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Big bank earnings wrap up as results disappoint and interest rates, recessionary fears bite

STEFANIE MAROTTA || MAY 26, 2023

The headquarters of TD Bank, left, CIBC, centre, and RBC in downtown Toronto. Many of Canada's biggest banks posted lower-than-expected quarterly results and lower profits this week.
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Canadian banks were weighed down by the crumbling economic outlook as climbing reserves for potential loan defaults and heated borrowing costs pinched second-quarter growth.

Climbing loan loss risk, surging expenses and slowing loan growth struck a blow to profits at the country's largest lenders, marking a turning point as the threat of a recession looms. Many of the country's biggest banks posted worse-than-expected quarterly results and lower profits this week, dragging the sector's shares to their lowest point in seven months.

"Markets are facing structurally different circumstances following the end of an era of low inflation, low interest rates and increased globalization," RBC chief executive officer Dave McKay said during a conference call with analysts Thursday. "With labour markets

remaining firm, despite declining levels of attrition and job postings combined with higher jobless claims, we do not expect central banks to cut interest rates through 2023."

Toronto-Dominion Bank TD-T -0.37% also reported lower profit and results Thursday that missed expectations. Bank of Nova Scotia BNS-T -0.51% and Bank of Montreal BMO-T +0.02% reported worse-than-expected results Wednesday. Canadian Imperial Bank of Commerce CM-T -0.11% reported Thursday as well, becoming the only lender so far to top analyst estimates and book higher net income from a year earlier. National Bank of Canada NA-T -0.03% reports next week.

TD's shares dropped 4.2 per cent Thursday and RBC slumped 1.8 per cent, while CIBC gained 2.1 per cent.

RBC RY-T +0.06% profit fell 14 per cent from a year earlier to $3.6-billion, or $2.58 per share. Adjusted to exclude certain items, the bank said it earned $2.65 per share, falling below the $2.80 per share analysts expected, according to Refinitiv.

The lender's expenses spiked 16 per cent to $7.49-billion, which "were the culprit in the quarter," Barclays analyst John Aiken said in a note to clients.

Compensation costs jumped 15 per cent, boosted by a 20 per cent increase in salaries and benefits. Mr. McKay said that RBC reacted "strongly" to compete during staffing shortages last year, when technology companies hired aggressively. Now that the tight labour market is easing, he expects to trim costs as hiring slows and some employees leave the bank.

"We had to respond to that with aggressive hiring and anticipating high turnover rates persisting into the first half of 2023," Mr. McKay said. "Well, that was not the case. Almost overnight, tech firms started laying off instead of hiring, and therefore attrition came off very rapidly. And honestly, we overshot by thousands of people."

Provisions for credit losses – the funds that banks reserve for loans that could go bad during an economic downturn – have been edging higher across the sector, climbing from their lows early last year when the extreme defaults feared during the COVID-19 pandemic were not as bad as anticipated.

In the quarter, RBC booked $600-million in provisions for credit losses. That was higher than analysts anticipated, and included $173-million against loans that are still being repaid. In the same quarter last year, RBC had a recovery of $342-million in provisions.

TD and CIBC also set aside more loan loss reserves. TD raised provisions to $599-million from $27-million in the same quarter last year, and CIBC set aside $438-million compared with a reversal.

But deposit books are shifting as market volatility and higher interest rates prompt customers move cash from low-cost chequing accounts to more expensive fixed-term savings products, causing banks to pay more interest to keep those deposits. As demand for loans slows, particularly for mortgages as the housing market cools, the trend is squeezing

net interest margins – the difference between the amounts that banks charge on loans and pay on deposits.

At TD, the deteriorating economic outlook, as well as the cancellation of its takeover of Tennessee-based First Horizon Corp., dampened the bank's growth forecast. The lender said in its second-quarter results that it does not expect to meet its target range for growth in earnings per share over the medium term of 7 to 10 per cent.

Canada's second-largest lender called off the US$13.4-billion deal in early May, scrapping its most significant acquisition in years after difficulties in securing regulatory approvals delayed the closing. Media reports citing unnamed sources said that the barriers were related to issues with TD's anti-money-laundering practices, causing concern among investors as to whether TD will be unable to purchase other U.S. banks in the coming years.

TD will have to pay First Horizon a termination fee of US$225-million that will affect earnings in the third quarter.

With TD's peer-leading capital cushion no longer earmarked for the deal, the bank plans to repurchase 30 million shares, representing 1.6 per cent of its outstanding shares. To bolster its derailed U.S. expansion plans, the lender will open 150 U.S. retail branches by 2027, executives told analysts during TD's conference call. Chief financial officer Kelvin Tran said that the lender is also considering raising its dividend and looking at other growth opportunities.

"There are plenty of opportunities and white space, especially in the U.S. for growth. And then for M&A, we always look at whether we have the opportunity to add capabilities or new customers or stores," Mr. Tran said in an interview. "The First Horizon issues were related to the uncertainty on the timing of the regulatory approvals, so we continue to look for opportunities for growth."

The banking crisis in the United States also cast a spotlight on liquidity and financial stability. Canada's banking regulator, the Office of the Superintendent of Financial Institutions, cited liquidity as the second-highest risk to the banking sector in its annual outlook, released in April.

CIBC said in its second quarter earnings that it plans to maintain an above-average liquidity coverage ratio (LCR) – a measure of a bank's ability to fund cash outflows. Typically the lender maintains its LCR above 120 per cent. That level is expected to rise to more than 130 per cent in the year ahead to help shield the bank from potential market volatility.

"That allows us to withstand some days and weeks of market disruption in the funding markets, as we saw in March," CIBC chief financial officer Hratch Panossian said in an interview.