Major Challenges and Opportunities Facing the Canadian Banks

Description

At a financials conference this week in Toronto, the big Canadian Banks went over their thoughts and discussed challenges and opportunities in the industry as well as for their particular companies. Let's take a look at some of the themes that came out of the day and zero in on the challenges and opportunities that the banks are facing.

Canadian Retail Segment Slowing

It is pretty unanimous amongst bank CEOs that growth on the retail side in Canada has clearly slowed and will remain that way. **Royal Bank** (TSX: RY) CEO Gord Nixon, for example, expects mid-single digit growth in the retail business versus double digit growth in recent years. He expects slower growth in consumer leverage and debt. Over at **TD** (TSX: TD), management expects to be at the lower end of its target of 7 to 10% growth in earnings this year, and if the Canadian retail segment will be as weak as feared, then even the 7% growth will be difficult to achieve.

Mortgage run-off, which refers to the reduction in the mortgage loan portfolio as loans are paid off and new mortgages do not fill the gap, is another challenge that the banks face in the coming years. At **Scotiabank** (TSX: BNS), almost $19 billion in mortgage run-off will occur by fiscal 2017. And at **CIBC** (TSX: CM), they are also battling a run off of loans of approximately $50 billion. On the mortgage side at CIBC, the retention rate is above the 25% that they were hoping for, but nevertheless it is still a big challenge for the bank. So banks are looking for a way to offset this reduction in income.

Efficiency Becoming Ever More Important in the Current Environment

Net interest margins have been declining, and with expected slower revenue growth, it is even more important to increase focus on controlling costs and efficiencies. Royal Bank's net interest margin was 2.7% in the latest quarter, a decrease of 7 basis points sequentially and 6 basis points year over year. **Bank of Montreal** (TSX: BMO) also saw a deterioration in its net interest margin, which fell 8 basis points sequentially and 14 basis points year over year.

To combat these trends, the banks are shifting gear and focusing more on cost savings and efficiencies that can be squeezed out of the business. Royal Bank announced that it would cut 1,129 full time jobs, or 1.5% of its work force. Scotiabank has also talked about trimming and cost cutting after a slightly disappointing quarter that saw the bank's international segment struggle with narrowing interest margins and an 18% increase in loan loss provisions.

Higher Rates a Positive for the Banks

Rates have been creeping higher in Canada as well as the U.S. Short term rates have stayed low but longer term rates have risen, more so in the U.S. than Canada, but the trend is the same for both countries. The risk here though is if rates rise too far and too fast, it could hurt loan demand and economic growth to a point where it becomes a bad thing. So it is very much a balancing act.

It would clearly be very positive for the banks if rates were to steadily increase in a measured fashion so as not to hurt consumer demand too much. **TD's** (TSX: TD) deposit balance in the U.S. alone is $2.4 billion. These deposits are not interest rate sensitive and the interest that TD is being paid on mortgages and other loans increases with the rise in rates. This relationship is essentially a license to print money in the right kind of environment.

Increased Focus on Wealth Management for Profitable Growth

The wealth management business is a very profitable business model with low capital investment required, and lower volatility and losses. Furthermore, growth rates in the segment are expected to be strong going forward as the aging population (baby boomers) are driving demand for wealth management services.

Bottom Line

The banks are clearly facing challenges ahead but it's not all dark and dreary. In a perfect case scenario, there will be a measured rise in interest rates so as to not hurt the consumer too much while the banks enjoy a rise in their net interest margins. Furthermore, the banks that can be most successful in cross selling their products and deepening their customer relationships will prove to be the most successful going forward.

CATEGORY

1. Investing

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3. TSX:CM (Canadian Imperial Bank of Commerce)
4. TSX:RY (Royal Bank of Canada)
5. TSX:TD (The Toronto-Dominion Bank)

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