Moody's Investors Service
Rating Action: Moody's downgrades Canadian Banks

Global Credit Research - 10 May 2017

Toronto, May 10, 2017 -- Moody's Investors Service ("Moody's") has today downgraded the Baseline Credit Assessments (BCAs), the long-term ratings and the Counterparty Risk Assessments (CRAs) of six Canadian banks and their affiliates, reflecting Moody's expectation of a more challenging operating environment for banks in Canada for the remainder of 2017 and beyond, that could lead to a deterioration in the banks' asset quality, and increase their sensitivity to external shocks.


The BCAs, long-term debt and deposit ratings and CRAs of the banks and their affiliates were downgraded by 1 notch, excepting only Toronto-Dominion Bank's CRA, which was affirmed. The short term Prime-1 ratings of the Canadian banks were affirmed. All relevant ratings for these banks continue to have negative outlooks, reflecting the expected introduction of an operational resolution regime in Canada.

"Today's downgrade of the Canadian banks reflects our ongoing concerns that expanding levels of private-sector debt could weaken asset quality in the future. Continued growth in Canadian consumer debt and elevated housing prices leaves consumers, and Canadian banks, more vulnerable to downside risks facing the Canadian economy than in the past." said David Beattie, a Moody's Senior Vice President.

In the same action, Moody's affirmed the BCAs, long-term ratings and CRAs of CIBC Mellon Trust (CIBC Mellon), the Fédération des caisses Desjardins du Québec (the Fédération) and Caisse centrale Desjardins.

In view of today's actions, Moody's does not expect any upward rating pressure on the affected banks in the near term. However, the Canadian banks' ratings could be revised upwards if macro-economic conditions in Canada improve and the Canadian banks maintain sound financial metrics.

The affected banks' ratings could be downgraded if their fundamentals weaken, as evidenced by an even more challenging operating environment and/or deterioration in their financial metrics.

Please click on the following link to access the full list of affected credit ratings, not all of which are discussed in the summary above. This list is an integral part of this press release and identifies each affected issuer. (http://www.moodys.com/viewresearchdoc.aspx?docid=PBC_195571)

MACRO PROFILE CHANGE

Under Moody's bank rating methodology, the first stage of our credit analysis for banks starts with the Macro Profile, our assessment of the macro environment within which a bank operates. This reflects our view that bank failures are very often associated with systemic crises driven by macroeconomics rather than idiosyncratic factors. Our country level analysis focuses on economic strength, institutional strength, susceptibility to event risk, credit conditions, funding conditions and industry structure. In today's action, Moody's has changed its assessment of Canada's Macro Profile to "Strong +" from "Very Strong -". This change was driven by our view that the credit conditions in Canada have deteriorated. High levels of debt and rapid credit expansion can signal credit quality problems that emerge later. In assessing a given country's credit conditions, we consider the level of private-sector debt to GDP and the growth in private sector debt. Please refer to our "Sector In-Depth; Canada Macro Profile: Strong +" (http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1071643) for further detail.

Please click on this link http://www.moodys.com/viewresearchdoc.aspx?docid=PBC_195571 for the List of Affected Credit Ratings. This list is an integral part of this Press Release and identifies each affected issuer.

RATINGS RATIONALE

Moody's considers that weakening credit conditions in Canada -- including an increase in private-sector debt to GDP to 185.0% as of the end of 2016, up from 179.3% for 2015 -- present increasing risk to Canadian banks' asset quality and profitability. This increase has been led by household debt, which is now at a record high of
167.3% of disposable income (as at Q4 2016) and accompanying house price appreciation. Despite macro-
prudential measures put into place by Canadian policymakers in recent years -- which have had some success in moderating the rate of housing price growth -- house prices and consumer debt levels remain historically high. Business credit, the other component of private-sector debt, has also grown rapidly, at a 6.2% CAGR over the past 3 years. We do note that the Canadian banks maintain strong buffers in terms of capital and liquidity. However, the resilience of household balance sheets, and consequently bank portfolios, to a serious economic downturn has not been tested at these levels of private sector indebtedness.

Toronto-Dominion Bank (TD, Aa2/Aa2 negative, a1); TD's strong ratings are attributable to its very strong domestic retail franchise -- which generates stable and recurring profitability and its business mix. This strength is due to leading market share positions in many personal & commercial financial services products, where TD typically has market shares in the high teens and holds first or second positions.

TD is the most retail oriented of its Canadian peers, with approximately 90% of earnings coming from retail (combined Canadian personal & commercial, wealth management and US personal & commercial, excluding corporate). While CM income has increased over recent quarters and capital allocated to the wholesale business is rising, we expect that reliance on this inherently volatile source of income will remain relatively modest.

Through acquisition and organic growth, TD has increased its exposure to unsecured Canadian consumer credit risk in recent years. In our view, however, the strength and stability of the earnings from TD's Canadian personal and commercial banking franchise remain the primary credit strength supporting its ratings. The ratings of TD's US affiliates benefit from support from the parent, and as such are also affected by this action.

Bank of Montreal (BMO A1/A1 negative, a3); BMO is one of the six major banks in Canada which benefit from the protection of significant barriers to entry and the stability of a prudent regulatory environment. Although its Canadian retail market shares are towards the lower end of the Canadian peer group, BMO has double digit market shares across all significant retail financial services and products, providing scale and recurring earnings power in its home market. In our view, however, the strength and stability of the earnings from BMO's Canadian personal and commercial (P&C) banking franchise remain the primary credit strength supporting its ratings. BMO has a strong and improving US regional banking presence through BMO Harris, which adds important diversification away from reliance on Canadian P&C earnings. However, BMO does not enjoy the same franchise strength and pricing power in the more competitive US market that it does in Canada. The ratings of BMO Harris and affiliates benefit from support from the parent, and as such are also affected by this action.

Bank of Nova Scotia (BNS A1/A1 negative, a3); BNS is the most internationally active of the Canadian banks with approximately half of its earnings generated outside of Canada. BNS has taken significant measures to increase its profitability that signal a fundamental shift away from the bank's traditionally low risk appetite. While the bank's strategic actions are intended to enhance current profitability -- in 2016, BNS reported domestic net interest margin lower than the six largest Canadian banks' average-- in our view, they increase the prospect of future incremental credit losses.

While BNS had strategically grown its credit card and auto finance portfolios -- both of which are particularly prone to deterioration during an economic downturn and exhibit higher defaults and loss severities than mortgage portfolios -- in recent years, growth in 2016 was flat. In addition, the bank has made a series of acquisitions away from its strong domestic franchise towards higher-growth but less stable international markets. BNS has aspirations to continue to grow its international earnings, which in Moody's view adds to bondholder risk.

Canadian Imperial Bank of Commerce (CIBC A1/A1 negative, a3); CIBC is the most reliant of the Canadian banks on domestic P&C earnings, which generate approximately 65% of total earnings, excluding Corporate. In our view, however, the strength and stability of the earnings from CIBC's Canadian personal and commercial banking franchise remain the primary credit strength supporting its ratings. CIBC has the second lowest proportionate exposure to unsecured and non-real estate secured consumer debt as a percentage of domestic consumer assets (roughly 11.5%), reflective of its very large book of insured mortgages.

CIBC is one of the six major banks in Canada that benefit from the protection of significant barriers to entry and the stability of a prudent regulatory environment. Although its Canadian retail market shares are mid-range relative to its Canadian peers, CIBC has solid double digit market shares across all significant retail financial services and products, providing scale and recurring earnings.
National Bank of Canada (NBC A1/A1 negative, baa1); NBC's dominant position in commercial banking and strong second place share of market in retail banking in Québec are the primary credit strengths supporting its high ratings. The stability of the recurring earnings power of NBC's regional retail franchise is, in Moody's view, highly unlikely to be challenged. That being said, NBC's asset base (CAD234 billion as of Q1 2017) and national deposit share (roughly 4%) are small relative to the other large Canadian banks whose branch systems are more national in scale. In our view, however, the strength and stability of the earnings from NBC's Canadian personal and commercial banking franchise remain the primary credit strength supporting its ratings.

While each of the major Canadian banks enjoys the benefits of superior pricing power due to sustainable large market shares in many significant retail and commercial products and services, this is true for NBC only in the context of its regional market, the province of Québec. As such, the challenges in geographic diversification and earnings stability and the Québec credit concentrations offset partially the strength in local market share and sustainability. NBC is the Canadian bank most reliant upon inherently less stable capital markets earnings, which generated 38% of total earnings, excluding Corporate for 2016 (38% for 2015.)

Royal Bank of Canada (RBC A1/A1 negative, a3 ); RBC's ratings reflect its profile as a strong and diversified universal bank with sustainable leading market shares across many retail products and services in its home market. The stable earnings from RBC's domestic Personal and Commercial franchise are a key credit strength. RBC has had very low earnings volatility, supported by the stabilizing effect of the recurring profitability of RBC's solid domestic retail banking franchise.

However, over the past four years RBC has demonstrated rapid growth in its Capital Markets business, led by growth in its US corporate loan book and the repo and securities finance business. We believe that RBC's US-focused Capital Markets growth strategy increases its exposure to risks that could more rapidly erode its creditworthiness in volatile or adverse market conditions, and is therefore negative for the credit. To date, this risk has been well managed and its performance has been very stable. Maintaining this performance through more volatile markets will be key to RBC's longer term risk management track record. We do not expect that this business will continue on this growth trajectory, and, in fact, that capital committed to the Capital Markets business will be more constrained.

Management plans to substantially grow the earnings of its recently acquired, California-based private and commercial bank, City National Bank, (deposits Aa3 stable, a2) both organically and through targeted acquisitions. Growth in the City National business presents less credit risk than continued growth in the Capital Markets area, in our view.

The ratings of two affiliates, RBC Capital Markets LLC and RBC (Barbados) Trading Bank Corporation were also affected by this action. In each case, both long and short term ratings were downgraded.

Fédération des caisses Desjardins du Québec (Aa2/Aa2 negative, a1 ); The Fédération is a cooperative entity responsible for governance and oversight activities for Desjardins Group (the Group). It acts as a control and supervisory body over the individual member caisses. The Fédération's pivotal importance to the Group's operations and performance, the application of regulatory supervision to the Group as a whole, as well as the strong strategic and financial cohesion among member caisses with a well-developed mutualist support framework, lead us to factor the strength of the Group into the Fédération's BCA.

The Group has a secure retail banking franchise in rural Québec as well as strong capitalization and limited reliance on wholesale funding. Its regional banking concentration in Québec is offset in part by the Group's national insurance and wealth management business.

The Fédération's ratings were affirmed despite the Macro Profile change because Moody's believes its operations to be largely isolated to the province of Québec (which has experienced lower house price appreciation than other provinces) and because a large proportion of Desjardins' net income is derived from non-banking sources, such as life and property and casualty insurance.

CIBC Mellon Trust (CIBC Mellon A1/A1 stable, a1); CIBC Mellon is a major player in the Canadian custody market, underpinning its franchise value. The operations and technology platform provided by BNY Mellon lends a further competitive advantage. BNY Mellon is the largest custodian, globally, and its operating platform allows CIBC Mellon to benefit from economies of scale and service not available to its primary domestic competitor.

CIBC Mellon's risk management and control environment is strong, with an appropriate emphasis on operational risk issues and effective supervision by the joint venture's owners. CMT does not make loans (other than short-term overdrafts to custody clients) but incurs credit risk through its securities portfolio. The
investment portfolio is made up largely of short-duration Canadian government and provincial bonds as well as corporate debt.

CIBC Mellon’s ratings were affirmed despite the change in the Macro Profile because Moody’s believes its custody bank business model is directly unaffected by high consumer debt as it does not lend to consumers.

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- Principal Methodologies

The principal methodology used in the ratings of the affected banks was Banks published in January 2016. The principal methodology used in the rating of RBC Capital Markets, LLC was Securities Industry Market Makers published in February 2017. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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• Lead Analyst
• Releasing Office
• Person Approving the Credit Rating

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