Foyston, Gordon & Payne Inc.
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PCLs, NII, FGP: Our comments on the Canadian banks' results

Canada's big banks just completed their quarterly reporting season. While we're still analyzing the numbers, we believe there were some positives in the earnings results given credit improvements and growth outlooks. Here are a few thoughts.

Credit losses are expected to moderate in 2025

Provisions for credit losses (PCLs) in the consumer sector (e.g., mortgages and unsecured loans) trended higher, but there were no red flags that consumer credit is collapsing. The negative credit standout was the Bank of Montreal (BMO), which had a meaningful increase in PCLs quarter over quarter. BMO's earnings were negatively impacted by its $1.5 billion in PCLs, of which roughly $1 billion was for non-performing loans and $500 million for performing loans. It is notable that BMO's higher credit losses were specific commercial loans made in 2021. Core EPS was $1.90 compared with the consensus estimate of $2.38. BMO's management, however, believes that the situation is now starting to improve and the worst should be in the past. We believe this optimism caused BMO's share price to outperform meaningfully on the day of the announcement.

Canadian Imperial Bank of Commerce (CIBC) was at the other end of the spectrum, with a quarter-over-quarter decrease in PCLs to $419 million, compared with $483 million in the previous quarter. The majority of the decline was in performing loans, which dropped to $2 million from $79 million.

It's also worth mentioning National Bank of Canada. While this bank's PCLs increased 9% during the quarter, the absolute level of PCLs remains at a bank sector low of 27 basis points. National Bank's credit cycle experienced a bit of pressure, with some credit challenges in its foreign banking operations (i.e., ABA Bank in Cambodia) and in its U.S. subsidiary, Credigy Solutions, Inc. Overall, though, the bank's credit situation is fine.

Looking forward, the banks have provided slightly different outlooks for exactly when peak credit losses should occur. A largely common message, though, is that 2025 is likely to be the peak, and the recent reduction in PCLs is a key driver for improving bank earnings and returns on equity.

In the banks' core lending business, NII was resilient

Leading the pack this quarter in year-over-year core net interest income (NII) growth were CIBC, up 17%, and Royal Bank of Canada (RBC), up 15%. The other banks reported lower NII growth.

The outlook for fiscal 2025, which started on November 1, is positive, with RBC in particular projecting growth of core NII in the mid to high single digits. Our understanding is that many corporate borrowers had paused taking out loans as the U.S. presidential election approached because they found it difficult to make capital investment decisions in the absence of government policy.

Overall, we're happy with our bank holdings, and our decision to sell TD and buy BMO

There is still good value in the banks we own: RBC, Bank of Nova Scotia, CIBC, and BMO. Toronto-Dominion Bank (TD) has significant business challenges, and its quarterly results shed new light on the duration for remediation. We do not own National Bank largely due to valuation, not bank quality. Indeed, National Bank is a high-quality bank.

We believe our decision to buy BMO and sell TD earlier this year is playing out as expected. Our thesis on BMO is that it is the best U.S. growth vehicle among Canada's big banks and that it has a credible path to an expansion in return on equity (ROE). While BMO has faced challenges with credit losses in its commercial loan book in the fiscal year that ended on October 31, the peak in credit losses appears to be in the rear-view mirror. Through a combination of U.S. segment improvement, normalizing PCLs, operational improvements, and capital optimization, we believe BMO has laid out a credible path to a 15% ROE over the medium term.

On the other hand, TD likely has many years of material challenges ahead because of its U.S. anti-money-laundering (AML) criminal conviction. This won't be an easy ride. In its latest quarterly release, TD removed its financial targets, including a 16% ROE target, and highlighted that the U.S. AML remediation actions would continue until 2028. TD's AML conviction also negatively impacted our Environmental, Social, and Governance (ESG) assessment of the bank as it is clear that TD had material lapses in management controls. While the bank is trying to rectify these issues, it's hard to see TD regaining its premium valuation anytime soon.