Numbers down: Scotiabank's capital markets profits fell 15.2% in the third quarter of 2019

CANADIAN BANKS SHORE UP THEIR DEFENCES

Faced with an increase in geopolitical and economic threats, Canada's banks are ramping up activity in loan-loss provisions and their more prosperous areas such as wealth management. Charlie Mitchell reports.

The 'Goldilocks' period for Canadian banks, characterised by unusually benign credit, has come to an end, ushering in a period of normalisation. And after a remarkably stable three years, headwinds have started blowing in the Canadian economy.

For now, it is a breeze rather than a gale, but Canada's biggest banks have not been spared. The third-quarter earnings for 2019 of Canada's big six reflect that, with three – Bank of Montreal (BMO), Toronto-Dominion Bank (TD Bank) and Royal Bank of Canada (RBC) – falling short of analysts' expectations. Overall, the group's collective net income exceeded C$12bn ($9bn), up 3.7% year on year in the quarter ending July 31, but was flat sequentially.

GLOBAL TENSIONS

But this is a story of changing times, as tough macro conditions and significant geopolitical and trade uncertainty increase lending risk and suppress profits. Some themes have emerged. Across the board, rocketing provisions for credit losses and weakened net interest margins in their US business – caused by two Federal Reserve rates cuts so far this year – have hit profits.

So, too, has the US-China trade war. "Slowing global growth, declining interest rates and possible contagion from US-China trade tensions could depress business volumes and stress future earnings," ratings agency Fitch noted in a post-earnings report.

Canada is not immune to the sabre-rattling, having arrested Huawei executive Meng Wanzhou on behalf of the US in December 2018. Beijing arrested two Canadians on espionage charges soon after, a move seen by some as retaliatory. China also proceeded to cut canola, pork and beef imports from Canada, spelling both trouble for farmers and broader economic fears.

There were occasional rays of light, however, chiefly in wealth management. And those lenders with large international footprints saw their Latin American and US businesses bolster earnings. But these cyclical business segments are unlikely to offset an economic slowdown. And with a potential recession on the horizon in Canada, bank executives are predicting slower profit growth and are looking at how they can adapt to a changing banking environment.

CAPITAL MARKETS UNCERTAINTY

Nowhere is macroeconomic uncertainty clearer than in the banks' capital markets divisions, where third-quarter 2019 aggregate profits were down 5% year on year, and 5.1% sequentially. It is worth noting that the third quarter is traditionally quieter for Canadian banks, as it encompasses the two summer months of June and July.

"There is definitely a challenging capital markets environment," says Toronto-based Cormark Securities analyst Meny Grauman, while Brian Madden, senior vice-president and portfolio manager at Goodreid Investment Counsel, also based in Toronto, notes: "There are some winners and losers, but overall it was a difficult quarter for earnings in investment banking units."

The average for capital markets profits was dragged down by RBC, Canada's largest lender, whose earnings from the segment fell by 6.4% year on year in the third quarter of 2019. Scotiabank's profits in the segment fell 15.2%, while capital markets earnings at Canadian Imperial Bank of Commerce (CIBC) were down 12.8%. Yet other banks prospered, even as tough macro conditions added pressure. BMO grew its earnings in the segment by 5% year on year, and income at TD Bank, which performed poorly in the third quarter of 2018, rose by 9% year on year.

While the US-China trade war had an indirect effect on these figures, it did slow

down decision making, which directly impacts banking profits. "If you're asking: 'Do I build a new plant in China? Do I build a new plant in Mexico?', [and] you're sitting on your hands not making those decisions, then you're not raising the capital to fund investments," says Mr Madden.

"The paralysis of companies with respect to what is going on in trade has really been driving most of the fundamental [investment] decisions," says Brian Belski, chief investment strategist at BMO Capital Markets, the investment banking subsidiary of BMO. "So we are still kind of in a wait-and-see mode, in terms of how and when we are going to spend money."

In addition, the new North American free trade agreement between Canada, the US and Mexico – USMCA – has yet to be ratified, despite being signed by all three countries in November 2018. Brexit, too, might be having a subliminal impact. Mr Belski says: "It is not as important to the world economy as many people would like to think. But I think from a behavioural side, from a psychology side, clearly it adds to the negativity and fear that is out there."

M&A HIT

Canadian banks have historically profited from domestic industries, including mining and energy, but those sectors are experiencing "a nuclear winter", according to Mr Madden. These macro headwinds are evident in declining merger and acquisition (M&A) activity, hitting profits for Canadian banks, which rely on very high margin M&A fees to bolster their balance sheets. Activity has fallen 11% globally in 2019 (up to the end of September) to $2800bn.

"Corporate hubris is often very present in the C-suite when executives make big splashy, bold acquisitions and they are really not doing that this year," says Mr Madden.

Despite Toronto establishing a reputation for being one of North America's fastest growing tech hubs, there have been no major initial public offerings – and very few secondary offerings – for Canada's banks to underwrite. Of all capital markets-related revenue, it was underwriting and advisory that fell the most in the third quarter of 2019, according to rating agency DBRS, slumping 16.4% year on year for Canada's big six.

Still, what really makes a difference for Canadian banks is their domestic personal and commercial business, which grew modestly in the quarter. Their US retail businesses also showed signs of resilience. But these earnings were offset by rocketing credit loss provisions, fuelled by uncertainty and rising household debt.

LOAN-LOSS PROVISIONS

Overall, the top six Canadian lenders grew loan-loss provisions 27% year on year to C$2.45bn in the third quarter of 2019. BMO raised them an impressive 65%. According to Nigel D'Souza, an analyst at Toronto-based Veritas Investment Research, this is "considerably higher" than a gradual normalisation, which would be 10% to 15%. And given that credit losses were at cycle lows as recently as 2018, the shift has dented earnings.

Six lenders dominate Canada's highly concentrated banking market: BMO, TD Bank, National Bank, RBC, CIBC and Scotiabank. According to Mr D'Souza, National Bank performed best overall of the six in the third quarter of 2019, buoyed by its high concentration in Québec and a relatively small rise in credit losses.

CIBC's quarterly income came in at C$1.4bn, up 2% year on year. It was a 6% growth in US commercial banking and wealth management and a 3% rise in domestic business that helped the bank overcome falling capital markets profits. Others fell short of expectations, including RBC, whose net income of C$3.3bn represented a modest 1% quarter-on-quarter rise and a 5% year-on-year increase on the back of a solid performance in insurance and wealth management. Lower investment banking fees and a dearth of M&A activity stopped the bank from performing better. TD Bank saw income of C$3.3bn, or C$1.74 a share, in the third quarter. It is slightly below analysts' expectations of C$1.80 a share.

With decent loan and deposit growth, BMO recorded overall net income of C$1.56bn in the third quarter of 2019, up from C$1.54bn during the same period in 2018. But earnings were constrained by rising loan-loss provisions and a non-recurring loss from a new collection system.

Provisions for credit losses have also risen on the commercial side in Canada, due in part to persistently low energy prices. Scotiabank was the only bank to lower provisions, which declined to C$713m in the third quarter from C$943m a year earlier, while the bank's Latin American footprint helped generate an adjusted net income of C$2.5bn. Jake Lawrence, co-group head of global banking and markets at Scotiabank, describes its strategy as "diversification by geography and diversification by product".

According to some analysts, this decision is imprudent, because the bank might need to build up credit losses much »

ONE OF THE THINGS THAT HAS EVOLVED THROUGH [SCOTIABANK'S] HISTORY IS DEVELOPING A REALLY STRONG RISK CULTURE AND A VERY REASONABLE RISK APPETITE

Jake Lawrence

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Nigel D'Souza

quicker than its peers in the future. "For that reason, I would put Scotiabank at the low end in terms of quarterly results," says Mr D'Souza. Mr Lawrence retorts: "One of the things that has evolved through our bank's history is developing a really strong risk culture and a very reasonable risk appetite." As a result, he says, loan-loss provisions are traditionally low at Scotiabank.

ACROSS THE BORDER

Canada's big banks have also suffered from falling interest rates in the US, which compressed their net interest margins. In recent years, their US businesses benefited from rising interest rates, causing them to increase their footprints, leaving them exposed. As a result, when the Fed cut interest rates for the first time in 11 years in July 2019 – and again in September – it hit the interest rate margins of Canadian banks. They will now hope that low rates spur consumer spending, benefiting their US retail businesses.

With sky-high household debt, Canada's Liberal government has tightened the screws on mortgage lending, and sales in major property markets such as Vancouver are at near multi-year lows. These negative effects explain why banking stocks have underperformed the wider market in 2018. While the benchmark Toronto Stock Index has risen 14.4% between January and the end of August 2019, the banking sector is up just 5.2%. And banking stocks are now trading at a price-to-book ratio of 1.06, the lowest level in three years.

Half of the major lenders took a hit on the stock market after they released their third-quarter results, including BMO, whose stock fell 3.3% to C$89.33, a post-January low. Scotiabank's stock price, by contrast, rose 1.7%. "The market essentially punished a bank for being prudent and rewarded a bank for being less conservative by reversing performing loan losses," says Mr D'Souza.

Although their shares are likely to remain at the low end for the time being, Canadian lenders continue to offer strong dividends. It is important to remember, too, that slowing growth comes against the backdrop of three years of tailwinds and rising profits.

WEALTH MANAGEMENT HOPE

Forced to contend with rising credit provisions and interest margin compression, Canadian banks are looking to their fee-based businesses to offset losses. In 2010, RBC acquired London-based BlueBay Asset Management, which had more than [US dollars] $60bn assets under management at the end of March 2019. Scotiabank, formerly a relatively sub-scale player in asset management, bought MD Financial Management in October 2018, which caters to physicians and manages assets exceeding C$49bn. TD Bank acquired Greystone Capital Management, with assets totalling C$35bn. The list goes on.

But whether the segment can offset losses elsewhere is unclear. "Wealth management, like investment banking and capital markets, is a good diversifier in terms of non-interest income, but it is not a countercyclical business, so if there is a slowdown in the economy, wealth management earnings would also come under pressure," says Mr D'Souza.

Perhaps the only sector still growing rapidly is commercial lending, but that, too, is on course for a credit normalisation, according to analysts. In the longer term, diversification appears to be the name of the game. While the major banks remain highly leveraged domestically, they have been looking to increase their footprints overseas.

Scotiabank, Canada's most international bank, is pursuing a long-term growth strategy in the Pacific Alliance countries. While 95% of Canadians currently have bank accounts, the proportion in Chile, Colombia, Peru and Mexico is closer to half. Right now, the bank is busy taking large US and Canadian clients into Latin America.

"We have a very envious position where we want to be the number one bank in the Americas," says Scotiabank's Mr Lawrence. "We have the footprint and we're going to be able to build the business and execute the strategy to get us there."

Fintech also holds promise, both in terms of lowering non-interest expenses and acquiring companies. However, Canadian lenders are aware that they cannot rely on tech acquisitions for substantial growth in the coming quarters.

RECESSION VIEWS

While Canada's banks are bullish, some analysts predict a recession in the country. Naturally, a recession would further accelerate the rate of credit losses and constrain earnings, because even the most international banks are highly leveraged domestically and exposed to shocks in the Canadian economy. For now, the Bank of Canada is optimistic, despite the uncertainty that has forced down rates elsewhere. (The central bank will next decide on its overnight rate, currently at 1.75%, on October 30. Federal elections took place on October 21, as *The Banker* went to press.)

"The question is not if but rather when," says Mr Madden. "What people forget about a recession is that you don't see them coming, because a recession by definition occurs at the point of maximum expansion." Mr D'Souza agrees, adding: "The market is signalling a recession with the yield curve inversion."

Mr Grauman, by contrast, says a recession is "very, very unlikely", but that an external shock could change that view, while Mr Belski of BMO Capital Markets says: "We have no forecast for a recession in Canada."

Scotiabank's Mr Lawrence says: "We don't see a recession, we're not planning for one from a business perspective but we like that we've got optionality and diversification in our footprint, that should something arise we can focus attention and allocate resources into other parts of our business or geography."

In Canada, a period of credit restraint is in the pipeline that could choke banking profits. Together with the malaise in business confidence due to geopolitical uncertainty, a dramatic or subtle change could leave its mark on Canada's economy. For this reason, banks must diversify their offerings and prioritise fee-based businesses – fortunately for consumers and investors, they appear to be doing just that. TB