Canadian Western Bank

Third Quarter 2021 Results

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CORPORATE PARTICIPANTS

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

Matt Rudd, *Canadian Western Bank — Executive Vice President, Chief Financial Officer*

Patrick Gallagher, *Canadian Western Bank — Vice President, Strategy and Investor Relations*

CONFERENCE CALL PARTICIPANTS

Doug Young, *Desjardins Capital— Analyst*

Paul Holden, *CIBC World Markets— Analyst*

Marcel McLean, *TD Securities — Analyst*

Meny Grauman, *Scotiabank — Analyst*

Cihan Tuncay, *Stifel — Analyst*

Sohrab Movahedi, *BMO Capital Markets — Analyst*

Gabriel Dechaine, *National Bank Financial — Analyst*

Nigel D'Souza, *Veritas Investment Research — Analyst*

PRESENTATION

Operator

Good morning. My name is Colin and I'll be your conference Operator today. At this time, I'd like to welcome everyone to CWB's third quarter financial results 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. Mr. Patrick Gallagher, you may begin your conference.

Patrick Gallagher — Vice President, Strategy and Investor Relations, Canadian Western Bank

Good morning and welcome to our third quarter 2021 financial results conference call. My name is Patrick Gallagher, and I'm the Vice President leading our Strategy and Investor Relations team.

I'd 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 CWB's business. Please refer to our forward-looking statement advisory on Slide No. 2.

The agenda for today's call is on the third slide. Presenting to you today are Chris Fowler, our President and Chief Executive Officer, and Matt Rudd, our Executive Vice President and Chief Financial Officer. Following their presentations, we'll open the lines for the question-and-answer session. I'll now turn the call over to Chris, who will begin his discussion on Slide 4.

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

Thank you, Patrick, and good morning. The strong results we reported today reflect the momentum our teams have created in recent years as we continue to deliver on our winning strategy uniquely focused on meeting the full service needs of business owners in Canada. Clients choose CWB for our proactive, personalized service and the specialized advice, tools, and financial solutions we provide. We're very encouraged by the results our strategic investments are delivering. We will continue to enhance our capabilities and product offerings to accelerate our growth and further diversify our business.

We delivered very strong results again this quarter. Compared to the same quarter last year, our pre-tax, pre-provision income increased 15 percent, adjusted earnings per share was up 36 percent, and ROE increased 300 basis points. I am very pleased with this level of performance as it reflects the significant improvements we have made to diversify our funding sources, our portfolio composition, as well as improving our revenue mix through our growing wealth management business we provide to business owners and their families.

Driven by the strategic focus on growth enabling activities, our revenue has increased 16 percent from the strong momentum our teams have generated. This quarter, our client-centric teams produced sequential growth of full-service client relationships with 4 percent growth in lower cost branch-raised deposits and 3 percent growth of specifically targeted lending. The quarterly results are of the strongest growth levels in our history.

The highest growth this quarter was recorded in the commercial mortgage and general commercial portfolios, driven by both supporting existing clients and on-boarding new full-service clients. Our geographic diversification is producing a strong pipeline with 10 percent year-to-date loan growth in Ontario. We expect our strong growth momentum to continue as we enhance our full-service client experience through investments in our in-person and digital channels.

Our digital client offering is advancing well and we are on track to release our enhanced digital banking platform for personal and small business clients, including a limited initial rollout of our virtual COO solution later this year. The virtual COO is a differentiated solution for our small business owner clients that, once fully deployed, will assist in driving strong client growth in this segment. Once fully operational, we expect our enhanced and targeted digital capabilities will enable us to continue to grow and diversify our business across Canada by winning new clients both within and outside our banking centre footprint while further broadening our access to stable lower cost funding.

There's no question our people are core to our success. Our strong growth is supported by our positive and inclusive culture. We remain a clear destination for top talent as our employee experience creates value. Our unwavering commitment to advance our people first culture was recognized again during the quarter by Great Place to Work as one of the Best Workplaces in Alberta, and we were also very pleased to be recognized nationally as one of the Best Workplaces for Mental Wellness in 2021.

As Matt will discuss in a moment, we supported our robust loan growth this quarter with active usage of our at-the-market equity distribution program. This program allows us to support strong loan growth while dynamically managing our capital in light of the current economic volatility and providing attractive sustainable returns to our investors. We also continue to use our AIRB tools to assess and manage credit risk and, as we noted last quarter, we're working on components of our tools and processes that we have determined can be improved. Work on these enhancements will make our tools more efficient for our teams to use, increase precision in the measurement of credit risk, and incorporate the changes required to adopt OSFI's capital adequacy guidelines for the Basel III revisions in Canada.

We remain confident our work will obtain approval for us to transition to the AIRB approach. We will provide further updates on our progress once we finalize the timeframe to resubmit our application, while considering all relevant stakeholders. I'll now turn the call over to Matt, who will provide greater detail on our third quarter performance and improved outlook as we close Fiscal 2021.

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Thanks, Chris, and good morning, everyone. If we turn to Slide 5, compared to last year, branch-raised deposits grew 17 percent and now represent 57 percent of our total funding. Our focus to expand full-service relationships with existing and new clients supported a 31 percent increase in low cost demand and notice deposits compared to last year. We also continued to build on the strength of our capital markets program with a $500 million floating rate note issuance during the quarter at an attractive spread. Our efforts to grow and diversify our funding sources drove a reduction in the outstanding balance of broker deposits again this quarter, and they now represent only 20 percent of our total funding compared to 26 percent at this time last year.

Looking at Slide 6, our total loans were up 9 percent in the past year with positive momentum across our national footprint. The 13 percent growth in our strategically targeted general commercial portfolio reflected our focus to increase full-service client relationships. We also delivered 21 percent growth in commercial mortgages, and that reflects strong new lending volumes in B.C., Alberta and Ontario with high-quality borrowers that remain within our risk appetite. Total loans in Ontario grew 10 percent compared to last year and now represent 23 percent of our total loans.

On a sequential basis, we delivered 4 percent growth in commercial mortgages with the majority of that growth generated from strong existing CWB clients, including providing the commercial mortgage on completed real estate project lending. Our general commercial growth of 3 percent this quarter was well balanced across numerous industries with strong credit profiles. Personal loans and mortgages grew 3 percent this quarter and represent a strong improvement in the performance of this portfolio compared to the previous several quarters.

As Slide 7 shows, we delivered another very strong quarter of profitability. Common shareholders net income increased 39 percent and pre-tax, pre-provision income increased 15 percent compared to last year, and that reflects the benefit of 9 percent annual loan growth and an 11 basis point increase in net interest margin despite the continued low interest rate environment.

Adjusted and diluted EPS each increased by $0.26 from the same quarter last year. Higher net interest income contributed $0.25 and reflects strong loan growth and higher net interest margin. We had a $0.13 contribution from a lower total provision for credit losses primarily driven by a net performing loan recovery of $7 million compared to a charge of $8 million last year. Higher non-interest income excluding the wealth acquisition contributed $0.03 and primarily reflects higher credit-related fees driven by strong annual loan growth. One cent was contributed by the wealth acquisition, which we owned for only two months in the same quarter last year.

Excluding the wealth acquisition, higher non-interest expenses reduced EPS by $0.13, which reflected our continued investments in our people and technology infrastructure to support our strategic execution and costs associated with operating and enhancing our AIRB tools and processes. This quarter also included a partial coupon payment on our Series 2 limited recourse capital notes that were issued in March, which reduced EPS by $0.02.

Our sequential performance shown on Slide 8 reflects 7 percent growth in revenue and a decline in the provision for credit losses that more than offset a 4 percent sequential increase in non-interest expenses. Common shareholders net income increased 20 percent and pre-tax, pre-provision income increased 9 percent compared to last quarter.

Diluted EPS increased $0.16 primarily due to higher net interest income that contributed $0.11 and lower PCL that added $0.05. Higher non-interest income contributed $0.03 and a lower LRCN coupon payment added an additional $0.02. Higher NIEs had a $0.05 negative impact, and that was due to increased performance-based compensation costs, annual salary increments, continued investment in our technology infrastructure to support our strategic execution, and costs associated with enhancing our AIRB tools and processes.

As shown on Slide 9, our revenue has continued to build each quarter over the last year despite no change in prime interest rates over that same period. Revenue has been driven with very strong NIM performance due to very careful management of our funding costs, supported by very strong growth of branch-raised deposits and continued progress in enhancing the diversity of our funding channels.

On a sequential basis, our net interest income increased as the benefit of three additional interest earning days and 3 percent sequential loan growth more than offset the impact of a 2 basis point decline in net interest margin. Our net interest margin in the prior quarter did include a one-time 2 basis point benefit associated with adjusting certain balance sheet management activities in response to a shift in our funding mix. So, if we excluded this one-time item, our NIM was flat compared to the previous quarter.

On Slide 10, we highlight our delivery of another quarter of strong credit performance with low write-offs and low provisions for credit losses and a decline in impaired loans reflective of our conservative credit risk management. Our third quarter provision for credit losses on total loans of 11 basis points was down 9 basis points from last quarter. Our performing loan provision for credit losses was a recovery of 9 basis points compared to a 7 basis point recovery last quarter. Compared to the same quarter last year, the total provision for credit losses was 22 basis points lower, largely driven by a 20 basis point decrease in the performing loan provision for credit losses, and that reflected continued improvements in the near term economic forecast, lower loan default rates, and a continued migration of loans from Stage 2 back to Stage 1.

We continue to maintain an appropriate level of performing loan allowance for credit losses based on the current volatile economic conditions. Our allowance for credit losses on performing loans totalled $113 million—that was a decrease of $7 million compared to the previous quarter. The forecast used in our estimation of the performing loan allowance this quarter was more optimistic than last quarter, and loan default rates continued to trend lower. Ongoing shifts in macroeconomic factors, changes in the level of portfolio defaults, or changes in the risk ratings of our loans will continue to impact the performing loan allowance in future quarters.

At 20 basis points, our provision for credit losses on impaired loans was 7 basis points lower than last quarter and 2 basis points lower than the same quarter last year. Gross impaired loans were 86 basis points as a percentage of total loans, down from 95 basis points last [quarter] and last year. New formations of gross impaired loans were down around 30 percent compared to last year and last quarter, with resolutions of previously impaired loans up 40 percent compared to last quarter and up 34 percent compared to last year. Our realized write-offs remain low, which has been consistent with our historical experience even through periods of elevated levels of gross impaired loan formations.

Our solid credit performance reflects our prudent underwriting, the secured nature of our lending portfolio, and our disciplined management of impaired loans through to resolution while limiting realized loan losses. Based on our current outlook for the Canadian economy, as described further in our MD&A, we expect our fourth quarter provision for credit losses to increase to within a mid-20 basis point range as a percentage of average loans.

Calculated using the Standardized approach, both our Tier 1 and total capital ratios increased from the prior year due to our two limited recourse capital note issuances, partially offset by the redemption of our Series 7 preferred shares on July 31. Our common equity Tier 1 ratio was consistent with last year at 8.8 percent and 10 basis points higher than last quarter, as the combined benefit of retained earnings growth and approximately $30 million of common shares issued under our ATM program more than offset the impact of strong risk-weighted asset growth.

Our ATM program is an effective tool to dynamically manage our capital ratios. We expect to continue to use common shares issued under our ATM to support strong loan growth. We will balance our use of the ATM to support ongoing returns for our investors while ensuring that our capital levels appropriately reflect the potential for near term volatility in the economic reopening and the spread of more infectious variants of COVID-19.

Yesterday, our Board declared a common share dividend of $0.29 per share, consistent with the dividends declared last year and last quarter.

Looking ahead on Slide 12, we've delivered very strong earnings growth on a year-to-date basis that sets us up really well for strong full year performance. We continue to expect annual percentage loan growth in the high single digits in fiscal 2021 where prudent. While we expect that the origination of new branch-raised deposits will remain strong, we believe that this growth may be offset by declines due to increased business and consumer spending through the economic recovery currently underway. Assuming continued stability in our funding costs, we expect our fourth quarter net interest margin to be roughly consistent with the current quarter.

On an annual basis, we expect an efficiency ratio of approximately 49 percent. Non-interest expenses are expected to increase in the fourth quarter due to the continued planned investments in our strategic priorities, which includes ongoing development of our digital client offering, incremental expenditures associated with our AIRB parallel run, and typical seasonal increases in certain expenses.

Our outlook on profitability has improved from the expectations we provided last quarter based on our strong third quarter performance. We now expect to deliver full year 2021 growth of adjusted earnings per share that exceeds 20 percent. With that, Colin, let's go ahead and open the lines for Q&A.

Q & A

Operator

Thank you. Okay, your first question comes from Doug Young from Desjardins. Doug, please go ahead.

Doug Young – Analyst, Desjardins

Hi, good morning, just several questions here. First, Matt, on the 31 percent increase in new branch-raised demand and notice deposits, can you quantify how much of that came from new clients versus existing clients, and as well you mentioned in the release that you did some proactive deposit pricing changes, hoping you can just elaborate a little bit on that.

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, sure Doug. On the first one, it's been a pretty consistent them pretty much all through COVID that the majority of our deposit increases have come from either new client relationships to CWB or the conversion of a lending-only relationship to full service, and with that comes deposits. That's been a long term strategic focus in building capabilities to drive that outcome, and we're seeing really good momentum.

What that's allowed us to do with that robust volume coming in, and we think a large chunk of that is very sticky, we've been able to critically analyze the pricing of certain deposit products and really taken our foot off the gas from a competitive perspective on them, and that's allowed us to put a bit of NIM in our back pocket, actually. The other big benefit it's given us, that strong branch-raised deposit growth, is reliance on wholesale funding channels has been significantly reduced, where we have tapped into, say, the broker market on occasion or in looking at capital market issuances, we've been very selective when we've tapped into those sources. We do it when we see pricing that looks compelling, but we're not in a position where we feel like it's a requirement. It's just given us a lot of levers to pull to really reduce our funding costs as low as we possibly can. That's been a big driver year-over-year.

If you looked at our NIM Q3 last year to Q3 this year, we've improved it by 11 basis points. That's a very different trend than what we've seen in the market from others, and just our focus on that branch-raised deposit growth is paying dividends and that's what's put the tools in our toolkit that's allowed us to generate that growth in NIM despite really no help from market interest rates, so very pleased with the progress there.

Doug Young – Analyst, Desjardins

If I wanted to quantify how much is coming from new clients, would it be fair to say 60 percent, 70 percent? Then the NIM expansion is the other place I did want to go to, so thanks for that lead-in. Again, as you mentioned, very different message and quantitatively very different from what we're seeing from the big six. Is this all as a result of deposits, growth in the branch-raised deposit growth, or is there other items that have factored into that?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, on the first question, we've been kind of bouncing between as low as 50 percent, as high as 70 percent depending on the quarter in terms of contribution from new to bank clients or conversion from lending only to full service.

On the second one, yes, it has been entirely funding costs. We have not had really any help on asset yields. Asset mix year-over-year has actually been a bit of a headwind. You'd note that our overall levels of liquidity have actually increased year-over-year, so on a more normalized basis there's likely some incremental NIM that might have come if we lowered our levels of liquidity. We're carrying a prudent amount right now and appropriate for the conditions, but it just highlights just how much torque we've had with really focusing on funding costs. To say it's been an organizational focus would probably be an understatement. We study our deposit pricing, we study our access to funding channels very carefully on a very frequent basis and in a very strategic way, so good to see that focus has been paying off.

Doug Young – Analyst, Desjardins

Then just second on non-interest expense ratio, 49 percent for Fiscal '21, I mean, you've signaled that there is strategic spend coming in Q4, and I get all that. But my math suggests in Q4, we'd be looking at a mix ratio in the 53 percent range, which is much higher than what we've seen in the past. Do I have that messaging and number about right?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, your math is pretty good, pretty close. If you look at last Q4, it was a similar result as well. Fourth quarter, just based on the seasonality of certain expenses, typically is a bit of a tick up in the nix ratio. What we're seeing this quarter, and if you did your backwards math you'd likely see sequential NIE growth kind of in that—just hitting in the double digits. If I were to break that down into three pieces, about a third of that is just the normal seasonal increases we typically see in things like marketing and things like training. About a third of that comes from the costs we're incurring to enhance our AIRB tools and processes, as we've discussed, and then a third of that is just strategic execution, predominantly our big push on digital. You would have seen in the release, we're pushing really hard to get two tools launched later this year—that's our VCOO and our small and midsized commercial digital offerings. It's just a big push on those that drives the mix up a bit higher in Q4. But a couple of those big things are heavily strategic focused items that we think will drive us pretty strong growth in the future, worth making the big push to continue moving those along.

Doug Young – Analyst, Desjardins

Then just lastly for me, and thank you for that, lastly on the PCL, you're signaling mid-20 basis point range for Q4 versus 11 basis points this quarter. Essentially is the message that we shouldn't expect any relief in performing loan PCLs and impaired PCLs probably stay roughly where they were this quarter, maybe a little bit higher? Is that really what the messaging is?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, that would be our base case, and that has been our base case. When we look at the macroeconomic forecast that underpins our performing loan allowance, when we're thinking about no releases from this quarter to next, it's stability in that forecast and stability in default rates. What we've been continually surprised by, I suppose each quarter, is that the macro economy continues to improve and default rates continue to tick down. So, if we saw that continue to occur in fourth quarter, then there is some allowance that could be released on the performing loan side, although not our base case, but I suppose we've continued to be surprised to the upside all year so we'll see how that plays out.

Doug Young – Analyst, Desjardins

Makes sense, thank you very much.

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

Thanks, Doug.

Operator

Your next question comes from Paul Holden from CIBC. Paul, please go ahead.

Paul Holden – Analyst, CIBC

Thank you, good morning. Also have a few questions. I guess the one I want to start with, and continuing with this growth in NIE, I imagine when you take on these types of projects, you run some kind of financial analysis and have certain hurdles rates in mind. I think what would be helpful for us just to kind of understand maybe what those types of hurdle rates are, how we should think about future return on the investments we're seeing flow through into the P&L today.

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, you're absolutely right. When we're taking on these projects—and some of these are capital intensive, some of these hit us directly in non-interest expenses right away, which is what we're seeing on a couple of the projects—but we consider it as a use of capital right up against using that capital for loan growth, acquisitions, etc. so yes, it has to make sense on a return on capital basis compared to the other ways we could deploy and use that capital. You would not see us incurring these investments if we did not believe that the returns were there in the long term.

In terms of when we see them, digital is a big one. There is a few different components working together there that we believe are essential to continue the strong momentum we've had on branch-raised deposit growth. You've seen what the investments we've made in the past have done for us in terms of just the momentum its driven for branch-raised deposit growth and then how that shakes out into how we can manage the NIM and drive some really profitable and accretive outcomes without any help, really, from the market.

That's a trend we expect to continue and keep producing as a result of these investments we're making, just as one example.

Paul Holden – Analyst, CIBC

Roughly, what would your return on capital hurdle be, somewhere around 12 percent?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

We don't publish it, but I would suggest your gut would not be too far off. I think I understand how you're getting there, and it wouldn't be completely out of line.

Paul Holden – Analyst, CIBC

Okay, that's helpful, thank you. Then just continuing with the investments in digital, the federal government put something out roughly a month ago on open banking. Just wondering how your digital offering fits with an open banking-type world. Is it designed or at least partly designed to be able to take advantage of that data portability?

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

Paul, it's Chris. Absolutely, our investment in our technology platform is really geared to give us the ability to take advantage of the opportunities that open banking provides and are focused to ensure that we have a digital access to our banking programs and the ability for us to really manage data in a very secure way. As we think about the opportunities that open banking will provide, given our footprint and our view of really expanding geographically, we see the opportunity of open banking as very positive for us, and to make sure that we can turn it into that opportunity, we have invested very specifically in our technology platform to allow us to really take those steps.

Paul Holden – Analyst, CIBC

Okay, good. Then one final question, and it relates to NIM. Appreciate the guidance specific for next quarter, but as we think further out and the trends you're seeing in commercial loan growth, trends you're seeing in branch-raised deposit growth, why shouldn't we expect NIM expansion over the next several quarters, and is there anything particular to Q4 that's kind of holding back that potential NIM expansion in the near term?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, I mean, I'll cover the potential headwinds and tailwinds and then I think that will help explain Q4, and then maybe some upside that might be there.

Yes, you've hit on a predominant tailwind—growth in commercial lending and our growth in particular, I mean, that's something that is accretive to our NIM. The second factor that could be accretive to our NIM as we see how things settle here—as we get through a couple, maybe further choppy economic periods—is our overall level of liquidity. I mean, part of that is just structural balance sheet composition, part of that is just being prudent, and working that down is something that could give us a bit of a tailwind from a NIM perspective.

Headwind on NIM, we think of it as a temporary factor. It's this idea that there is some element of the deposit growth we've had that, being honest, we think is just simply excess liquidity being held by our clients that will eventually be put back to work as the economy continues to recover, reopen and that's one where if we're seeing likely our lowest cost of funding, our notice and demand deposits are the ones we think roll off first. If we need to replace them in the near term with a more expensive deposit source—broker deposits or other wholesale opportunities, I mean, that's something that could put a little bit of temporary pressure on NIM. But once you get through that temporary impact and temporary churn in funding mix, the ongoing momentum we'll have in branch-raised deposit growth, which we think accelerates and continues when the smoke clears from all this, is something that has NIM look to normalize.

The other thing we've thought about too is if you see conditions that have excess deposits being consumed in the economy, that's probably a factor that also results in incremental loan growth. Maybe there's a timing factor there where deposits run first and then the growth comes later on the loan side of things, maybe that's ultimately a positive in the long run as well. From a long run perspective, I agree with your thesis; to me when I look at the factors, there's a lot more tailwinds than headwinds if you get through just maybe a temporary period here of a little bit of volatility, and that's what we're thinking about in Q4. It's one where strong new growth of deposits from the branch-raised side of things, we expect to be there. How much of that gets soaked up with runoff of our existing deposits could be a factor that has our NIM looking flattish. If we don't see that runoff come, then you could see some bit of upside there for over delivering against our current base case.

Paul Holden – Analyst, CIBC

Thank you, that answer was very helpful. That's all for me.

Operator

Your next question comes from Marcel McLean from TD Securities. Marcel, please go ahead.

Marcel McLean – Analyst, TD Securities

Okay, thanks for taking my question. I kind of want to go back to PCLs here. Thinking about it maybe beyond just the guidance you provided for next quarter, and specifically on the impaired side, how do you guys see things playing out, thinking about things like Delta variant and the tapering off of government assistance. Do you see the impaired sort of just trending towards a normalized level, or should we expect maybe to run above historical averages for some period of time? How do you see things playing out maybe over the course of the next couple months? I know it's hard with the amount of uncertainty, but what are your thoughts on that?

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

Yes, thanks Marcel. I think the amount of uncertainty is the key part of what you just said. I think as we think about where we sit, we've come through quite an interesting, to say the least, 18 months. And our expectation on how the loan portfolio would perform as all banks took increased provisions, and we sit here today and we've really come through with all this stimulus that has been, stabilizing in the economy, we expect to see it just cool off. Then, as we think about our clients, what impact does that have. I think we've had a long period of time for clients to adjust, kind of really determine what their revenue profile looks like, how they match their expenses to their revenue. As we think about that, typically when we come out of downturns, we do see the ones that have hung on that just don't make it. We want to be conservative as we think about that gross impaired potential and as we work through our portfolio and see the different areas that might be impacted, we're conservatively thinking of maintaining PCLs in that mid-20 basis point level.

Marcel McLean – Analyst, TD Securities

Okay, thanks for that. Then I just had one quick one, going back to the branch-raised deposit growth. I think I recall you saying last quarter that there was virtually no runoff in that number and we could expect branch-raised deposit growth, the pace of it to slow over time. It doesn't look like that has really appeared yet this quarter. Just wondering if there was any runoff included in this quarter's number and the timing—I guess it likely will coincide with loan growth, but just your thoughts on how branch-raised deposits evolve from here.

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, we did start to see a little bit of runoff in certain products, but certainly not as high as what we might have expected. But we did start to see it occur on a limited basis towards the end of the quarter, but not what I would call a material impact at this point, not something that, for instance, would have changed our deposit growth in the quarter by, say, a percent. It was a factor much smaller than that. But obviously something we're keeping an eye on, and you can see in our fourth quarter outlook we are expecting that trend to accelerate a bit, but also don't think this is something that will materially impact us from a NIM perspective.

Marcel McLean – Analyst, TD Securities

Okay, thank you. That's it for me.

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

Thank you.

Operator

Your next question comes from Meny Grauman from Scotiabank. Please go ahead.

Meny Grauman – Analyst, Scotiabank

Hi, good morning. Curious to follow up more broadly on how the business has changed pre-pandemic to post-pandemic. You talked about the funding structure, and it looks like the margin is definitely sort of on a different track before the pandemic and now. In terms of credit and other key drivers, are there any key areas where you'd say, yes, the business is definitely—post pandemic, we're not going back to pre-pandemic run rates, you've changed that through this period here? Are there any other notable items you'd highlight there?

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

I'll start, Meny, and Matt can step in. Where we sit today is, yes, the pandemic absolutely changed client behavior and we are seeing obviously there is higher deposit levels across the economy, and all banks have seen that, but our access to the deposits has fundamentally changed. The execution of our strategic direction really to focus on that full-service opportunity with the clients and supported that with an increase in product delivery, an increase in different capabilities we're able to provide our client base and their next move to digital that improves that whole process even further. For us we've had a meaningful change in how we engage with our clients and we see that as, again, a real tailwind for growth, and as we think of diversification, that opportunity for us to really push that geographic diversification but also revenue as well. Yes, we see post pandemic as realizing on the opportunities that we've invested and our strategic direction. Matt, do you want to add?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

No, I totally agree. I mean, we're exiting the pandemic with a lot more tools in the toolkit to drive growth, and exiting the pandemic with the sort of funding profile and funding strength that will allow us to fund that growth on a very efficient and accretive basis, so very happy about how we're positioned. Then of course we have what we believe will be a more constructive macroeconomic backdrop for growth as well, so we're quite excited looking forward, Meny.

Meny Grauman – Analyst, Scotiabank

In terms of just the PCL ratio specifically, obviously there's still uncertainty but if we just think whatever that time is post-pandemic, it's behind us. Do PCL ratios kind of go back to where they were or, because the business mix is changing, is there a sense that maybe you'd have a higher PCL ratio in a normal time going forward?

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

We don't anticipate our PCL ratio changing. We've had this 18 to 23 basis points. We haven't changed our underwriting, we're focused on the same core client, we are very disciplined in our underwriting, loan management. We think we're just continuing to improve that client experience, and with the improved tools that we are building through the AIRB process that enhances your credit insight on your book. So no, we don't see any change at all in that outlook.

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

No. That's been the key theme of our growth, Meny, is we've achieved the growth not by stretching risk appetite; if anything, through the pandemic we might have tightened in a few areas. So, that would mean the composition of the book exiting the pandemic is one that just pound for pound, like for like, overall probably a higher credit quality and one that might not cause us to deviate from the historical range and hopefully put us somewhere to the slightly lower end when the smoke clears.

Meny Grauman – Analyst, Scotiabank

That's helpful. Just a question on the ATM in terms of how quickly that can be deployed, and how far ahead are you looking, meaning should we be surprised if you raise money under the ATM this quarter or the next quarter? Obviously it's based on your forecasts, so what kind of time range are you looking for here on this current raise?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes Meny, the ATM, it's a great tool. It's dynamic capital management. It allows us to have the right capital for the moment. It's something realistically we're looking at quarter to quarter how much capital we believe we need to support the growth? How much capital we just want to have in our back pocket based on other factors out there that might present potential downside risk as well? Strength of pipelines. But it is something we can adjust and calibrate very quickly, and it's not quite the sort of dynamic capital management you'd expect to have as an AIRB bank but it's a bit of an audition here to demonstrate that we do have the focus, capabilities, forecasting strength to be able to appropriately dynamically manage our capital through cycles. So, pretty pleased with the results so far and how we're using it.

Meny Grauman – Analyst, Scotiabank

Just one follow-up, can I think of it as you're kind of steering CET1, like you expect it to be kind of in the 8.8 percent range for the foreseeable future until we get to AIRB, I guess? You're kind of actively managing towards the kind of number that we're seeing this past quarter, would that be the right way to think about it?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

That will depend on the quarter and what's in front of us. I think a lot will depend on how Delta variant plays out. Our base case is that we don't expect any significant losses or any big disruptions coming from that, but it's an area of uncertainty; it's one where we'll look at where we sit next quarter with what's in front of us and potential downside and make the call on capital, so you could see us flex it up. You could see us feather it down, if we get to a point where we think we're through that uncertainty. The amount of growth we're generating right now that, even if we thought we had a little bit extra in our jeans, as it turns out we'd soak it up pretty quickly with growth. This really is dynamic in the quarter management of capital and one we can reposition pretty quickly based on the circumstances in front of us.

Meny Grauman – Analyst, Scotiabank

Thanks a lot.

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

Thanks, Meny.

Operator

Your next question comes from Cihan Tuncay from Stifel. Please go ahead.

Cihan Tuncay – Analyst, Stifel

Hi Matt, good morning. First, maybe just if you can elaborate a little bit more on the digital product rollout you've got planned for the end of this year and into next year. If you could give us a little bit more detail on what that product shelf could look like on the both the personal and commercial banking opportunities, and how should we think about the incremental benefit? I mean, is it just the potential incremental reduction in funding costs that you could get from digitally first deposits, or are other projects you're working on that could enhance non-interest income or any revenue opportunities attached to that as well?

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

Sure, I'll start on this. Yes, the initial rollout that we will have in Q4 will deliver the small business and personal online banking and convert those to digital. That gives us that access to just a better way for clients to navigate within our online banking program, so that's a big win. The commercial banking platform will come in Q1, Q2 of Fiscal '22, and that will then provide that commercial banking digital platform that allows, again, our clients there to navigate with more ease and single sign-on in terms of managing their daily affairs, and then that also adds into how we can manage payments. There's lots of opportunities from that perspective.

The other deliverable in this quarter coming up in a full go-live as we get into '22 is the Virtual COO that's targeted at a small business client. The goal there is to provide essentially a cash management program as well with artificial intelligence that assists in them looking at how they manage their cash, looking at receivables, payables, payroll, and giving them cues on how they can look at their accounts and provide that extra insight into the cash flows of the company. The opportunity we see is one clearly for increasing our low-cost deposits as we look to really support that small business client, which are typically net depositors. It also looks to increase our footprint. With the digital delivery we are less dependent on physical branch interactions with clients—we can do much more online. Again, we're focused on that full service, it does translate into more non-interest income as we look at service fees and transaction fees and our ability to just generate more business with our client. So, digital has a meaningful impact on how we think about our ability to grow, support our clients, and really focus on that geographic diversification as well.

Cihan Tuncay – Analyst, Stifel

Thanks for that, Chris. Maybe just a follow-up to your answer, how do you think about now going forward—I mean, you've always had new branch openings that have performed quite well for deposit growth and full service banking opportunities, but how do you look forward in terms of how do you balance digital growth versus opening new branches, or has that changed at all? Just maybe an update on the branch rollout as well, please.

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

Yes, well branches still remain very important for us. We're actually scheduling a branch opening in Markham in mid-2022, so looking forward to that. We see that GTA opportunity for us to have more feet on the ground; that also adds out on the marketing side. The sort of transactional side of branches, I think we'll see less of that, but really be focused on the advice and those client meetings that allow us to really provide that special service that we historically have delivered to clients with strong expertise in loan structuring and providing that appropriate financial solution to the client. Yes, we expect to also add branches along with digital so we can really capture that broader geographic footprint, but be very targeted where we think we've got, from a physical presence, we have good opportunities. And again, that's the GTA opportunity in front of us.

Cihan Tuncay – Analyst, Stifel

Thanks for that. Then just another update—sorry, one follow-up on, and I apologize if I missed it, but for your Q4 guidance, what do you factor in, in terms of ATM usage for that guidance?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, on that one, it would not be surprising to see us continue to issue a bit on the ATM in fourth quarter as well. I think if you're looking at hitting our EPS growth of in excess of 20 percent, we have factored some incremental usage of our ATM to drive to that outcome. Not a material amount, not something that would cause our EPS to change by more than a cent or two, but we are expecting a bit of continued usage.

Cihan Tuncay – Analyst, Stifel

Thanks for that. Just one last question from me, guys. As we look forward to the removal of capital distribution—shareholder capital distribution restrictions from OSFI—how do you balance or has there been any change in your thinking how you look at the dividend, as you balance the use of the ATM, your growth opportunities? How should we think about the dividend going forward, if and when those restrictions are lifted?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, dividends we've always managed within a target for payout ratio prior to the pandemic, and you can see by our results we were typically in the mid-30s in terms of a payout ratio percentage. Consequently, if you took our earnings projection this year and maybe if you normalized PCL to something that was more representative of a midpoint of a historical range, you'd see that our payout ratio is probably landing pretty similar right now to where we were pre-pandemic. If we were following that same trajectory, it would suggest that we don't need to see a big boost to the dividend to continue to deliver that same level of payout ratio.

It was always a bit of a balance of what we thought was an appropriate direct return to shareholders while also acknowledging that internal retention of capital, we could do some pretty accretive things with it. In fact, the shareholder returns in the long run, retaining capital and deploying it with loan growth and some of the strategic initiatives we're working on actually drives a more favourable outcome. It's one where you'll continue to see us have that balance as a Standardized bank and certainly as an AIRB bank in the future. It's how we think about capital allocation as well. Preference is to growth organically and acquisitions that help drive our strategic progress and are accretive. And then when we get through those two, anything we have left over for a return to shareholders, our preference would be buybacks and then maybe dividends thereafter because those last two, when we model them out, are less accretive to shareholder returns.

Cihan Tuncay – Analyst, Stifel

Thanks very much, that's it for me.

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

Thank you.

Operator

Your next question comes from Sohrab Movahedi from BMO Capital Markets. Please go ahead.

Sohrab Movahedi – Analyst, BMO Capital Markets

Okay, thank you. Just a couple of just clarifying, I think, hopefully quick ones here for you, Matt. If I think back over the last three or four quarters and our conversations, it was going to be a bit of a transitional year, I guess, with the addition of the wealth management acquisition and the investments that you've articulated around digital, so the expenses were going to be a little bit, I suppose, uneven from quarter to quarter. You've kind of talked a little bit about what next quarter may look like. Is it fair to assume that the guidance around expenses for next quarter benefit from maybe some pulling forward of some of the rollout expenses associated with the future version that Chris was talking about in Q1, Q2, or do you think some of what may be implied in next quarter's expense line may continue to trickle into next year?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, I mean, we haven't finalized our budget for next year, but just in terms of broad themes on things that would drive or benefit NIE growth this year compared to next year. Investments we'll continue to make in enhancing our AIRB tools, that's something that is impacting our expense growth in Q4, likely something that we see continuing into some period into next year as well. We're working on how long and when we provide our full-year guidance, that will be a factor we'll discuss.

The push on digital, I mean, it's a big push this quarter to launch the limited rollout of the VCOO. How clients respond to that initial rollout and what enhancements or tweaks we decide to make to it as a result, they could be minor, there could be some incremental build we put onto it as we think about the full rollout of that tool, that will be a bit of a wait and see. But in terms of the development progress on digital – yes it's a big push this coming quarter – it's one that should moderate over time, but perhaps in the first half of next year, we might see that trend continuing.

But year-over-year and if we're thinking about '21 versus '20, NIE growth in '22 versus '21 NIE growth, despite not having a finalized budget, all indications point to a bit of a moderating of that trend, but with some factors that maybe on a temporary basis don't have it moderate perhaps as much as we'd like.

Sohrab Movahedi – Analyst, BMO Capital Markets

Okay, that's helpful. Then just looking at the other income line, the fee income line. Security gains—just looking at your step back, I think over the last seven quarters, they've kind of been anywhere from zero to $5 million benefit. Can you tell us how much unrealized gains you still have sitting around?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Well, using the gains on securities, it's not something we're necessarily using to drive earnings. It's more of an outcome of balance sheet management activities. Our expectation going forward, and when we thought about Q4 guidance certainly, that was pinned to an expectation that we wouldn't have any significant realized gains. When we're thinking about movements in the balance sheet quarter to quarter, we didn't see anything there that we thought would give rise to us realizing any big gains in the quarter. I wouldn't expect gains on securities to be a continued driver of earnings and certainly not an intentional driver of earnings, more of an outcome of the activity in the quarter; so I wouldn't bank on it for next quarter.

Sohrab Movahedi – Analyst, BMO Capital Markets

Okay, and just one last—that's very helpful, thank you. Then my last question, until you eventually, hopefully, successfully transition over to the AIRB, you are still under the Standardized. When you think about this quarter's loan growth, the mix of this quarter's loan growth, you talked about the success in commercial real estate year-over-year, you talked about general commercial. Do you think that where you are having success now and you expect to continue to generate growth in the coming quarters, is there any reason to believe the capital intensity of the business, not because of the growth but because of the risk weighted associated with that growth, is going to increase here? In other words, if I think of your RWAs to assets as a proxy, are we on a bit of an upward trend here?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Commercial lending as a Standardized bank, that is our biggest consumer of our RWA density. Ass long as that growth continues, fair to say that it would cause our RWA density to increase. We're seeing good momentum on personal lending, though, and this quarter pretty good momentum on the insured residential lending, which from an RWA consumption basis is favourable—it's zero percent, it's one that as long as that residential mortgage growth continues. As a proportion basis this quarter, it kind of held right in there; that continues it's one where you'd probably see stability in RWA density, or certainly no material movements, and that's what we'd expect, at least into the fourth quarter, perhaps on a longer term trend. If we saw commercial lending accelerate at a pace beyond residential mortgages, then yes, that's a factor that would increase density as a Standardized bank.

Sohrab Movahedi – Analyst, BMO Capital Markets

Okay, when you think about some of the guidance you've shared around, for example, loan loss provisioning next year and so on and so forth, I assume implicit in that is some assumption around proportionality of that commercial versus, let's say, the insured mortgages that you made reference to. I assume your working assumption is that proportionality is not going to necessarily change?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Correct, yes. It would be relatively consistent, would be our view at this point.

Sohrab Movahedi – Analyst, BMO Capital Markets

Thank you very much.

Operator

Your next question comes from Gabriel Dechaine from National Bank. Please go ahead.

Gabriel Dechaine – Analyst, National Bank

Yes, a quick one here. AIRB transition, is there any change in the timing of your submission? I don't think so, but you've got some new language on this CAR 2023 revision that you have to integrate.

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

Well, we continue to work, Gabe. We've got lots of programs; we've got lots of people that are on it. We're going to give an update as we move along. We've got—we're seeing lots of opportunities, and we're going to incorporate the final Basel III amendments that will come into play. We're focused on AIRB. It's a tremendous long term positive for the bank as we think about particularly our business model with a commercial banking focus. It's a long-term investment that will pay off and that we're going to ensure that we deliver it appropriately.

Gabriel Dechaine – Analyst, National Bank

Okay. Then the other one, as far as the ATM issuance. Is it appropriate to measure what you issued this quarter relative to, say, excess loan growth this quarter, say something above 8 percent annually or whatever? Or did you issue more than what was necessitated by loan growth this quarter, as in it's not exactly lining up ATM to what you did that quarter, it's what's coming in the next quarter as well.

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, I mean, you would have seen we built our CET1 ratio from last quarter to this one. That's a factor of current growth, that's a factor of strength of pipeline, and then that's a factor of making an assessment of potential downside risk and external factors—a bit of choppiness with the reopening, a bit of Delta variant concern kind of rising quarter over quarter; those are all factors we'll consider each quarter in deciding how much to raise. Not a completely direct linkage to current loan growth, but that would be the primary factor.

Gabriel Dechaine – Analyst, National Bank

Yes, because if I'm making a few simple assumptions and trying to calculate some accretion, it may be neutral or maybe slightly accretive, the issuance this quarter, but that might be understating given that there's more to come. Is that kind of the right way to look at it?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

It depends on your math on accretion and the assumptions you're using. But if you were, for instance, using the ATM to fund loan growth and you were maintaining your CET1 ratio – so you weren't looking to build it, you were just looking to perfectly offset loan growth – then you might get a level of accretion in using the ATM in that manner in sort of the mid to high single digits as a percentage of EPS growth. Using the ATM in the manner of this quarter, for instance, of funding the capital needed for the loan growth and putting maybe 10 basis points of CET1 in the back pocket, it's something that would, say, reduce that level of accretion by perhaps a percent or two. Still obviously happy with how we're using it and the fact we can still be accretive and put a little capital in our jeans for what could be a choppy next couple of quarters, we're pretty happy with that outcome.

Gabriel Dechaine – Analyst, National Bank

Yes, I guess that's my point. I don't want to understate the accretion considering there's other factors, like you did accrete CET1 in doing this issuance. Anyway, maybe I should go offline for this discussion. Have a good weekend.

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

Thanks, Gabe.

Operator

Your next question comes from Nigel D'Souza. Please go ahead.

Nigel D'Souza – Analyst, Veritas Investment Research

Thank you, good morning. I had a follow-up for you on your Stage 2 loan migrations in the quarter, and based on my math, I have your percent of loans for Stage 2 relative to the whole portfolio going from about 12 percent last quarter to about 7 percent this quarter. First, is my math right there, and on that migration, was it entirely driven by changes to your forward-looking indicators or were there any portfolio-specific or borrower-specific factors that drove that migration?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, thanks Nigel. Your math is right. We did see that level of decline. A little bit of the decline from borrower-specific behaviour. Our watchlist loans decreased by about $100 million quarter over quarter, so that was a small proportion. The larger proportion was model driven. It's kind of the inverse of the conversation we had when our Stage 2 loan proportion was really running up, and running up at a faster rate than what you would have seen in the market, and what we pointed to was the short duration of our loan book causing some of that volatility. We talked about that point, would we see the opposite happen when things start improving, would the short duration of your book be a benefit, and the answer to that question is yes, and that's what you're seeing this quarter.

The assessment of Stage 2 is based on credit risk compared at origination to today, it's always a relative comparison. If you think about how quickly our loan book churns, we're originated a fair amount since COVID started, so if you're comparing credit conditions today to what they would have been at origination, it's certainly been an improvement and certainly not a worsening. What's happening with Stage 2 is exactly what we expected.

Nigel D'Souza – Analyst, Veritas Investment Research

Okay. Just a really quick clarification there, on the remaining Stage 2 balances, do you see that migration, further migration and movement lower driven by, again, borrower-specific factors or [macro factors], just to understand what's going to drive the remaining mix of your Stage 2?

Matt Rudd — Executive Vice President, Chief Financial Officer, Canadian Western Bank

Yes, I mean, it could be both, barring no improvement in either underlying default rates or macroeconomic conditions, then it would be borrower specific that would drive that down. But there is still some ability for our models to continue pushing that down if we continue to see improvements in those two key factors, the macro factors and default rates.

Nigel D'Souza – Analyst, Veritas Investment Research

Okay, that's really helpful. Thank you.

Operator

There are no further questions at this time. I'll turn it back to Chris for closing remarks.

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

Great, thank you Colin. Our year-to-date performance has been very strong. Our commitment to our teams and clients over the last 18 months is resonating with business owners in Canada and we're winning many new desirable full-service relationships. The proactive client-centric experience delivered by our teams is accelerating our growth to capture increased market share across our western and central Canadian target markets. Looking forward, we see robust opportunities and our continued focus to invest in our capabilities and product offerings will further accelerate our momentum. We're firm in our commitment to advance our strategic direction to deliver long term profitable growth and provide attractive, sustainable returns to investors.

We're also mindful of how we achieve these goals. We're currently undertaking a process to fit sustainability into our strategic direction and our risk management activities. We're also working to deliver an authentic approach that's best from a client, people, and investor perspective. We posted our latest corporate social responsibility report to our website this morning and are excited to share our progress as we support Canada's goals of transitioning to a lower carbon economy and a more sustainable future for all our stakeholders.

In closing, I'm proud of our team's commitment to achieving our goal to be the best full-service bank for business owners in Canada, and I'd like to say thank you for their efforts to advance our strategic objectives, transform our capabilities, and deliver another quarter of strong financial results.

To our investors, we appreciate your commitment to CWB as we undertake this transformational journey and deliver strong returns along the way. We look forward to reporting fourth quarter and annual financial results on December 3.

With that, we wish you all a great day. Thank you.

Operator

Ladies and gentlemen, this concludes your conference call for today. We thank you for participating and ask that you please disconnect your lines.