Canadian D-SIBs' Outlook 2024: Persistent Headwinds Will Pressure Operating Performance

However, strong balance sheets position the D-SIBs well for a slowing economy

S&P Global Ratings

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This report does not constitute a rating action

Contents

Key Takeaways

Key expectations

- Canadian domestic systemically important banks' (D-SIBs') profit growth is likely to remain under pressure in 2024 from rising provisions for loan losses and still-high expenses, although growth is moderating. Net interest income (NII) growth could lessen as loan growth may slow further until rates begin to drop, which will help loan growth and reduce cost of funds. Fee income growth is largely dependent on the performance of equity and capital markets.
- Asset quality will continue to deteriorate in 2024 due to pressure on borrowers from high rates and a flagging economy. We expect net charge-offs (NCOs) will continue to rise but remain manageable because of the banks' conservative underwriting and capacity to absorb higher provisions, given their strong earnings generation. We view sectors such as credit cards, auto, uninsured mortgages, and commercial real estate (CRE)--particularly office--as areas that could further weaken.
- We expect capital will be managed conservatively, given economic uncertainty and profit pressure, and OSFI's domestic stability buffer requirement that raised the Common Equity Tier 1 (CET1) ratio to 11.5% from 11%, which became effective Nov. 1, 2023.
- Liquidity could decrease but at the margin due to geopolitical and macroeconomic uncertainties. Funding will remain diversified and receptivity to D-SIBs' access to global wholesale funding will remain favorable. We believe growth in term deposits is stabilizing. Growth in higher-rate savings products such as GICs is stabilizing. Maturities are likely to be reinvested in term deposits so long as rates remain relatively high, with savings deposits continuing to decrease.

Key assumptions

- GDP growth of 0.7% for 2024 and 1.4% for 2025; the probability of a recession is higher than usual.
- The Bank of Canada (BoC) could begin to ease rates as early as second-quarter 2024 (policy rate at 5%) as weakness in GDP growth extends further and inflation (3.4%) starts on a clearer downward trend toward BoC's targeted range of 1%-3%. Unemployment will rise modestly to 6.1% in 2024 from 5.8% in December 2023.

Canadian D-SIBs' Rating Outlooks Are Stable

	Anchor	Business position	Capital and earnings	Risk position	Funding and liquidity	CRA Adjustment	SACP	Systemic importance	ICR/Outlook
Bank of Montreal	a-	Adequate	Adequate	Strong	Adequate and adequate	0	a	High	A+/Stable
Bank of Nova Scotia	bbb+	Strong	Adequate	Strong	Adequate and adequate	0	a	High	A+/Stable
Canadian Imperial Bank of Commerce	a-	Adequate	Adequate	Strong	Adequate and adequate	0	a	High	A+/Stable
National Bank of Canada	a-	Adequate	Adequate	Adequate	Adequate and adequate	0	a-	Moderate	A/Stable
Royal Bank of Canada	a-	Strong	Adequate	Strong	Adequate and adequate	0	a+	High	AA-/Stable
Toronto-Dominion Bank	a-	Strong	Adequate	Strong	Adequate and adequate	0	a+	High	AA-/Stable

Note: Notching for Very strong: (+2), Strong: (+1), Adequate: (0), Moderate: (-1), Constrained: (-2), and Weak: (-5). SACP--Stand-alone credit profile. ICR--Issuer credit rating. CRA--Comparable ratings analysis adjustment.
Source: S&P Global Ratings.

Key Risks For Canadian D-SIBs

Sticky core inflation or market disruption

Higher for longer interest rates pressure borrowers, increasing losses

Home price corrections cause increased defaults

Geopolitical risks creating uncertainty

Secular changes affecting commercial real estate

Challenges from fintech, cybersecurity, and digital transformation

Credit Conditions | Canada

S&P Global Ratings Canada economic forecast

Key indicators	2019	2020	2021	2022	2023f	2024f	2025f	2026f	2027f
Annual average % change									
Real GDP	1.89	-5.07	5.01	3.44	1.14	0.74	1.42	1.9	2.19
Change from Sept. (percentage point)					-0.1	-0.4	0	0.1	
Domestic demand	1.1	-5.57	6.86	4.86	-0.65	0.14	1.45	1.74	2.14
Consumer spending	1.53	-6.13	5	4.77	1.98	0.51	1.75	1.95	2.38
Nonresidential fixed investment	3.09	-9.37	4.54	4.63	2.11	2.52	1.43	0.04	2.19
Residential investment	-0.73	5.02	14.94	-11.17	-12.97	-1.02	2.4	4.74	2.88
Government consumption	0.97	1.29	6.39	2.02	0.18	-0.74	-0.11	1.48	1.54
Real exports	2.66	-8.81	1.47	2.85	5.6	2.58	2.35	2.16	1.72
Real imports	0.36	-9.12	7.95	7.51	-0.45	1.05	2.21	1.62	1.65
CPI	1.96	0.72	3.41	6.8	3.92	2.6	2.59	1.95	1.92
Core CPI	1.76	1.23	2.85	5.63	3.58	2.35	2.2	1.84	1.92
Annual average levels									
Unemployment rate (%)	5.7	9.73	7.51	5.27	5.37	6.11	5.51	5.38	5.47
Exchange rate per (US$)	1.33	1.34	1.25	1.3	1.35	1.34	1.28	1.29	1.28
Housing starts ('000s)	207.42	218.88	273.14	261.87	239.91	207.45	208.72	223.64	220.43
Bank of Canada policy rate (%, year-end)	1.75	0.25	0.25	4.25	5	4	2.75	2.5	2.5
10-year government bond (%)	1.73	1.08	1.8	2.86	3.41	3.45	3.08	2.98	2.97

Note: All percentages are annual averages, unless otherwise noted. Core CPI is consumer price index excluding energy and food components. f--forecast.
Sources: Statistics Canada, Bank of Canada, S&P Global Market Intelligence, S&P Global Ratings Economics' forecasts.

- The Canadian economy has cooled rapidly in recent months. We forecast sluggish growth of 0.7% in 2024 and 1.4% in 2025.
- With subpar domestic demand in store, the job market will also remain sluggish, with unemployment rising to 6.1% in 2024 from the current 5.8%.
- Barring a significant upward surprise from the Consumer Price Index, we expect the BoC will maintain a policy rate of 5%, allowing past rate hikes to work through the economy. The first cuts are likely to come in second-quarter 2024.

Canada Forecast | Rising Provisions Will Put Pressure On Profitability

Worsening		Neutral		Improving

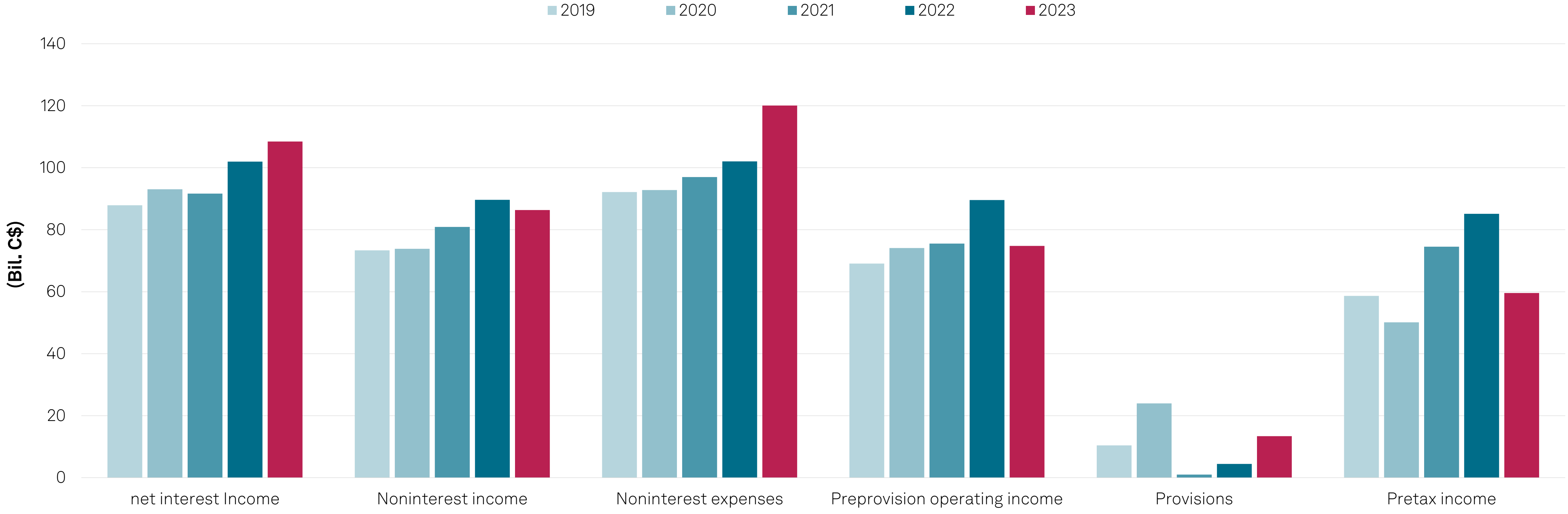
Revenues	NII growth could slow somewhat as loan growth continues to moderate but then pick up once rates begin to decline to benefit loan growth and reduce cost of funds. Fee income is highly reliant on the performance of equity and capital markets. More favorable market conditions could incrementally add to noninterest income. Overall revenue growth should be in the mid-single digits for 2024 versus an average of 2% in 2023.
Expenses	Expense growth will moderate (in the mid-single digits for 2024 versus an average of 14% in 2023 skewed by higher-than-peers' expenses for BMO and TD Bank) as banks are managing expenses by reducing discretionary costs, delaying certain investments in technology, and reducing full-time employees. We expect wage growth will continue to moderate as inflation falls.
Profitability	Profitability will remain under pressure in 2024 as provisions for loan losses continue to rise and revenue growth remains modest, although lower expenses will help offset some of that. We expect an industry return on common equity of 10%-15% similar to 2023.
Credit quality	Given the strain of high rates on borrowers, asset quality metrics will continue to deteriorate from low levels. We expect banks to build allowances. We also expect NCOs to rise but remain manageable. We forecast an average of 30 basis points (bps) of NCOs in 2024 versus 19 bps in 2023, which would slightly exceed the pre-pandemic average of 28 bps in 2019.
Capital	D-SIBs will prudently manage capital due to an uncertain geopolitical and macroeconomic environment, deteriorating asset quality, and OSFI's domestic stability buffer requirement that raised the CET1 ratio to 11.5% from 11%.
Funding and liquidity	Funding will remain well diversified and the banks will continue to access global funding markets. Liquidity metrics could decline at the margin but remain above pre-pandemic levels because of geopolitical and macroeconomic uncertainties. Growth in higher-rate savings products such as GICs is stabilizing. Maturities are likely to be reinvested in term deposits so long as rates remain relatively high, with savings deposits continuing to decrease.

Note: Forecast for next 12 months. Source: S&P Global Ratings.

Profitability Will Remain Under Pressure

- D-SIBs' 2024 profitability could be similar to 2023's or somewhat lower, should the economy slow more than anticipated, and will be particularly pressured by climbing provisions for loan losses. Revenue could surprise to the upside should fee income be better than expected. Lower expenses will help the bottom line, although inflation and wage growth would need to fall further.

Canadian D-SIBs' operating performance



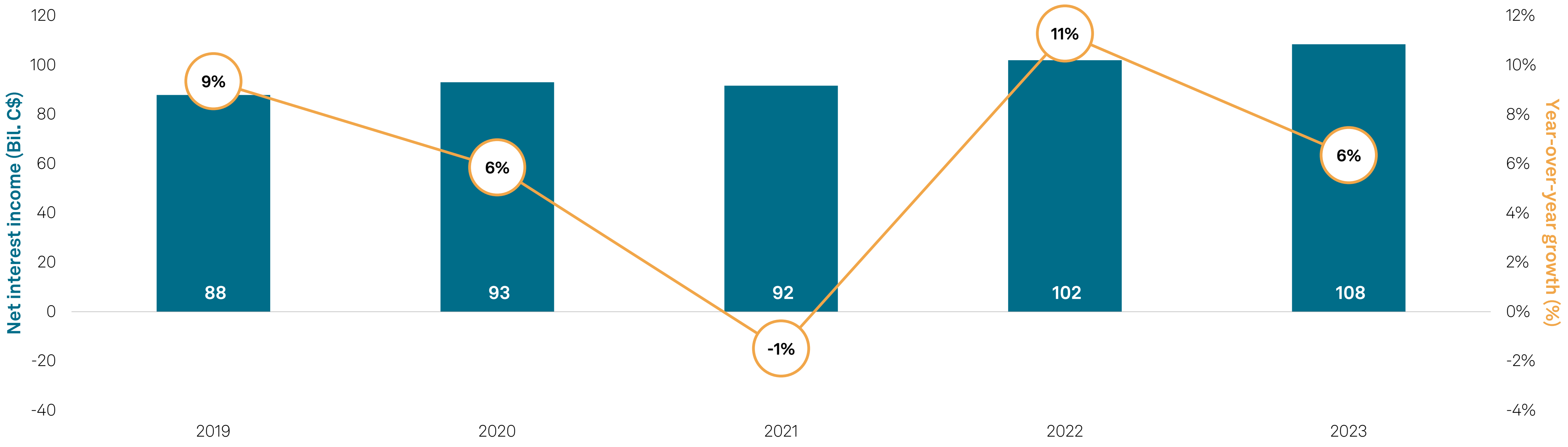
Sources: S&P Global Ratings, company filings.

S&P Global
Ratings

NII Growth Could Slow

- Declining loan balances will likely put pressure on NII through part of 2024. Growth in higher yielding loans, such as commercial and industrial and CRE, has slowed. We see loan growth picking up somewhat once rates begin to drop, benefiting interest income.
- On the liability side, we expect deposit growth will be similar to loan growth in 2024. Pressure on elevated cost of funds should ease once rates begin to fall.

Canadian D-SIBs' net interest income

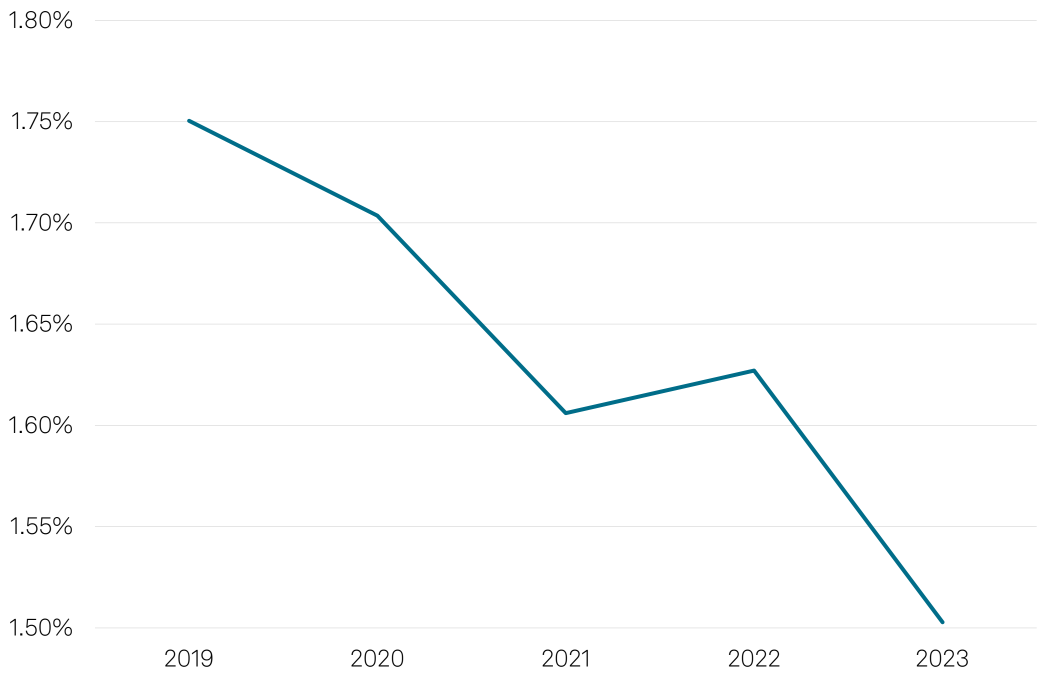


Sources: S&P Global Ratings, company filings.

D-SIBs’ NIMs Will Rise Modestly

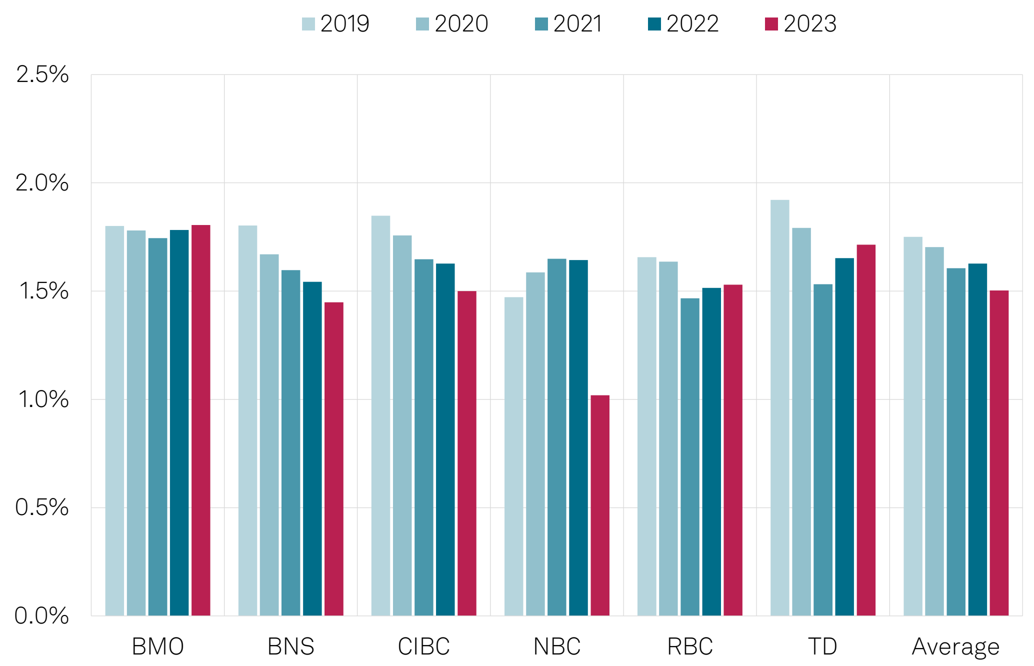
- Interest rates have stabilized. We expect rate cuts perhaps as early as April 2024. Deposits typically reprice faster than loans because of their shorter tenure and so in a declining rate environment, we expect cost of funds to decrease and benefit the banks’ NIMs in the latter part of 2024. A certain proportion of loans will reprice this year, which will limit NIM expansion. Overall, we expect several bps on average of NIM expansion in 2024.

Average D-SIBs’ NIMs



Note: NIM in 2023 is skewed downwards partly because of NBC's interest expenses on deposits that were higher in 2023 than in 2022. Sources: S&P Global Ratings, company filings.

NIM trends by bank



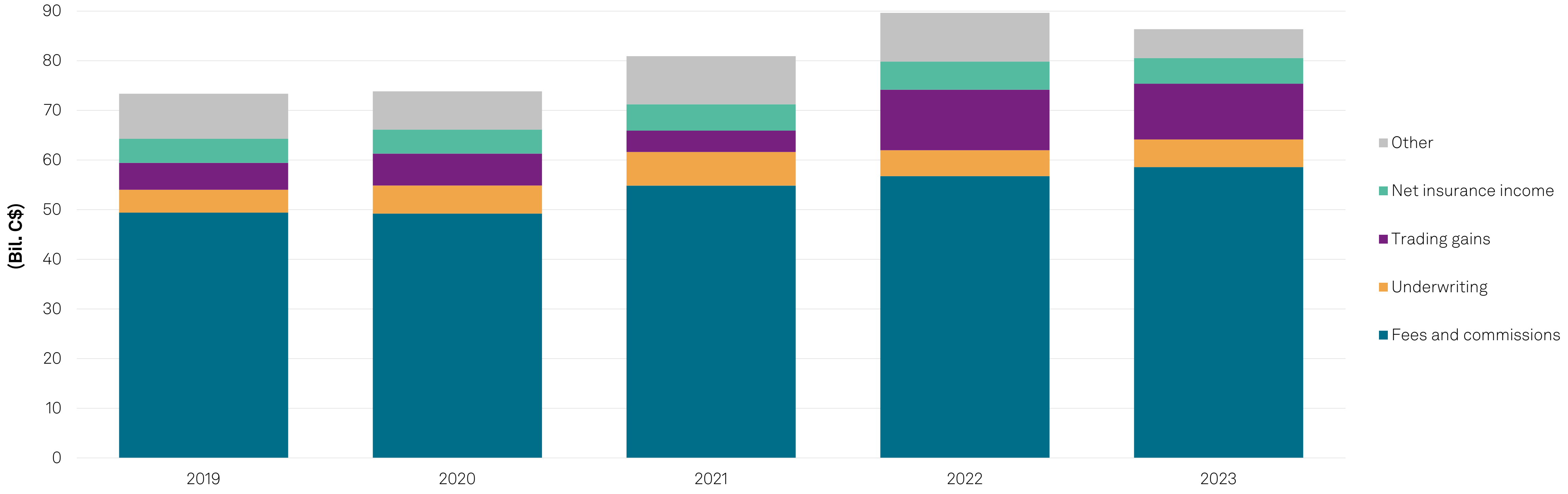
Sources: S&P Global Ratings, company filings.

S&P Global Ratings

More Favorable Markets Should Help Non-Interest Income

- We expect better market conditions to spur net sales in wealth management and higher corporate and investment banking revenues, largely fueled by expected recovery of investment banking fees; however, gains will be incremental relative to 2023's.

Canadian D-SIBs' non-interest income

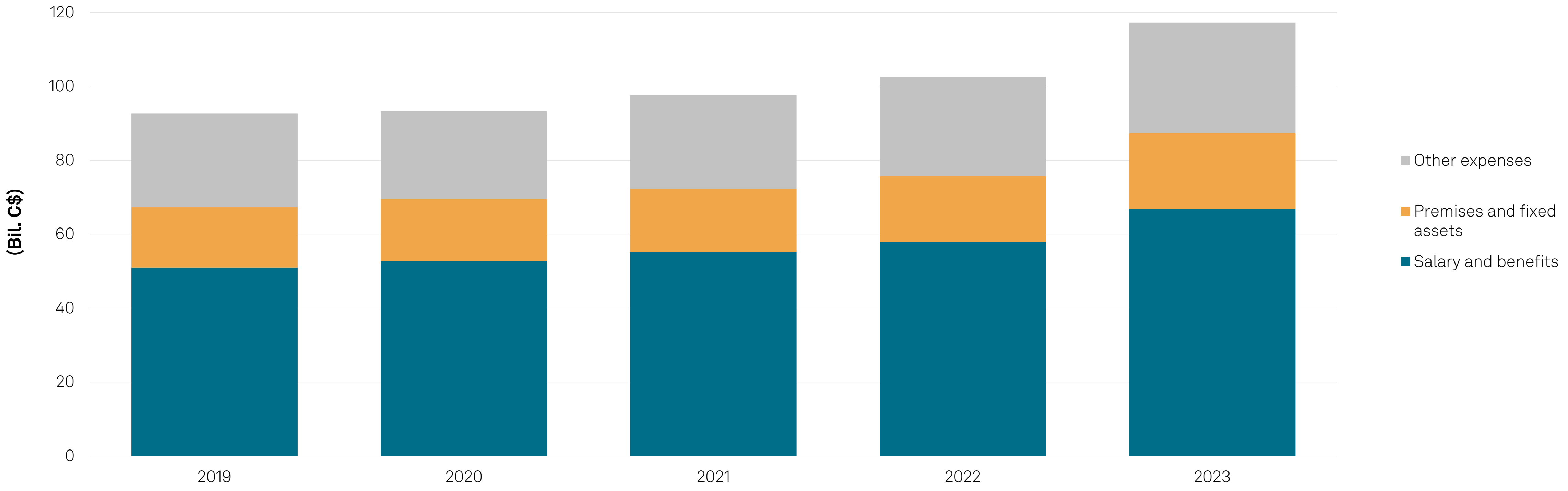


Note: Fees and commissions include trust income, asset management income, brokerage commissions, deposit fee, and other fees and commissions.
Sources: S&P Global Ratings, company filings.

Operating Expense Growth Will Moderate

- Decreasing inflation and moderating wage growth (from last year) should help reduce elevated expenses. Banks continue to look for ways to cut expenses by managing hiring, and vacancies and discretionary expenses, as well as investments, particularly as revenue growth is likely to be modest again in 2024.

D-SIBs' non-interest expenses

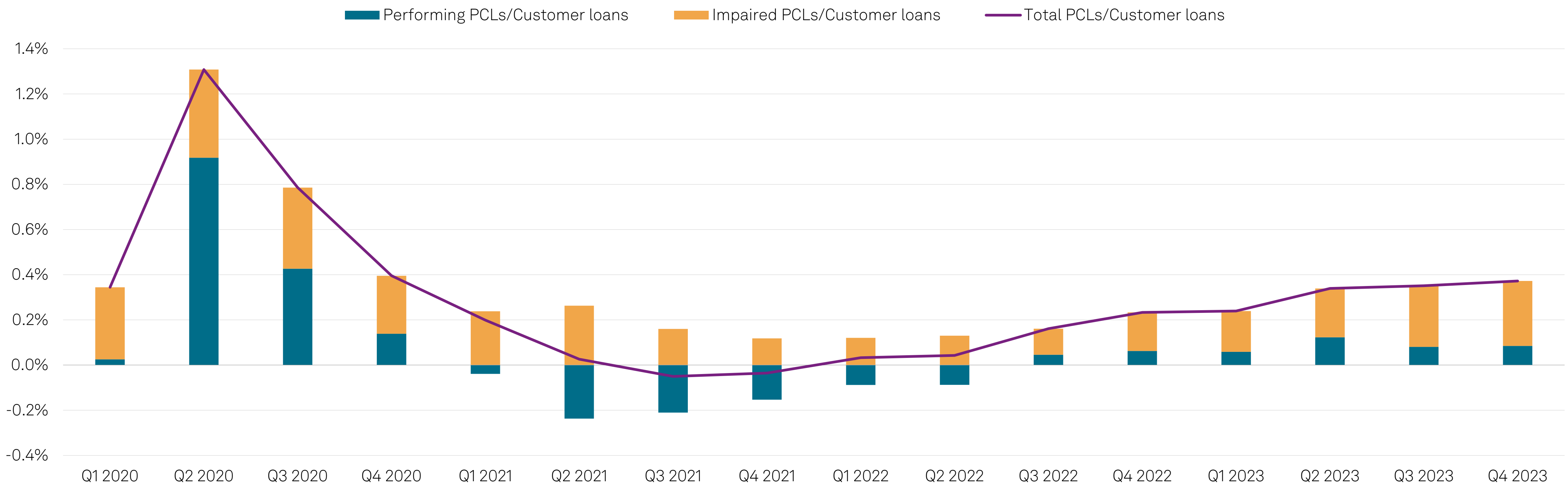


Sources: S&P Global Ratings, company filings.

Provisions For Loan Losses Are Increasing As Credit Conditions Weaken

- Given the weakening economic outlook and credit conditions, provisions for loan losses will continue to climb through 2024.
- However, we expect 2024 provisions to be well below pandemic levels.

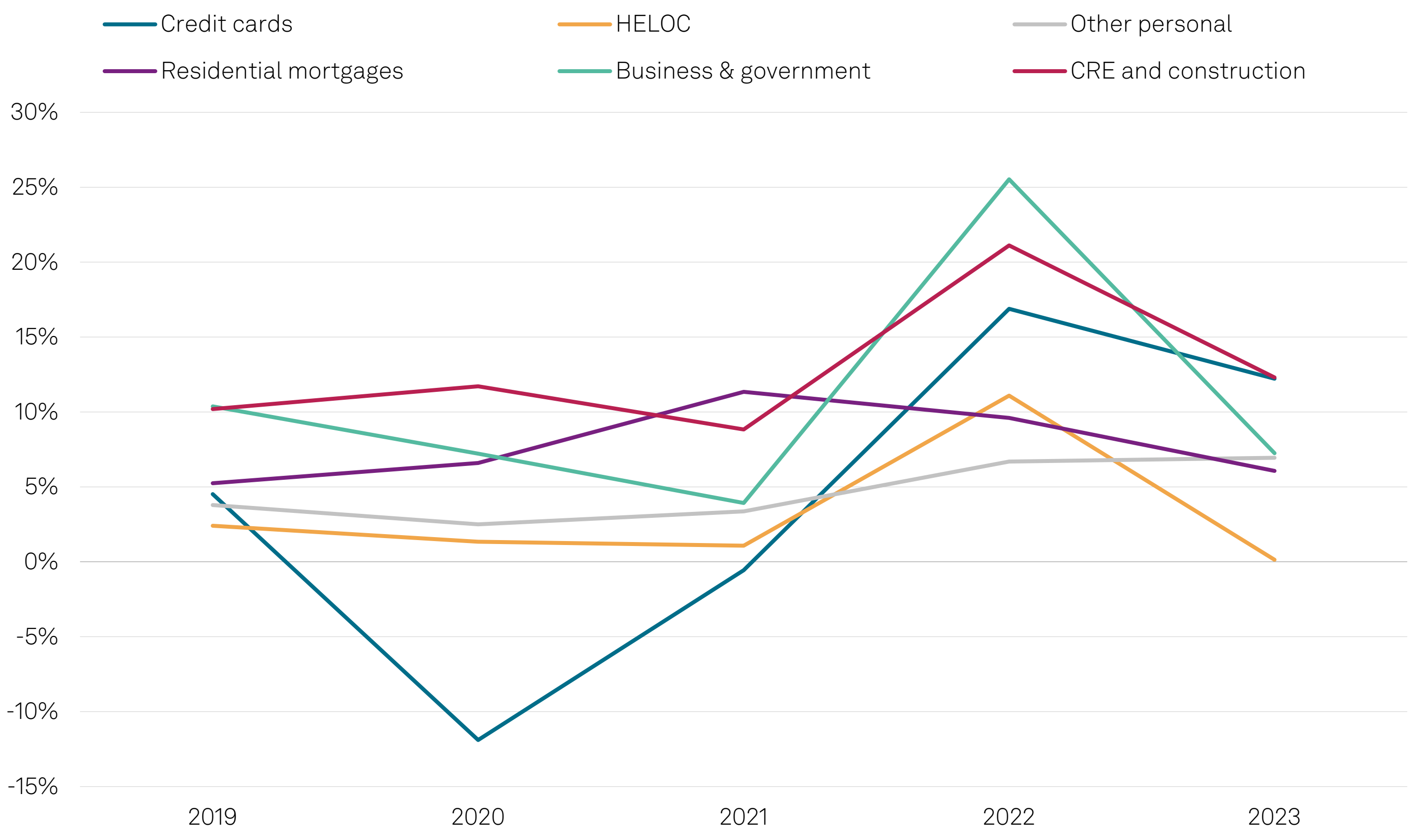
D-SIBs' provisions for loan losses



Note: PCLs--Provisions for loan losses. Ratios and amounts are D-SIB averages. Sources: S&P Global Ratings, company filings.

Loan Growth To Decelerate As The Economy Slows

D-SIBs' loan growth



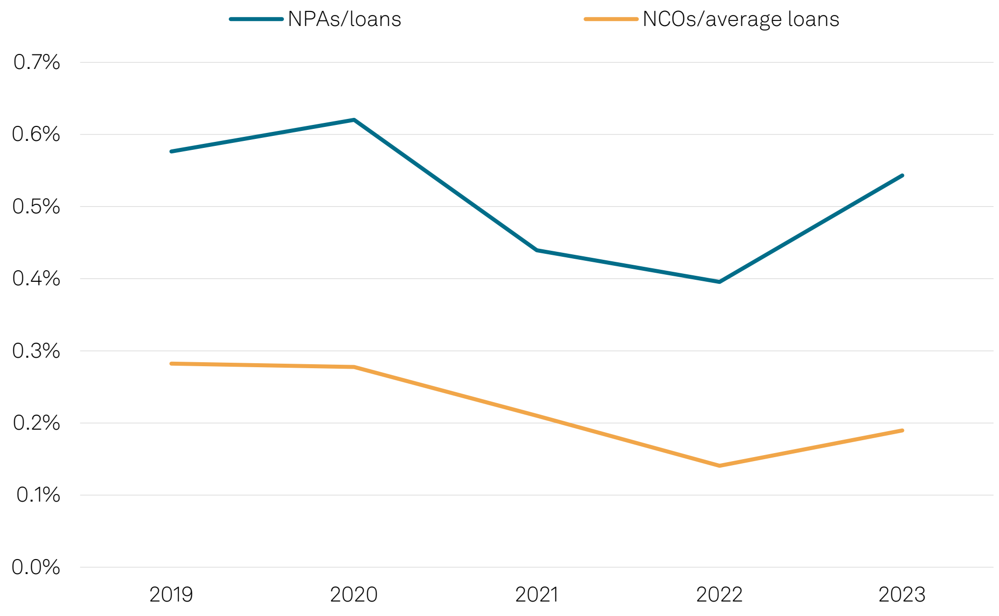
Note: Other personal excludes credit cards. HELOC – Home equity line of credit. Sources: S&P Global Ratings, company filings.

- High rates continue to slow demand for credit. Rate cuts will somewhat help loan growth. Overall, we expect loan growth of 4%-6% in 2024 from an average of 7% and 15% in 2023 and 2022, respectively.
- Mortgage loan growth, which has been modest, may pick up in the latter part of 2024, if interest rates begin to fall.
- Other consumer loan growth will slow as consumer spending abates due to higher personal debt levels affected by high rates.
- Business loan growth, including CRE, has declined and likely will be similar in growth or slightly lower to 2023's as business sentiment remains somewhat sour.

Incremental Asset Quality Deterioration Expected As Economy Slows

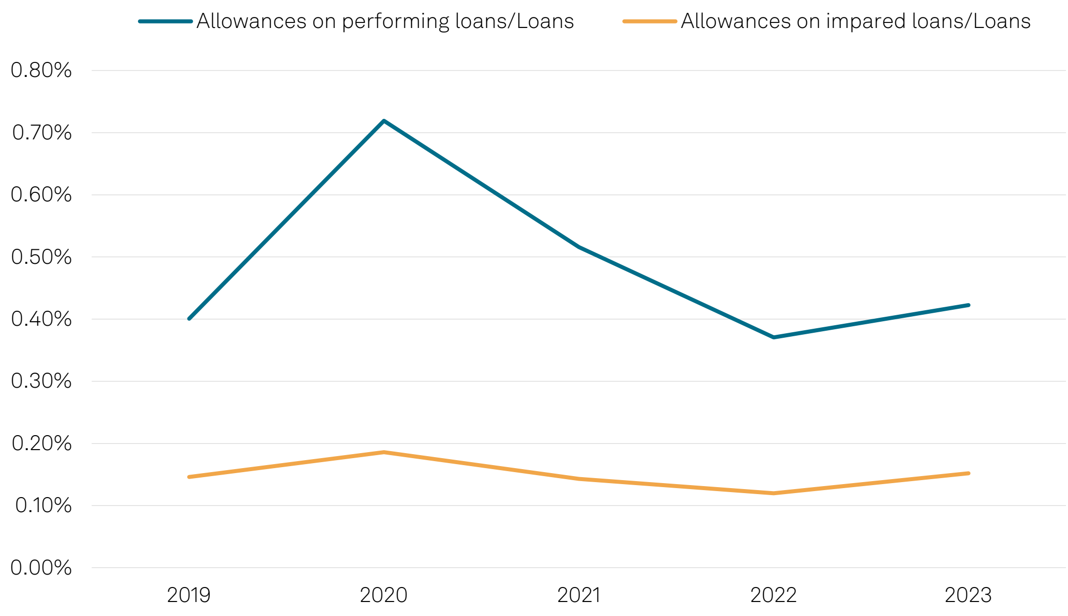
- As the full effects of higher rates are felt through the economy, we expect that they will hurt loan performance; however, we believe asset quality metrics will be manageable in 2024 owing to the banks' strong underwriting.
- NPAs and NCOs will continue to deteriorate in 2024 and may slightly exceed pre-pandemic levels. We believe the banks will continue to add to allowances as the credit environment deteriorates. We're closely monitoring the performance of credit cards, auto, uninsured mortgage, and office CRE, in particular.

D-SIBs' asset quality metrics



NPAs--Nonperforming assets. NCOs--Net charge-offs. Sources: S&P Global Ratings, company filings.

D-SIBs' allowances to loans

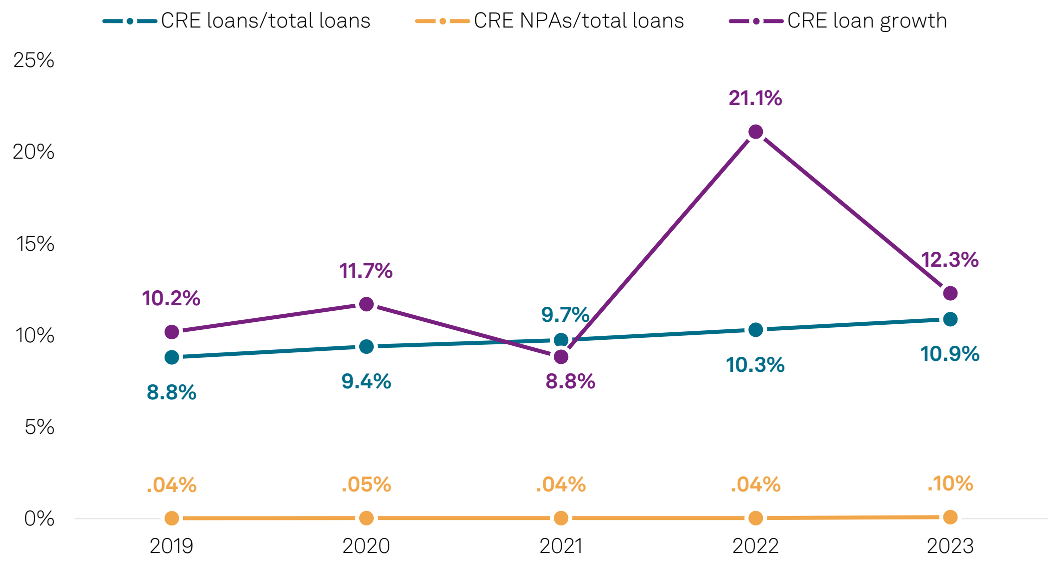


Sources: S&P Global Ratings, company filings.

CRE, Office Segment Under Pressure, Though Exposure Is Manageable

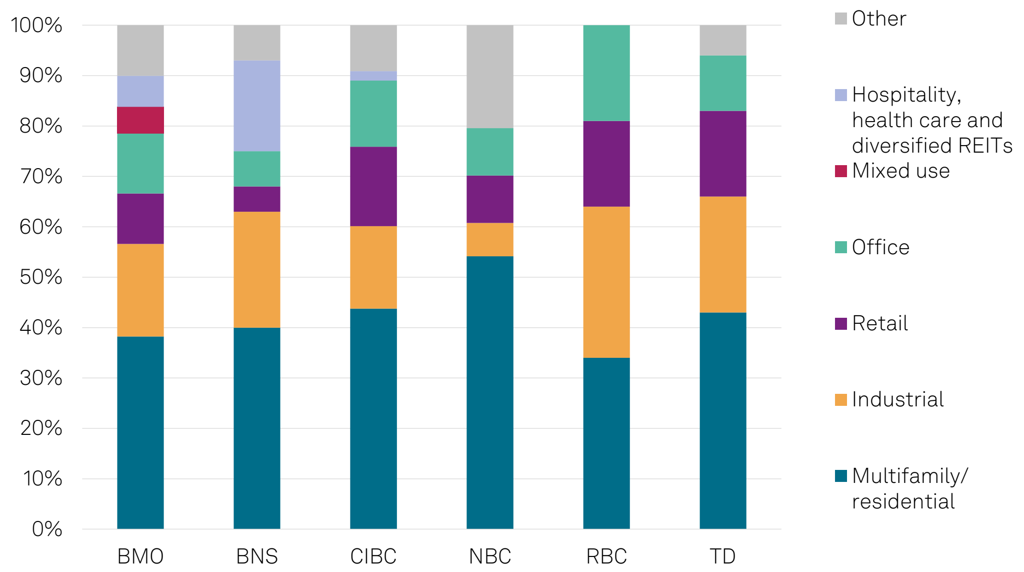
- CRE and construction loan exposures represent, on average, 11% of D-SIBs' total loans.
- Generally conservative loan-to-value ratios, good diversification geographically and by property type, and recourse should mitigate the impact of CRE loan losses; however, recourse in the banks' U.S. CRE portfolios is not as strong as it is in their Canadian CRE portfolios.
- The office segment is under pressure, though the banks' exposure to it is only 1%-2% of total loans. Banks have been increasing their exposure to the insured multifamily residential sector, given the housing shortage in Canada.

D-SIBs' exposure to CRE and construction loans



CRE--Commercial real estate. NPAs--Nonperforming assets. Source: S&P Global Ratings, company filings.

CRE exposure by property type

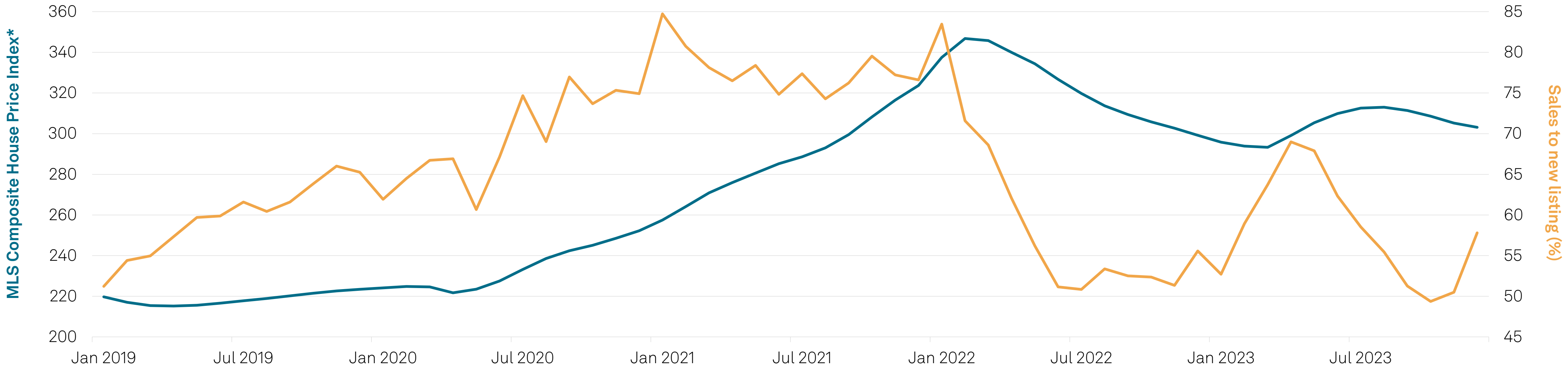


Source: S&P Global Ratings, company filings.

Modest Decline In Home Prices Should Persist In 2024

- Home prices fell on average 14% (median price) from their peak in March 2022 through December 2023. If rates stay higher for longer, they could depreciate further. S&P Global Ratings Economics expects a further modest drop in home prices in 2024.
- That said, higher levels of immigration and home supply constraints will continue to drive up home prices in the medium-to-long term. Affordability issues may ease at the margin once rates begin to fall.

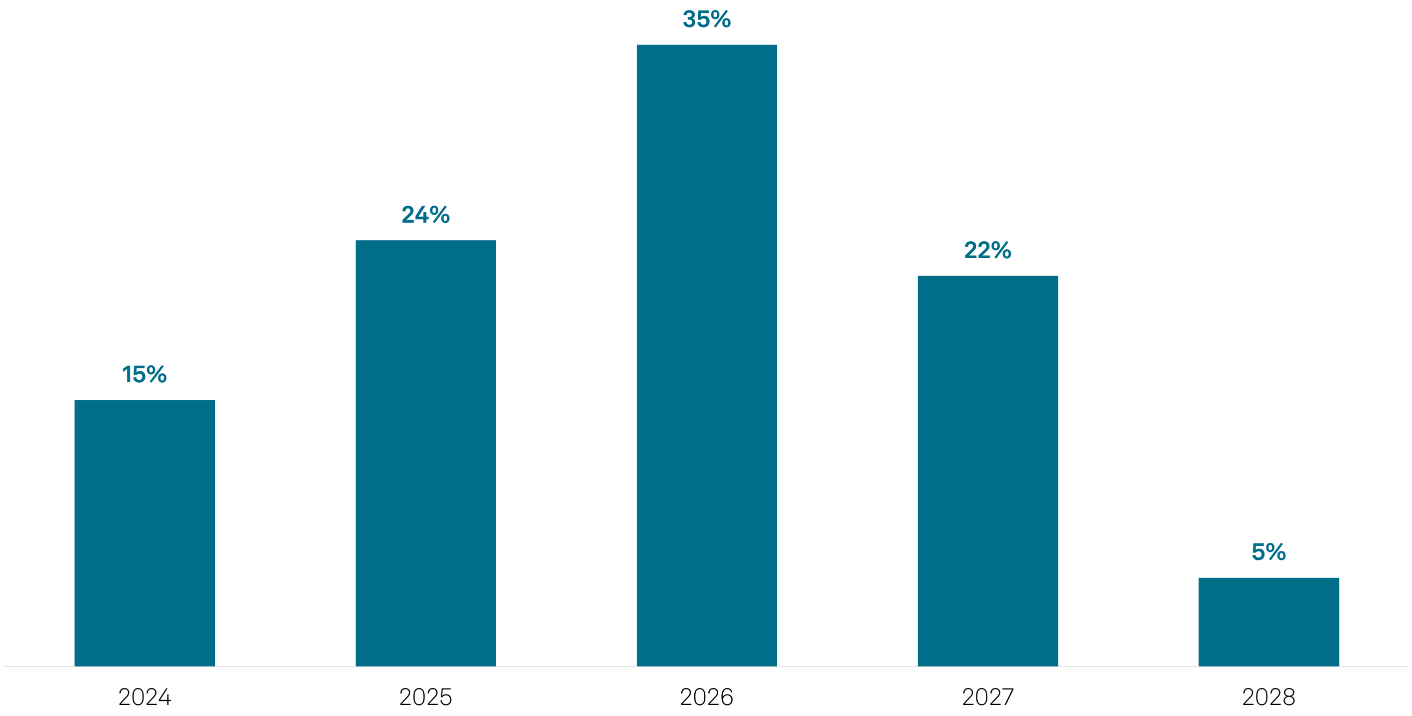
Housing market statistics



Note: Seasonally adjusted data. *2005 baseline. Source: The Canadian Real Estate Assn.

D-SIBs' Mortgage Renewals Are Manageable

D-SIBs' percentage of mortgage renewal balances*



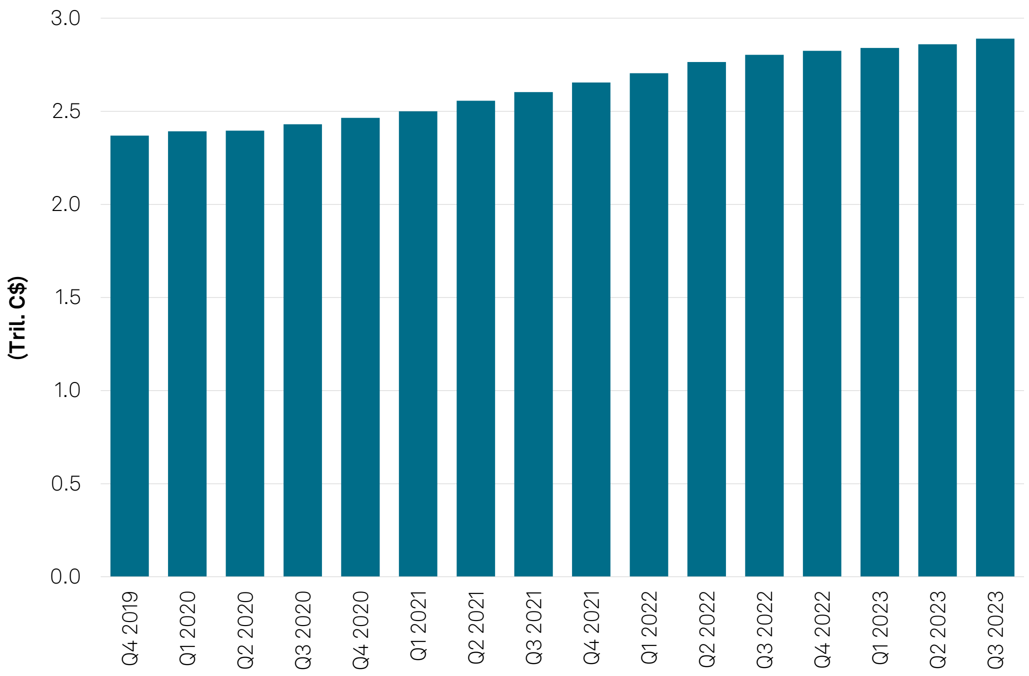
*Percentage of balances renewing within one year. Source: Banks' investor presentations including BMO,BNS, CIBC, and RBC. TD and NBC are not reflected here, given their more limited disclosure on mortgage renewals.

- Typically, mortgages in Canada are renewed every five years or less even if the amortization period is longer. The five major D-SIBs' mortgage portfolios are about 25% government insured while NBC has a higher proportion of insured mortgages. This helps mitigate loan losses in addition to conservative loan to value ratios.
- The level of D-SIBs' mortgage renewals should be manageable in 2024, while rates remain high for at least part of the year.
- We expect interest rates will be much lower in 2025 than they are today, alleviating pressure on borrowers.
- Mortgages in negative amortization will continue to decrease.

Debt Balances Are Rising, Savings Are Depleting

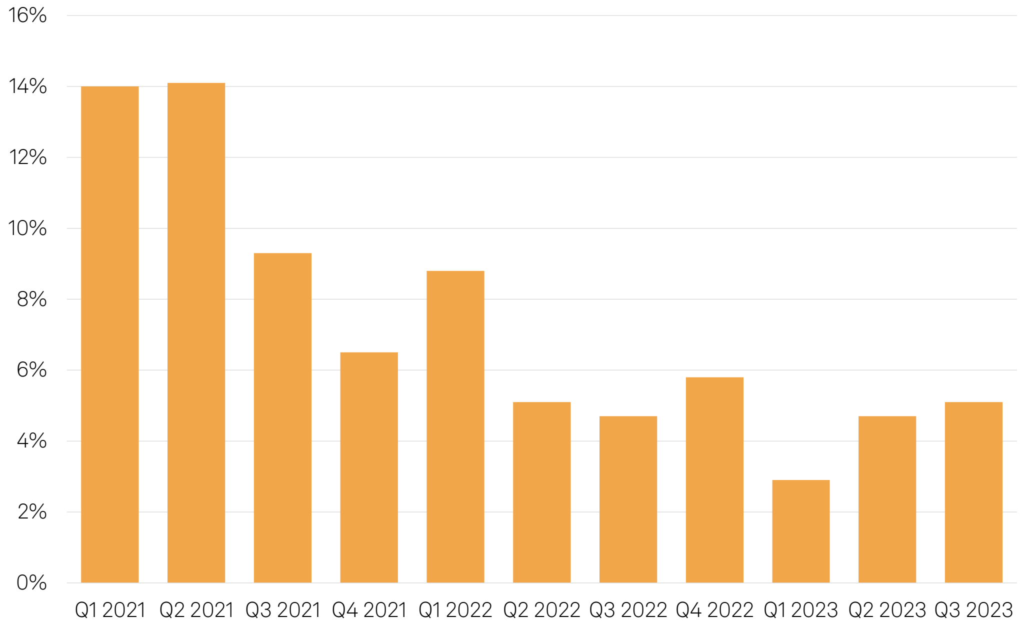
- Canada's household sector is highly leveraged, with household debt to disposable income at 170% plus. Rising mortgage rates have lifted the costs of mortgage debt service, leaving households more vulnerable.
- The household savings rate has been falling since it peaked in 2020 as borrowers are using their savings to cover higher mortgage debt. Savings have picked up more recently as consumers are reining in discretionary spending.

Household debt



Sources: S&P Global Ratings, Statistics Canada, TransUnion, and Bank of Canada.

Household savings rate



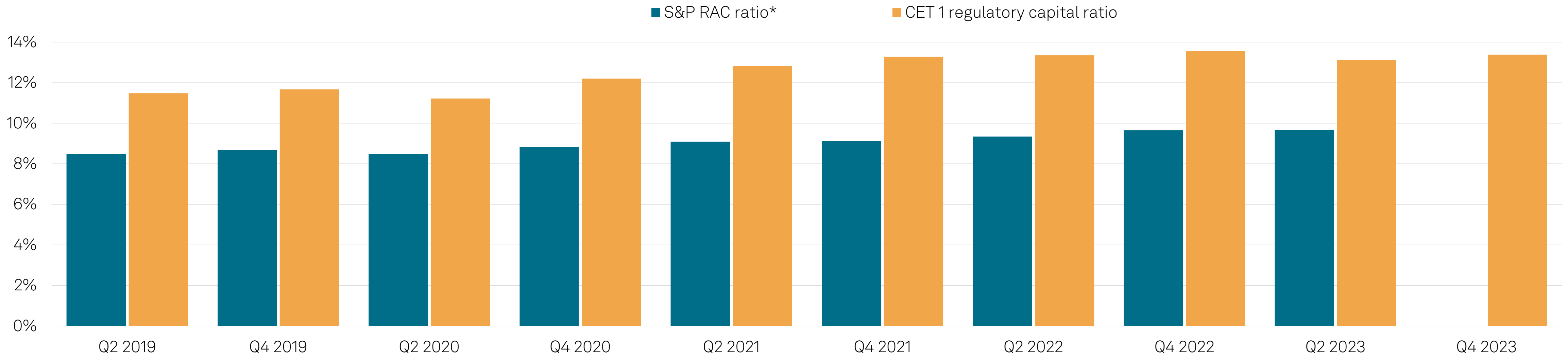
Note: In Canada, personal saving is defined as personal disposable income less personal expenditure on consumer goods and services, less current transfers from persons to corporations and to non-residents as a percent of disposable income.

Source: Statistics Canada.

Capital Ratios To Remain Around Current Levels

- Despite moderating risk-weighted asset (RWA) growth, internal capital generation should slow because of profitability headwinds. Appetite for bank M&A activity is curbing.
- We expect the impact of the Basel 3 Reform (FRTB and CVA charge in Q1 2024) will have a neutral-to-slightly negative impact on D-SIBs' capital ratios, ranging from 0 to negative 75 bps with an average of about 25 bps. Phase 1 of the Basel 3 Reform (credit and operational risk), which came into effect in Q2 2023, overall was a slight positive to D-SIBs' capital ratios.
- We expect D-SIBs will reach the 72.5% RWA output floor by the regulatory timeframe of 2026. We do not expect the regulatory changes will affect our ratings on D-SIBs.

D-SIBs' capital metrics

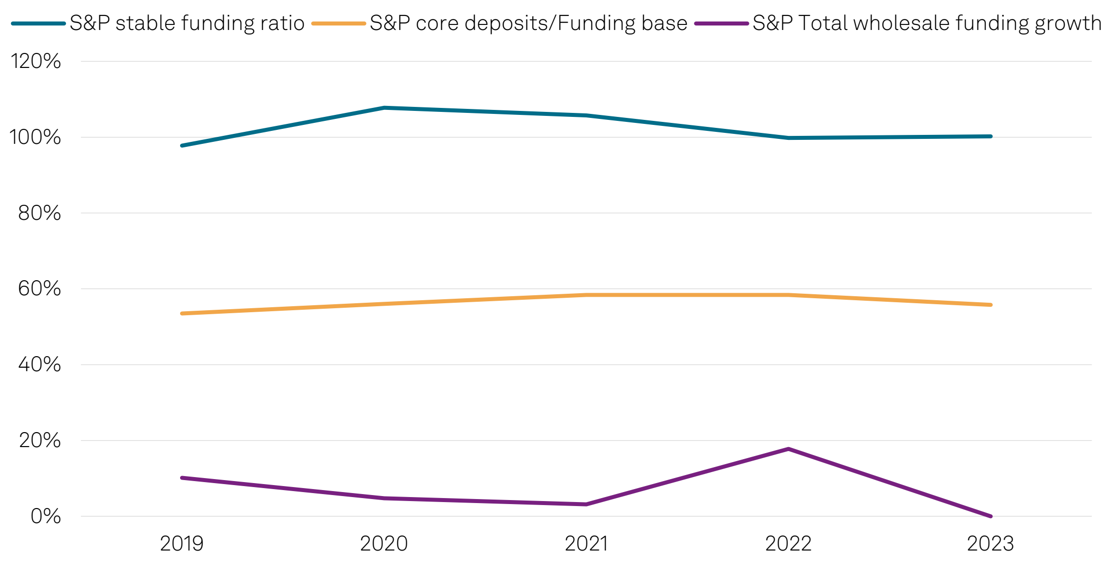


*S&P Global Ratings RAC ratio not yet available for Q4 2023; RAC/CET1 ratios are averages of the Big 6 banks. RAC--Risk-adjusted capital. CET1--Common Equity Tier 1. Sources: S&P Global Ratings, company filings.

Funding And Liquidity Metrics Will Remain Relatively Unchanged

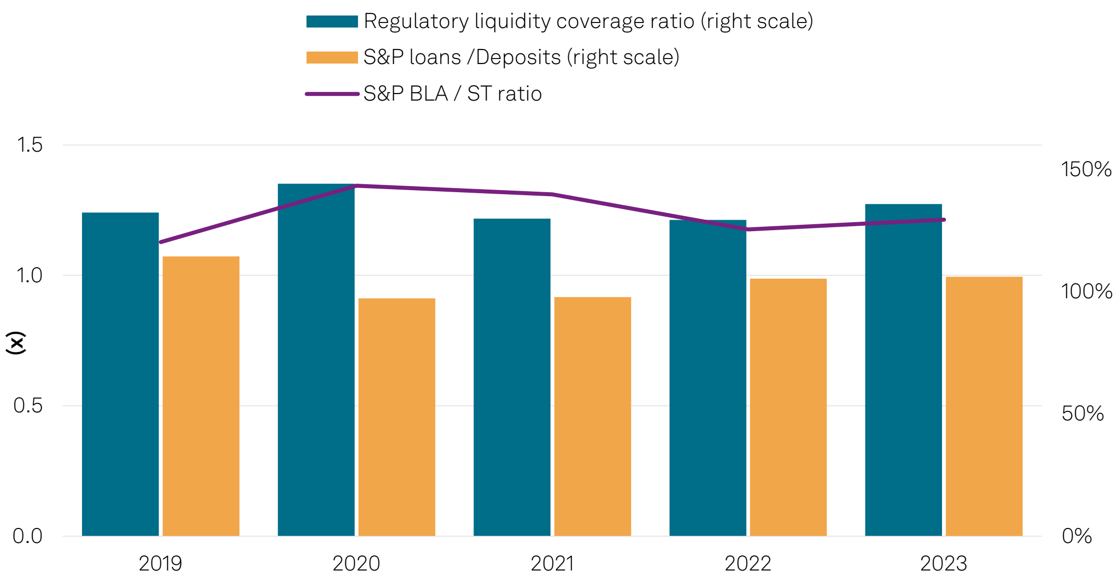
- We expect the banks' overall funding and liquidity metrics will be relatively unchanged. D-SIBs' regulatory liquidity coverage ratio, which was on average 136% at year-end 2023 (compared with an average of 129% at year-end 2022) could decline modestly as liquidity is expensive for banks to hold. However, we expect that D-SIBs will manage liquidity carefully as geopolitical and economic uncertainties remain.
- Loans-to-deposits ratio should remain relatively stable as customer loans and deposit growth will likely be similar.

D-SIBs' funding metrics



Source: S&P Global Ratings, company filings.

D-SIBs' liquidity metrics

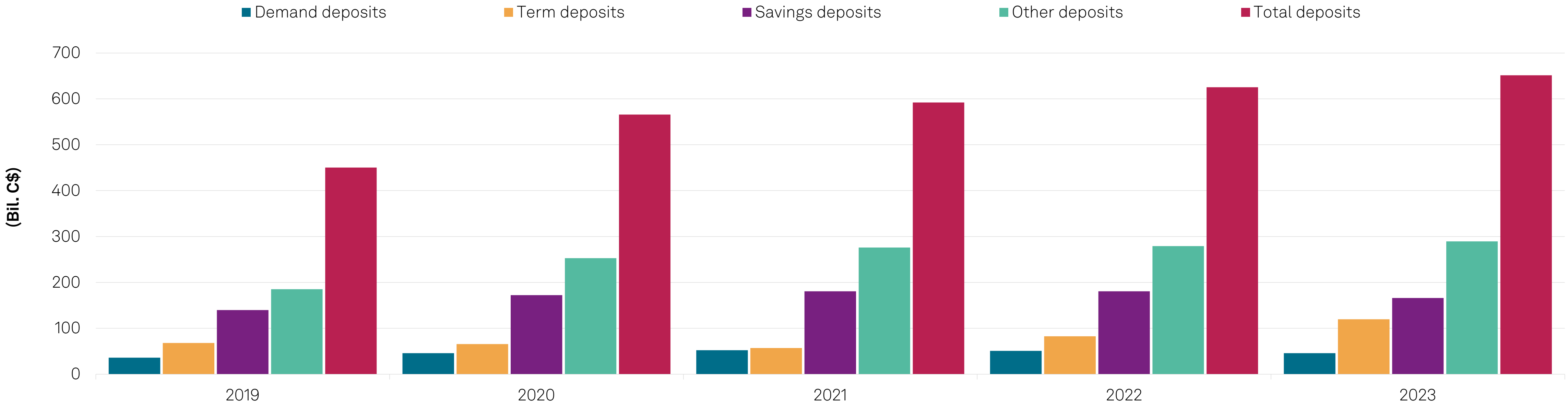


Note: BLA/ST--Broad liquid assets to short-term wholesale funding. Source: S&P Global Ratings, company filings.

The Composition Of Deposits Could Change At The Margin

- Term deposits have been increasing since rates began to rise because of the more favorable returns that they offer versus other deposit products.
- Term deposit growth has likely peaked and is stabilizing. Most deposit renewals will likely be in term deposits but growth will moderate once rates begin to fall.

D-SIBs' average deposits by type

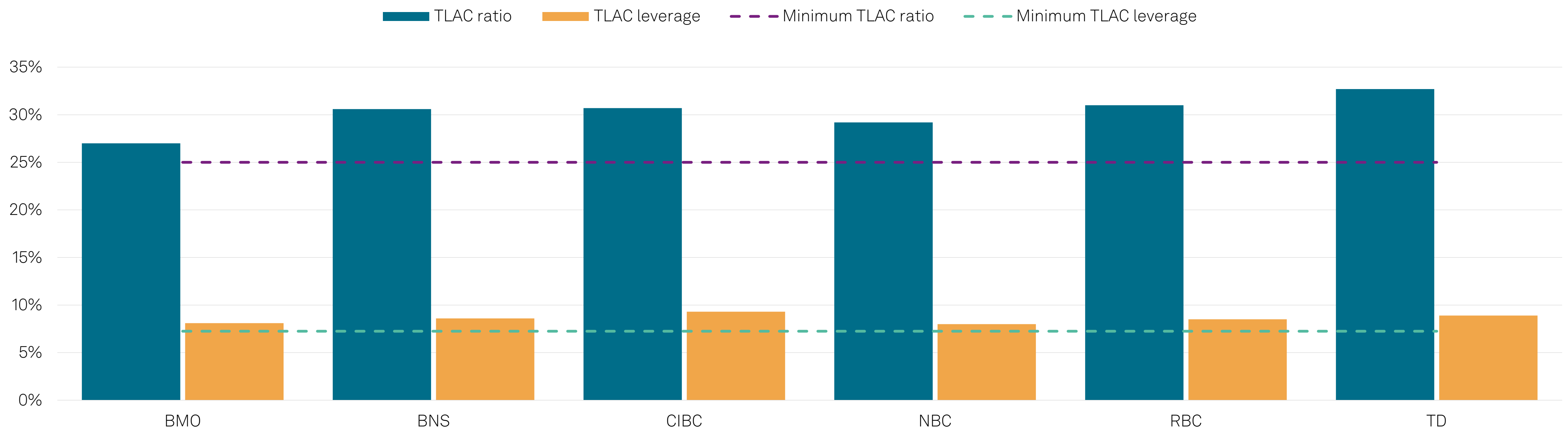


Source: S&P Global Ratings, company filings.

Banks' TLAC Ratios Are Well Positioned

- At year-end 2023, D-SIBs' average regulatory TLAC (of RWAs) and TLAC leverage ratios were 30.2% and 8.6%, respectively, and above the regulatory minimums of 25.0% and 7.25% TLAC and TLAC leverage. We expect these levels will be relatively unchanged in 2024.

Regulatory TLAC and TLAC leverage ratios*



*As of October 2023. TLAC--Total loss-absorbing capacity. TLAC ratio--TLAC as a percentage of risk-weighted assets.
TLAC leverage ratio--TLAC as a percentage of leverage. Sources: S&P Global Ratings, company filings.

Related Research

- Economic Outlook Canada Q1 2024: Growth Is Set To Continue Slowing
- Global Banks Outlook 2024: Forewarned Is Forearmed
- Global Banks Country-By-Country Outlook 2024: Forewarned Is Forearmed
- Banking Industry Country Risk Assessment: Canada
- Canada Full Analysis
- Large Canadian Banks' Domestic Residential Mortgage Portfolios Are On A Solid Footing

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