



How Risky Is Bank of Nova Scotia After Moody's Downgrade?

Description

Global ratings agency Moody's recently affirmed its ratings of Canada's seven largest banks and downgraded its outlook from stable to negative on the back of Ottawa's proposed "bail in regime" for Canadian banks. One of the banks hardest hit was **Bank of Nova Scotia** ([TSX: BNS](#))([NYSE: BNS](#)), because Moody's not only downgraded its outlook to negative along with the other top seven banks, but also downgraded its financial strength to negative.

This was on the back of the bank increasing the level of risk in its credit portfolio, with the bank increasing its exposure to higher-risk unsecured consumer credit at a time of peak consumer debt domestically. Most of this came about through the bank's plan to accelerate growth in its higher-risk auto finance and credit card portfolios, which has already seen the bank acquire a 20% stake in **Canadian Tire's** ([TSX: CTC.A](#)) financial services division. As part of this acquisition, the bank has agreed to provide up to \$2.25 billion in credit card receivables financing to the business in an effort to boost credit growth.

Another concern of Moody's was the bank's decision to sell the majority of its stake in mutual fund manager **CI Financial** ([TSX: CIX](#)) in order to fund further growth across its higher-risk international operations.

According to Moody's, these things represent a fundamental shift in the bank's historically conservative approach to risk management. However, there is a logical reason for this shift in the bank's risk appetite.

Why is Bank of Nova Scotia increasing its risk appetite?

Each of those actions is a key plank in driving further earnings growth in a financial services market that is oversaturated and has little room for additional growth in traditional growth markets such as secured mortgage lending. The lack of growth opportunities in the Canadian financial services market has already spurred the major banks to invest significantly in wealth management, but growth opportunities here are diminishing rapidly.

As a result, **Toronto Dominion Bank** ([TSX: TD](#))([NYSE: TD](#)) and the **Bank of Montreal** ([TSX: BMO](#))([NYSE: BMO](#))

) have aggressively expanded their U.S. operations as a means of driving growth, while Bank of Nova Scotia has typically looked to emerging markets.

Is there a tangible benefit for Bank of Nova Scotia and its investors?

These are all relatively high-risk growth strategies, each with their own unique set of risks. However, if managed effectively within the right risk management framework, they have the potential to be significant drivers of growth for the bank.

The acquisition of a 20% stake in Canadian Tire's financial services business gives the bank access to the eighth-largest credit card portfolio in Canada and the ability to cross-sell a range of products, including insurances and mortgages.

The bank's international strategy is also not as risky as it first appears, and is well positioned to pay dividends for the bank. This strategy is primarily focused on building the bank's Latin American exposure in Colombia, Peru, Mexico, and Chile; all four countries have investment-grade sovereign debt ratings. These four countries also have some of the highest forecast GDP growth rates in the region, and as a whole, an average forecast GDP growth rate of almost 4% for 2014 and 2015.

This is almost double the 2% forecast for Canada over the same period. Unlike Canada, there is also a growing demand for credit, savings, and wealth management products in the region, with the middle class continuing to grow strongly. The OECD has estimated the middle class in Latin America will grow by two-thirds over the next 16 years.

The region is also heavily under-banked, with only around a quarter of Colombians and a fifth of Peruvians holding a debit card or some form of transactional bank account. This is further evidenced by domestic credit provided to the private sector by banks representing only 41% of GDP, whereas it totals 130% in Canada.

These facts highlight the growth opportunities that exist for Bank of Nova Scotia in Latin America, where it has already established a strong presence as the third-largest bank in Peru and the fifth-largest in Colombia. International banking contributes around 23% of the bank's net income and generates a superior profit margin with a net interest margin of 4% compared to Canadian banking's 2%. As these operations grow, international banking will contribute a greater portion of the bank's net income.

Just what do the key risk indicators tell us?

Upon closer inspection, the bank's key risk indicators are particularly conservative, indicating it has a low degree of risk and that there is some room to boost the bank's risk appetite as a means of growing earnings.

It has a Tier 1 capital ratio of 9.8%, well above the required minimum of 5.5% and higher than Toronto Dominion's 9.2% or Bank of Montreal's 9.7%. Bank of Nova Scotia, like the majority of Canadian banks, has a particularly low non-performing loan ratio of 0.45%, which is a key measure of credit risk. This ratio is lower than Toronto Dominion's 0.48%, but double Bank of Montreal's 0.22%.

These indicators highlight that there is significant room for the bank to increase its risk appetite as a means of growing earnings. Therefore the increased consumer lending exposure, as well as the bank's

exposure to expected solid long-term growth in emerging markets, will see its earnings grow significantly. This means that it's a must-have investment for growth-oriented investors seeking exposure to Canada's banks.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:BMO (Bank Of Montreal)
2. TSX:BNS (Bank Of Nova Scotia)
3. TSX:CIX (CI Financial)
4. TSX:CTC.A (Canadian Tire Corporation, Limited)
5. TSX:TD (The Toronto-Dominion Bank)

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