Are Your Bank Stocks Exposed to “Unpredictable Losses”?

Description

In Canada, there are three banks that have significant exposure to capital markets (CM) activities: **Royal Bank of Canada** (TSX:RY)(NYSE:RY), **Bank of Montreal** (TSX:BMO)(NYSE:BMO) and **National Bank of Canada** (TSX:NA).

Recently, David Beattie, vice-president and senior risk officer at Moody’s, issued a report that raises concerns about these exposures. He claims, rightly so, that CM activities expose the banks to higher earnings volatility and unpredictable losses. Certainly this is something for shareholders to watch out for.

Each of the banks have a slightly different approach to the CM business, which present their own opportunities and risks.

Royal Bank – The most international

RBC not only has the largest CM business in Canada, but one of the largest in the world. The bank made a big push into capital markets back in 2007, right when most of the major banks worldwide were in retreat. RBC emerged from the crisis relatively unscathed and well-capitalized, allowing the bank to make significant inroads. Currently the bank ranks 11th on Dealogic’s list of global investment banking revenue.

Of all the Canadian banks, RBC’s CM business is the most international – Mr. Beattie estimates that 71% of revenue comes from outside Canada. This exposes the bank to “large and unpredictable” losses. But RBC’s capital markets business accounted for only 21% of earnings in 2013, compared to 56% for Canadian banking. So it still has a nice cushion to fall back on.

Bank of Montreal – The most American

Sitting at number 18 on Dealogic's rankings is BMO Capital Markets, which accounted for 26% of the Bank of Montreal's total earnings in 2013. The United States has been a particular focus for BMO, and last year accounted for nearly a third of total CM revenue. The bank wants to become the top investment bank for mid-cap issuers in the US.

Mr. Beattie pointed out that BMO derives a larger proportion of CM revenues from trading products, making revenues "the most volatile in the peer group". Also BMO does not have as large a cushion to fall back on as RBC. Its Canadian banking business accounted for 44% of total earnings.

National Bank – The most exposed

National Bank's CM business accounts to 35% of total net income, making the bank more exposed to CM than any of its large peers. This is something that investors must remain very wary of; Mr. Beattie said that this leaves the bank "more exposed to rapid credit profile deterioration." National also has the lowest capital ratios among the big banks. It's no wonder that its price to earnings ratio is also the lowest amongst its peers.

Foolish bottom line

On a global standard, Canada's banks are still relatively stable. They all have very profitable and secure Canadian banking businesses to fall back on, which should make their shareholders sleep more easily. But investors, especially the ones that count on smooth earnings, must always be aware of these kinds of risks and exposures.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:BMO (Bank of Montreal)
2. NYSE:RY (Royal Bank of Canada)
3. TSX:BMO (Bank Of Montreal)
4. TSX:NA (National Bank of Canada)
5. TSX:RY (Royal Bank of Canada)

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