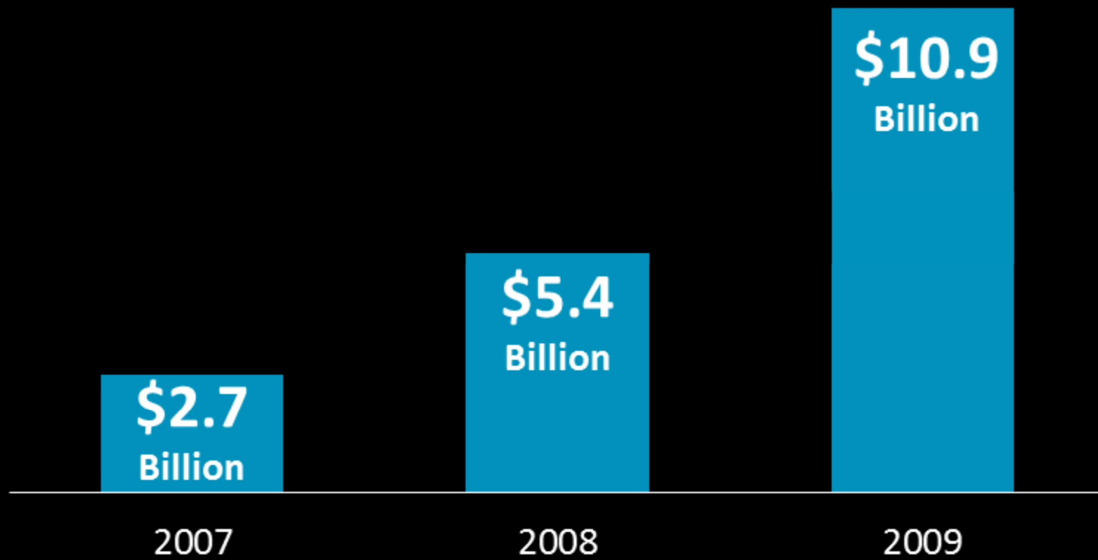
What Are You Banking On?
By Benjamin Sinclair, HBA, CFA | Equity Analyst

I’d like to start by going back to late 2008. At the time, I had recently graduated from university, and was looking to break into the world of finance. As one could imagine, this was not an easy thing to do.

U.S. mortgages had brought the global financial system to the brink of collapse. Even though the Canadian banks fared better than their American and European counterparts, they were badly affected too.

In 2008, the big five banks – that's RBC, TD, Scotiabank, BMO and CIBC – incurred $5.4 billion in credit losses, more than double the previous year.



Then in 2009, credit losses doubled again. The problems didn’t stop there, as impairment charges, poorly timed acquisitions and falling interest rates all acted as headwinds. Some found themselves under serious pressure, forced to raise capital at a very inopportune time.

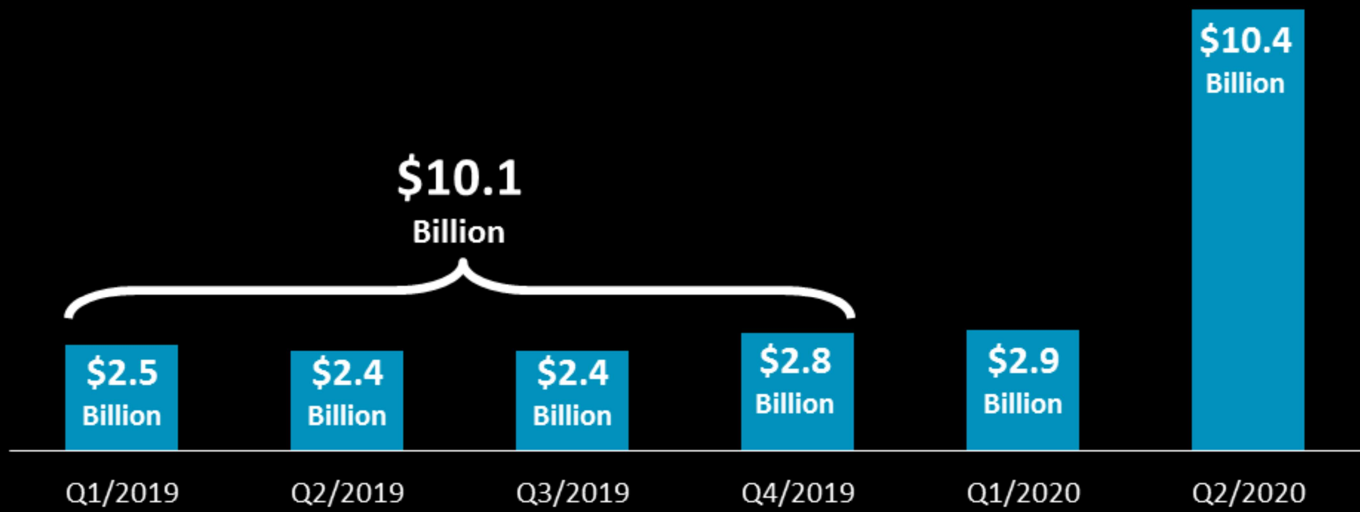
It wasn't just jobseekers such as myself who paid the price – investors certainly felt their share of pain too.

All told, an equally weighted portfolio of the big five banks fell by more than half as the crisis worsened. Even by the beginning of 2013, such a portfolio was worth barely more than it had been six years earlier.

In the years following the crisis, investors were understandably cautious when it came to the banks. While the banks were on sound footing again, big questions still remained unanswered:

- How would banks respond when the next crisis came along?
- Would they have enough capital?
- Would we again see massive write-offs?
- Above all else, could the banks be considered reliable long-term investments?

Needless to say, COVID-19 has put the banks to such a test. Only by withstanding the next crisis could the banks truly prove themselves to investors.

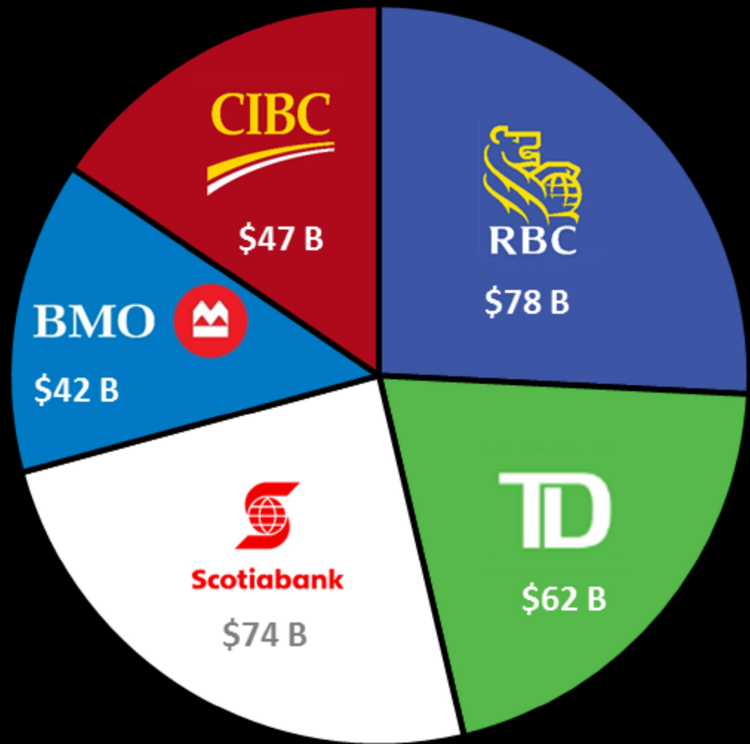


Source: Company Reports

In the quarter right after the pandemic struck, the banks incurred $10.4 billion in credit losses, surpassing the total from all of 2019.

Commercial customers drew down on their credit lines, putting pressure on the banks' capital ratios. Interest rates, stock prices and capital-raising activity all plunged quickly and severely, putting pressure on the banks' top lines.

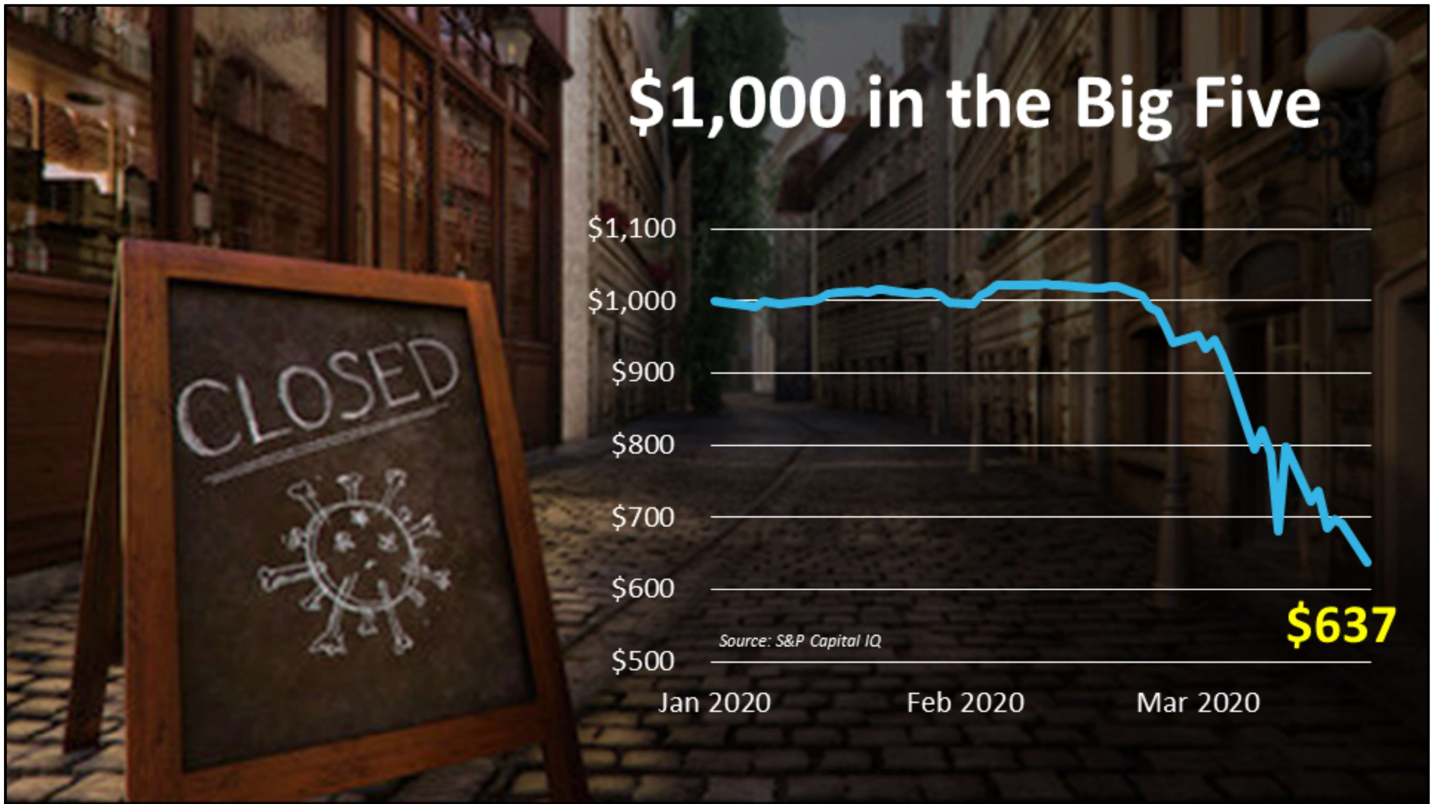
Loan Deferrals
(April 2020)
$303
Billion



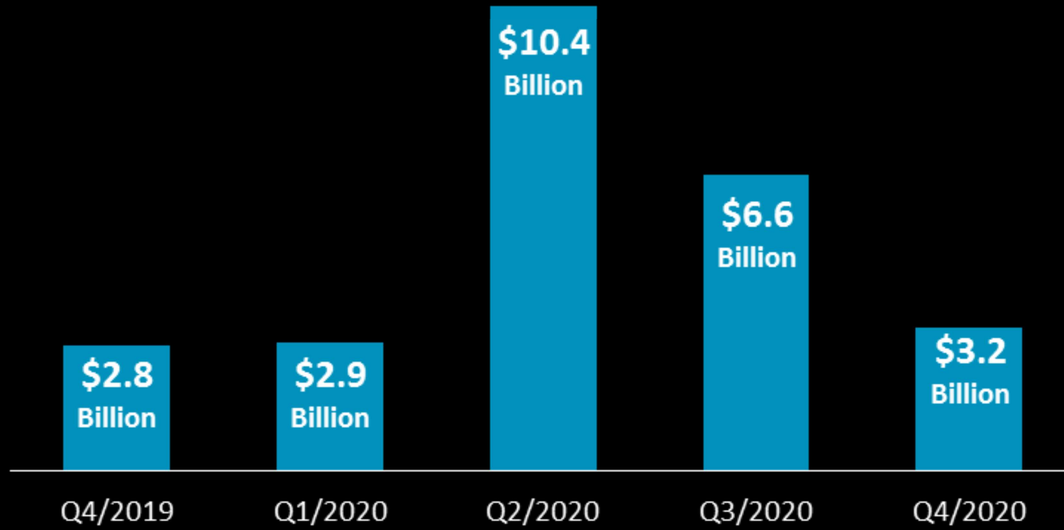
Source: Company Reports

The banks also set up loan deferral programs, allowing those hardest-hit by the pandemic to skip payments.

Among the big five, these deferral programs accounted for more than $300 billion of loans by the end of April. As the pandemic continued to spread, how such loans would ultimately perform was anyone’s guess.



Bank share prices plunged, as investors' worst fears were being realized, and those big questions were front-of-mind once again.



Source: Company Reports

Fast forward a year and the banks have started to answer those questions.

Credit losses have fallen by more than two-thirds since the start of the pandemic. The banks' capital ratios have rebounded and are stronger now than before the pandemic hit.

Meanwhile, the loan deferral programs have largely expired, with the vast majority of beneficiaries now making regular payments. And, investors are no longer seriously questioning if the dividends are sustainable.

There were other factors at play. Governments in Canada, the United States and elsewhere responded with significant stimulus programs, helping to cushion the economic blow. Central banks also opened their spigots, allowing credit to flow more easily.

Stock markets rebounded sharply, and more recently, interest rates have come back too. The environment could certainly have been much worse, and to a certain extent the banks should consider themselves lucky.

Yet, the banks deserve credit too. Unlike during the financial crisis, when they were part of the problem, in this case they were part of the solution. And despite such severe credit losses, worse than during the financial crisis, the banks seem to have landed on their feet, without having to raise significant new capital. Share prices have responded in kind and are now trading at close to pre-pandemic highs.

Also unlike the financial crisis, layoffs from the banks have been very minimal, which is welcome news for jobseekers and new graduates during such a difficult time.

So what does that mean as we look ahead?

Well, it is far too soon to declare victory, with the pandemic far from over and the global economy still in a precarious state. But, the banks are more battle-tested than they were a year ago, so we can feel a lot better about their stability, as well as their dividends. Most importantly, as we look for solid companies to invest in for the long term, we can feel more confident in making the banks a part of that strategy.

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