# Is Bank of Nova Scotia Losing its Lustre?

## Description

At the start of 2016, international ratings agency **Moody's** downgraded **Bank of Nova Scotia** ( TSX:BNS)(NYSE:BNS) due to concerns about the headwinds facing Canada's economy and its exposure to the troubled energy patch. This came after a series of earlier downgrades because of the bank's growing exposure to volatile emerging markets and higher-risk consumer lending.



As a result, Bank of Nova Scotia's stock has not performed as well as many of its peers; it's down by almost 2% over the last year. If this isn't bad enough news for investors, there are concerns that there is worse to come.

**So what?**

The primary headwind the bank is facing at this time is its considerable exposure to the deeply troubled oil industry with $16.3 billion in drawn commitments to the energy patch. This amount appears to be manageable as it represents just over 3% of the value of the bank's total loan portfolio, but there are indications that it will have a sharp impact on Bank of Nova Scotia's performance.

You see, its complete exposure including undrawn commitments is roughly double its drawn commitments, totaling about $32 billion, which represents almost 7% of the value of its total loans.

Then there are the admissions by management that the majority of its drawn loans to the oil industry are not of investment grade. This is easy to see when considering that by the end of the second quarter 2016, the value of impaired energy loans were seven times higher than a year earlier.

The impact this is already having on the bank's operational performance is quite startling. The sharp increase in impaired loans is acting as a considerable drain on the bank's capital; credit loss provisions have ballooned to $150 million, an astonishing 30 times higher than they were a year earlier. This is diverting considerable amounts of capital away from productive activities, which will eventually impact the bank's ability to grow its earnings.

The bad news doesn't stop there. Bank of Nova Scotia also has considerable indirect exposure to weak oil and other commodity prices, because of its focus on expanding its operations into the commodity-dependent economies of Latin America, including Colombia, Peru, and Chile.

These countries are highly reliant on the extraction and exportation of commodities, including oil, copper, coal, and precious metals as key drivers of economic growth. With the commodity rout in full swing, economic growth in the region has dropped sharply, while economic stressors have continued to rise. Then there is the $3 billion in outstanding loans to Brazil, a country which finds itself caught in its worst economic crisis ever.

**Now what?**

These factors certainly don’t bode well for the health of the bank’s credit portfolio or its short-term growth prospects, making it imperative that investors prepare themselves for further bad news. These factors also highlight the risks banks face when focusing solely on rapidly growing their credit portfolios without paying ample attention to the potential impact of future economic shocks.

Nevertheless, despite the poor short-term outlook, these issues will only amount to minor hiccups over the long term for a bank that is well capitalized and has a history of maintaining a solid balance sheet.

**CATEGORY**

1. Bank Stocks
2. Investing



**TICKERS GLOBAL**

1. NYSE:BNS (The Bank of Nova Scotia)
2. TSX:BNS (Bank Of Nova Scotia)

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