comfortably remain below the back-testing probability of default (BASEL PILLAR 3), alleviating any concerns.

Table 2. Percentage of Mortgages within Gross Loans and Acceptance
2018-2023, Canada Only

	RBC	TD	BMO	BNS	CIBC
mean	46%	29%	18%	44%	63
stdev	1%	1%	2%	2%	1%

Exhibit 6. Gross Impaired Loans on Canadian Mortgage as a percentage of Gross Loans and Acceptance



In addition, 77% of Big Five's Canadian Real Estate Secured Lending (RESL) exposures are uninsured. Within this category, 73% boast a FICO credit score of over 750, and 80% maintain a loan-to-value ratio below 65%. These uninsured RESL portfolios are poised to act as a defensive cushion, capable of absorbing adverse impacts in the event of an economic downturn [8].

"Although mortgage repayment poses a noteworthy challenge, Canadian banks are renowned for their well-diversified and matched long-term assets and liabilities. In times of low-interest rates (pandemic period), banks are inclined to approve loans with higher credit risk. Also, the lending regulation is loose. As we transition to a high-interest rate environment, these high-risk loans are likely to experience defaults first. Therefore, the rise in mortgage impairments might not reflect the whole picture and, should not be a major concern for now." Says Shuo Wang (former credit analyst at Crédit Agricole Corporate).

Section. 5 Comments on the Other Loan Portfolio Items.

5.1 Retail Sector

The borrowing cost has risen, which in turn, affects various forms of credit. including mortgages, personal loans, and credit cards. Higher interest rates may also deter potential borrowers from taking on new debt. Reduced disposal income leads to reduced spending on non-essential items, hence cascading the effects on retail and other consumer-driven industries. On the flip side, higher interest rates do offer improved returns on savings and certain investments [see section 2.2].

With mortgage loans constituting a significant portion of the portfolio, the performance of the retail sector in loans is expected to closely mimic that of mortgage loans.

5.2 Wholesale Sector

The impact on the commercial market is twofold. Firstly, there is a heightened cost of capital being observed, which, in turn, may dissuade companies from undertaking new debt. This can impede their capacity to finance projects, acquire assets, and manage their overall liquidity and financial well-being. Secondly, there is a decline in consumer discretionary spending, which has repercussions for businesses heavily relying on consumer demand.

The table below highlights wholesale sectors that have experienced notable impacts, with the real estate sector standing out the most. Elevated borrowing expenses can compromise the viability of acquiring and developing properties. Moreover, the valuation of current commercial properties might be influenced, impacting investment choices within the real estate sector.

Table 3. Gross Impaired Loans by Sector (MM, CAD)

	23 Q4	23 Q3	23 Q2	23 Q1	22 Q4	22 Q3	22 Q2	22 Q1
RBC								
Telecom and Media	186	56	40	38	8	12	5	5
Consumer Staples	148	163	202	191	122	111	78	40
Investments	96	58	23	12	9	8	6	7
Real Estate	1104	965	502	459	322	326	231	255
TD								
Real Estate	406	222	163	152	107	89	105	110
Health and Social Services	191	202	162	168	79	63	65	69
BMO								
Real Estate	438	203	174	77	72	58	51	76
Manufacturing	422	181	246	166	184	163	164	203
Professional Services	417	96	117	110	142	125	82	89
BNS								
Real Estate	773	690	626	581	491	408	344	343
CIBC								
Retail Wholesale	309	300	271	172	181	168	170	161
Real Estate	1096	874	583	327	235	262	353	312

Section. 6 Stress Test Result from Bank of Canada

Bank of Canada's Stress Test [9] outlines a scenario where global trade tensions intensify, leading to a decline in international trade and global productivity, persistent above-target inflation, rapid tightening of monetary policy, followed by downturns in the housing market and credit cycle, ultimately resulting in a marked weakening of economic activity.

The anticipated outcome is credit losses across various sectors (4.4% for all product lines): credit cards experiencing substantial losses (35%) due to poor recoverability, business loans facing high loss rates, especially in the construction and real estate sector, and the mortgage portfolio encountering elevated, but a small lose rate thanks to sound underwriting standards (0.7%).

Overall Canadian banks are expected to exhibit resilience in a severe scenario.

Section 7. Conclusion

In conclusion, the resilience of Canadian banks is evident. Although the macro economic condition will continue to pressure earnings, the Big Five Canadian Banks remain well positioned with robust deposits and adequate capital levels even in downside scenarios.

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Appendix A. Office of the Superintendent of Financial Institutions (OSFI)

The Office of the Superintendent of Financial Institutions (OSFI) is an independent regulatory agency in Canada that supervises and regulates financial institutions to ensure their soundness and stability. OSFI operates under the jurisdiction of the federal government of Canada and reports to the Minister of Finance.

Responsibilities of OSFI include:
Supervision, Prudential Regulation, Crisis Management, Policy Development, Information Sharing and Cooperation

Appendix B. Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision is an international committee of banking supervisory authorities. The primary purpose of the Basel Committee is to enhance the stability and soundness of the international banking system through the development of global regulatory standards and guidelines.

Basel III is a set of regulations developed by the Basel Committee in response to the global 2008 financial crisis. These reforms were introduced to strengthen the regulation, supervision, and risk management within the banking sector. Basel III builds on the earlier Basel I and Basel II accords and aims to address some of their shortcomings by introducing more rigorous capital requirements and risk management standards.

Key regulation requirements include:

Capital Adequacy, Leverage, Liquidity, Credit Risk.

The Office of the Superintendent of Financial Institutions (OSFI) in Canada works closely with international regulatory bodies and frameworks, including Basel III, to ensure the stability and soundness of the Canadian financial system.

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