Trading strategy loaded with risk, analyst says

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Published: July 10, 2007

Canadian Imperial Bank of Commerce's trading operations quietly made a dramatic push into credit derivatives last year, exposing the bank and its investors to greater potential risk, a **Veritas Investment Research** report says.

The report from the independent research firm sheds light on the difficulty that analysts and investors are having when it comes to understanding the complex trading operations of Canada's big banks and the lack of disclosure surrounding them.

Concern about trading operations at the banks was heightened after Bank of Montreal revealed in May that its commodity trading desk unexpectedly lost $680-million this year. The bank says it is still investigating the circumstances surrounding its trading losses to determine whether any potential irregularities in trading and valuation took place.

"The reality is that the trading operations of each of the big banks are so complex that investors must trust that the bank's risk-management function is designed effectively and operating as designed," **Veritas** analyst **Ohad Lederer** wrote in the recent report to clients, about CIBC.

Mr. Lederer pored over the notes to CIBC's financial statements and found indications that the bank's exposure to credit derivatives is on the rise, pointing to increased risk.

Last year, "CIBC rushed into trading long-dated credit default swaps (CDS) whereas, in prior years, it took only very small positions" in swaps with a greater than five-year residual term to maturity, **Mr. Lederer** said in his note. In general, long-dated options are harder to price than short-term options.

The notional value of CIBC's credit derivative book increased by 95 per cent in 2006, while its credit derivatives with a term to maturity of over five years increased a whopping 739 per cent, he said.

Despite having the smallest market value and least Tier 1 capital of the Big Five banks, CIBC has the second-largest portfolio of credit derivatives with a term greater than five years, **Mr. Lederer** said.

Royal Bank of Canada and Toronto-Dominion Bank have also been active in this area. Last year, RBC had $91-billion of notional credit default swaps outstanding compared with CIBC's $79.9-billion. But RBC has significantly more Tier 1 capital to cushion itself, **Mr. Lederer** pointed out.

He added that CIBC appears to be dealing with a lower average quality of counterparty - the people on the other side of the transactions - than the other banks, and "the average counterparty quality is trending worse rather than staying level or improving, as it is at the other large banks, which leads us to believe that a much greater proportion of [CIBC's] CDS trading is with hedge funds rather than with regulated financial institutions.

Mr. Lederer said he is not accusing CIBC's risk management department of not delivering on either design or execution. "We don't know that any problems are going to arise from CIBC's credit-derivative trading operations," he concluded.

However, he noted, the regulatory capital framework of the Office of the Superintendent of Financial Institutions, which regulates Canadian banks, requires CIBC to put aside more capital for each dollar of "in-the-money [long-dated] CDS than its peers, strongly implying higher counterparty risk. Further, the bank's activities in longer-duration, harder-to-price options have drastically increased. Caveat emptor."

CIBC declined to comment.

CIBC

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