Canadian banks and COVID-19 – Impacts on half-year results

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How is the pandemic affecting Canadian banks' loan books?

Canadian banks' half-year reports show significant impact of COVID-19 on their loan books

In our **previous blog**, we reported on the pandemic's impact on the expected credit losses (ECL) in loan books of some large European banks as disclosed in their March 2020 quarterly reports. April 2020 was an important month in shaping the potential impact of COVID-19 on the global economy. So, what difference does a month make? In today's blog we look at what Canadian banks have disclosed in their 30 April 2020 half-year reports.

We've looked at the 30 April 2020 half-year reports from five Canadian banks and compared them to the **selection of European banks** discussed in our previous blog. Here, we consider ECL charges in profit or loss, the loss allowance ratio, the staging of loans and the disclosure of forward-looking information.

ECL charges

First, we looked at how the loan ECL charge in profit or loss and profit before tax have changed in Q2 2020 compared to Q2 2019. The graph below sets out the percentage change for both measures for the Canadian banks as well as the average for the selection of 11 European banks (Q1 2020 compared to Q1 2019).

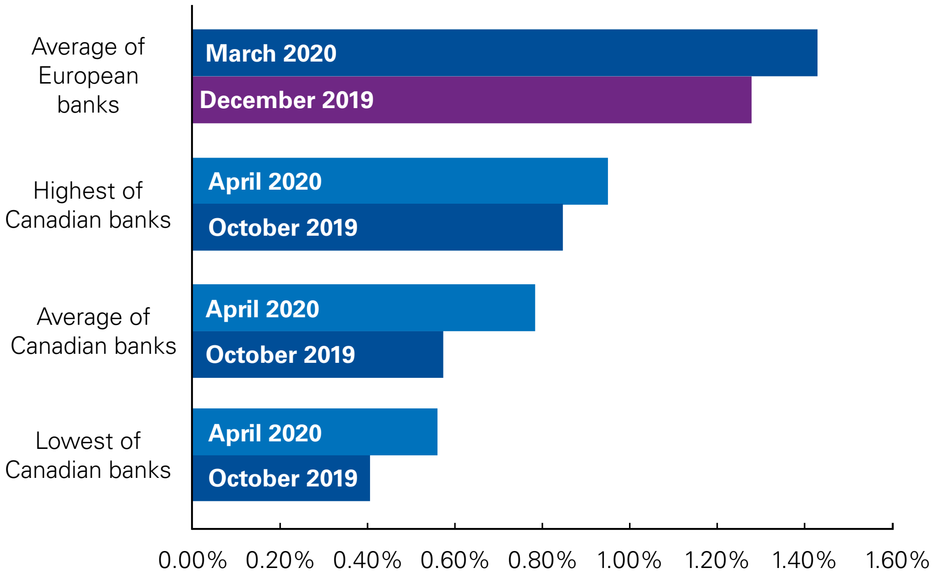
The Canadian banks' ECL charge in Q2 2020 increased on average by four times compared to Q2 2019. However, this was less than the average increase of six times reported by the European banks in Q1 2020 compared to Q1 2019.

The loss allowance ratio

The chart below shows the increase in the Canadian and eight European banks' loss allowance ratios[1] for loans carried at amortised cost.

1. The loss allowance ratio is a ratio of the closing balance of loss allowance to the closing balance of gross carrying amount of loans carried at amortised cost.

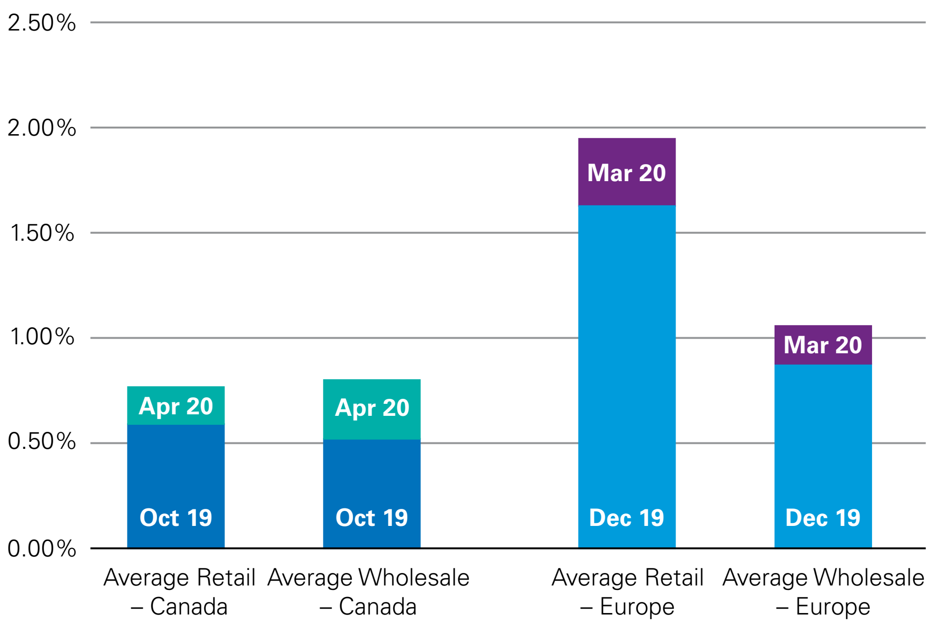
Loss allowance ratio for the Canadian and European banks



The Canadian banks' average loss allowance ratio[2] increased from 0.58% to 0.78% between 31 October 2019 and 30 April 2020. This increase of 0.20 percentage points (pp) is higher than the 0.15 pp increase reported by the European banks between 31 December 2019 and 31 March 2020. The larger increase was not surprising as April saw a much bigger than expected impact from the pandemic.

All of the Canadian banks disclosed loss allowances separately for retail and wholesale loans. The chart below compares their average retail and wholesale loss allowance ratios to the average reported by the two European banks that disclosed loss allowance separately for their wholesale and retail businesses.

Average loss allowance in retail and wholesale



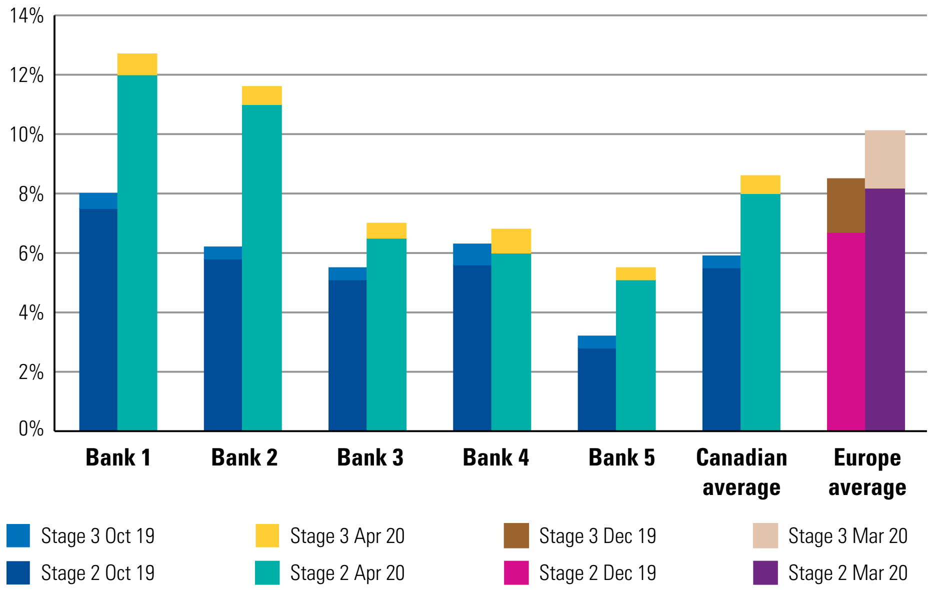
2. The average loss allowance ratio is calculated by adding the loss allowance ratios of all selected banks and dividing it by the number of banks. This means that the average does not take into account the different sizes of bank loan portfolios and loss allowance – i.e. all banks are weighted equally.

While the European banks reported a similar average increase in loss allowance ratio of roughly 20% in both businesses in Q1, the Canadian banks reported a significantly higher average increase of over 50% in their wholesale business in H1.

Staging of loans

All of the Canadian banks disclosed an analysis of their amortised cost loans by IFRS 9 impairment stages[3]. Any movement between stages is a key indicator of changes in the credit quality of those loans. The graph below shows how the proportions of loans in Stages 2 and 3 changed from 31 October 2019 to 30 April 2020 for each of the Canadian banks. It also compares the Canadian banks' average change to the seven European banks' average change from 31 December 2019 to 31 March 2020.

Proportions of loan in Stages 2 and 3



The impact of the pandemic on staging differs between the banks. Two of the banks reported an increase in the proportion of Stage 2 loans of over 4.55 pp, while the other three banks reported smaller increases between 0.55 pp and 1.88 pp.

The average share of loans in Stage 2 for the Canadian banks increased from 5.31% to 8.07%, a 2.75 pp increase compared to a 1.50 pp increase reported by the European banks[4].

Similar to the European banks, there appears to be very little change for the loan book proportions classified as Stage 3.

Forward-looking information

In our last blog we looked at how European banks have tackled the formidable task of assessing the impact of COVID-19 on the future economic scenarios that they used to measure ECL. So, what have the Canadian banks disclosed?

All of the banks reported that they have updated their base line and downside scenarios to reflect the pandemic's economic impact.

3. Under IFRS 9 *Financial Instruments*, financial assets are grouped into three stages – Stage 1 for financial assets that have not undergone a significant increase in credit risk (SICR) since initial recognition; Stage 2 when they have experienced a SICR but are not credit-impaired; Stage 3 when they are credit-impaired.
4. The average share of loans assigned to Stage 2 is calculated by adding the proportions in Stage 2 and dividing it by the number of banks assessed. This means that the average does not take into account the different sizes of bank loan portfolios – i.e. all banks are weighted equally.

Of the five Canadian banks, two disclosed that their base line scenario assumed a severe downturn in the second calendar quarter of 2020 and three disclosed that they assumed a rebound in economic activity in the second calendar half of 2020. Four banks appeared to use the same number of economic scenarios at both 30 April 2020 and 31 October 2019, while one included an additional downside scenario in both Q1 and Q2.

The Canadian banks did not disclose the probabilities of their base, upside or downside scenarios, although one bank disclosed that it increased the probability attached to its base line scenario.

Two of the Canadian banks reported that they had used management overlays on top of the amounts calculated by their ECL models to respond to the pandemic's economic impacts, government support measures and low oil prices, while the other three banks were silent on this matter. However, the quantitative impact of these overlays on the total ECL balance was not disclosed.

What next?

The Canadian banks' half-year reports show how those banks have evaluated the impact of the pandemic on their loan books, based on the information available at 30 April 2020. As many economies take their first tentative steps out of lockdown, the economic impacts of the pandemic will become clearer. Our next blog will look at how European banks reflect this new information in their half-year reports for the six months to 30 June 2020.

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