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Why problem loans could blindside investors in Canada's big banks

By David Milstead

You could say Canada's banks may be healthier than ever, with the small amount of problem loans just a speck on their balance sheets.

You could also say that, as a result, Canada's banks are less prepared for a downturn than ever, as the money they're setting aside for problem loans are a fraction of the long-term average.

And, you could say this is exactly how it's supposed to be: Banks set aside money for impaired loans, as they're called, only after customers have stopped making payments for set periods of time. For the most part, banks don't bulk up their loan-loss reserves prospectively in case the economy turns bad.

But just because that's business as usual in the industry doesn't mean that it isn't any business of the banks' investors. Low levels of problem loans have meant that the banks have been able to make relatively small provisions. In the first quarter, the bank's provisions, in the aggregate, fell from the fourth quarter and were flat from the year before. And that has a direct benefit to net income, as bad-loan provisions reduce profits.

What comes around, goes around, however, even for a group as fortunate as the Canadian banks. You may be concerned that a number of factors – sky-high housing prices, large levels of consumer debt, a weakening jobs picture, the collapse of oil – suggest banks' loan portfolios may be at risk. And that would mean provision expense, which has worked in the banks' favour so many times since the end of the financial crisis, may now be poised to cut directly into their profits in the coming years.

"The problem with provisions is they're backward-looking," says ***Anthony Scilipoti***, president of ***Veritas Investment Research***. "Provisions are set based on what happened yesterday, and we've been through what has been a tremendous period of economic growth, and loan impairments have been minuscule. Provisioning follows that."

A brief primer: Banks maintain "loan-loss reserves," a set amount on their books, to cover loans gone bad. When banks put money into reserves, they make a "provision" that's charged against profits. When it's time to write off a bad loan, the amount gets taken out of the reserve.

Here's some data that show how the banks have benefited: The Big Six banks made just under $1.5-billion in provisions in the fiscal first quarter of 2015 that ended Jan. 31, down from $1.7-billion in the fourth. Provisions were essentially the same in the first quarters of both 2014 and 2013, as well.

Veritas calculates that provisions, as a percentage of loans, are now at a post-financial-crisis low point, and at a level about half their historical norms.

"Earnings have benefited thus far because of the reduced provision, because you take less charges to income, and it makes income higher," ***Mr. Scilipoti*** says. "As things turn, and some loans may become impaired, provisions go up, and income goes down."

It's not that banks are unaware of this; they're telling shareholders they believe they can deal with a downturn in the Canadian economy, in large part because of the results of "stress tests" they're doing on their balance sheets, particularly related to oil prices.

At Toronto-Dominion Bank, chief risk officer Mark Chauvin said provisions are at "cyclically low levels," as the bank's provision rate – provisions as a percentage of loans – dropped to 0.29 per cent, down 0.04 percentage points from the fourth quarter and 0.11 percentage points from 2014's first quarter. (Total provisions were $362-million.)

"I don't believe the sustained low oil prices represent a material risk to the bank," Mr. Chauvin said, citing disciplined underwriting standards in lending to the energy sector and a small amount of unsecured lending to consumers in areas most affected by oil's downturn.

At National Bank, executive vice-president of risk management Bill Bonnell said that "low interest rates, low fuel prices and the weaker Canadian dollar remain supportive of a stable credit environment," and his bank is maintaining its forecast of provisions staying steadily low for the next two quarters.

Stephen Hart, Bank of Nova Scotia's chief risk officer, says his bank's oil and gas exposure is "manageable. And just to be clear, by manageable, I mean that any stress losses would leave the bank within our risk tolerances for both capital and loan loss provisions and would not affect our ongoing strategies."

But "manageable" issues in the portfolio, whether from oil or housing, isn't the same thing as the banks' continuing to benefit from low provisioning as 2015 turns to 2016.

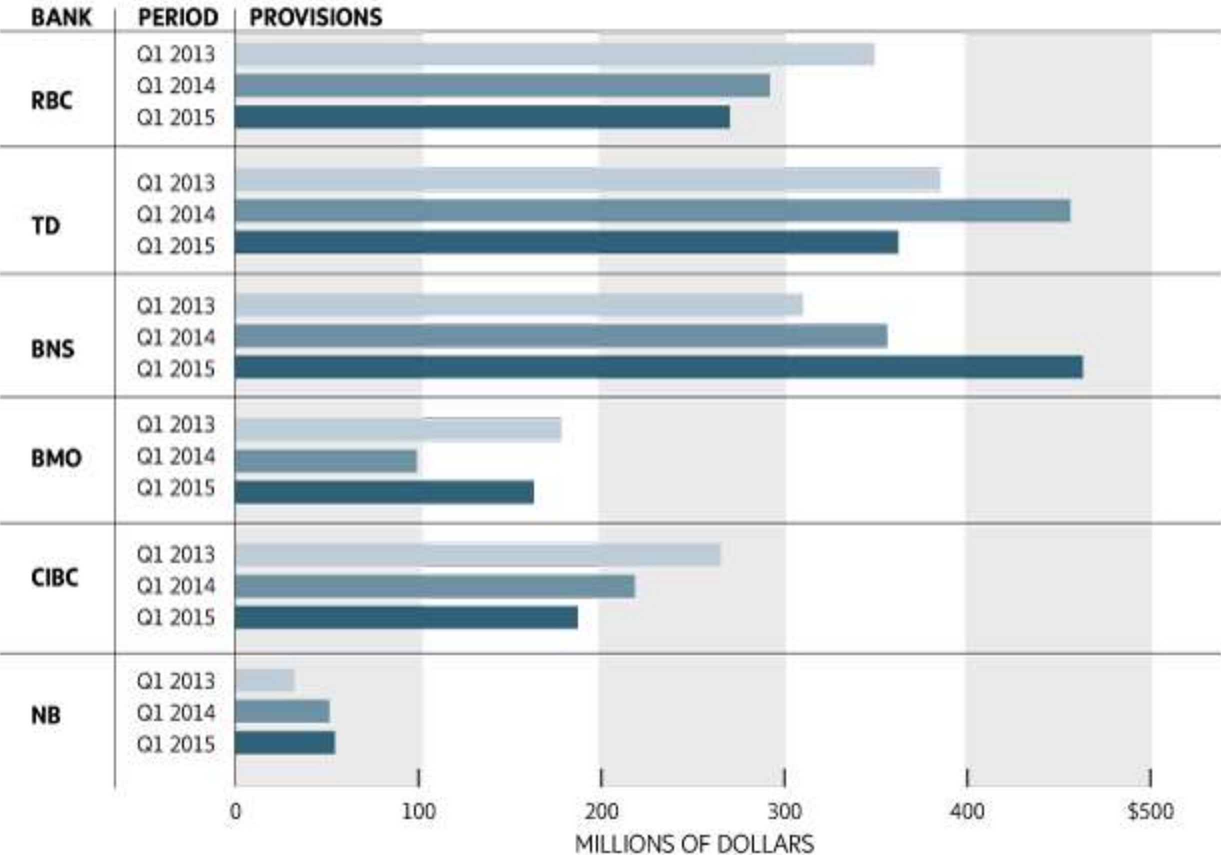
For specifics, look to analyst Brian Klock of Keefe Bruyette & Woods, a U.S.-based research firm that specializes in financial stocks.

Mr. Klock sees provisions at Bank of Montreal rising from $561-million in 2014 to $775-million this year and $915-million in 2016. At Royal Bank of Canada, he sees provisions rising from $1.16-billion in 2014 to $1.39-billion in 2015 and $1.65-billion in 2016. He sees provisions rising at Canadian Imperial Bank of Commerce, Scotia and TD as well, just not as sharply. (Earlier this year, he recommended underweighting the entire Canadian banking sector and specifically cut RBC and CIBC to "underperform," citing their high exposure to the Canadian domestic economy.)

Veritas, as well, suggests investors scale back on bank exposure now that they make up more than one-third of the S&P/TSX composite index. If one simply must own banks, ***Veritas*** says, its picks are RBC, TD and Scotia.

"The accounting for loan provisions is backward-looking, and investing in banks today has to be forward-looking," ***Scilipoti*** says.

The amount of money a bank "provisions" for bad loans is an expense that cuts into profits. So it's been a boon to bank earnings that Canada's big financial institutions have been able to keep provisions low into 2015's first quarter.



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