



Have the Banks Understated the Risks Posed by the Slump in Crude?

Description

There are growing concerns that the exposure of Canada's banks to the beleaguered energy patch will impair their financial performance. Of even greater concern is that the recognition of impaired energy loans and their related losses is in its early stages, which means they will continue to rise over the course of 2016, thereby impacting earnings.

Now what?

The slump in crude has gone for far longer and has been far deeper than many industry insiders predicted, and it isn't only the energy patch that is suffering. The majority of Canada's Big Six banks are also feeling the pain because they have considerable direct exposure to the energy patch, making them vulnerable to the ongoing slump in crude.

Of the Big Six, the most vulnerable is **Bank of Nova Scotia** ([TSX:BNS](#))([NYSE:BNS](#)), which has \$16.3 billion in drawn loans to oil companies. This is equivalent to a worrying 3.3% of the value of its total loan book. Then there are management's admissions that the majority of its drawn loans are not investment grade, which means that for as long as oil prices remain weak, those loans can only continue to deteriorate.

You see, by the end of the second quarter 2016, Bank of Nova Scotia's impaired energy loans more than tripled. More alarmingly is that provisions for credit losses for those loans had grown 30-fold, making them the largest contributor to the massive 68% increase in provisions for loan losses across the bank's loan portfolio.

However, it isn't only Bank of Nova Scotia that is suffering from this potentially disastrous phenomena.

Royal Bank of Canada ([TSX:RY](#))([NYSE:RY](#)), which has drawn loans to the oil industry totaling \$8 billion, saw the value of its impaired energy loans spike by 23 times their value a year before. This caused its provisions for credit losses related to the industry to rise by an unbelievable 1,000%, draining a considerable volume of capital away from revenue-earning activities.

Then there is **Bank of Montreal** ([TSX:BMO](#))([NYSE:BMO](#)), which—with total drawn commitments

totaling \$7 billion—has the third-highest direct exposure to the energy patch of Canada's major banks. For the first quarter 2016, its impaired energy loans more than quintupled, while its provisions for credit losses in the industry quadrupled.

What is of considerable concern is that only a year ago Canada's banks were assuring investors that their exposure to the energy patch was manageable and would have only a minimal impact on their operations. Now, a year later, the health of their loan portfolios has deteriorated, and with signs that [weak oil prices](#) are here to stay for the foreseeable future, investors should expect further pain.

So what?

While the banks remain adequately capitalized, the rapid deterioration in the health of their loans to the oil industry indicates that they have understated the risks associated with that segment of their loan portfolios.

With the slump in crude entering its second year and with signs that it will continue for the foreseeable future, there is certainly more pain ahead for those banks that have considerable exposure to the energy industry. With considerable capital now being diverted away from productive investments to cover loan loss provisions, investors should expect a marked decline in earnings growth.

CATEGORY

1. Bank Stocks
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2. NYSE:BNS (The Bank of Nova Scotia)
3. NYSE:RY (Royal Bank of Canada)
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