ECONOMICS | **RESEARCH**

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QUARTERLY FINANCIAL INDUSTRY REVIEW

July 2007

A mid-year assessment of the financial industry

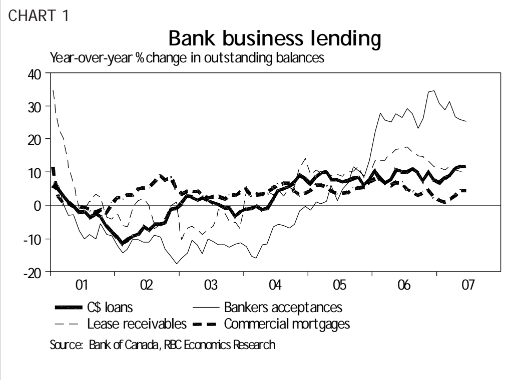
The following assessment of the performance of our financial industry forecasts — both the broad themes and how close the numbers are tracking — uses industry data now available for the first half of the fiscal year. The table at the back summarizes how our forecasts are performing on a fiscal year-to-date basis.

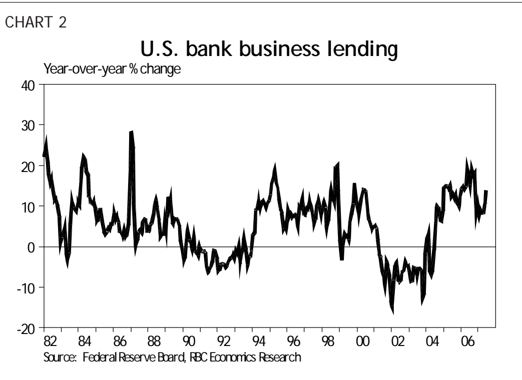
The U.S. forecast picture is performing well on themes and numbers, but risks are building. Growth in household and business credit markets has slowed in line with forecast; sub-prime challenges remain contained, but wrongly fingered as the culprit behind what is instead a broader and long-expected restoration of liquidity risk premia; consumer spending remains fairly insulated from the housing drag; and credit quality is deteriorating in a modest cyclical fashion.

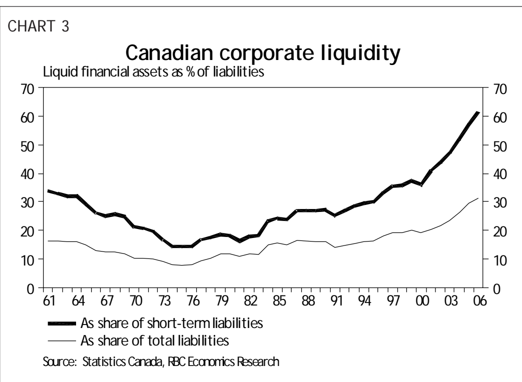
Our Canadian market forecasts are generally tracking well, but a significant number of positive forecast variances exist for household and business loan products. In terms of household debt, this is largely due to innovation that is occurring later than in other countries since the federal government only recently deregulated the Canadian mortgage insurance market. In business markets, it is because of stubbornly high amounts of internal liquidity instead of substituting liquidity for rapid loan growth, and intense leveraged buy-out activity.

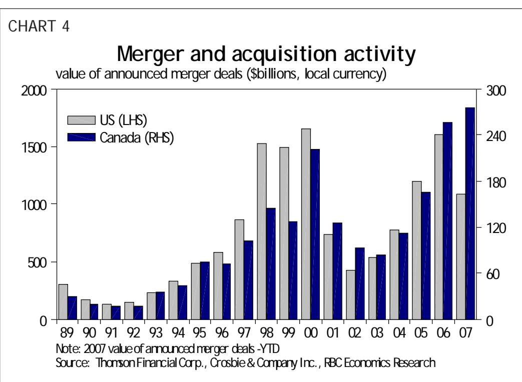
Beyond the numbers, our broad forecast themes remain on track. First, household credit quality is gently weakening, not going over a hyped cliff in either country. Recent financial innovation is playing a prominent role in redefining the consumer and housing cycle in Canada and thereby making the Bank of Canada's job more difficult. Extended amortization mortgages have had rapid take-up rates that *lessen* the household sector's sensitivities to higher interest rates compared to past cycles when the full rate shock flowed through to payments on inflexible 25-year mortgages. This serves to insulate households, and means that other sectors of the economy will bear the brunt of greater hikes than would otherwise be needed. The rise of principal-deferred consumer loans further reinforces this view. Sensational talk of a mild rate shock sparking a surge in bankruptcies assumes that lenders would rather foreclose than extend amortization, raise loan-to-value ratios, or consolidate debt.

The restructuring of corporate North America continues and, while it has common drivers throughout the world, the forces are strongest in Canada. A souring LBO market will crimp deal flows and loan growth after widespread excesses, but other drivers remain intact, particularly in Canada: record-high corporate liquidity; low overall leverage; record high profits-to-GDP; succession planning by aging owners; commodities strength; competitive pressures through labour scarcity and a Canadian dollar; productivity challenges; and questionable tax policies. This is an unparalleled post-war alignment of M&A drivers, and it helps to explain why the strongest loan growth has been at larger firms.









I. North American business markets

U.S. and Canadian business banking markets remain on divergent paths (charts 1 and 2). While U.S. loan growth remains healthy, it has subsided from the peaks of last fall as firms rely relatively more on redeploying high amounts of internal liquidity, particularly now as external liquidity conditions weaken. Not so in Canada, where by any conceivable measure, even higher levels of record liquidity are being maintained at levels that are orders of magnitude beyond what could be justified by reasonable amounts of risk aversion. The number-one risk facing Canadian business banking markets remains sudden liquidity reversal.

I(i) Canada — Financing expansion still going strong

The pace at which Canadian businesses are raising new financing is outpacing our forecasts for both short- and long-term vehicles. We had already thought that our forecasts were fairly aggressive compared to industry expectations, but stronger than expected growth is mostly through borrowing by larger firms. Our forecast for SME financing remains closer to actual borrowing patterns.

Liquidity risks remain key. By any conceivable measure, corporate liquidity remains sky-high. There is still a net surplus of internally generated funds beyond investment uses. Further, the outstanding amounts of liquid cash- and near-cash holdings remain pointed firmly upward in record territory as a share of liabilities (chart 3). This is true if a proper maturity-matched measure of short-term liquid holdings to short-term liabilities is used or if the measure switches to liquidity relative to total liabilities to capture the need to have cash on hand as longer-tailed liabilities mature or are redeemed. Note also that this is not strictly a commodity play given that liquidity has been rising since the 1980s and because the recent surge started right after the popping of the dot-com bubble, 9/11 and other adverse shocks that pre-dated much of the commodity surge. This massive liquidity overhang still poses a risk to loan growth, supports M&As given the double-edged sword aspect to keeping idle cash, and is a powerful ongoing support for buybacks, dividend hikes and even faster investment growth.

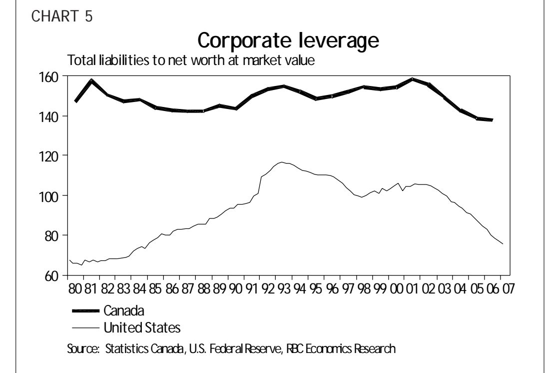
Much of the financing strength reflects growth in inventories and investment in machinery and equipment with diversified investment strength showing across numerous industries but with varying degrees of success in keeping up with rates of capital obsolescence. Most industries are investing simultaneously in Canada and abroad through foreign direct investment, which suggests diversified financing opportunities.

Through leveraged buy-outs, M&As are a clear additional support to loan growth beyond standard inventory and equipment spending drivers. We have been pointing to consolidation forces for years, but our view that a new annual record on deals could be set has already occurred in just the first half of 2007 (chart 4), reinforcing a two-year decline in head office counts during 2005 and 2006.

While current accounts have benefitted from the surge in corporate risk aversion, the growth rate in balances has declined in line with our forecast as signs continue to grow that world markets are shifting to a topping out on liquidity that will pose further pressures for loan and deposit products. While the message that excess liquidity is being socked away may be sensitive, the overall impact on business financing markets has to be the bigger concern.

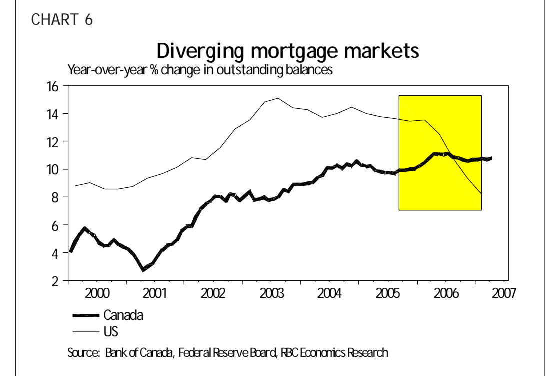
I(ii) United States — Slower loan growth

There are no significant forecast variances to be explained for U.S. business financing markets. Forecasts for total business credit and the mix of short- and long-term products are tracking well so far and all of these credit growth measures are off their recent cyclical peaks. However, while business deposits continue to fall compared to year-ago levels, the yearly pace of decline has slowed sharply. This is mostly due to a one-quarter lift in cash and deposit holdings as risk aversion likely picked up in the early part of this year. The long expected surge in market volatility is likely to cool LBO and some credit derivative activity, with spillovers into cooler loan growth.

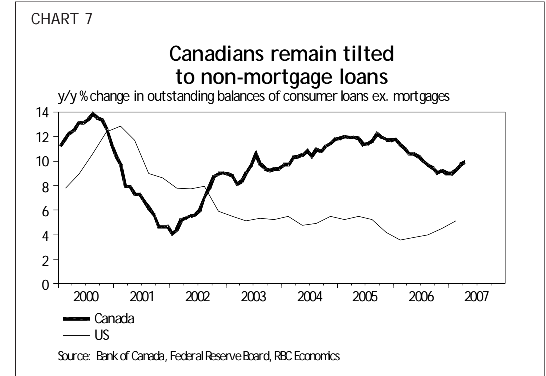


I(iii) Business credit quality — Gentle deterioration

Business credit quality peaked in late 2005 according to proxies for industry-wide charge-offs in both Canada and the United States. This came as existing debt was repriced at higher short-term rates and more debt was taken out. So far at least, the turning point has been gentle in both countries. A Q1 surge in charge-offs in Canada was narrowly concentrated upon the information and cultural industries in the single month of January. But, should leverage be added to a list of widespread concerns that may suggest a more rapid reversal in future corporate credit quality, or is it concentrated in some markets?

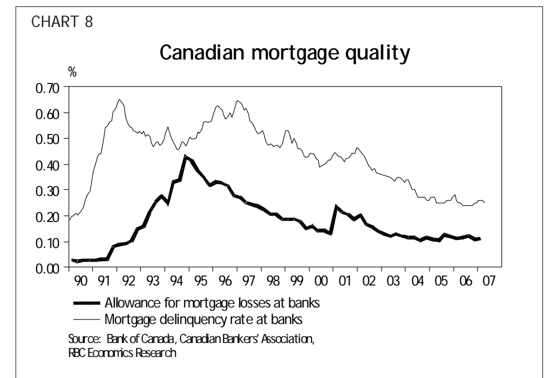


In some markets, it is definitely the case that more assets have been changing hands at a quicker and more highly leveraged pace and within the context of the lowest loan spreads in decades. That's obviously changing now, with implications for future quality. One example has tended to be that takeover premiums offered up by private equity and institutional investors often exceeded share premiums being offered by other potential acquirers that had a shot at achieving vertical or horizontal efficiencies. That's either because outside investors with limited industry knowledge think they can extract more value than in-market combinations would have achieved, or more likely just because of the zero-sum economy-wide effects of hiking leverage. Regardless, this concern is not showing up in leverage measures on the overall non-financial corporate balance sheet in either Canada or the United States (chart 5). If anything, overall leverage remains relatively low by historical standards.

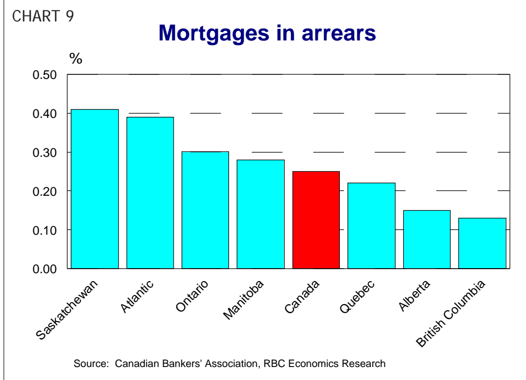


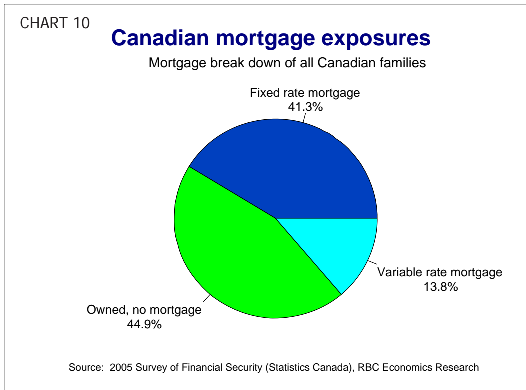
II. North American household markets

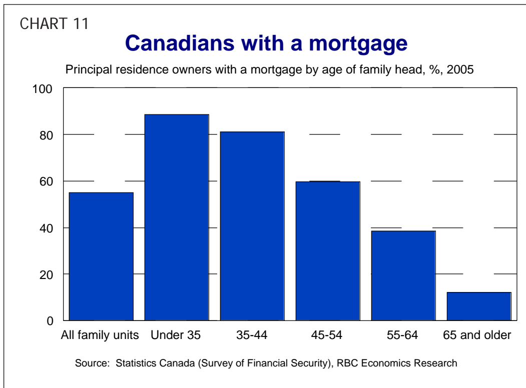
On balance, our forecasts for household banking markets are tracking well, but more so in the United States than in Canada. The two markets have sharply diverged in recent years (charts 6 and 7), leaving the debate open as to whether Canadian markets are immune to U.S. developments. Our view is that they are, largely because of federal regulatory changes that opened up the Canadian mortgage insurance market in the spring of 2006 to more entrants. The result has been falling mortgage insurance premiums, higher insured ratios and more product variety as innovation arrives on Canadian shores later than in most other countries. The risk of improvidence remains if innovation is adopted at a faster pace than consumers can accept, but the structural characteristics of Canadian retail banking markets make a replay of the U.S. experience unlikely.

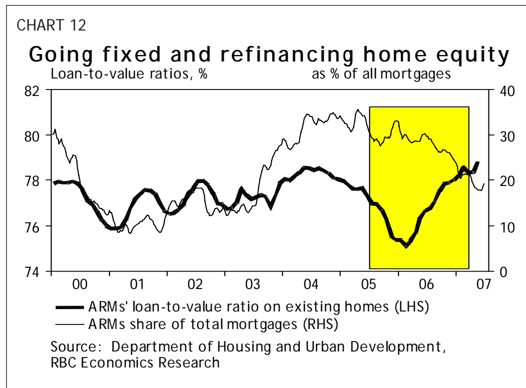


Forecasts for saving markets in both countries are on track and new records for mutual fund sales may be in sight on both sides of the border; $30 billion out of our $50 billion annual sales forecast for Canada has already been booked.









II(i) Canada — Innovation lifting debt growth

Our forecast performance for Canadian household debt markets is partly right in that we argued that financial innovation could lift mortgage growth, but partly wrong because it is happening somewhat faster than we had thought likely. The slowing mortgage growth picture that had emerged last fall has very recently swung around and modestly positive forecast variances are expected for the year due to faster take-up rates for new products than previously expected.

There is enough evidence to convince us that a very material amount of mortgage originations are going for much longer amortization periods. Unlike the cookie cutter conventional 25-year mortgage of the 1980s housing cycle, the past year has seen the introduction of 30-, 35- and 40-year extended amortization mortgages to broaden the ways in which households can cope with payment shock through higher rates. As we have argued, Canada is a late adopter of such products compared to other countries.

This raises a number of interesting issues. First, a rising rate environment may not crimp home affordability as hard as in the past, as typically measured by housing-related payments over income. To offset the impact on payments of our forecast for a one percentage-point hit to rates, a borrower would need to go from a 25-year mortgage to a 33-year amortization period, assuming the same house price, while still having the flexibility to pay off the mortgage faster later on. In the absence of higher rates, longer amortizations are contributing to upward price pressures in some markets, but also insulate against higher rates.

Second, although it is still early, the industry needs to ensure careful market segmentation instead of simply treating new products as more offerings to be mass-marketed. So far, there is little, if anything, to be concerned about as borrower criteria remain far sounder than in the extreme experiences stateside. Further, Canadian mortgage quality remains impressive (chart 8), although with small regional variations on this theme (chart 9). Also, the share of Canadian families who own their homes free and clear of mortgage debt (chart 10) is somewhat higher than in the United States, although this is partly due to mortgage interest deductibility stateside and is skewed to the over-50 set (chart 11). For the age cohorts in which mortgages are concentrated, three-quarters are at fixed rates, but for much shorter terms than in the United States, and the remaining one-quarter will be reset at rising variable rates going forward.

Finally, given the policy implications, there is a need for a much more active role by the Bank of Canada and Statistics Canada in securing and publicly disseminating industry data on these products as has been done in the past on matters such as adding back off-balance sheet securitized flows in reported credit figures. This adds to the need for more of a data stewardship role by public institutions that would also address inconsistent classification of HELOCs that is making the mixture between mortgages and consumer loans difficult to read.

II(ii) United States — Story intact

So far, there are no real variances from forecasts that are worth reporting. Credit growth has slowed sharply in line with our forecasts, deposit growth remains firm, but trendless, and both new savings and household liquidity are being poured into mutual funds with the risk that sales may overshoot our bullish call.

Furthermore, U.S. sub-prime challenges are still exaggerated as a macroeconomic event affecting consumer spending. The growth trend in consumer spending has softened as we argued it would. Credit growth has definitely slowed and so has consumer spending compared to peak rates of growth in the 6-7% range from 2004 until early 2006, but a sharp retrenchment is unlikely. Indeed, the more fear that gets created in markets, the greater the offset to higher credit spreads through falling benchmark government bond yields via a flight to safety, while an equity correction has a concentrated hit mostly on the top 10% of earners.

The sub-prime shock is being coped with exactly as forecast. Adjustable rate mortgage (ARMs) resets are being addressed by boosting loan-to-value ratios especially on resales, and borrowers are going fixed with 80% of mortgages now at fixed rates compared to 65% over the 2004-05 ARMs craze (chart 12). Further, the term to maturity on fixed rate mortgages has increased from an average of 26½ years in 2003 when variable rates bottomed out, to 29½ years today which also helps to smooth payments. Understanding the ability to adjust mortgage contracts in this manner is critically important to appreciating how interest rate shocks no longer fully flow through to a household's short-term bottom line.

Further, the whole distribution of interest rate sensitivities must be considered, and not just the extreme sub-prime tail that has garnered all the hype. One-third of all U.S. homeowners are free and clear of any mortgage debt, and about 80% of mortgages are at fixed rates such that about 85% of all homeowners are now largely immune to interest rate changes and are happy to spend. This is one reason why evaluating what matters to Wall Street in terms of subprime exposures and LBOs doesn't necessarily matter anywhere nearly as much to main street when evaluating economy-wide consumer conditions and doing so by evaluating actions versus words conveyed through confidence surveys.

II(iii) Household credit quality — Stronger than portrayed

Our views on Canadian and U.S. credit quality are still tracking well. U.S. consumer credit quality continues to deteriorate gently from the best starting point in many years, but it is not collapsing by any stretch. The worst problems remain in sub-prime mortgage lending. The total delinquency rate is likely to go modestly above where it did after the dot-com and 9/11 shocks (chart 13), and the same for the foreclosure rate.

Evidence of direct spillover effects into other credit categories remains weak. Charge-off rates on credit cards and other consumer loan products have ticked up very modestly (chart 14), and not so much because of spillovers from sub-prime mortgage markets as opposed to common drivers such as the fact that interest rates are simply higher than a few years ago. Further, charge-offs on prime and sub-prime mortgages have only risen to about the price of a cup of coffee per $1000 in mortgages despite the best losing efforts of a few bad apples.

In Canada, housing and mortgage problems south of the border are showing up in weakened prospects for export industries feeding U.S. housing markets, but the quality of the Canadian mortgage book is very much marching to the beat of its own drummer. The combined 30-, 60- and 90-day mortgage delinquency rate remains firmly planted at the rock bottom level of one-10th of one percent of all mortgages outstanding. For other consumer loan products, quality appears to remain strong except for a handful of explainable and localized slips.

CHART 13

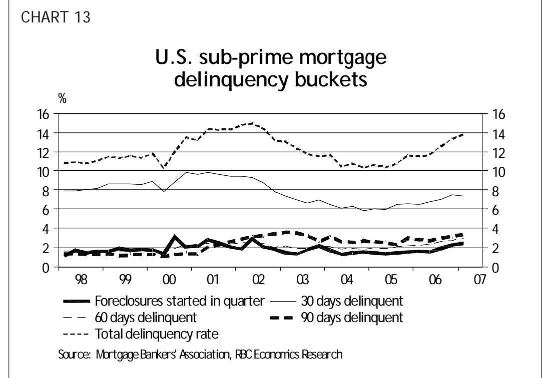


CHART 14

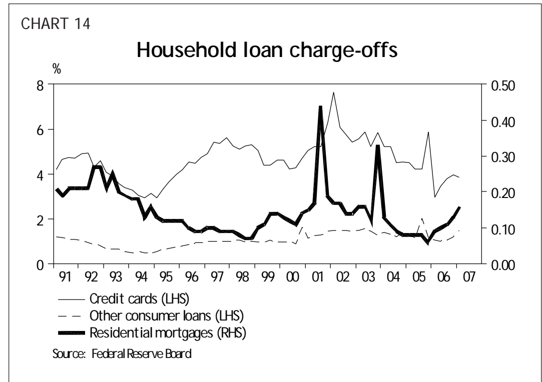


CHART 15

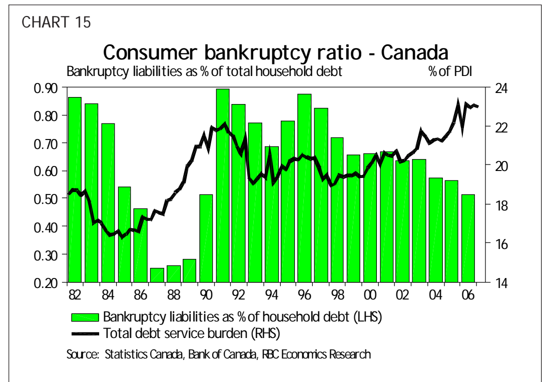
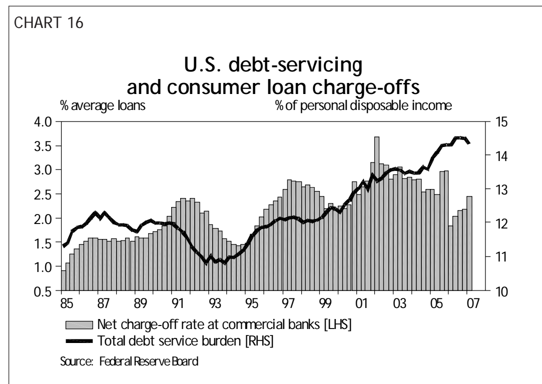


CHART 16



Forecast tracking — North American financial industry

Canada

Seasonally adjusted at annual rates	Latest period	Outstandings (C$ billions)	y/y % change	m/m* or q/q % change	Recent trend	FYTD** % change	FY forecast % change	Probable 2007 forecast risks
Household markets								
1. Household credit	May-07	1,108.2	10.6	11.7	Flat	11.2	7.7	Positive variance
2. Residential mortgages	May-07	758.9	10.8	11.8	Flat	11.5	8.0	Positive variance
3. Consumer loans	May-07	349.3	10.1	11.5	Flat	10.5	7.0	Positive variance
4. Fixed & variable rate loans	May-07	147.7	8.3	6.5	Down	7.4	3.5	Positive variance
5. Credit card balances	May-07	70.7	12.6	16.4	Up	13.4	8.0	Positive variance
6. Personal lines of credit	Jun-07	132.4	11.0	16.2	Up	13.0	13.9	On track
7. Personal deposits	May-07	699.1	6.9	6.2	Flat	6.3	8.0	On track
8. Banks	Jun-07	505.7	6.5	5.3	Flat	5.6	7.5	On track
9. of which: fixed term	May-07	280.8	6.4	0.5	Down	1.7	8.7	Negative variance
10. of which: chequing/saving accounts	May-07	221.3	7.1	9.9	Up	9.5	6.0	Positive variance
11. Mutual fund net sales (C$B hist. nonann.)***	Jun-07	N/A	N/A	N/A	Up	$30.5	$50.0	On track
Business markets								
12. Total business financing	Jun-07	1,131.5	7.1	9.6	Up	9.0	5.4	Positive variance
13. Short-term business credit	Jun-07	331.7	11.8	11.6	Flat	14.4	10.0	Positive variance
14. Banks	Jun-07	244.8	13.5	13.3	Flat	15.8	9.0	Positive variance
15. C$ bank loans	Jun-07	165.7	11.8	25.0	Up	15.4	7.0	Positive variance
16. SME loans	Q1 2007	56.4	8.7	10.1	Flat	7.9	5.5	On track
17. Small bus. loans	Q1 2007	28.6	6.5	5.0	Down	6.5	4.5	On track
18. Commercial paper	Jun-07	12.3	4.3	-1.4	Down	4.6	-3.0	Positive variance
19. Long-term business financing	Jun-07	800.5	5.3	9.1	Up	7.0	3.2	Positive variance
20. Equities	Jun-07	308.0	2.4	10.6	Up	5.7	2.5	Positive variance
21. Income trust units	Jun-07	81.7	5.7	-3.3	Down	1.2	N/A	N/A
22. Bonds	Jun-07	269.6	5.1	9.3	Up	7.0	4.0	Positive variance
23. Commercial mortgages	May-07	70.8	6.7	10.2	Up	7.3	8.0	On track
24. Lease receivables	May-07	31.5	6.9	8.9	Up	8.4	3.5	Positive variance
25. Current accounts	May-07	195.1	8.3	5.8	Down	3.2	8.5	On track

United States

Seasonally adjusted at annual rates	Latest period	Outstandings (US$ billions)	y/y % change	m/m* or q/q % change	Recent trend	FYTD** % change	FY forecast % change	Probable 2007 forecast risks
Household markets								
26. Household credit	Q1 2007	12,268.6	7.4	6.4	Flat	6.6	6.3	On track
27. Residential mortgages	Q1 2007	8,804.8	7.8	6.9	Flat	7.1	6.5	On track
28. Consumer loans	Q1 2007	3,463.8	6.5	5.2	Flat	5.3	6.0	On track
29. Revolving credit	Q1 2007	1,931.4	9.0	5.6	Down	7.3	6.8	On track
30. Home equity lines of credit	Q1 2007	1,048.9	10.9	6.7	Down	8.3	8.5	On track
31. Credit cards	May-07	894.8	6.9	0.8	Down	6.9	4.8	On track
32. Non-revolving credit	May-07	1,545.8	3.5	0.4	Down	5.0	5.0	On track
33. Personal deposits	Q1 2007	5,363.4	6.0	4.8	Flat	4.8	5.8	On track
34. Mutual fund net sales (US$B hist. nonann.)***	May-07	N/A	N/A	N/A	Up	275.4	450.0	On track
Business markets								
35. Total Business Credit	Q1 2007	19,972.0	6.1	6.8	Flat	5.9	5.1	On track
36. Short-term business credit	Q1 2007	1,533.4	9.6	6.4	Down	10.1	9.0	On track
37. of which: commercial bank C&I loans	Jun-07	1,258.9	12.3	1.4	Down	11.8	12.0	Negative variance
38. Long-term business credit	Q1 2007	18,438.6	5.9	6.8	Flat	5.5	4.8	On track
39. Bonds	Q1 2007	3,289.1	7.7	7.6	Flat	8.8	7.0	On track
40. Equities	Q1 2007	11,484.9	3.5	5.2	Up	2.9	3.0	On track
41. Commercial mortgages	Q1 2007	3,211.0	13.2	12.2	Flat	12.7	9.5	Positive variance
42. Finance company loans	Q1 2007	453.6	4.7	7.5	Up	2.0	4.5	Negative variance
43. Cash and chequable deposits	Q1 2007	431.1	-11.1	51.2	Up	-4.7	-60.0	Positive variance

*Month-over-month % change, three-month moving average.

**For quarterly data, September 30 is used as proxy for October 31 fiscal year-end.

***Lines 11 & 36. Reported on a calendar year basis. In Canada, reinvested dividends are included in mutual fund totals; in the United States, they are not.

Source: Bank of Canada, Statistics Canada, Investment Funds Institute of Canada, Canadian Bankers' Association, Federal Reserve Board, RBC Economics Research forecasts.

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