Are Canada’s Banks as Risky as Moody’s Claims?

Description

The recent downgrading of the outlook for the Canadian banking system from stable to negative by ratings agency **Moody’s** has brought to the attention of investors the risks inherent in investing in financial institutions. However, does this downgrade actually mean the degree of investment has grown for investors?

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Let’s try and quantify the risks facing Canada’s top five and the reasoning behind Moody’s downgrade to determine whether the degree of risk has actually increased.

The reasoning behind the downgrade

The ratings agency’s key motivation for the downgrade was the government’s move to place a greater share of the onus for bank bailouts back onto banks and in particular their creditors, including bond investors and depositors.

It is also increasingly concerned by the trend among the top five banks to increase their exposure to higher-risk offshore markets, as well as riskier operations, including capital markets and unsecured lending, as a means of growth.

However, while this may initially appear alarming for investors, the truth is far different.

Just how risky are offshore operations?

While investing in offshore operations may be riskier than operating solely in Canada, it provides significant opportunities for growth. Both the **Bank of Montreal** (TSX: BMO)(NYSE: BMO) and **Toronto Dominion Bank** (TSX: TD)(NYSE: TD) have elected to enter the U.S. retail and commercial banking market.

As the world’s largest financial services market, the U.S. offers considerable growth potential, but execution risk is high, with a number of foreign banks having either failed to successfully operate and/or incurred significant losses. This includes the **Canadian Imperial Bank of Commerce** (TSX: CM)(NYSE: CM), which incurred significant losses as a result of its U.S. operations during the global financial crisis. These losses amounted to writedowns of $6.8 billion, highlighting the risks inherent in the U.S. market.

However, both the Bank of Montreal and Toronto Dominion Bank have taken a relatively conservative approach to entering the market and have a thorough understanding of the risks involved. Both have focused primarily on retail banking and, to a lesser extent, wealth management, which carries considerably lower risk than capital markets and institutional banking operations.

Royal Bank of Canada (TSX: RY)(NYSE: RY) has boosted its offshore presence primarily in capital markets and wealth management both in the U.S. and globally. This carries considerable risk because significant losses can occur in capital markets and institutional banking operations if the wrong decisions are made.

However, the majority of the Royal Bank of Canada's net income is derived from bread-and-butter commercial banking in Canada, which for the last quarter delivered 50% of the bank's total net income. For the same period, capital markets contributed only a quarter of its net income, though the majority of that was derived from the U.S. and other offshore operations.

In the eyes of many analysts, the **Bank of Nova Scotia** (TSX:BNS)(NYSE: BNS) has probably undertaken the riskiest growth strategy, with a renewed focus on Latin America, particularly Chile, Colombia, and Peru, along with growing unsecured consumer lending. However, while the public perception may be that Latin America is high-risk, this is overblown and based on outdated notions of internal conflict and unstable political systems. Many of these countries offer significantly higher growth prospects than either the Canada or the U.S. and are heavily under-banked with a rapidly growing middle class.

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How do the banks shape up?

Interestingly, Moody's noted in its report that the potential for external shocks to the Canadian economy had receded, which lowers the degree of risk across the Canadian banking system. Furthermore, despite record levels of personal debt among Canadians and fears of a decline in housing prices, the banks continue to maintain relatively conservative credit portfolios.

This can be seen with the top five banks having provisions for credit loss as a proportion of gross loans of between 0.2% and 0.4%, highlighting the low degree of risk in their credit portfolios. Furthermore, a large chunk of that lending, including mortgages, is secured, protecting the banks from significant losses. They also continue to maintain solid balance sheets with high levels of capital adequacy and manageable loan to deposit ratios, coupled with relatively low exposure to higher-risk derivatives and structured products.

The Canadian banking system has shown itself to be one of the world's most durable, emerging from the global financial crisis and its aftershocks in good condition, with all of the top five banks going on to report record profits. If anything, the greatest risk may be the banks' conservative approach to risk, curtailing growth with better-than-expected economic growth south of the border and global economic growth better than expected.

CATEGORY

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2. TSX:BNS (Bank Of Nova Scotia)
3. TSX:CM (Canadian Imperial Bank of Commerce)
4. TSX:RY (Royal Bank of Canada)
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