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January 4, 2023 **Industry Update**

Canadian Banks – Dissecting EPS Risk

Consensus Too High? Guidance Too Rosy? What's The Risk To 2023 Expectations?

Sector:
Financials

Our Conclusion

The potential range of economic outcomes in 2023 remains wide, with the midpoint of expectations shifting down for much of the last year. Consensus EPS estimates for the banks are down 5% from peak on average and continue to imply average EPS growth of 2% next year. While consensus estimates appear to be broadly aligned with banks' guidance, we think there is a high probability that numbers will have to come down further. This note explores key earnings drivers and associated EPS sensitivities across each of the big banks. Our estimates suggest downside risk to consensus EPS is greatest for TD and BNS, based mostly on PCL and NIM sensitivities.

Key Points

Credit provisioning will dictate the year. Guidance from the banks suggests it will be an average year for credit provisions. We find that hard to swallow given the significant move in borrowing rates, inflationary pressures and an economic slowdown. We have positioned our PCL assumptions at the high end of, or above, guidance. Every 10bps change in the PCL ratio impacts F2023E EPS by 5% on average. TD and BNS have the highest sensitivity.

The interest rate story has become complicated. The simple assumption is that banks benefit from higher short-term rates. We have seen a significant divergence in NIM among the Canadian banks over the last two quarters and expect further divergence in F2023, with recent winners (TD, RY and BMO) continuing to win over the next two quarters, and then the laggards (BNS and CM) narrowing the gap in H2-23. Every 2bps change in NIM impacts EPS by 1.5% on average, with BNS, TD and BMO being the most NIM-sensitive.

Loan growth likely to fall short of guidance. Loan growth guidance across the banks was relatively consistent, with a call for low single-digit residential mortgage growth and high single-digit commercial loan growth. We agree with the call on mortgage growth, but believe commercial loan growth will cool more than anticipated. EPS for BMO and BNS shows the most sensitivity to slowing loan growth.

Expense growth less likely to be a source of downside risk. Expense growth ended up being a source of earnings downside relative to beginning-of-year expectations. We think that is less likely to be the case in F2023 given that expense growth expectations have moved higher. We do, however, think positive operating leverage will be hard to achieve for those without significant NIM expansion. We estimate that every 1% change in operating expenses impacts EPS by 1%, with little difference among the banks.

All figures in Canadian dollars unless otherwise stated.

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F2023 Guidance

The banks were good at providing guidance for the upcoming year across a number of earnings drivers. We provide a summary of what we think are the key drivers for the year ahead, and how these compare to 2022A and our F2023E in Exhibit 1. A more fulsome summary of guidance bank-by-bank is provided in Appendix 1 on page 6.

The key points from this summary are: i) PCLs are expected to be significantly higher in F2023, resulting in an earnings drag, and we have generally positioned our assumptions to be in the upper half of guidance ranges; ii) NIM expansion remains a little nebulous with the potential for positive or negative surprises and hence we have applied conservative assumptions; and iii) loan growth is expected to slow significantly in F2023, but with still strong commercial loan growth and we have assumed slower growth versus guidance.

Exhibit 1: Canadian Banks – Guidance vs. 2022 Actuals & 2023 Estimates

	PCL[1]			NIM - Q4 to Q4 Comparison			Loan Growth		
	2022A	2023G	2023E	2022A	2023G	2023E	2022A	2023G	2023E
BMO	0.06%	0.17% - 0.27%	0.24%	0.21%	High-single digits	0.06%	19.4%	High-single digits	6.4%
BNS	0.19%	0.30% - 0.40%	0.40%	-0.08%	Gradual growth	0.00%	16.1%	N/A	5.3%
NA	0.07%	0.20% - 0.30%	0.25%	0.11%	Gradual growth	0.04%	13.1%	Robust commercial growth	5.5%
RY	0.06%	0.20% - 0.30%	0.28%	0.21%	10-15bps (More in H1)	0.07%	13.5%	Continued growth (commercial)	5.1%
TD	0.13%	0.35% - 0.45%	0.42%	0.18%	Gradual growth (More in H1)	0.10%	14.7%	N/A	4.4%

(1) If no range was provided, roughly 5bps was added to our assumed lower-end range, and 5bps was subtracted for our higher-end. Where guidance was only for impaired PCLs, we added 5bps of PCLs for performing loans.

Source: Company reports and CIBC World Markets Inc.

We provide a comparison of F2023 estimated EPS growth using company guidance versus current consensus and CIBCe in Exhibit 2. Consensus EPS growth is slightly below guidance on average; however, there are a number of large differences across the individual banks. Consensus is higher than guidance-implied EPS growth for TD, which we attribute to consensus including some benefit for acquisitions. Consensus looks conservative relative to guidance for both NA and RY (our two Outperformer rated banks), which suggests there may be less downside risk to consensus EPS. Consensus is relatively close to guidance on BNS.

Our estimates are generally lower than consensus and guidance-implied EPS. This is intentional as we have taken a more conservative stance on forward assumptions. The biggest divergence based on our estimates is for BNS, which relates back to our macro view on credit and BNS having a lower ACL buffer. We are also well below consensus and guidance-implied EPS for TD as TD is a more credit-sensitive bank.

Exhibit 2: Canadian Banks – F2023 Guidance vs. Consensus vs. CIBCe

	Estimated EPS Growth		
	Following Guidance[1]	Consensus	CIBCe
BMO	2.9%	2.7%	2.6%
BNS	-1.2%	-2.1%	-5.8%
CM	NA	-2.8%	NA
NA	3.2%	0.7%	1.4%
RY	8.4%	6.6%	6.5%
TD	5.9%	8.0%	2.8%
Average	3.9%	2.2%	1.5%

(1) Assumes the mid-point of EPS guidance and high-single digit loan growth.

Source: Factset, company reports and CIBC World Markets Inc.

Credit Provisioning Will Dictate The Year

Credit losses have started to normalize and guidance across the banks implies that credit provisioning will continue to push higher in F2023. We have skewed our assumptions toward the upper end of management guidance with recognition that there is a wide range of potential outcomes.

We provide a comparison of total PCL ratios between F2023 guidance and 2022 actuals in Exhibit 3. Guidance implies that TD is expected to experience the largest increase and BMO the smallest increase. We have also provided the estimated impact to our F2023 adjusted EPS estimates based on a 10bps change in the total PCL ratio, which effectively represents the difference between the low end of the guidance range versus the high end (for the banks that provided a range).

RY shows the least EPS sensitivity for a 10bps change while BNS shows the highest sensitivity. We then combine PCL guidance and earnings sensitivity to see which bank faces the biggest expected EPS drag from higher PCLs in F2023. Based on this approach TD is expected to see the greatest EPS impact, followed by BNS and NA. BMO shows the smallest impact, but that math changes somewhat with the Bank of the West acquisition as the ratio of loans-to-equity will increase.

Exhibit 3: Canadian Banks – F2023 Estimated EPS Impact From Higher PCLs

	Implied Increase In PCL Ratio Using Mid-point of 2023 Guidance	EPS Impact From 10bps Increase in PCL Ratio	Implied EPS Drag Based on PCL Guidance
BMO	0.14%	-4.8%	-6.7%
BNS	0.16%	-6.0%	-9.6%
NA	0.18%	-4.7%	-8.5%
RY	0.19%	-4.0%	-7.6%
TD	0.27%	-4.5%	-12.2%

Source: Company reports and CIBC World Markets Inc.

The Interest Rate Story Gets Complicated

The general assumption, and an appropriate assumption, is that higher interest rates benefit banks' earnings. However, we have seen a significant dichotomy in actual interest rate benefits among the banks. We do expect all the Canadian banks to benefit from higher rates over time, but the pace at which that flows into earnings is very different in some cases, and that pace will matter a lot as we think about the first half of F2023 versus the second half.

Since the end of F2022, the Bank of Canada (BoC) has already announced another 50bps increase and the Fed has raised 125bps. We expect the BoC will pause, but recognize the possibility of a further 25bps rate increase in FQ2. The Fed on the other hand is expected to tighten by another 50-75bps in early 2023, with meeting dates landing during FQ2. This will likely provide a tailwind for the banks with the greatest sensitivity to short-term interest rates for another two quarters as these rate-sensitive banks all have material US banking businesses. This includes TD, RY and BMO. Banks that have extended asset duration are expecting to see a benefit from higher rates once central bank rates stop increasing; this includes CM and BNS.

We provide a summary of disclosed NII sensitivities and how they have evolved over the last year for each of the banks in Exhibit 4. We have to keep in mind that using this disclosed sensitivity has its limitations in terms of earnings estimates, but we still think it is instructive in terms of differences among the banks and how rate sensitivity has changed over time.

TD remains the most interest rate-sensitive bank (twice the group average), but NII upside from a 100bps parallel shift in the curve has diminished 35% from a year ago. BMO now has the second-highest earnings sensitivity to higher rates, surpassing RY. BMO's disclosed sensitivity was down only 5% Q/Q while RY's sensitivity dipped 28%. However, NIM guidance, which we think is more valuable than the NII disclosure, suggests that RY retains a slight advantage to BMO. BNS remains an outlier with a negative correlation to higher rates, and with a larger negative at year-end versus the prior quarter.

Exhibit 4: Canadian Banks – Disclosed NII Sensitivity For 100bps Parallel Yield Curve Shift – Q4/2021, Q3/2022 And Q4/2022

	NII Sensitivity (Pre-Tax) 100bps Interest Rate Increase			Q4/22 Vs.	
	Q4/2021	Q3/22	Q4/22	Last Q.	Yr. Ago
BMO	384	525	499	-5%	30%
BNS	212	-267	-340	27%	-260%
CM	444	364	269	-26%	-39%
NA	108	151	130	-14%	20%
RY	929	1091	781	-28%	-16%
TD	1857	1291	1213	-6%	-35%

Source: Company reports and CIBC World Markets Inc.

We have summarized consensus expectations for NIM expansion in F2023 and earnings sensitivity to NIM in Exhibit 5. It is not surprising to us to see that TD is expected to experience the greatest NIM expansion and thereby the biggest implied EPS lift associated with NIM expansion. BMO is a close second both in terms of expected NIM expansion and associated EPS benefit. RY is right at the group average in terms of expected NIM expansion and slightly below average in terms of the EPS benefit. NA is marginally below average on both bases, but with less EPS sensitivity to NIM. BNS is an outlier as consensus expectation has zero NIM expansion in F2023 and therefore no EPS benefit. However, the more interesting observation for BNS, in our view, is that it actually has the highest EPS sensitivity to NIM. If BNS starts to see NIM improvement in the second half of F2023 then perhaps the EPS picture could quickly improve.

Exhibit 5: Canadian Banks – Consensus NIM Expansion, EPS Sensitivity And EPS Impact – 2023

	BMO	BNS	NA	RY	TD	Average
Consensus NIM Expansion	16bps	-1bps	8bps	11bps	20bps	11bps
EPS Impact per 2bps	1.60%	1.80%	1.30%	1.40%	1.60%	1.54%
Implied EPS Lift From NIM	12.8%	-0.9%	5.2%	7.7%	16.0%	8.3%

Source: Factset, company reports and CIBC World Markets Inc.

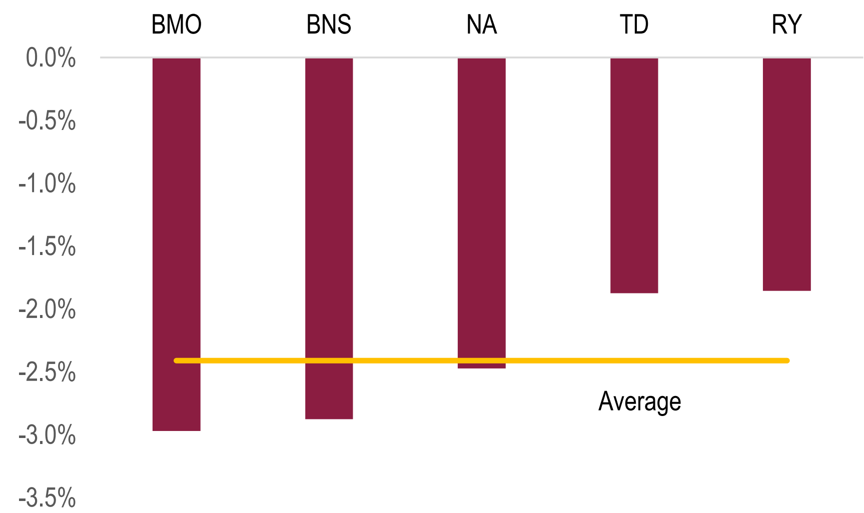
Loan Growth Most Likely To Fall Short, But Not The Biggest Risk To Earnings Estimates

We think there is downside risk to F2023 loan growth guidance, which was relatively consistent across the banks. Management teams are generally expecting low single-digit residential mortgage growth, which appears reasonable, and high single-digit commercial loan growth, which appears too optimistic. The increase in the minimum CET1 ratio is partially intended to slow commercial loan growth and we believe it will prove effective given the higher risk weightings associated with commercial loans. It is therefore worth looking at the potential earnings implications from slower loan growth.

We assume mid-single-digit loan growth on average, with loan growth for each individual bank coming in lower than guidance. We compare the EPS impact relative to our F2023 adjusted EPS estimates assuming zero loan growth. While we are asked from time-to-time if zero loan growth is a plausible scenario, we think it is a very low probability scenario. We use it here instead to show relative earnings sensitivity among the banks for downside risk to loan growth.

EPS sensitivity to loan growth is not significant for the group. While we think there is a high probability that loan growth will fall short of guidance, the EPS implications are not as severe as other factors. BMO and BNS show the greatest earnings leverage to loan growth. TD and RY show the least leverage.

Exhibit 6: Canadian Banks – EPS Sensitivity To Zero Loan Growth – F2023E



Source: CIBC World Markets Inc.

Could Expenses Be A Source Of Downside Again?

Expense growth easily exceeded our expectations in F2022, and operating leverage fell short of guidance for most banks. It's reasonable to ask whether banks could be facing a similar risk in F2023.

Most banks did not provide explicit expense growth guidance for F2023, but instead guided based on operating leverage expectations. The most reasonable explanation for that is the uncertain revenue environment and the intended message that the banks will manage expenses based on top-line results. In other words, the banks are saying that the expense growth story is fluid. No question there are controllable expenses, but wage inflation and third-party vendor pricing suggests that there is some persistency to higher-than-normal expense growth.

Non-interest expenses increased 6.3% in F2022, significantly higher than our assumption at the beginning of the year of 3.6%. We are assuming expense growth of 8% on average for next year, excluding acquisitions. Given the high starting point for assumed expense growth, the probability of expense growth exceeding our forecast appears small. We estimate that every 1% delta relative to our forecast impacts our F2023 adjusted EPS estimate by 1.3% on average, with very little variation among the banks.

Exhibit 7: Canadian Banks – Expense Sensitivity – F2023E

Expense Sensitivity	BMO EPS Impact	BNS EPS Impact	NA EPS Impact	RY EPS Impact	TD EPS Impact	Average EPS Impact
1% Higher Than CIBCe	-1.3%	-1.3%	-1.2%	-1.2%	-1.3%	-1.3%

Source: Company reports and CIBC World Markets Inc.

Appendix 1 – Canadian Banks – F2023 Guidance

	FY23 PCL Guidance Across The Big 6					
	BMO	**BNS**	**RY**	**NA**	**TD**	**CM**
PCL	FY23 impaired PCL rate in the range of high-teens to low-20bps.	FY23 PCL ratio in the mid-30bps range.	Total PCL for FY23 expected to be 25-30bps; PCL on impaired loans expected to be 20-25bps.	Impaired PCL to return to range of 15-25bps.	FY23 total PCL to be within the 35-45bps range.	June 2022 Investor Day guidance reaffirmed; total PCL guidance of mid to high-20bps.
NIM	High single-digit NIM expansion compared to FY22 based on expanded deposit margins and higher long-term rates.	Gradual growth through the course of FY23.	All-bank NIM guidance of 10-15bps for FY23. Most of that will be coming in the first half, but continued NIM expansion through the full year.	Higher interest rates to result in some margin expansion over the next couple of quarters.	Total bank NIM to improve on a more gradual basis over time. P&C business NIM to improve in the near term.	Margin pressure to continue until Q2 2023, but expect margins to gradually improve thereafter.
CET1	CET1 Ratio of 11% or above post BoW acquisition.	N/A	Activating a 2% discount to be applied to our DRIP; expected to add about CAD 2B in capital. Defer share repurchases until close of the HSBC Canada acquisition.	N/A	CET1 ratio >11% post FH and Cowen transactions.	N/A
Operating Leverage	Positive operating leverage again next year.	N/A	All-bank level operating leverage to be positive FY23.	Targeting positive operating leverage for FY23.	Target of positive offering leverage over the medium term.	Generate positive operating leverage in aggregate through 2025.
Loan Growth	FY23 loan growth to be in the high single-digit range.	N/A	Growth in commercial lending to continue over the next couple of quarters.	Commercial loan growth to remain robust but below rates observed in the last two years.	N/A	Canadian Commercial business to moderate in 2023, and high single-digit loan growth for the US segment.
Deposits	Customer deposit growth in the mid-to-high single digits Y/Y. Deposit betas to move higher with future rate hikes.	N/A	Cumulative deposit beta to end in the 40% range once rates stop rising.	N/A	Deposit betas to increase in the medium term. FY23 to see increased price sensitivity among mass affluent, high net worth and institutional commercial clients.	N/A
Acquisitions	BoW acquisition to close in first calendar quarter of 2023.	N/A	N/A	N/A	FH planned to close in first half of 2023.	N/A
Economy	Real GDP growth in both Canada and the US expected to be close to zero, and we expect interest rates to peak by the end of the first calendar quarter, with rates lowering from January of 2024.	N/A	Added a record 400,000 clients this year; positioned to attract more clients next year. Partnership with ICICI Bank Canada to create a seamless banking experience for newcomers to Canada is expected to attract approximately 50,000 clients as immigration levels reach record highs.	Delinquencies and provisions to continue rising throughout FY23. Speed contingent on inflation and interest rates. Expect more dispersion in credit performance.	N/A	Global economic growth expected to slow through FY23.
Housing/ Mortgages	N/A	N/A	Mortgage growth to be in the mid single digits next year.	Residential mortgage to slowly normalize back near pre-COVID levels.	Revised housing outlook downward on higher rates. Not expecting a crisis, but see an unwind of some of the gains that have occurred since COVID.	Portfolio growth of low single digits for FY23; do not expect to see material losses.

Source: Company reports and CIBC World Markets Inc.

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