Canadian Western Bank

Second Quarter 2020 Financial Results

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PRESENTATION

Operator

Good morning. My name is Sylvie and I will be your conference operator today. At this time, I would like to welcome everyone to the CWB's Q2 Earnings Conference Call and Webcast. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. If you would like to ask a question during this time, simply press star then the number one on your telephone keypad. If you would like to withdraw your question, please press star followed by two. Thank you.

Mr. Matt Rudd, you may begin your conference, sir.

Matt Rudd — Senior Vice President, Finance & Investor Relations, Canadian Western Bank

Thank you, Sylvie, and good morning, everyone. Welcome to our second quarter 2020 financial results conference call. My name is Matt Rudd and I'm the Senior Vice President leading our Finance and Investor Relations team. Presenting to you today are Chris Fowler, our President and CEO, and Carolyn Graham, our Executive Vice President and CFO.

I would like to remind listeners and webcast participants that statements about future events made on this call are forward looking in nature and based on certain assumptions and analysis made by management. Actual results could differ materially from expectations due to various risks and uncertainties associated with our business. Please refer to our forward-looking statement advisory on slide 19.

The agenda for today's call is on the second slide and, to take us through that agenda, I turn the call over to Chris.

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

Thanks, Matt.

Clearly, the topic of the COVID-19 pandemic is the key matter for this quarter. I'll begin by sharing my thoughts on the strength of CWB's position going into this period of economic volatility and how we have used our proactive approach to assist our clients in these challenging times. Carolyn will follow with detail on our second quarter financial results and then we'll open the lines for the question-and-answer session before I provide closing comments.

We have made significant progress over the last decade to strengthen our business, which is highlighted on slide three. The actions taken by our dedicated team members to diversify our business and enhance our capabilities while maintaining our strong capital and funding levels puts CWB Financial Group in a position of strength to navigate these challenging conditions and continue to support our clients. Our disciplined and secured lending model, with no significant exposure to unsecured personal borrowing, including credit cards, continues to support the resiliency of our business. Our capital ratios remain strong and well above regulatory requirements and we hold ample liquidity to support our clients as we continue to invest in our strategic priorities.

Our strong position heading into this period of economic uncertainty has allowed us to be proactive in supporting our clients. Slide four displays how we quickly responded to this unprecedented situation while keeping our people-first core value firmly in focus. Throughout the entire quarter we provided the full range of personalized service our clients expect from us through digital, remote, and essential branch operations. Our past investment in technology infrastructure supported the rollout of our business continuity plan and enabled us to smoothly transition over 85% of our team members to work remotely. Our clients have leveraged our expanding digital capabilities and in our branches we have implemented additional precautions to keep our team members and clients safe. Beginning this week, our temporarily closed branches have reopened following provincial protocols and the implementation of a phased strategy that is focused on the continued well-being of our people and clients to support our teams as they gradually return to the workplace.

Turning to slide five, we quickly mobilized our teams to reach out to clients to provide advice, support, and offer the right solutions for those in need of financial assistance using our #CWBhasyourback program. Our teams were among the first in the industry to deliver loan relief to business and at April 30th we had granted some form of payment relief on approximately 20% of our loans to help through the initial volatility of this challenging situation. Our process was to triage each loan for deferral and, for those accepted, primarily grant a three-month term. We saw the volume of deferral requests slow down considerably as the quarter closed and the government-sponsored loan programs rolled out. As we work with our clients to find the right solutions for them in this challenging environment –whether that be payment relief or use of a government-sponsored lending program – we continue to triage our loan book to assess evolving risk profiles with a focus on portfolios particularly affected by the economic slowdown.

We are also paying close attention to our Alberta exposures given the current downward pressure on oil prices, but so far have not seen trends that are any more concerning in granting payment relief, use of the government-sponsored programs, or migration in risk ratings in our Alberta exposures compared to the remaining provinces. Alberta is a market we know well and we have developed deep relationships and, as we do with our entire footprint, we follow prudent, secured lending structures when granting credit. We are on top of our exposures and are more focused than ever to be ahead of anticipated challenges arising from the economic disruption.

As you'll hear from Carolyn later in our discussion of the second quarter financial results, we've recorded elevated levels of provisions for credit losses on our performing loans this quarter as a result of an adverse shift in forecasts for the Canadian economy. We believe the prudent actions we have taken to diversify our portfolio over the last number of years, our secured and prudent lending approach with no significant exposures to unsecured personal lending or credit cards, and our low historical credit losses realized through economic cycles support the overall resiliency of our loans through this period of volatility.

As you'll see on slide six, the current operating environment has not stopped us from continuing to execute against our strategic priorities on all fronts. In fact, we remain extremely active preparing for the opportunities of tomorrow. Our people have worked tirelessly to enhance the agility of our teams with remote work arrangements and have kept our teams informed through virtual communication channels. I'm extremely proud of how our teams have adapted and collaborated to ensure we support each other and continue to have our clients' backs when they need us the most.

With so much change asked of our team members this quarter, it is especially rewarding that confidential employee survey results supported our recognition as one of the 50 best workplaces in Canada for 2020 and that CWB Optimum Mortgage's was named one of the top mortgage workplaces. This recognition reinforces that our actions to evolve our culture and our employee experience continue to create value for our people and ensure we are a career destination for top talent.

During the quarter we announced our strategic acquisition of T.E. Wealth and Leon Frazer & Associates, which will enhance our ability to provide broader and deeper investment counselling and planning capabilities with an extended geographic footprint. The acquisition will close Monday and will increase our total wealth assets under management, administration, and advisement to approximately $8 billion. This acquisition accelerates our strategy to be a leading provider of wealth management services to successful business families across Canada and increase our addressable market to support further growth of full-service client relationships.

We also made strong progress on the improvement in our digital capabilities and remain committed to achievement of key milestones despite the impacts of COVID-19. Digital onboarding capability for Motive Financial's personal clients will go live in the third quarter and support our strategy for continued growth of branch-raised deposits. This will be followed by digital onboarding of the remainder of our personal banking clients in Q4 and will expand to our business clients next year.

Despite in this period of economic volatility, our strategy and focus remains unchanged. We are continuing our plan to transform our business to become a disruptive force in Canadian financial services and a clear full-service alternative for business owners. I am confident that our ongoing initiatives will position us to deliver breakout growth and maximize value creation for our upcoming transition to the advanced internal ratings-based approach for regulatory capital and risk management. With our formal application submitted earlier this quarter, I'm pleased to confirm we continue to expect approval in fiscal 2020.

I'll now turn the call over to Carolyn, who will provide more detail on our second quarter financial performance.

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

Thank you, Chris, and good morning, everyone.

Our second quarter performance highlights are on slide eight and you'll see that the economic and financial market volatility has negatively impacted our financial performance. Compared to the second quarter last year, our pre-tax, pre-provision income was up 1% while our common shareholders' net income and diluted earnings per common share were down 17%. Adjusted common shareholders' net income and adjusted cash earnings per common share declined 20% and 19%, respectively. Common shareholders' net income was lower compared to last year as the 2% increase in total revenue was more than offset by an elevated performing loan provision for credit losses, which I'll discuss in more detail shortly.

Net interest income was stable and non-interest income increased 25%, primarily due to net gains on securities. Net interest expenses were up 3% compared to last year as continued investment in our teams and technology to support overall business growth and execution of strategic priorities was partially offset by lower spending this quarter on certain expenses in light of the current operating environment.

Our efficiency ratio of 47.1% compares to 46.8% last year and 45.5% in the previous quarter. The increase from last year and last quarter primarily reflects constrained revenue growth in the current low interest rate environment and, sequentially, two fewer interest-earning days this quarter. Operating leverage this quarter was negative 0.8%, improved from negative 3.1% last year and negative 2.6% last quarter.

On a year-to-date basis, on slide nine, pre-tax, pre-provision income was up 1%, while our common shareholders' net income and diluted earnings per common share were down 4% and 3%, respectively. Adjusted common shareholders' net income and adjusted cash earnings per common share were down 8%. The year-to-date decline in common shareholders' net income was driven by the same factors as the quarterly year-over-year comparison as well as higher non-interest expenses as we continue to invest in people and technology to support ongoing strategic execution.

Turning to slide 10, cumulative reductions in the Bank of Canada policy rate of 150 basis points in March negatively affected our net interest margin as our loans re-priced more quickly than our deposits and deposit costs have reached a notional floor due to very low interest rates. Our other funding costs were also slower to decline in comparison to the drop in the prime interest rate this quarter due to higher market demand for liquidity. This impact was partially offset by a favourable shift in our funding mix due to ongoing strong branch-raised deposit growth and a resulting decline in broker deposits.

Our quarterly net interest margin of 2.4% does not reflect the full quarter impact of the cumulative Bank of Canada rate cuts. Our net interest margin for the month of April, up 2.3%, does reflect that full impact and we consider it a reasonable expectation for the remainder of the year. There is potential upside if conditions are appropriate to prudently manage liquidity lower or if funding costs continue to trend down to further reflect the market interest rate declines. Of course, net interest margin will also be impacted by any further Bank of Canada policy interest rate changes, competitive deposit pricing factors, changes to the cost effectiveness or accessibility of funding channels, loan growth, adjustments to loan pricing, and our clients' abilities to recommence contractual payments following the completion of payment deferral periods. In assessing deposit rate pricing, benefits to net interest margin will continue to be balanced against maintenance and branch-raised deposit balances to support appropriate levels of liquidity considering the market conditions.

Slide 11 demonstrates our success in executing on key strategic objectives to grow and diversify funding sources. This quarter marks our fifth consecutive quarter with a strong sequential increase in branch-raised deposits. Compared to last year, demand and notice deposits increased 31% to surpass $10 billion and now account for 35% of total funding compared to 29% last year. This robust performance drove branch-raised deposit growth of 20% and contributed to a 17% reduction in the total balance of broker deposits, which now represent 26% of total funding compared to 34% last year.

The reduction in our reliance on the deposit broker network is another of our key strategic priorities. While the cost effectiveness of the broker deposit market was adversely impacted by the economic impacts of COVID-19 this quarter, I do want to note that this funding source remains a reliable and effective way to raise insured fixed-term retail deposits over a wide geographic base and remains a deep and liquid funding source.

You'll see on slide 12 that total loans were up 7% over the past year with positive contributions from our strategically targeted areas of general commercial and in Ontario. On a sequential basis, total outstanding loans were up 2%, primarily related to strong growth of 5% in Ontario driven by general commercial loans as well as 1% growth in both Alberta and British Columbia. Draws on lines of credit were not a contributor to loan growth this quarter as the average utilization of outstanding commercial and personal lines of credit remained stable compared to both last quarter and last year. The impact of loan deferrals also did not significantly contribute to loan growth this quarter. Looking forward, while our original forecast anticipated double-digit loan growth, always where prudent, we now expect mid-single digit loan growth for fiscal 2020 based on current conditions.

Turning to slide 13, the credit quality of our portfolio and our provisioning for impaired and performing loans under IFRS 9 continues to reflect our secured lending business model, disciplined underwriting practices, and proactive loan management, all hallmarks of our historic success. Gross impaired loans totalled $271 million at April 30th compared to $243 million last quarter and we recognized a provision for credit losses of 22 basis points on impaired loans. The increase in gross impaired loans compared to last quarter primarily related to two Alberta-based oilfield service providers in our general commercial exposures that experienced financial difficulty prior to this period of disruption. These accounts were partially offset by the resolution with no loss of a portion of a significant Alberta-based commercial mortgage connection that we reported as impaired last quarter.

As Chris noted, we continue to triage our loan portfolio to assess evolving risk profiles with a focus on portfolios particularly affected by the economic shutdown. As we've highlighted many times before, our exposure to oil and gas production and oilfield service portfolios represent under 1% and 2%, respectively, of our total loans. We've also done an in-depth review of other portfolios we believe present a higher risk in the current operating environment. Our exposure to the hospitality and leisure sectors is just under 5% of total loans, while office and retail real estate sector represents another 4%, and we have insignificant exposure to air travel. Our exposure within these industries is well diversified across the country and represents high-quality resilient borrowers that we have handpicked. We deeply understand their businesses and the individual exposures. We remain comfortable with our exposures in these areas.

The second quarter IFRS 9 provision for credit losses on performing loans, calculated using our past performance as well as a forward-looking view of macroeconomic factors, totalled 27 basis points, a significant increase compared to one basis point last year and three basis points last quarter. As a result, our allowance for credit losses on performing loans was $111 million this quarter, an increase of $20 million or 22% compared to the previous quarter. The increase in the provision on the performing loans was driven by a material adverse shift in forward-looking economic conditions.

The forecast, calibrated to the average of the six large Canadian banks, assumes a significant deterioration in GDP and unemployment to the end of the third quarter of fiscal 2020, followed by a recovery fuelled by the reopening of the economy and the impact of various government and central bank stimulus programs. Housing price growth typically lags behind other economic factors, with the low point in housing prices forecast for the latter half of 2021, followed by a gradual recovery. The oil price forecast begins at the April 30th price with a gradual recovery following increased energy demand as the economy reopens. The impact of COVID-19 on the economy and the timing of recovery continue to evolve. As our performing loan allowance is estimated considering expectations for future macroeconomic factors, portfolio defaults or increases in the risk ratings of our performing loans, shift in these factors will impact the allowance balance in future quarters.

As you can see on slide 14, our realized write-offs have been low over the last several years, with the exception of a unique situation in 2016 where we were prevented by provincial regulators from realizing our security rights in our oil and gas portfolio. While the current economic volatility and challenges are unprecedented, our solid credit performance in the past, in both healthy and challenged economic times, reflects our prudent underwriting and secured credit model. While there is uncertainty in what lies ahead, we are confident that our secured and high-quality credit portfolio provides a solid foundation as we navigate this period of economic volatility.

Our strong capital ratios at April 30th appear on slide 15. Calculated using a *Standardized* approach, our common equity Tier 1 ratio was 9.1%, Tier 1 ratio was 10.5%, and our total capital ratio was 11.9%. At 8.3%, our Basel III leverage ratio remains very strong. With these strong capital ratios and very low leverage, we are well positioned to create increased value for shareholders while ensuring we remain conservatively capitalized through the current economic challenges. We will invest approximately 30 basis points of capital in the wealth management acquisition set to close on Monday.

As Chris mentioned, we have submitted our formal AIRB application. OSFI has publicly confirmed that our application review is not impacted by the various regulatory actions taken in response to COVID-19. Approval of our application, expected by the end of this fiscal year, will boost our already strong capital ratios as risk-weighted assets will be calculated using more risk-sensitive models.

Yesterday our Board declared a common share dividend of $0.29 per share, up $0.02 or 7% from the common share dividend declared one year ago and consistent with the prior quarter. We are comfortable that our current dividend level remains appropriate given our conservative, strong capital position and the results of ongoing stress testing.

And speaking of stress testing, I'll turn now to slide 16. To satisfy ourselves that our allowance for credit losses on performing loans is adequate given the uncertainty of the economic outlook and to confirm the resiliency of our capital levels and earnings, we utilized our AIRB and IFRS 9 capabilities to perform additional stress testing to simulate the impact of a more severe and prolonged period of challenging economic conditions throughout our geographic footprint.

As you can see, relative to the forward-looking macroeconomic scenario used to estimate our April 30th allowance for credit losses, our stress test assumed a deeper initial decline in GDP, lower oil prices, and significantly higher levels of unemployment that recover at a much slower pace, remaining worse than pre-recession levels through the duration of 2021. The allowance for credit losses produced under this stress scenario confirmed the resilience of our secured and diversified portfolio to economic volatility, further supported by our historical experience of low write-offs. Considering the broader financial results of this stress test, we remain confident in our ability to deliver positive earnings for shareholders while we maintain financial stability, our current dividend level, and a strong capital position as we manage through the uncertain economic outlook while continuing to have our clients' backs.

And with that, Sylvie, let's open the lines for Q&A.

Q & A

Operator

Thank you, Ms. Graham. Ladies and gentlemen, if you do have a question at this time, please press star followed by one on your touchtone phone. You will hear a three-tone prompt acknowledging your request. Should you decide to withdraw your question, simply press star followed by two. If you are using a speakerphone, please lift the handset before pressing any keys.

And your first question will be from Sumit Malhotra at Scotia. Please go ahead.

Sumit Malhotra — Analyst, Scotiabank

Thanks. Good morning. I'll start with a question on loan growth. I think you mentioned in your comments, perhaps given your business mix is skewed more to commercial borrowers and corporate, line draw-downs were not a significant part of the growth. Just kind of curious, from a business perspective – particularly following the month of March – how the activity levels from your client base have trended. Is there enough going on that they are still coming to the bank and looking for financing for project activity or has it slowed significantly in this environment that we're in right now?

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

Sumit, I've talked to all our main branch managers and business leaders and there's still been continued activity and interest by clients for different projects as they're evaluating the future. So we have seen a continued pipeline of business, both on the project loan side but also on general commercial too, which is our key target area for growth.

Sumit Malhotra — Analyst, Scotiabank

And one on the credit side, Chris, I'll come back to you. I think you've given us some good detail here on how you thought about the provisioning trend and more so the factors that go into building allowance; I'll make it a two-parter.

Number one, we've been through a few of these cycles in the past with the bank and you've talked a lot about the secured nature or reserve-based nature of your lending. That said, when we look at your coverage ratios today, they're materially lower than even the levels you've had in the past and obviously, under IFRS 9, you do have more management overlay in terms of how aggressive you build reserves. Given your capital strength, why did you opt not to go for a bigger move and strengthen some of that allowance base? And then secondly, if you do feel what you've done in performing is adequate, how should we think about the trend line in provisioning for the rest of 2020?

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

So Sumit, as we thought about the performing loan allowance and – as you can imagine, we spent a lot of time over the last two or three months thinking very, very carefully about that – it came back to thinking carefully about what were the macroeconomic assumptions that we built into our forecast, as well as the appropriateness of the numerous management overlays that we have in place that supplement the estimate that comes through from our risk-based models. And we looked at a stress test to try to determine potential additional provisioning that may be required if the reopening doesn't come to pass the way that we all hope that it does and determined that this was the right level; thinking about our portfolio, thinking about our past experience and history, and the exposures that we have today.

Looking ahead and thinking about provisioning going forward we, like everyone, believe that we are in for some challenging times, so we do think that there may be more impaired provisioning as our clients work through the economic recovery. I think on the performing loan allowance side, if the economic forecast deteriorates, we've provided what we believe would be the estimate for additional provisioning related to those macro forecasts. The other factors are: individual clients shifts in risk rating and shifts in default rates, which could have a temporary impact on our performing provisions as well.

Sumit Malhotra — Analyst, Scotiabank

So, all else equal, and thanks. You gave me a lot to think about there. It sounds like you're of the view that the impaired are obviously going to increase but the performing, given you've made this move in indicators, unless there's something that causes you to go back to your models, the performing piece, while it's not going to zero, it should be lower in your expectation from what we saw today.

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

I think that's fair, assuming the forecasts don't materially deteriorate.

Sumit Malhotra — Analyst, Scotiabank

All right. Thank you for your time.

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

Thanks, Sumit.

Operator

Thank you. Next question will be from Scott Chan at Canaccord. Please go ahead.

Scott Chan — Analyst, Canaccord Genuity

Good morning. Carolyn, when you referenced slide 14 on the historical, on the write-offs, and you talked about 2016, can you remind us the experience during the GFC (Global Financial Crisis) period in 2008 and 2009?

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

You can see right at the very beginning of that chart on page 14, in the global financial crisis our impaired loans peaked in the second quarter of 2010 and they peaked at 168 basis points of the total loan portfolio. But we really didn't see a material shift in the level of actual write-offs coming out of that. They remained at our historic levels.

Scott Chan — Analyst, Canaccord Genuity

Okay. And then maybe just like a broader question on your wealth acquisition of T.E. and Leon Frazer. When you think about what you have out west and what you've purchased, which is predominantly on the east side, what are your intentions on the bigger picture in terms of this acquisition to your overall wealth franchise or strategy?

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

Well, we are really excited to close on this acquisition on Monday. The footprint of T.E. Wealth and Leon Frazer is Vancouver, Calgary, Toronto, and Montreal, so it fits very well with our footprint. Vancouver is new for us.

Our main acquisitions in the past in wealth management have been in Alberta – in Calgary and Edmonton – so this is a great addition for us. And also, as we really look at our growth in Ontario, the addition of the really strong teams of those two groups in Toronto, we see that as a great opportunity for us as we look to continue to build our franchise there.

We have the opening of our Mississauga branch, which of course has been slowed because of the COVID situation with construction, but it will be opening in late summer – early fall, in that time range. We see the teams that we'll have on the commercial banking side there work very collaboratively with the wealth side. So we really are looking forward to that being a great opportunity for us to really continue to deliver full-service banking and a big step forward for CWB.

Scott Chan — Analyst, Canaccord Genuity

Okay. And just lastly, Chris, while I have you, you talked about real estate project loans and called out condo developments or projects being delayed in BC. What about Ontario and kind of what, in your sense, you see where it could resume and what factors might impact that?

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

We see a continued pay down in our real estate project loan book, which means of course that that's successful completion of the projects. So we're obviously very happy with the quality of that book and it's been operated – in terms of our focus on Tier 1 clients – is operating very well. Ontario, we participate there in syndicated exposures as opposed to in BC and Alberta where we have direct lending to clients. So Ontario has been very positive and, again, we participate there with typically the large banks as the leader of those projects. We've seen good quality projects that have come forward with well capitalized Tier 1 borrowers there.

Scott Chan — Analyst, Canaccord Genuity

Great. Thank you very much.

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

And Scott, I'll just circle back on your first question, so just to confirm, in 2010, gross impaired loans peaked at 168 basis points, as I mentioned. Our provision that year was about 22 basis points.

Scott Chan — Analyst, Canaccord Genuity

Okay, got it. Thanks, Carolyn.

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

Thanks.

Operator

Thank you. Next question will be from Gabriel Dechaine at National Bank Financial. Please go ahead.

Gabriel Dechaine — Analyst, National Bank Financial

Good morning. I've got a dumb question here, but all those loans that are on deferred payment programs, you're still accruing interest for them?

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

Yes. So they remain performing and we accrue interest on them.

Gabriel Dechaine — Analyst, National Bank Financial

So walk me through how this works in the next four to six months. Let's say, I don't know, half, I mean pick whatever number, if you want to answer me that way, but the customers that go back to paying you as they normally would, there's no accounting noise, but then what would happen to the portion that don't? Because subsequently, you know, they're impaired loans and they're not paying you, but would there be a reversal of sorts?

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

So, when loans move to impaired the accounting that we use is that we do reverse interest that has been accrued but not collected. So that happens in normal course today and is just part of the regular NIM that we see every day.

Our deferrals were almost exclusively for a three-month period, so coming up, in the month of June, we will be reconnecting with all of those clients to get an update on their business, talk more about their current ability to restart making payments on their loans. So that will be work that we are actively doing and so we would anticipate that some will restart making payments on their loan. We would expect that some may request an additional three-month deferral period and we will assess those on an individual basis as we have done now.

You will notice in our financial statement note where we provide the detail of our deferrals by portfolio, you can see that about 15% of those loans are in stage two at the end of April. So, while they've remain performing, we did allow our models, where the conditional probability of default indicated they should move to stage two, we did move them to stage two and have estimated lifetime losses on them.

Gabriel Dechaine — Analyst, National Bank Financial

Okay. All right. So those deferrals would be the performing provision this quarter, that subset.

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

Yes.

Gabriel Dechaine — Analyst, National Bank Financial

Okay. And then the rest wouldn't. But like do you have any indications? Because we hear from some banks that they have this number out there, X for the percentage of customers not paying us right now, but some are already making minimum payments. I don't know exactly how that works but do you have any data or insight like that that you could share?

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

We have about 86% of the deferrals are full payment deferrals and about 14% are interest only. And as Carolyn said, our teams are triaging these loans. So we're staying on top of the clients, understanding what their prospects are, what does the re-launched economy look like, how does it impact their ability to generate their (inaudible). We are very much on top of this. It's a key focus, Gabe.

Gabriel Dechaine — Analyst, National Bank Financial

Yeah, yeah, no, no, I don't doubt it. But I just, so just so I understand the definitions, 14% of those, of the ones in that schedule are paying interest only?

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

Interest only. Yes.

Gabriel Dechaine — Analyst, National Bank Financial

The 86% are not paying anything?

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

They're full payment deferrals, yes.

Gabriel Dechaine — Analyst, National Bank Financial

Okay. And just, ah, what's the other one I had here? Can you maybe describe the base case, worst case, optimistic case? Like when you set your performing provisions, I assume you skewed heavily to the pessimistic case. Is that how it works?

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

Our process is that rather than three or four finite individual cases that are then weighted, we start with our base case – based on the average of the big six forecast - we do a Monte Carlo analysis, and then we potentially looked at other pessimistic scenarios – like we've described in the stress test scenario – to help us understand potential moves in the performing loan allowance moving forward. We've described on page 16 of the deck sort of a broad comparison of the base case that we've used for Q2 and our stress test assumptions, then we've got a lot of detail by quarter on the base case scenario in the financial statement note.

Gabriel Dechaine — Analyst, National Bank Financial

And last one for me, another maybe a stupid question, but the average of the big six scenarios that you used, like was that Q1 or you saw something Q2 that, I don't know, OFSI or something allowed you guys to see?

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

We used the publicly available as they evolved through the quarter.

Gabriel Dechaine — Analyst, National Bank Financial

Okay. Thank you and talk soon.

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

Thanks, Gabe.

Operator

Thank you. Next question will be from Steve Theriault at Eight Capital. Please go ahead.

Steve Theriault — Analyst, Eight Capital

Thanks very much. Just maybe one more to start on the deferrals. Chris, you said you saw a deceleration of deferrals in the quarter end. There's a big focus here, so could you discuss a little more what you've seen through May? And as I look at what you've given us, there was $6.5 billion of deferred loans at the end of the quarter. Like can you put some numbers around how much higher that's gotten over the last month or so?

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

As of last Friday, we're at about $7.1 billion of loans under deferral so a difference of between 22% of the portfolio at April 30th and about 24% in May. 80% of the amounts that are deferred today were processed by April 16th. So the last six weeks that has really slowed and that would be consistent with the timing of when the government loan program started to roll out and started to be funded. So clients may have taken, requested the initial deferral and then as the various government programs have been put in place have been thinking about what makes sense for them over the next, three to six to twelve months.

Steve Theriault — Analyst, Eight Capital

Okay. That's super helpful. Thanks for that, Carolyn. And then just a question on credit. I was hoping we could take a couple of minutes and you could just refresh us a little bit on the franchise finance business. Can you give some colour on what level of deferrals you're seeing there, maybe remind us of the business mix of quick-serve versus the rest of the book and how you're feeling on credit for that portfolio in particular?

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

Steve, obviously we have a very strong team that runs that group that we acquired in 2016. They've done a very detailed review of their portfolio. So they've got about 75% of that is hotels, 25% is restaurants. On the hotel side, they've got very conservative loan to values in the 50% loan-to-value range. For the restaurant side, based on leverage, very conservative leverage ratios. They do specialize in this area, so they've really looked at picking the borrowers that, as they think of credit risk, they've got good diversification.

So that book we are obviously working hard with. It's got the highest level of deferrals in our overall portfolio, which makes sense given that it's the most impacted by this economic shutdown that we've had. But we've got a team there that's on top of it. We've got very strong borrowers there that have properties that would not just be necessarily located in one city. They'd have multiple locations in a number of cities. Not focused at all in sort of the vacation parts where you'd have more or sort of less chance of business travel, so they're in more of that limited serve hotel space where it's not dependent on a ton of services and conventions to generate revenue. And on the restaurant side, there's a balance there between a quick service and full restaurant. So it's a good, well balanced book, and we're obviously working closely with the team there as they stay on top with their clients.

Steve Theriault — Analyst, Eight Capital

When we think about your performing allowances, is there any numbers you'd be comfortable giving us in terms of, you know, with some of the calls this reporting season we've gotten energy allowances, stage one, stage two. Have you, I guess, maybe if I haven't seen it, or could you split that for like the hotel and hospitality or franchise finance or give any numbers along those lines?

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

Yeah, that level of granularity, no. From an outcome perspective, our oil and gas production book – I mean we have one impaired loan in there that's the same when we had last quarter and you noticed it went down $1 million because we actually wrote off $1 million because the court-approved sale of the company has occurred and it closes June 30th. So we're comfortable with our oil and gas production loans.

Steve Theriault — Analyst, Eight Capital

No, the question was really more just on the franchise finance stuff.

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

Yeah. In terms of having a detailed number, we haven't segregated that out. We're comfortable with the structure of the finance we have in place, the loan to values, the leverage ratios on the restaurants.

Steve Theriault — Analyst, Eight Capital

Okay. Then just if I could finish up, it's great to see the AIRB conversions happening on schedule and that there's no delay there. I just did want to ask though, is there any material change in how we should think about the conversion of risk-weighted assets, either given the credit migration that would be structurally a little bit different under advanced AIRB or just the overall recession, the sensitivity to RWA under AIRB versus *Standardized*?

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

Yeah, that's a good question, Steve. As a standardized bank, your risk rates when a loan goes impaired depends on the level of specific allowance that you record against them. For example, a commercial loan that is 100% risk rated, when it is performing, if it goes impaired, if you have a 20% or higher specific allowance recorded against it, it remains at the 100% risk rate. No provision or less than 20%, it goes to 150%. So there is a cliff effect under the *Standardized* approach that is already factored into the results that we continue to disclose and so that's a little bit different than in AIRB where you would expect a gradual increase in their risk-weighted asset density as loans deteriorate in credit quality. So there is a component of that in the *Standardized* calculations already.

Steve Theriault — Analyst, Eight Capital

Okay. That's helpful. I may circle back on that. Thanks so much.

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

You bet, Steve.

Operator

Thank you. Next question will be from Sohrab Movahedi at BMO Capital Markets. Please go ahead.

Sohrab Movahedi — Analyst, BMO Capital Markets

Just a quick one, Carolyn: In the commentary you offered around the outlook for net interest margins, were you contemplating any shifts in your funding mix?

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

We expect to continue to focus on branch-raised deposits. We did bring down the rate on our Motive Savvy Savings Account in both April and again a small decrease in early May. We saw very strong growth in our CWB Trust Services notice deposits this quarter. That is a portfolio that we expect to flex. That's a portfolio where when equity markets are volatile and investors turn to cash, those balances increase, and so we do expect them to remain strong until equity markets settle. And so that gives us a bit of a natural hedge if we have other deposits where clients are using their cash balances, so that has been positive for us this quarter in those portfolios.

And I would say all of our deposit balances have performed as we would expect them to in the quarter. We continue to access the broker deposit market as required as our marginal source of funding to balance off other things, so it remains deep and liquid, but it did become more expensive. And so the fact that our other deposit sources have been stronger and we've reduced our reliance on the broker market has supported net interest margin. And in the second quarter we drew $350 million from the Bank of Canada's new Standing Term Liquidity Facility. Whenever you're a liquidity manager and there's a new potential channel available to you, you want to put it in place and try it on and see how it works. So we drew March 31st. It rolled over on April 30th for 90 days.

Sohrab Movahedi — Analyst, BMO Capital Markets

Perfect. And just maybe just to follow-up, on Steve's question, are you, like I assume, still *Standardized*, so your risk ratings and everything are currently being calculated on that basis, but would you have a sense of what your quarter-over-quarter RWA inflation would have been under the AIRB approach?

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

I don't have that handy, Sohrab.

Sohrab Movahedi — Analyst, BMO Capital Markets

Okay. Thank you.

Operator

Thank you. Next question will be from Darko Mihelic at RBC Capital Markets. Please go ahead.

Darko Mihelic — Analyst, RBC Capital Markets

Hi. Thank you. Good morning. Just a few questions here. I think I may have misheard you, Carolyn, so I just want to, and I apologize if we're sort of going over something again, but did I hear you say that the stage-two loans, that you've included all of the deferred in the stage two? Is that why there's a big increase?

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

No, not quite right, Darko. So we allowed the models to move loans with deferrals into stage two if the conditional probability of default for those portfolios – based on what industry segment they're in, where they're located in the country – move the loans, we let them move. So, about 15% of our loans with deferred payments are in stage two.

The other reason for the increase in stage two allowances in the second quarter is just the impact of the deterioration in the macroeconomic forecasts. In total our stage two loans for the second quarter, 20% of them are in stage two because of individual client characteristics. So they were past due. They're on our watch list. And the 80% of the loans in stage two are in there because our models shifted them over there. So not because of any client behaviour, but just the way the models work with our conditional PD (probability of default) estimates.

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

And just to add to that, any client that was past due or in that watch list wasn't eligible for a deferral.

Darko Mihelic — Analyst, RBC Capital Markets

Okay. It's just that the number that are in stage two is relatively high, that's why I asked. I mean, by our calculations it's 17% of the portfolio is now in stage two and that's significantly higher quarter over quarter and significantly different from peers. And this brings me really to my question, which is, and you've mentioned this a few times, you referred to this a few times in your remarks, which is your secured lending model is what gives you a lot of comfort and the model could say a whole bunch of these are in a tough spot but not to worry, we have secured lending.

And so what I'm getting at is I wonder if you'd be able to or you'd be willing to share something for me to help sort of formalize something in my mind. And maybe the easiest way to do this is to look at page 16 of your presentation. And when I look at this and I say, okay, there's a stress test and it's 19% higher, your ACL versus the one you've just built – the question is if I look at the existing performing loan allowance of 111, I wonder if you can provide just a rough guide of the probability of default and then the loss given default. And then what would that look like under your stress test?

And what I'm driving at, Carolyn, is I kind of feel like you're relying on the asset value and that's why you simply just don't get a lot of loss. And I'm wondering, you know, I don't want to get into what your house price number is and the value of the equipment falling or whatever, but I'm just really curious if under this extreme stress test we have a significant reduction in the assets that are backing the loans and therefore a significant increase in the loss given default.

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

Great question. I think we're going to have to come back to you, Darko. I don't have that information right at my fingertips. I think one of the other things that we've realized this quarter as we work through this process from multiple directions is a couple of things. The first is, is that our portfolio has a relatively short life and a number of our portfolios amortized materially and quite quickly. So the borrower has equity in the asset. And what that means for us is that if you look at the loss rates between stage one and stage two on average, for us there is about, I'm going off my memory here, but about 115 basis point increase in the expected loss rate for us if a loan is in stage one versus stage two. And that differential for our peer group is more like 400 basis points. So that's characteristics of our secured lending model, the duration of our loan portfolio, all of these things that impact that historic differential between stage one and stage two.

Darko Mihelic — Analyst, RBC Capital Markets

Yeah, and I guess that's what we, I mean the general fear and the general sense I'm getting from many people that I'm speaking to today is just a kind of a scary reliance on models. And that's why we had thought maybe the overlay would be bigger this quarter, the expert credit judgment, just to say, look, on the other side of this, if this gets really ugly, the assets will fall tremendously. House prices will fall significantly, equipment. And in particular in your case, just getting back to franchise finance, I mean hotels and restaurants, this is kind of new. I don't think it was really around during the financial crisis. So history doesn't really help us too much I don't think and that's why I was really curious if you had some sort of statistic around the asset prices that are backing your loss given default numbers. So it's fine. I don't mind coming back afterwards. That would be great to get some comfort on that, if at all possible.

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

Yeah, we can do that, Darko. In speaking of Franchise Finance, yes, that's a group we bought, but actually our percentage of hotel loans in our portfolio is actually lower today than it was in 2010 and 2009, just to be clear.

Darko Mihelic — Analyst, RBC Capital Markets

Yeah. Okay. That's good. Thank you very much.

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

Thanks, Darko.

Operator

Thank you. Next question will be from Nigel D'Souza at Veritas Investment Research. Please go ahead.

Nigel D'Souza — Analyst, Veritas Investment Research

Thank you. Good morning. So I had a quick question and I wanted to circle back and follow up on the stress test assumptions that you've outlined. And I was hoping you could perhaps maybe quantify some of the assumptions, just so it would help us in kind of contextualizing your expected increase in provision.

So, for example, in your stress test, what is the percentage decline you expect for GDP, where do you see unemployment peaking, and what's the floor for oil prices in your stress test assumptions? And I think that would really help us put the increase in your PCLs relative to the base case in perspective.

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

Okay. I can give you a little bit a bit of perspective on that, Nigel. Our stress scenario assumes, in the second quarter of 2020, a 45% decline in GDP with a 20% recovery in the third quarter. Unemployment peaks at 14%, stays double-digit through the first half of 2021. Oil price Q2 of 2020 of $16, recovering to just over $30 in the end of 2020 and remaining below $50 out through the end of 2021.

Nigel D'Souza — Analyst, Veritas Investment Research

Okay. That's really helpful commentary. Appreciate it. Thanks.

Carolyn Graham — Executive Vice President & Chief Financial Officer, Canadian Western Bank

Thanks, Nigel.

Operator

Thank you. Ladies and gentlemen, this concludes the question-and-answer period. We will now turn the call back to Chris for his closing comments.

Chris Fowler — President & Chief Executive Officer, Canadian Western Bank

Thank you, Sylvie, and thank you, everyone, for your continued interest in CWB. There's no question that the current economic outlook will continue to challenge every Canadian. Actions we have taken over the last decade to strengthen and diversify our business enable us to face these challenges from a position of stability and confidence.

We have a history of emerging from difficult economic periods with robust growth because of our approach with current and potential quality clients. We chose our small and medium-sized business owner clients carefully and we stick with them through tough economic cycles, taking a proactive and long-term approach. We're not the same bank we were in prior downturns. We're stronger, we're more diversified, and we have better tools. I'm confident that our sound business model, including our unchanged approach to strong underwriting, will serve us well in this challenging environment as it has many times before.

We have a tremendous opportunity in front of us and a solid plan to transform our bank to increase value for our people, our clients, and our investors. We have a big year ahead with our transition to the ARB approach, the launch of digital banking, leveraging our wealth management acquisition into more full-service client relationships, and opening of our first Ontario branch in Mississauga. Thank you and I look forward to speaking with you when we report our third quarter financial results on August 27th. With that, we wish you all a good morning.

Operator

Thank you, sir. Ladies and gentlemen, this does indeed conclude your conference call for today. Once again, thank you for attending and at this time we do ask that you please disconnect your lines. Have a good weekend.