Are Canada's Top 5 Banks Making Risky Bets?

Description

After another quarter of solid profits there are claims among some industry analysts and pundits that Canada's banks will soon be unable to continue delivering record profits for shareholders, and the domestic banking market is over-saturated. There is also the looming threat of a slowdown in the housing sector, as domestic residential mortgages are a key profit driver for Canada's banks.

But it is clear that the banks have identified these threats to their bottom lines and are implementing strategies to deal with them.

Aggressive expansion into wealth management

One key strategy adopted by **Royal Bank of Canada** (TSX: RY)(NYSE: RY) and **Bank of Nova Scotia** (TSX: BNS)(NYSE: BNS) has been to aggressively grow their wealth management businesses. Royal Bank's wealth management business already contributes 11% of its profit, while for Bank of Nova Scotia wealth management makes up a massive 19% of profit.

But like Canadian banking, this market is set to eventually reach a saturation point domestically, with all of the banks aggressively expanding into it. The revenue that wealth management earns is not as consistent or as sticky as traditional retail banking because consumers view wealth management products as expendable when economic times are tough. In contrast, residential mortgages tend to be a very sticky business, given the physical need and emotional attachment connected to owning your own home.

This gives Royal Bank an advantage over its peers, because the bank is Canada's largest mortgage lender by market share and has the largest retail and commercial banking operation in Canada.
Its commercial banking business makes up over half of its earnings, and with such a large market share, it is easy for the bank to implement strategies to increase revenue.

Like Royal Bank, Canada's fifth-largest bank **Canadian Imperial Bank of Commerce** (TSX: CM)(NYSE: CM) has chosen to focus on the domestic market, which accounts for 49% of the bank's net income. This decision to focus on the domestic market resulted from the bank experiencing several costly setbacks when it attempted to expand into the U.S. market.

But as Canada's fifth-largest bank, it lacks the scale of Royal Bank to rely predominantly upon the Canadian market as a growth engine, and many analysts have stated that it needs to further diversify. This over-reliance on the domestic market exposes Canadian Imperial Bank of Commerce to any disruption in the housing market and the Canadian economy as a whole.

The bank also continues to suffer from its poorly performing Caribbean operations, which continue to falter as the much-anticipated economic recovery in the region fails to materialize. For the financial second quarter (calendar first quarter) of 2014 the bank took a $543 million impairment charge against its Caribbean operations.

Expansion into the U.S. market

Both **Bank of Montreal** (TSX: BMO)(NYSE: BMO) and **Toronto-Dominion Bank** (TSX: TD)(NYSE: TD) have staked their future on expanding into the U.S., the world's largest banking market. This provides both banks with considerable growth opportunities but also considerable risks, since the market is known for its fickle nature.

Based on the latest quarterly results, the U.S. provides 13% of Bank of Montreal's net income and 26% of TD Bank's.

Bank of Montreal continues to derive the majority of its net income from the Canadian market. Both Canadian retail banking and wealth management contributed a greater share of its net income, at 45% and 18% respectively, than its U.S. operations did for the same period.

Are emerging markets key to driving growth?

Meanwhile, Bank of Nova Scotia has gone out on a limb compared to its Canadian peers and expanded aggressively into a number of high-growth emerging markets in Latin America and Asia. This strategy has paid dividends for the bank, with it now being the third-largest in Peru and fifth-largest in Colombia; international banking now makes up 23% of its net income.

However, this strategy is fraught with execution risk. Those emerging markets have significantly higher geopolitical and economic risks than Canada, as well as language barriers and opaque legal and regulatory systems. Yet it does provide the bank with a potentially massive growth engine, since some of those economies are expected to be among the fastest-growing in the world and have low degrees of banking penetration.

What does this mean for investors?

Each bank has a different risk profile based on its chosen growth strategy. Royal Bank is probably the least risky given its dominance in the domestic market and relatively low exposure to potentially unstable international markets.

In contrast, Bank of Montreal, Toronto Dominion Bank, and Bank of Nova Scotia are facing considerable execution risk by looking offshore to expand their operations and grow their bottom lines. So far this strategy has paid dividends for all three, but investors need only look at Canadian Imperial Bank of Commerce's experience in the U.S. and Caribbean to get a feel for the risks this entails.

CATEGORY

1. Investing

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1. NYSE:BNS (The Bank of Nova Scotia)
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4. TSX:CM (Canadian Imperial Bank of Commerce)
5. TSX:RY (Royal Bank of Canada)
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