Q3 2017 Canadian Western Bank Earnings Call

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TEXT version of Transcript

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Canadian Western Bank - CFO and EVP

* Christopher H. Fowler

Canadian Western Bank - CEO, President and Non-Independent Director

* Matthew Evans

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Presentation

Operator [1]

Good day, ladies and gentlemen, and welcome to CWB Financial Group's Third Quarter 2017 Financial Results Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded. I would now like to turn the call over to Mr. Matt Evans. Sir, you may begin.

Matthew Evans, [2]

Thanks, Chelsea. Good afternoon, and welcome to our earnings call today. My name is Matt Evans, and I lead the Investor Relations team for CWB Financial Group.

Presenting to you today is Chris Fowler, CWB's President and Chief Executive Officer; and Carolyn Graham, our Executive Vice President and Chief Financial Officer. Also with us today are the other members of CWB's Executive Committee: Kelly Blackett, Glen Eastwood, Darrell Jones, Stephen Murphy and Bogie Ozdemir.

Before we begin, please note that the conference call graphs, quarterly results, news release and supplemental financial report are available on our Investor Relations website at cwb.com. Let me also remind you that our call today may include forward-looking statements, and it's possible that actual results may differ materially from these statements. Our forward-looking statements advisory is found on Slide 13, and the agenda for today's call is on the second slide.

I'll now turn the call over to Chris.

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [3]

Thanks a lot, Matt. I'll begin with the third quarter performance highlights and a few comments on the continued execution of our strategy. Carolyn will follow with detail on our financial results before we move to the question-and-answer period.

Moving to Slide 3. This morning, we reported very strong third quarter results from the successful execution of our balanced growth strategy. Highlights this quarter include very strong 24% growth of our common shareholders' net income with positive operating leverage, positive loan growth and ongoing growth of stable, relationship-based, branch-raised deposits. Credit quality remains entirely consistent with our expectations and the long-term track record of our secured lending business model. We continue to support our solid operating performance with a very strong capital position. In fact, for 2017, The Banker magazine ranked CWB as the soundest bank in Canada as measured by capital-to-assets ratio. Our balance sheet strength provides us with flexibility to create value for shareholders through a range of strategic initiatives, and we're pleased to announce a 4% increase in our common share dividend this quarter.

Our balanced growth strategy includes a very clear objective to deliver strong growth of client relationships with a focus on business owners. We define balanced growth as growth that delivers a broader geographic footprint, reduced industry concentrations and an improved funding model for the bank with more full-service clients. For over 10 years, geographic diversification opportunities outside of Western Canada have been sought to significantly enhance our future growth opportunities without compromising the competitive advantage conferred through our business-owner focus. Our third quarter results indicate clear evidence that our strategy is working.

Performance against our balanced growth objectives for loans this quarter is a great example of the contribution from our broader geographic diversification. While Alberta and Saskatchewan continue to recover from a prolonged recession, our loan book outside of these provinces grew 11% from the third quarter last year and 4% this quarter alone. Our core portfolio of general commercial loans outside of Alberta and Saskatchewan grew 15% over the past 12 months and 6% in the third quarter. At the same time, we remain active supporting and seeking new business in Alberta and Saskatchewan with our clients there and anticipate the economic recovery in these provinces will continue. With our businesses across the rest of the country delivering very strong performance, we are well positioned to benefit as the recovery takes hold.

The bar graph on Slide 4 tells the story. It demonstrates the continued progress we've made over the past year against our geographic diversification objectives. CWB Maxium and CWB Franchise Finance have both delivered strong performance since we acquired them last year, and both have made significant contributions to the execution of our balanced growth strategy. Combined with ongoing growth from CWB Optimum and National Leasing, we delivered a net increase of about $1 billion in CWB's Ontario-based loan balance. This very strong, well-diversified 34% increase resulted in significant expansion in the proportion of CWB's total portfolio located outside of Western Canada.

Loans in Ontario and East now represent 22% of our total portfolio, up significantly from 17% last year. We are very clearly making steady progress towards our strategic goal to achieve a 30-30-30 geographic split between BC, Alberta and Ontario and East. British Columbia now represents our largest exposure by province, and I want to be sure to note we are working hard to actively support clients affected by the wildfires, including through payment relief. We are also closely monitoring the potential impact of the wildfires on our business. While they may result in lower-than-expected forestry-related activity throughout the interior of the province in the near term, we expect logging to accelerate after the summer wildfire season. As such, any related slowdown of activity is likely to be short-lived.

As shown on Slide 5, strong year-over-year growth of our core general commercial loans portfolio and ongoing strong performance within CWB Optimum Mortgage has also contributed to strategic industry diversification. General commercial loans now comprise 26% of our overall portfolio compared to 25% last year. Our strategy specifically targets growth within this category.

General commercial activity represents the largest segment of Canada's economy, and client relationships in this segment provide opportunities for CWB to deliver our full range of products and services. This includes lending, cash management, business savings and other deposit services, along with personal banking and targeted wealth management and trust services for business owners.

Now a few last notes related to our successful progress on industry diversification. Personal loans and mortgages now represent 20% of overall loans compared to 17% last year. Real estate project loans now comprise 18% of total loans, down from 21% a year ago. Project loans comprised a greater proportion of growth in 2015 and '16. While we continue to actively support strong developers within our markets, the lower growth rate in this portfolio more recently is consistent with our strategic objective to deliver balanced growth over a full cycle. Going forward, our strategy is to continue to pursue opportunities to service good businesses with strong management teams operating within our targeted industry segments across the country.

Slide 5 also demonstrates success against our balanced growth strategy to diversify our funding. Targeted growth of business and personal deposits raised through our branches remains a key focus. In addition to being lower cost, these products strengthen multiproduct relationships by supplying clients with the tools they need to manage their finances. Third quarter branch-raised deposits were up 6% from the same period last year, including strong 8% growth of lower-cost demand in notice deposits. Total branch-raised deposits, including Trust Services deposits, accounted for 56% of total deposits at July 31, 2017, up from 52% last year. Demand in notice deposits comprised 37% of total deposits, up from 34% last year.

With loan growth picking up, it's clear that successful execution of our balanced growth strategy is creating long-term value for shareholders. We expect to meet our medium-term performance targets in fiscal 2017, with the exception of adjusted return on common shareholders' equity and the dividend payout ratio. We expect adjusted ROE to remain below 12%, primarily due to the higher balance of shareholders' equity with the issuance of common shares last year. And we expect earnings growth to result in migration of the dividend payout ratio towards 30% over the medium term. As we look ahead, we are eager to capitalize on both our broader reach and the ongoing transformation of the financial services landscape. Our approach will increasingly leverage our recent technology investments and related initiatives to deliver exceptional client experiences and provide banking services anytime, anywhere. CWB Financial Group has the unique opportunity to build full-service banking relationships with business owners in targeted markets both within and beyond our branch footprint. We're very excited to continue our steady progress towards this goal.

With that, I'll turn the call over to Carolyn.

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [4]

Thanks, Chris, and good afternoon, everyone. CWB Financial Group delivered a very strong third quarter. Compared to the third quarter last year, results included positive loan growth with significantly higher net interest margin; a lower provision for credit losses; ongoing growth of relationship-based, branch-raised deposits; record total revenue; and substantial earnings growth; all supported by very strong regulatory capital ratios. Common shareholders' net income of $56 million and pretax pre-provision income of $101 million were up 24% and 9%, respectively. Record quarterly total revenue of $184 million increased 9% from the same quarter in 2016 with a 10% increase in net interest income and 2% higher noninterest income. Net interest income benefited from the 5% increase in average loan balances and a significant 20 basis point improvement in net interest margin to 2.60%. Higher net interest margin partly reflects CWB's improved funding mix, including the benefit of continued growth of lower-cost, branch-raised demand in notice deposits.

Earnings growth also benefited from a decrease in the provision for credit losses to 20 basis points of average loans compared to 32 basis points last year as well as lower preferred share dividend. These factors were partially offset within common shareholders' net income by higher noninterest expenses and acquisition-related fair value changes, up 9% and 16%, respectively. While noninterest expenses were up 9%, effective control of discretionary expenses continues across the group, and we delivered positive operating leverage this quarter.

Diluted earnings per common share of $0.64 and adjusted cash earnings per common share of $0.69 increased 16% and 15%, respectively, reflecting the factors noted above and the issuance of common shares last year. On a year-to-date basis, common shareholders' net income of $153 million and pretax pre-provision income of $287 million were up 18% and 8%, respectively. Strong earnings growth primarily reflects 8% growth of total revenue and a lower provision for credit losses.

Total revenue benefited from an 8% increase in net interest income and 11% growth in noninterest income. Higher net interest income was driven by the combined impact of 4% loan growth and a 9 basis point increase in net interest margin to 2.54%.

Growth of noninterest income mainly reflects higher credit-related fees, a small amount of net gains on securities this year compared to $3 million in net losses last year and higher wealth management fees. The provision for credit losses of 24 basis points as a percentage of average loans was down from 43 basis points last year, primarily reflecting the impact of specific allowances recorded against energy loans in 2016. These factors were partially offset within common shareholders' net income by increases in noninterest expenses, acquisition-related fair value changes and preferred share dividends. Diluted earnings per common share of $1.74 and adjusted cash earnings per common share of $1.89 were up 9% and 14%, respectively.

Third quarter net interest margin of 2.60% was up 20 basis points from the same quarter last year and 5 basis points from the prior quarter. Compared to last year, the increase in net interest margin reflects 3 primary factors: First, favorable changes in asset mix with increasing contributions from the relatively higher-yielding CWB Maxium, CWB Franchise Finance and CWB Optimum Mortgage portfolios, along with lower average balances of cash and securities; second, favorable changes in funding mix with ongoing growth of lower-cost, branch-raised deposits and lower utilization of deposits sourced through the broker market; and finally, higher asset yields reflecting the impact of pricing discipline, elevated prepayment fees and steepening of the yield curve. The impact of the July increase in the Bank of Canada's overnight rate was positive but not significant as it occurred relatively late in the quarter.

Year-to-date net interest margin increased 9 basis points to 2.54%, mainly due to the same factors I've just mentioned. While competitive factors continue to impact loan yields, the growing contributions from the relatively higher-yielding CWB Maxium portfolio, CWB Franchise Finance, CWB Optimum Mortgage portfolios, all helped to mitigate net interest margin pressure.

Before I move on to complete the outlook for net interest margin, I'll stay with CWB Optimum Mortgage for a moment to tie up the issues we saw a few months ago within the alternative lending space of the Canadian housing market. In short, these events did not meaningfully disrupt our operations or affect our margins. In May and early June, we saw both higher-than-normal mortgage application volumes for CWB Optimum and increased deposit pricing within the broker deposit funding channel. As we moved through our third quarter, mortgage volumes returned to normal, and the broker deposit market remained deep, liquid and just as accessible as ever to CWB. The weighted average cost of funding for broker deposits issued this quarter was less than the weighted average cost of maturing broker deposits despite the impact of the price disruption early in the quarter. This partly reflects the fact that broker deposit pricing was relatively low prior to the market turbulence.

Term deposits raised through the broker network represented 35% of total funding at quarter-end compared to 39% last year. This change is a direct result of our balanced growth strategy. As a reminder, the deposits that we raise through the broker market are entirely fixed-term deposits with terms of maturity between 1 and 5 years. We do not offer a high-interest savings account product. More than 50% of our broker term deposits have maturities longer than 1 year.

Now back to net interest margin and our outlook. The 25 basis point increase to the Bank of Canada's overnight rate in July, related steepening of the yield curve and growing contributions from CWB's relatively higher-yielding loan portfolios is expected to mitigate the continued impact of competitive factors on net interest margin over the near term. Acceleration of loan growth in 2018 may require increased usage of the relatively higher-cost broker deposit funding channel, and we may periodically hold higher average balances of cash and securities with a lower average yield in the event of macroeconomic or financial market volatility. However, the balance of factors we consider in the outlook for net interest margin supports our expectation for incremental improvement in this key metric over the near term. Any further increases in the Bank of Canada's overnight rate would also be expected to have a positive impact on this key metric.

Slide 9 shows our strong efficiency ratio. The third quarter efficiency ratio of 45.3% was relatively unchanged from last year, and the year-to-date efficiency ratio was also stable at 46.3%. Operating leverage over the past 12 months was positive 0.3% and 0.1% on a year-to-date basis. We remain committed to effective control of all discretionary expenses. Recent increases to our cost base reflect both strategic investment in technology to support exceptional client experiences and acquisitions to expand our future growth opportunities. We've offset these increases with the stronger rate of revenue growth, with important contributions from newly acquired CWB Maxium and CWB Franchise Finance. We fully expect our investments to drive future revenue growth and contribute to positive operating leverage over the medium term.

Turning to Slide 10. Overall credit quality remains consistent with our expectation and reflects CWB's secured lending business model, disciplined underwriting practices and proactive loan management. The third quarter provision for credit losses was 20 basis points of average loans. This was down from 32 basis points in the same period last year and 25 basis points last quarter. On a year-to-date basis, the provision for credit losses was 24 basis points, below the low end of our expected range of 25 to 35 basis points for this year and down from 43 basis points a year ago. Abnormally high third quarter and year-to-date write-offs last year related to energy loans as we took a proactive approach to resolve positions within our small portfolio of loans to oil and gas producers. We've reduced the balance of this portfolio substantially in the past year, and it now represents less than 1% of our total loans. We do not expect material credit impacts related to our remaining energy loans going forward.

Slide 11 shows the level of gross impaired loans at July 31. Gross impaired loans totaled $169 million and represented 74 basis points of total loans, which compares to $107 million or 49 basis points last year and $138 million or 62 basis points last quarter. While Alberta-based loans represent 34% of CWB's overall loan portfolio, impaired loans within Alberta accounted for 56% of total impairments. Two accounts in the general commercial category, one based in Alberta and the other in Manitoba, comprised approximately half of the balance of new impaired loan formations this quarter, and neither of them require a specific allowance. The level of gross impaired loans fluctuates as new impairments are identified and existing impaired loans are either resolved or written off and does not directly reflect the dollar value of expected write-offs, given tangible security held in support of our lending exposure.

We review the entire loan portfolio regularly to provide early identification of potential adverse trends, with impairment decisions undertaken on a cost -- case-by-case basis. Realization plans for impaired loans are monitored closely by a specialized team. Specific allowance for potential write-offs are conservatively established through detailed analyses of both the overall quality and marketability of security held against each individual impaired account. These prudent measures support our comfort in the level of provisioning and allowances.

Looking forward, we continue to proactively monitor all accounts as well as developments within the residential housing sector. With the exception of the greater Toronto area and certain parts of greater Vancouver, Canadian residential real estate markets remain affordable. The material decrease in the volume of home sales has become apparent within greater Toronto and the surrounding areas as buyers and sellers react to the Ontario Fair Housing Plan. The average price of detached homes softened within parts of the GTA during the third quarter. In addition to the impact of the Ontario Fair Housing Plan, the change in housing market activity also relates to earlier regulatory changes implemented at the federal level, which primarily targeted insured mortgages and mortgages funded through securitization.

And if implemented as proposed, potential revisions to OSFI's underwriting guideline B20 could serve to further curtail market activity and reduce the pace of home price increases across the country. In particular, the 200 basis point qualifying stress test and limitations on co-lending arrangements could make it more difficult for certain prospective buyers to qualify for uninsured mortgages and have a negative impact on originations within CWB Optimum. However, the changes may also result in incremental lending opportunities within the alternative mortgage space as large lenders are also affected by revisions to the guideline. In view of these somewhat offsetting factors, we expect a moderate negative impact to origination volumes within CWB Optimum if B20 revisions were implemented as proposed.

Turning to CWB Optimum's current performance. We tightened our lending criteria to deal with the temporarily elevated mortgage application volumes within CWB Optimum this quarter, and origination volumes were maintained at levels consistent with our strategic growth objectives and established risk appetite. As we said before, we individually adjudicate each loan and focus on good-quality borrowers in this segment. Our risk appetite is conservatively focused on affordably priced homes, and we're disciplined in focusing on a borrower's ability to pay. CWB Optimum's business model targets an average loan to value at initial funding of 67% this quarter on an average origination of $348,000. The average size of each outstanding mortgage is $231,000. We assess markets by postal code and continue to actively adjust our maximum loan-to-value criteria based on local conditions. In general, we require larger down payments on more expensive homes to manage our exposures.

Notwithstanding current -- continued strong growth from CWB Optimum, Alt-A mortgages still represent a relatively small proportion of our overall loan portfolio at approximately 11% of the total. This portfolio has performed very well for us since we started the business in 2004, and we expect it to continue to deliver strong results as we remain consistent with our conservative risk appetite and our selective approach to approve new loans.

Slide 12 shows our very strong capital ratios at July 31. Using the standardized approach for calculating risk-weighted assets, our Common Equity Tier 1 ratio was 9.6%. The Tier 1 ratio was 10.9%, and our total ratio was 12.7%. At 8.4%, our Basel III leverage ratio remains very conservative. The increase in CWB's CET1 capital ratio from last year was driven primarily by earnings growth. Going forward, all capital levels will remain strong.

As Chris mentioned, yesterday, our board declared a quarterly cash dividend of $0.24 per common share, up $0.01 or 4% from the dividends declared both last year and the prior quarter. Common share dividend increases are evaluated every quarter against the dividend payout ratio target of approximately 30%. The third quarter dividend payout ratio is approximately 40%. Our very strong financial performance this quarter and optimistic outlook support the dividend increase. And as Chris mentioned, we expect earnings growth to result in migration of this metric toward 30% over the medium term.

With that, I'll turn things back over to Matt to begin the Q&A session.

Matthew Evans, [5]

Thank you, Carolyn. That concludes our formal presentation for today's call, and I'll ask the operator to begin the question-and-answer period.

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Questions and Answers

Operator [1]

(Operator Instructions) And our first question comes from the line of Meny Grauman with Cormark Securities.

Meny Grauman, Cormark Securities Inc., Research Division - Analyst of Institutional Equity Research [2]

I want to start up by asking about cash balances, noticing that they're down to basically where they were in Q2 '16. I'm wondering if there's any message in that number.

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [3]

Meny, there's a couple of factors. The first thing I would say is that we remain fully compliant with the liquidity adequacy requirements as well as our internal liquidity management policy. A couple of the factors in there, strong growth in branch-raised deposits over the last several quarters. They're relationship deposits. They're operational, and they bring a higher funding value from a liquidity management perspective. The second is, is that over time, a larger proportion of what we hold in cash and securities on the balance sheet qualify as high-quality liquid assets. So if we look back a year or 2, we had a much larger portfolio of preferred shares and common shares, which don't qualify as high-quality liquid assets, so there is more of -- a higher proportion of the outstanding cash and security balances are now high-quality liquid assets. So that's part of the shift we see as well.

Meny Grauman, Cormark Securities Inc., Research Division - Analyst of Institutional Equity Research [4]

And then if I can just ask about the dividend and then talk about improving outlook. Wondering, in recommending the dividend increase, can you point to some specifics? What did you see in Q3 specifically that gave you confidence to recommend a dividend increase?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [5]

I'd say it's the continued performance in the diversification of the loan portfolio across the country that is delivering the results. And it's benefiting earnings, net interest margin. It's supported by strong branch-raised deposit growth. And then as we look out with, one, Bank of Canada increase, that also supports our outlook and improves our outlook as it relates to NIM.

Meny Grauman, Cormark Securities Inc., Research Division - Analyst of Institutional Equity Research [6]

So is this sort of a signal that you're back on track in terms of -- before the pause, you were raising the dividend every other quarter. Do you see any difference in terms of -- I know you determine it on a quarter-by-quarter basis, but do you see any difference in how you're thinking about the dividend going forward?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [7]

I think, overall, we are more positive, and that factors into the dividends that we look at every quarter. We are still considerate of the medium-term performance target at about 30%, but we forecast that we'll trend back towards that.

Meny Grauman, Cormark Securities Inc., Research Division - Analyst of Institutional Equity Research [8]

And then if I could just ask on the loan loss provisions -- or the loan loss ratios. Specifically, you talk about the impact that business mix is having on the margin, but can you talk about the shift in business mix specifically when it comes to credit in the context of the 20 basis points loan loss ratio that you put up this quarter?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [9]

I think the -- we absolutely talked about loan growth coming from some of our higher-yield portfolios. But if I think about those specific portfolios and then think about it from a credit quality perspective, they all are performing consistent with what I would call our historic normal PCL ratios. So there isn't a materially different credit quality component in any of those books that are growing very strongly.

Operator [10]

And our next question comes from the line of Robert Sedran with CIBC Asset Management.

Robert Sedran, CIBC World Markets Inc., Research Division - MD & Head of Research [11]

Not quite yet. Just plain old CIBC for now. I want to follow up on that credit quality question. Just the interesting comment you made, Carolyn, about the historically normal loss rates. I mean, 20 is back in the old range when the "nothing going on here" is what our provisioning level is. And I'm sorry if I missed it in the prepared remarks, but when we think about the 25 to 35 range that was being called for when there was a little bit more stress in the environment, are we getting back to more normal levels of loan losses? And as you think about 2018, can we start to think about credit in the old way again?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [12]

I'll comment on it from 2 perspectives, and then Chris might want to comment as well. I would say that the first is that, for this quarter, it felt more like normal levels. But the other comment I would make is that Alberta and Saskatchewan continue to work their way out of the economic recession. And so I think things will continue to be a little bumpy, right? So it wouldn't surprise me -- we're seeing impaired continue to tick up a bit. So we're still comfortable at 25 to 35 for 2017. We think we'll be towards the lower end, and I'm absolutely comfortable with that. Looking forward to 2018, we haven't formalized our thoughts on that yet, but I would say we're returning towards more normal credit quality environment.

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [13]

Yes, I would concur with and certainly echo Carolyn's remarks. The portfolio composition we have today, I think we've -- look, we've managed down our energy exposures, and we are seeing a pretty consistent performance in our books. So I think we're comfortable with that 25 to 35 this year. And we'll evaluate what we think for '18, but we do believe it's stabilized compared to where we were a year ago coming into fiscal '17.

Robert Sedran, CIBC World Markets Inc., Research Division - MD & Head of Research [14]

Okay. And just a point of clarification. When you mentioned the impact of the B20, you suggested that it could have a moderate impact -- or not a big impact, but some impact on your origination volumes. But I'm curious if you can clarify whether that is from the currently elevated levels that we have seen or from a more normal level of growth that you would have previously seen and probably expect to get back to anyway.

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [15]

I would say the more normal level. And by the end of the quarter, we're back to what would be historic levels of volumes and applications and fundings.

Robert Sedran, CIBC World Markets Inc., Research Division - MD & Head of Research [16]

Do you think it's an opportunity -- I mean, perhaps the growth will slow, but it's an opportunity to get an even higher grade of credit quality in the portfolio? Because you mentioned some of the traditional channel -- you'll have some people falling out of that traditional channel. Is it an opportunity for the growth then to be high-graded a little bit as well?

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [17]

Absolutely. And this is one of the first portfolios that we actually have operating under our AIRB risk-rating process, so we are targeting a lower risk rate. So we're certainly seeking to improve the quality of that book. Not that it's been a bad quality because we've got excellent historical performance, but I think it just improves that -- the opportunity set for us with better tools, with our AIRB approach, but also just a change in the selection that we can underwrite from.

Operator [18]

And our next question comes from the line of Gabriel Dechaine with National Bank Financial.

Gabriel Dechaine, National Bank Financial, Inc., Research Division - Analyst [19]

Just wanted to follow up on that loan growth. I missed -- sorry, which portfolio is the one that you're underwriting under AIRB or...

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [20]

The Optimum Mortgage portfolio. We've got 2 that we are -- yes, Optimum and then National Leasing portfolio as well.

Gabriel Dechaine, National Bank Financial, Inc., Research Division - Analyst [21]

But they're still capitalized and...

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [22]

100%. It was just the manner under which we risk rate. It's a -- we're still working on our entire AIRB project.

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [23]

Yes, all of our capital is still calculated under the standardized.

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [24]

It's still -- we're still standardized, yes.

Gabriel Dechaine, National Bank Financial, Inc., Research Division - Analyst [25]

What does that mean? Like, just from a -- in layman's terms, when you say you're evaluating the risk under the AIRB lens, like how...

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [26]

It's a different risk-rating model than we had in the past. So it has different quantitative features to it than we would have underwritten before. So it just scores the loans differently.

Gabriel Dechaine, National Bank Financial, Inc., Research Division - Analyst [27]

Is it more conservative? Or are you able to look at more...

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [28]

Yes, it's much more granular than the prior approach. It's an enhancement.

Gabriel Dechaine, National Bank Financial, Inc., Research Division - Analyst [29]

Okay. Well, staying on this loan growth issue. Your year-over-year growth rate was, what, 4%, so down. But sequentially, it was 2%, so annualized at 8%. That's my math anyway. It looks like maybe you're turning a corner here. I even noticed the real estate project loans, after a few quarters of seeing those balances shrink, you're sequentially up anyway. You're more positive on margin, credit. My comment, but -- or my word, but it sounds like you're cautiously optimistic on 2018 or better. Is loan growth also an area of improvement that you -- and you're starting to see some green shoots?

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [30]

Well, definitely. Loan growth is -- again, that we see as the foot in the door with the client base. As we look at the different books, we have geographically expanded with the addition of CWB Maxium and CWB Franchise Finance. So that Ontario market for us has certainly improved and had great progress in our business there. BC continues to have the strongest economy in Canada. So the overall GDP that came out today is strong. So that, certainly, is a great -- for us, a reflection of opportunity, that our core focus on business owners is one that, I think, we believe we have great green shoots there. I mean, Alberta is still challenged. Let's be clear. I mean, the price of oil has been pretty range-bound in the $46 to $48 range, but there's still double the drilling going on today than there was a year ago. So that's positive. So I think as we think about the opportunities for growth, we will continue to be aspirationally targeting double digit but prudently taking on the business that makes sense for us.

Gabriel Dechaine, National Bank Financial, Inc., Research Division - Analyst [31]

Okay. Just the real estate loans, is that a seasonal thing? Or I know it's not that big of a deal, like $100 million or something like that. But is there something going on there that we might get excited about?

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [32]

Well, on the project lending, those -- they are a bit cyclical because you can take on a number of loans and the projects get built and then sell out. We still have a very strong group focused on that in Edmonton, Calgary and Vancouver, in particular. We've got a very high-quality borrower profile. And if you look at the Lower Mainland in particular, it's still a very robust market. Edmonton and Calgary has been, obviously, slower given the slowdown here, but it continues -- both Edmonton and Calgary are holding their own, and our clients are doing well. So we continue to focus on that. We believe it's a portfolio that we continue to manage and perform well with. So it is -- remains a target focus for us, and we will certainly deliver on those clients as the opportunities present themselves.

Gabriel Dechaine, National Bank Financial, Inc., Research Division - Analyst [33]

Okay. And my last one, I mean, it's not a huge number, but you had positive operating leverage this quarter, best year-to-date performance anyway. We don't have the hyper focus on operating leverage for your bank as we do for some of the others, but it's still a very important metric. Just wondering, again, looking out to 2018, are you expecting to have better efficiency metrics and better operating leverage than you've done so far this year?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [34]

So on an efficiency ratio perspective, we are targeting in and around 46%, somewhere in there, on a go-forward basis through 2018 and beyond, with striving for positive operating leverage through the medium term. So yes, we see that in 2018 and beyond.

Operator [35]

And our next question comes from the line of Sumit Malhotra with Scotia Capital.

Sumit Malhotra, Scotiabank Global Banking and Markets, Research Division - MD of Canadian Financial Services [36]

I just wanted to start with Carolyn and your comments in the first question with the cash balances. Just on liquidity in general, when we spoke 3 months ago, I got the impression that the liquidity number that you ended Q2 with was unusually low. So if -- it doesn't look that much different to end Q3. So should I take your comments earlier to mean that some of the branch deposit growth has been so much stronger that you feel that you can permanently run with a lower liquidity ratio than -- or a lower liquidity level than we had seen in the past? Or do you still expect it to migrate higher, especially as the loan portfolio grows?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [37]

So a couple of things. Our comments at the end of the second quarter or sort of in early June, the market was disrupted there on the broker space, so we were cautious about how long that disruption would last, and our conservative reaction has always been in the past in times of volatility to carry more liquidity. So we weren't sure how quickly it would dissipate. It actually dissipated more quickly than we had anticipated. Branch-raised deposit growth, yes, we are positive about where we're seeing the deposit growth coming from, so it is more relationship-based. It is accounts that carry a higher funding value. So that would -- is positive. We expect that to continue moving forward, but it does fluctuate depending on where the growth comes in the deposit balances.

So -- and the third one that I mentioned was that more and more of what we're holding in cash and security all qualify as high-quality liquid assets as opposed to other security balances that may be supportive of NIM potentially, but aren't included in the -- in what counts as a liquid asset for the regulatory purposes. And probably that's -- given current conditions, that's probably something that will continue.

Sumit Malhotra, Scotiabank Global Banking and Markets, Research Division - MD of Canadian Financial Services [38]

So said differently, obviously, we're -- in my case anyway, I'm looking at the aggregate what I consider to be liquidity number and the dollar amount is lower. But in your view, it's a higher-quality liquidity as far as maybe some of the calculations are concerned. And the improvement in the, let's call it, the operating environment is such that you can hold at this level. I'm paraphrasing, but that's what I get to. And I take to mean that changes in your margin going forward will have -- will be a lot less dependent on changes in the aggregate liquidity level. Is that a fair characterization?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [39]

I think that's fair going forward from here.

Sumit Malhotra, Scotiabank Global Banking and Markets, Research Division - MD of Canadian Financial Services [40]

And then a couple for Chris to wrap up. Chris, when I first met you, you were -- I always think of you as a lending guy. So some of these questions I'm always going to come back to you on. Just on housing in general. You discussed -- or the real estate outlook is maybe a different way to put it. We've talked about some of the disruption your peers faced in the alternative channel as well as the impact of B20. Just your aggregate view, we've seen a lot of, let's call it, regulatory or tax-based changes to try to cool the housing market. It's an area where the bank is getting bigger in terms of overall exposure. When you think of the changes that have been enacted to attempt to cool the market, do you have any heightened sense of risk in terms of your growth profile in this business and some of the customers you're attracting?

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [41]

Well, we talk about that all the time internally, of course. So as we built, in particular, the Optimum book -- so it's about 60% of our total book. The other book is in our branch network. But the Optimum book, we are very targeted on the mid-range house, so houses in that sort of $400,000 to $600,000 range. We've got very little exposure in loans with appraised -- where the house's appraised value is greater than $600,000, and over $1 million, it's about 3% of our book. So in aggregate, as we think about this market, we want to be at that average house. We want to have a -- we want the ability to be able to react and deal with our security if we do have a problem. Clearly, the regulatory changes will have an impact on all lenders within it, be it the private lenders, the large banks and the mono lines. So where we sit, we think we sit right in the middle. We have the -- a very disciplined risk appetite in how we look at the size of these loans that we're interested in. We expect that the B20 changes -- we think we already account for a number of them. We are very active in how we think about loan-to-value. We go by postal code. We think about the -- and it comes into the stress test and the co-lending. We haven't seen what that -- the final rules will be there. But we expect that, that might shrink some of the origination that we would historically have done. But we also think it will change the categories of these loans at other originators as well. So we think the overall impact of the current regulatory changes that are being proposed will be moderately negative, but we don't see it as significantly negative to that business. And really, it's because of the -- that sort of very conservative focus we've taken on how we underwrite in that market.

Sumit Malhotra, Scotiabank Global Banking and Markets, Research Division - MD of Canadian Financial Services [42]

That's a very detailed answer. And maybe one that's shorter-term to add to that, across the Banking sector, as we've seen the Q3 results over the last couple of weeks, most of the banks have had strong sequential loan growth when it comes to mortgages, but they've pointed us to the fact that -- well, you've all seen the slowdown in sales activity, particularly in the GTA over the last couple of months, so balances may not grow as fast going forward. I think what you're telling us is some of that is likely true for your bank even though the overall mortgage profile is different?

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [43]

Yes.

Sumit Malhotra, Scotiabank Global Banking and Markets, Research Division - MD of Canadian Financial Services [44]

Is that fair?

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [45]

And that's that moderately negative perspective that I -- that we're adding to that equation.

Sumit Malhotra, Scotiabank Global Banking and Markets, Research Division - MD of Canadian Financial Services [46]

Last question is around your capital ratio. I think you mentioned it or you were around it when you talked about the ROE. And you said there's just more equity in the denominator than there used to be. And obviously, the positive side of that is we have a very good capital ratio. I'll be honest, from my seat, once your capital ratio got up a while ago above the 9.5% mark, I didn't think it was going to be there for this long. I thought there would most likely be some use of proceeds that came from the bank. I wanted to just get your thoughts there. Are you comfortable running with a higher level of capital given some of the, let's call them, macro uncertainties that we've seen? Is there any early preparation for IFRS 9? I know you have another year or 2 to adopt that before -- the other banks are moving to it more quickly. Or is there just been a case where there hasn't been acquisition opportunities that have come up and you're happy to keep your powder dry? Wrap all that together and just thinking about a 9.5%, 9.6% CET1 ratio, which seems like it's a lot higher than you need to run at as a non-DSIB bank.

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [47]

Well, absolutely. I mean, we've got a higher ratio that really has come from the slower loan growth over this past year with overall 5% growth, where we would have anticipated using some of that capital up for sure. So we think about -- obviously, we're working through what IFRS 9 is going to look like. On the acquisition side, we're very interested in looking at acquisitions. So we think we did extremely well in 2016 with the CWB Maxium and the Franchise Finance acquisitions, so we would absolutely looking to follow that up with the same type of sort of accretive acquisition that those were. But at 9.6%, we have that dry powder, as you mentioned. It does give us the flexibility to make choices, and it's certainly our intention that we will manage to a very appropriate capital level, but our goal is to grow the business and find the right ways to deploy that capital.

Operator [48]

Our next question comes from the line of Doug Young with Desjardins Capital Markets.

Doug Young, Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst [49]

First question, just going back to the growing into the dividend payout ratio of 30%. Just want to get a sense of how you're thinking about it. I mean, medium term for me is 3 to 5 years, just curious of your views on that. And is this like one increase and then grow into it? Or is this -- you may do further increases and grow into it over time? Just trying to get a sense.

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [50]

Our view of medium term would be the same as yours. And we have always had a reputation of being a growth company. That includes loans, that includes earnings, that includes the dividends. So thinking about going forward, that is one of the considerations that we take into account.

Doug Young, Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst [51]

And why wouldn't you just increase the dividend payout? I mean, it's lower than most of your peers. You have some room. You've got excess capital. Why not run at a higher payout ratio?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [52]

We've -- internally, we can support -- organically, we can support about 10% to 12% annual loan growth organically just from the earnings that the portfolio generates. So it's always been -- a lower dividend payout ratio has allowed us to retain that. We felt it was a better value for the shareholders to retain it in the business and use it to grow the book and the earnings and the value over the longer term.

Doug Young, Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst [53]

And by default, that view hasn't, obviously, changed then?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [54]

No, that would be consistent with the strategic direction that we're pursuing and executing.

Doug Young, Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst [55]

Okay. Just on to NIMs, can you quantify what the prepayment impact was in the quarter?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [56]

Prepayment impact in the quarter contributed about 2 basis points of the 5 basis point increase from the second quarter and about 3 basis points of the 20 in the year-over-year quarterly NIM. So a factor, but not the factor.

Doug Young, Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst [57]

No. And then when you think about -- I don't know if there's an easy rule of thumb, bank -- I mean, all else considered, all else remain the same, where you stand today, if Bank of Canada raises rates 25 basis points, what's the impact on the NIM? Do you have a -- is there a rule of thumb we can think about?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [58]

There isn't a clear rule of thumb. We've looked, as you've done, right, what was the impact of the last 2 drops that came in 2015. It might be a fair assumption to assume we might see upticks the same in the first 2 pickups of the Bank of Canada. Really, our portfolio, we've got about 45% of the loan book that is floating rate, so it reprices immediately. We've got probably just under 20% of the deposit portfolio that immediately reprices. So we get that lift immediately. And then it really depends how deposit pricing in the market moves over time, and it depends on the duration and how our fixed rate loans and deposits roll over and reprice. So it's not a quick formula.

Doug Young, Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst [59]

No, fair point. And then I guess, if loan growth remains slow, deposits grow faster than loans, you're going to get a pickup. And as loan growth starts to pick back up to the 10% to 15% -- or

10% to 12% range, you would naturally see some compression as you have to go to the wholesaler, or if you have to go to the wholesale market. That's a fair point as well?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [60]

It's a fair assumption about how we would fund at the margin. Generally, those deposits are higher cost, but it depends on the -- again, the broker market as well as the time.

Doug Young, Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst [61]

Then just on your organic growth, just looking at organic growth in the general commercial loans year-over-year, excluding Franchise Finance, maximum (sic) [Maxium]. Fair to assume that there was some organic growth? Or did most the growth emanate from those 2 acquisitions? So just thinking of organic on that commercial -- general commercial loan book.

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [62]

Bear with us a minute. Sorry, general commercial grew about just under $300 million in the quarter. About half of that is Maxium and half would be the rest of the portfolio -- the rest of the sort of the organic business or the non-acquisition.

Doug Young, Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst [63]

Okay. So half of that is organic?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [64]

Yes.

Doug Young, Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst [65]

Okay. And then just lastly, in Q4, there's a onetime gain of about $0.06. Is that right? And then next year, there's going to be a noninterest income that will be a tail-off from revenue that came from that -- the business that you sold? Is that the way to think of that?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [66]

Yes. So the $0.06 is the gain on sale, and the transaction is also about the 1-month -- about a 1-month earnings impact from that business. And then the numbers that we included in the quarter would be the impact looking forward for a full year.

Operator [67]

And our next question comes from the line of Lemar Persaud with TD Securities.

Lemar Persaud, TD Securities Equity Research - Analyst [68]

I just have a quick one. On the 2 accounts in the general commercial category that formed half the increase in impaireds, were those, by chance, loans from Maxium or Franchise Finance?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [69]

Neither of them were.

Lemar Persaud, TD Securities Equity Research - Analyst [70]

Neither of them? Okay. All my other questions have been asked and answered.

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [71]

Yes.

Operator [72]

Our next question comes from the line of Nick Stogdill with Crédit Suisse.

Nick Stogdill, Crédit Suisse AG, Research Division - Research Analyst [73]

Just a follow-up question on the mortgage volumes. I guess, we should expect Q4 to still be quite strong because you said the uptick in applications was in May and June. And those typically fund, I guess, 90 to 120 days out. So we should expect, I guess, a good quarter next quarter on the mortgage side. Is that fair?

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [74]

Actually, Optimum's book is much shorter. It's about a 35-day turnaround between application and funding.

Nick Stogdill, Crédit Suisse AG, Research Division - Research Analyst [75]

Okay. So they fund quicker, and that's actually in the numbers now.

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [76]

Yes. So by the month of July, it's pretty much worked its way through.

Nick Stogdill, Crédit Suisse AG, Research Division - Research Analyst [77]

Okay. My second question, maybe for Chris. Maybe you could just update us on your -- what you're seeing on the ground in BC and how conversations are going with your business clients given the political changes in the province. Did they have any general concerns about the economic outlook yet at all? Or is there any indication they may hold off on spend or investments in the near term?

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [78]

Yes, thanks, Nick. Yes, well, clearly, there is a change there, and we have to wait and see what happens with Kinder Morgan, Site C. I would say that the -- in the Lower Mainland, we still -- it's still pretty robust. I mean we have lots of good originations. The clients are doing well. I think there is some time that will need to be spent just to get that -- what that environment's going to look like because it's quite a change in the political environment. But I think we've got solid clients out there. They still have good economic growth. And we haven't had -- seen anybody that's really chosen not to participate. So I would say that it's something we're going to continue to follow, but it still continues to be positive. BC is still the strongest economy in the country.

Nick Stogdill, Crédit Suisse AG, Research Division - Research Analyst [79]

Okay, business as usual for now.

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [80]

Yes.

Operator [81]

And our next question comes from the line of Darko Mihelic with RBC Capital Markets.

Darko Mihelic, RBC Capital Markets, LLC, Research Division - Financials Analyst [82]

I just wanted to return to the 2 impairments in general commercial loans. You mentioned one was in Manitoba and one was in Alberta. But my headphone was acting really funny during your commentary around that. Were you saying that they were in a similar industry or they're dissimilar industries? And I think you were saying that they were within your expectations. Is that -- I apologize to go back to this right now, but I want to follow-up with another question.

Carolyn J. Graham, Canadian Western Bank - CFO and EVP [83]

So the 2 impairments, one of those clients was based in Alberta, the other was based in Manitoba, both in the general commercial category. And the comments about -- within our expectations was about the provision for credit losses as well as the level of growth impaired at this stage of a recovery out of an economic recession. So that was a portfolio comment and not specific to these 2 clients.

Darko Mihelic, RBC Capital Markets, LLC, Research Division - Financials Analyst [84]

I see, okay. And then as a portfolio comment, as we sit here and I look at that graph of gross impaired loans, is it your expectation that we're nearing a peak area on the impairment side?

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [85]

Well, that's always the crystal ball that we're trying to get clarity on. I would say that if you look at the chart we have on Page 15 of our news release, it's got -- if you take out the fact we had these -- in terms of the new formations, those 2 large loans, we've got fairly similar resolutions over a year ago last quarter and this quarter. We're making a lot of progress. We've got a very dedicated team that works through these loans. The challenge always is how long it takes to resolve them once we've identified the impairment. In terms of the formations, we've always been very aggressive in how we manage our loans. So we will continue to be aggressive and continue to make the right decisions. So you never know totally if you're at the top of the cycle or not. I think we have not emerged in Alberta yet from this recession, for sure, but we don't really -- we're not seeing systemic issues in the portfolio where -- we are seeing these are kind of idiosyncratic credit problems from individual companies that are running into trouble.

Darko Mihelic, RBC Capital Markets, LLC, Research Division - Financials Analyst [86]

Okay. That's helpful. That's actually what I was looking for. And my last question, which is going to turn -- take a bit of a U-turn here. It's not a line of business you talk much about, but the wealth management business, the AUM growth, when I look at it, it doesn't look like it's relatively high compared to many other companies I'm used to sort of seeing. And when you mentioned acquisitions, you really sort of strayed away from the wealth side. Can you give us an update, Chris, on your aspirations on the wealth side of the business?

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [87]

So wealth, what's occurred there is, really, the last couple of years -- a couple of years ago, we set up a new structure for how we're looking at wealth. And over -- so what we've built in the last 2 years -- we just kind of completed this March, April of this year -- is building a CW wealth management company with a separate CEO, pulling the 2 independent wealth management companies into that group, structuring how it is we approach the market. We believe we now are able to take that new structure and go to market much more effectively than we could before. So our goal is to grow the AUM here. And if we have great opportunities to add an acquisition to this equation, we will absolutely look at that. So it's both the organic growth, but also the potential for acquisition. And we do see this as a great fit for our business-owner targets. So that combination of general commercial focus along with cash management, personal banking, wealth management, that's kind of the suite of services we're looking to really deliver in a very effective way. And we have spent time and energy to get that structure in place. And we do have it in place now, so really the next steps are to look to grow it.

Operator [88]

And our next question comes from the line of Scott Chan with Canaccord Genuity.

Scott Chan, Canaccord Genuity Limited, Research Division - Financial Services Analyst [89]

Chris, just on the last answer, just talking about wealth management acquisitions. As a more balanced approach, would you consider something in the Eastern region like Ontario? I know in the past, you've talked about Vancouver specifically, but it's been a bit quiet since.

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [90]

Well, since we have broadened our footprint and -- yes, absolutely, in the past, it was very much we looked at that Western focus where we had branches. But as we've made these acquisitions in Ontario with CWB Maxium and Franchise Finance, we do have a bigger client base now in Ontario, so we do see that as sort of added to the opportunity set for us to look at acquisitions.

Scott Chan, Canaccord Genuity Limited, Research Division - Financial Services Analyst [91]

Okay. And then just lastly, if Alberta continues to be in this prolonged recession, is it possible for CWB to get back to double-digit loan growth? Or is Alberta a contributing factor towards it?

Christopher H. Fowler, Canadian Western Bank - CEO, President and Non-Independent Director [92]

We still have a lot of very strong clients in Alberta, and we still have strong fundings in this -- in the province in this last quarter, we had $1 billion worth of fundings in Alberta. So clearly, in the past, Alberta was probably a bigger part of our footprint. But our goal is to have a broader footprint, so we're not as dependent on Alberta. We obviously completely support our clients here and do see it as a core area for us to continue to grow in, but we are still looking to just have a bigger footprint, to have more places that we can grow the bank from.

Operator [93]

And I'm showing no further questions at this time. I would now like to turn the call back to Mr. Matt Evans for any closing remarks.

Matthew Evans, [94]

Thank you, Chelsea. And thank you all very much for your continued interest in CWB Financial Group. We look forward to reporting our 2017 fourth quarter and fiscal year results on December 7. With that, we wish you all a good afternoon.

Operator [95]

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.