The Super Traders of Toronto-Dominion Bank and Royal Bank of Canada

Description

Toronto-Dominion Bank (TSX: TD) (NYSE: TD) and **Royal Bank of Canada** (TSX: RY)(NYSE: RY) both have considerable trading operations that contribute meaningfully to the revenues of their overall banking operations. These trading activities seem to be very profitable and rarely to lose money. Thus the importance of these operations to the banks.

So far in the 2014 financial year, the trading activities in TD Bank generated revenue of $1,098 million, or 5% of total bank revenue. Since 2011, this amounted to $3.7 billion, or about 5% of total banking revenue. In the case of Royal Bank, the contribution is more substantive, with trading revenue of $2.8 billion, or 11% of total revenue so far this year. Since 2012, trading revenue amounted to $9.0 billion, or around 11% of total banking revenue.

Even more impressive is the fact that these trading activities do not often lose money. So far this financial year (nine months), the trading activities at TD Bank made losses on only 10 trading days while those at Royal Bank fared even better with only one day of trading losses — truly formidable performances.

How do they do it?

The question obviously arises whether the traders at these banks discovered the ultimate trading strategies or is there something else to the excellent outcomes?

The publicly available information on the trading activities of the banks is limited but the financial statements and supplementary information provide some information.

In the case of TD Bank, the trading related income includes net interest income on trading positions and normal trading income. Interest rate and credit trading (which includes interest income) makes up the bulk of trading income, averaging about 43% over the past three years with further equal contributions from foreign exchange and equity and commodity trading. Interestingly, the actual “normal” trading activities (excluding interest income) seem to be rather unprofitable, with a loss of $148 million so far this year on top of losses in every year since 2011. However, the considerable interest income earned on the instruments held in the trading portfolios is more than adequate to cover the trading losses.

TD manages the trading risk exposures fairly tightly with an average daily “value at risk” over the past quarter indicated at $17.7 million, which implies that the bank estimates that it could lose this amount of money daily on the current trading positions under negative market conditions.

The balance sheet also provides clues as to the trading positions held by the traders at the end of the previous quarter. As expected, the bulk of the trading exposure is to interest rate and credit instruments, with a smaller exposure to equities, foreign exchange and commodities.

Royal Bank breaks its revenues from trading up as around 50% from interest rate and credit trading, 40% from equities, and 10% from foreign exchange and commodities. As indicated above, the total trading revenue for the first nine months of the current financial year amounted to $2.8 billion, of which $895 million was “normal” trading revenue rather than interest earned on the trading portfolio. In contrast to the loss-making trading operations at TD Bank (excluding interest), the Royal Bank operations seem to be very profitable having booked trading profits (excluding interest) every year since 2008, when a small loss was recorded. Nevertheless, considerable swings in the quarter on quarter profits of the trading operations are evident, making the outcomes unpredictable.

Royal Bank indicates an average value at risk for the past quarter at $26 million, which implies that the bank estimates that it could lose this amount of money daily on the current trading positions under negative market conditions.

Given the importance of the trading operations for Royal Bank, it is not surprising that the bank is in the process of reorganising certain U.S. trading activities to ensure compliance by the July 2015 deadline with U.S. prohibitions on banking entities engaging in proprietary trading (the so-called “Volcker Rule”). The bank does not expect the impact of these changes to materially affect the overall results.

Trading profits are unpredictable and is valued at a lower multiple than recurring income

Both these banks are high-quality operations with substantial capabilities to operate successful trading operations. However, given the unpredictable and volatile nature of trading profits, it will not be considered as valuable to shareholders as more sustainable income such as interest income or income from banking services.

CATEGORY

1. Bank Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:RY (Royal Bank of Canada)
2. NYSE:TD (The Toronto-Dominion Bank)
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