Why Moody's Corporation Is Worried About Bank of Nova Scotia

Description

On Monday evening, **Moody's Corporation's** (NYSE:MCO) Investors Service downgraded the long-term debt of **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) from Aa3 to Aa2. This shouldn't come as an absolute shock–Moody's had put the bank on notice for a possible downgrade back in early November.

So why did Moody's make this decision? And does this spell concern for the bank's shareholders?

It's not the reason you think…

In the past year, Bank of Nova Scotia has come under increasing scrutiny for its exposure to the energy sector as well as the dubious state of the Canadian economy. Yet Moody's has cited different reasons for the downgrade.

Moody's noted in its November report that the bank has increased its exposure to auto loans and credit cards, two assets that are much riskier than corporate loans or mortgages. It's all part of the bank's overall shift towards non-mortgage consumer loans, which can certainly increase returns but also come with increased risk.

To illustrate, let's take a look at the bank's 2015 annual report. During the fiscal year, the bank's personal loans and credit cards portfolio yielded (before counting credit losses) 7.5%. Meanwhile, the residential mortgage portfolio yielded just 3.5%.

Yet at the same time, credit losses from personal loans and credit cards were 13 times higher than losses from mortgages, even though the mortgage portfolio was 2.4 times bigger. And that was at a time when losses were relatively low; if the Canadian economy really turns south, then these credit card loans could become a big problem.

And here's what concerns Moody's: from 2013 to 2015 the bank's average personal and credit card loan book grew by more than 20%. Meanwhile, the mortgage portfolio grew by less than 4%. This hasn't happened on purpose–the bank increased has increased its exposure to credit cards through various transactions, including with Canadian Tire Financial Services and Latin American retailer

Cencosud. And these numbers don't include the bank's recent $1.7 billion credit card deal with **JPMorgan**.

Other concerns

In addition to Bank of Nova Scotia's increasing focus on credit cards, Moody's has highlighted some other risks.

One is the bank's high reliance on short-term funding, which increases the risk of a funding shortfall in later years. Moody's is also worried about the bank's exposure to emerging markets, which are much more volatile than Canada.

Don't overreact

Moody's doesn't actually think Bank of Nova Scotia is especially risky. Three of Canada's other Big Five banks also have ratings of Aa2. Only **Toronto-Dominion Bank** has a higher rating.

In fact, an Aa2 rating is still quite high. According to recent figures, only 0.6% of companies with this rating default after 10 years. Even the chances of a dividend cut are very remote. So equity investors don't have to sell their Bank of Nova Scotia shares just yet.

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