Will the Slump in Crude Force the Banks to Cut Their Dividends?

Description

It isn't only the energy patch that is suffering under the brutal burden of the prolonged slump in crude. Canada's banks are also feeling the pressure from weak oil prices. This has many analysts concerned that it could have a considerable impact on their capital with the potential to force the most vulnerable to trim their dividends in order to shore up their balance sheets and conserve capital.

Now what?

The Canadian banks with the greatest exposure by dollar value are **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS), **Royal Bank of Canada** (TSX:RY)(NYSE:RY) and **Bank of Montreal** (TSX:BMO)(NYSE:BMO). They have drawn commitments to the energy patch of $16.3 billion, $8 billion, and $7.2 billion, respectively.

Nonetheless, this is only half the story. A more accurate measure of exposure to the troubled energy industry is the value of drawn commitments as a proportion of the total value of their loan portfolios. On this basis, Bank of Nova Scotia, **National Bank of Canada** (TSX:NA) and **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) are the most exposed with drawn oil loans making up 3.3%, 2.4%, and 2.1% of their total loans, respectively.

With oil prices being significantly weak for an extended period, the loan loss provisions for troubled energy loans have ballooned across the banks; Bank of Nova Scotia's results are the most disquieting. By the end of the second quarter 2016, its loan loss provisions for the oil industry had more than tripled compared with a year earlier, making them worth $351 million–equivalent to about a 20th of its 2015 profit.

Meanwhile, provisions for impaired energy loans at Royal Bank shot up by more than 1,000% to $115 million; for National Bank they almost tripled to $81 million. This sizeable uptick in impaired loans and provisions is placing considerable pressure on the profitability of these banks and could have an impact on their capital.

However, it isn't only this direct exposure that has the potential to impact their profitability and capital. There are also signs that there will be a marked increase in impaired consumer loans, mortgages, and commercial credit facilities. This can be attributed to oil being Canada’s single largest export, responsible for generating 6% of its GDP.

As a result, the economy is suffering. First-quarter 2016 GDP grew less than expected, highlighting that there has been a decline in business activity. Unemployment also remains high, particularly in the energy patch, and it is feared that this, in conjunction with the factors mentioned earlier, could trigger a marked increase in bad debts across consumer lending, mortgage, and commercial loan portfolios.

If this occurred, it would have a significant impact on the capital and profitability of the most vulnerable of the major banks: Canadian Imperial Bank and Bank of Nova Scotia.

You see, Canadian Imperial Bank’s focus on Canada makes it susceptible to a broader economic slump caused by weak oil prices. Bank of Nova Scotia’s considerable loans to the oil industry and substantial operations in the oil-dependent economies of Mexico and Colombia make it extraordinarily vulnerable.

According to ratings agency **Moody’s**, in a severe-stress situation this could cause their common equity tier one capital ratios to fall below 9.5%, forcing them to take measures to bolster capital, including trimming their dividends or raising equity.

So what?

It wasn’t long ago that investors thought that investing in Canada’s banks was as “safe as houses,” but–as the oil crunch–has shown, they are just as vulnerable to downturns in the economic cycle as any other company. It should be noted, however, that all of the major banks remain adequately capitalised, meaning that the likelihood of a dividend cut or dilutive equity raising is exceptionally slim.

While their short-term profitability is certainly under pressure, the slump in oil will pass. The banks remain solid long-term investments.

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2. NYSE:BNS (The Bank of Nova Scotia)
3. NYSE:CM (Canadian Imperial Bank of Commerce)
4. NYSE:RY (Royal Bank of Canada)
5. TSX:BMO (Bank Of Montreal)
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Author
mattdsmith