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Canadian Banks: Exposure to Sovereign Debt

Geoff Ho, CFA – *Director – Canadian Equities, Portfolio Advisory Group*

European sovereign debt issues remain in the spotlight as the vicious circle involving weak job markets, stagnant or declining GDP, waning government revenues, and cumbersome austerity measures continues to take its toll on the overall economy. Particularly in some of the peripheral European countries (Portugal, Ireland, Italy, Greece, Spain), such circumstances have weighed heavily on fiscal balance sheets as countries such as Greece and Italy are faced with mounting debt. This appears to be somewhat of a spiralling situation as many of these countries require substantial loans from the International Monetary Fund and various Euro-zone governments in order to satisfy current interest costs and debt maturities. Although one of the major stipulations of such loans require the struggling nations to implement major structural reforms, it will certainly take extremely drastic measures to improve fiscal balances; or else, the loans extended by the IMF and various central banks simply serve to delay the inevitable, which is either major debt restructuring or default. At the moment, despite pledges of support from various central banks over the past year, investor sentiment surrounding select European countries remains weak as they continue to demand higher yields to hold government issued bonds. In fact, government bond yields in many of the troubled countries continue to rise, and of course this only serves to worsen the situation as a result of the higher costs associated with servicing debt. Further compounding the problem is the growing risk of debt rating downgrades as refinancing options become increasingly expensive. At present, the yields on the 10-year Greek, Portuguese, and Irish bonds are yielding 16.1%, 11.1%, and 11.6%, respectively. We do not believe this is sustainable.

What does this mean for the Canadian banks?

Based on various regulatory filings, transcripts from recent conference calls, and discussions with Scotia Capital's Bank Research team, the Portfolio Advisory Group has thus far found that most of the Canadian banks have limited direct exposure to Europe. The disclosed exposure we have come across appears to be fairly manageable against a backdrop of strong capital ratios, diversified revenue streams (by operations and geography), and relatively conservative investment practices that have made the sector an exemplary model within the global financial system. Accordingly, if and when a distressed nation has to restructure or default (a scenario that could take years to occur – as we have seen in the case of Argentina), any reduction to the net present value of sovereign debt holdings appears to be fairly small when compared to the asset base of most Canadian banks.

Accordingly, based on the information we have found thus far, we believe that the risks associated with the European debt crisis reside at a more macro level for the Canadian banks as the direct risk associated with possible write-downs in the value of sovereign debt holdings appears limited. For example, if any major U.S. or European bank has material exposure to Greece or Ireland and a severe write-down is required on their investments, this could possibly undermine the confidence in the asset values of various institutions and in turn, once again lead to concerns over financial contagion. At the moment, the ultimate exposure of the U.S. and European banking system to these sovereign debt issues appear rather opaque at best (particularly given various derivative products plus selective disclosure) and understandably, it is exactly this obscurity that leaves investors on edge.

On a somewhat more positive note, although sovereign debt issues and more importantly the risk of contagion presents one of the largest dangers in the market over the near to medium term, we believe that the other perspective worth considering is that:

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a) During the last financial crisis, Canadian banks performed relatively well as the sector was perceived to be a relatively 'safe' investment. Based on their disclosures at the moment and what appears to be limited exposure to Europe, this may once again be recognized and rewarded by investors via fund flow.

b) Also during the financial crisis, some Canadian banks were opportunistic in expanding their operations organically and via acquisitions as their global competitors de-risked their operations. Accordingly a European debt crisis could present opportunities to acquire non-core assets of other banks as Bank of Nova Scotia did in purchasing assets from both RBS and BNP Paribas during the recent recession.

Exposure to Europe (info compiled by PAG based on various regulatory filings, transcripts from recent conference calls, and discussions with Scotia Capital's Bank Research team)

Bank of Montreal (BMO)

- In the euro zone, BMO's direct credit exposures in Greece, Ireland, Italy, Spain and Portugal totalled approximately $189 million at the end of Q2 ended April 30, 2011. Of this amount, direct credit exposures in Greece, Ireland and Portugal (the three countries that have negotiated or are in the process of negotiating bailout packages) were $4 million, $3 million and $79 million, respectively, and were primarily to banks for trade finance, lending and trading products.
- In addition, BMO's Irish subsidiary is required to maintain reserves with the Irish central bank. These reserves totalled approximately $174 million at quarter end.
- The BMO-managed structured investment vehicles had exposure with a par value of approximately $55 million to counterparties in Ireland, with no exposure in Greece, Italy, Spain and Portugal. This exposure was comprised of approximately $38 million of government guaranteed Irish bank senior debt and approximately $17 million of subordinated debt of an Irish insurance company, relatively unchanged from the preceding quarter.
- BMO's direct credit exposures in the North African countries of Egypt, Libya, Morocco, Algeria and Tunisia consist solely of trade finance products with bank counterparties. Exposures in these countries amounted to approximately $65 million at quarter end, including counterparty exposure of approximately $10 million in Egypt and negligible amounts in Libya and Tunisia. BMO has no direct credit exposure in the Middle Eastern countries of Syria and Yemen.
- For context, Bank of Montreal's current market capitalization is just over $34 billion (based on shares outstanding of 570 million).

Bank of Nova Scotia (BNS)

- Based on Q1 results ended January 31, 2011, BNS indicated that the bank's sovereign credit risk exposure for certain European regions was fairly unchanged from October 2010. At that time, BNS indicated that their exposure to certain European countries that have come under recent focus is not significant, with no non-trading sovereign risk exposure to Greece, Portugal or Spain.
- Based on financials as at October 31, 2010, the bank had $142 million non-trading Irish sovereign exposure in the form of central bank deposits arising from regulatory reserve requirements to support the Bank's operations in Ireland. With respect to Irish banks, the bank had exposures of $255 million as at October 31, 2010, primarily in the form of securities.
- Net trading securities exposure to Greece, Portugal or Spain was negligible as at October 31, 2010.
- The bank's sovereign credit risk exposure to Libya is nil.

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- For context, Bank of Nova Scotia's current market capitalization is just over $62 billion (based on shares outstanding of 1.1 billion).

CIBC (CM)

- Based on the bank's Q2 earnings report, CIBC has no direct sovereign exposure to Greece, Ireland, Italy, Portugal, and Spain (previously as at October 31, 2010: $43 million).
- CIBC has no direct non-sovereign exposure to Greece and Portugal. Direct non-sovereign exposure to borrowers within the other countries is materially all to investment grade banks, with $88 million (October 31, 2010: $232 million) in deposits with banks, $192 million (October 31, 2010: $185 million) in derivative mark-to-market receivables (before any collateral held), and $2 million (October 31, 2010: $12 million) in letters of credit.
- Exposure to counterparties in selected countries in the Middle East and North Africa (Algeria, Bahrain, Egypt, Jordan, Lebanon, Libya, Morocco, Oman, Saudi Arabia, Syria, Tunisia, and Yemen) that have either experienced or may be at risk of unrest is $5 million (October 31, 2010: $4 million) in letters of credit and $4 million (October 31, 2010: $5 million) in derivative mark-to-market receivables (before any collateral held).
- CIBC has indirect exposures through Collateralized Loan Obligation (CLO) securities in their structured-credit run-off portfolio to the European countries noted above. These amounted to $564 million (October 31, 2010: $640 million). There is no exposure to the Middle East and North African countries noted above through these CLO securities.
    - CLO is a special purpose vehicle with securitization payments in the form of different tranches. Financial institutions back this security with receivables from loans.
- For context, CIBC's current market capitalization is just over $30 billion (based on shares outstanding of 400 million).

Royal Bank (RY)

- As at April 30, 2011, RY's loans to Ireland and Spain, were $175 million and $92 million, respectively (January 31, 2011 – $192 million and $325 million, respectively; April 30, 2010, $nil and $nil, respectively).
- RY has no loan exposures to sovereign Portugal, Italy and Greece.
- For context, RY's current market capitalization is just over $77 billion (based on shares outstanding of 1.4 billion).

TD Bank (TD)

- Based on the bank's Q2 earnings report, TD has no exposure to the countries in Africa and the Middle East most affected by the recent geopolitical developments.
- Exposure to Greece and Portugal is nominal; exposure to Ireland, Italy and Spain is to the sovereigns themselves and the largest financial institutions in those countries. All these exposures are considered manageable.

National Bank (NA)

- Based on the bank's Q2 earnings report and transcripts from the conference call, NA does not appear to have material exposure to Europe or the Middle East.

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Comparative Canadian Bank Information

Bank	Symbol	Scotia Capital Recommendation	Risk Rating	1 Yr Target
Bank of Montreal	BMO	2-Sector Perform	Low	$70.00
Bank of Nova Scotia	BNS	2-Sector Perform	Low	$72.00
CIBC	CM	1-Sector Outperform	Low	$105.00
National Bank	NA	3-Sector Underperform	Low	$90.00
Royal Bank	RY	1-Sector Outperform	Low	$70.00
Toronto-Dominion Bank	TD	1-Sector Outperform	Low	$105.00