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Unsafe havens

You can hardly beat a Canadian bank for prudence or profitability. And for the cleverest and soundest system of mortgage finance under the sun, look no farther than Denmark. The world holds these propositions to be self-evident, but the world, we think, will presently reconsider.

Short-sale candidates are the subjects at hand: Easy-to-borrow Bank of Nova Scotia of Canada (BNS in Toronto and New York) is the first item on the agenda. Hard-to-borrow Danske Bank A/S of Denmark (DANSKE in Copenhagen) is the second. Danske figured in these pages a year ago in a bearish analysis of Denmark (*Grant's*, Aug. 10, 2012), while Scotiabank is a newcomer to *Grant's*. That highly reputed company's appearance in a bearish context may surprise Mr. Market, but, if so, that gentleman has not been keeping up with new developments.

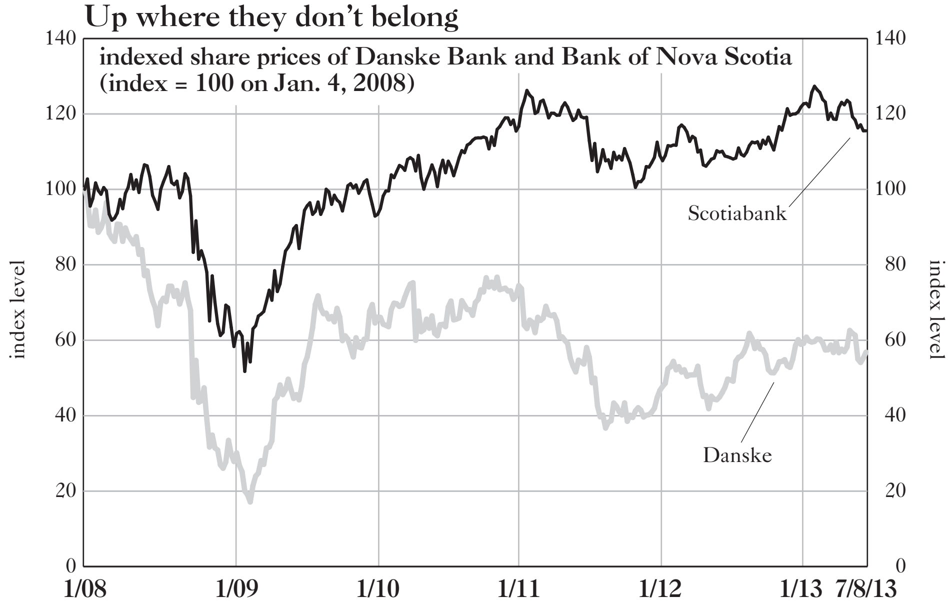
"The management team is really quite good—top drawer, I would say," Ohad Lederer, analyst (and paid-up subscriber) at Veritas Investment Research in Toronto, advises colleague Evan Lorenz concerning Scotiabank. "Through the crisis, there were any number of issues that were supposed to derail Scotia," Lederer goes on. "They were a partner of GMAC and had a ton of car loans that had been one-off securitizations, and they had a lot of that on the balance sheet. That was supposed to blow up and it didn't. They were one of the biggest corporate lenders in Canada, and their loan losses stayed low. They were a big lender to resorts in the Caribbean, and that was supposed to blow up, and it didn't. They had an asset-based commercial paper conduit in the States—people got very worried about those for a period.

"Lots of things that were supposed to go wrong, and they never did," Lederer continues. "The guy who was chief risk officer is going to take over as CEO. In terms of management quality, I think they have earned their stripes. The Canadian system is on a bit of a pedestal because the IMF and the World Bank and whoever else will tell you that the Canadians are the best banks. Within that group, Scotia is probably within the top, if not the top two."

In the second fiscal quarter ending April 30, Scotiabank's assets ballooned by 14.3% year-over-year, to C$754.2 billion ($718.3 billion). Equity amounted to just 5% of those assets if you take the loans and securities and mortgages just as they are and do not "weight" them for the regulators' idea of risk.

Historically, Canadian banks have been failure-proof, and that enviable record of solvency dates from long before the Canadian government took to absorbing 100% of the losses on insured Canadian mortgages. Of Scotiabank's C$188.2 billion in Canadian mortgages, C$108.3 billion are insured by the Canada Mortgage and Housing Corp. (CMHC), a formidable safeguard, if not to the Canadian taxpayers, then to the bank and its stockholders. But no one insures Scotia's C$18.9 billion in home-equity loans to Canadian borrowers or the C$12.8 bil-

Up where they don't belong



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lion in commercial real estate lending, of which C$771 million is extended to Canadian condo builders.

But the bear story on Scotiabank isn't principally about Canada or the toppy-looking Canadian real estate markets. The main point of vulnerability is, rather, China as transmitted through exposures to Latin America and other sino-sensitive markets.

Half of Scotiabank's net income derives from Canada, half from outside, with Latin America being the main driver of growth. In the second quarter, the United States chipped in 9% of after-tax profit. Mexico was good for 7%, Peru for 5% and the vast region designated "other" for 30%. "However," Lorenz notes, "from the bank's past acquisitions and from disclosure about cross-border exposures in the 2012 annual report, we can infer that Scotia is active in China, India, South Korea, Chile, Brazil and other Latin American and Asian countries. And there were signs of trouble in Scotia's international division even before the latest stumble in emerging markets."

"The international segment of Scotia has had 20 acquisitions in the past five years for about C$6 billion," Lederer relates. "The accounting is muddled to say the least. Canadian banks' disclosures are not as good as U.S. banks'. Scotiabank, within the group, doesn't have the best disclosures. At the segment level, they are even worse, so it is very hard to see through the acquisitions. What caused us to go negative is, one, you peeled out the acquired earnings from Colombia—they bought the sixth-largest bank in Colombia and that closed in the second quarter of last year, so it had been affecting comps for a while—once you peel that out and you peel out the temporary depression of earnings in Thailand as a result of the floods a year-and-a-half ago, the earnings of the international bank weren't growing. In fact, they looked like they were shrinking. That was first quarter and that caused us to downgrade it. We said, 'The earnings are shrinking and yet everyone thinks they are growing.'"

If you, like us, are bearish on China and for that reason bearish on South America (see the previous issue of *Grant's*), then you, like us, will be led to expect higher loan losses and lower net income growth from Scotiabank.

Incredulous observers of the largely uncorrected boom in Canadian residential real estate will be wondering if Scotiabank is vulnerable to drooping house prices. Because of the prevalence of government mortgage insurance, mortgage-related impairment is not the immediate problem. More worrying, advises Brian Klock, analyst at Keefe, Bruyette & Woods, would be the depressing effect of a real estate bear market on consumer finances.

"What I am watching more is credit-card delinquencies," says Klock. "So far, Canadian consumers are still paying their credit-card bills. If the unemployment rate doesn't come down and you have a housing-market correction that starts with unemployment levels going up because there are more construction workers unemployed or if all the reciprocal industries that would be impacted, that is what I am worried about. The bank balance sheets in Canada are largely consumer focused.

"We are starting to see housing prices roll over in Vancouver, especially condo prices," Klock goes on. "If it happens in Toronto next, then Montreal isn't far behind. Those are the three biggest housing markets that could lead to unemployment levels going higher, and to higher delinquencies." Homebuilding employed 5.7% of the U.S. labor force at the peak of the boom; in Canada today, 7.3% of the workforce is so engaged. Ergo, projections of a drop in housing starts to between 173,300 to 192,500 units in 2013 from 214,827 in 2012 hold implications both macro and micro.

In short, someone is very wrong about Scotiabank, either Mr. Market or *Grant's*. The stock changes hands at 176% of book value and yields 4.3%. Non-performers amount to an inconsequential 0.44% of total loans, which blemish is 180% covered—indeed, smothered—by the loan-loss allowance. But old man Market, we think, reckons without South America, i.e., without China.

As for Denmark, there have been some changes since our analytical visit of not quite 12 months ago. While Danish consumers are still the most indebted in the world, and Denmark's sovereign credit is still unanimously judged triple-A (three agencies out of three), the Danish economy is now contracting, not expanding; foreign capital is exiting, not entering; and interest rates are rising, not falling. The Danske Bank share price, however, is a little higher than it was last summer. It ought to be lower in our opinion.

With 3.5 trillion kroner ($600.5 billion) in assets, Danske is 1.9 times bigger than the Danish economy. If we were the Danish economy, we could hardly sleep, even if, judged by "core Tier 1 equity," the bank seems reasonably well armored against adversity. But equity in the sum of 15.1% of "risk-weighted" assets invites the always interesting questions, "What's risk, and who's defining it?" In the case of Danske, the bank itself seems to be making the calls, or enough of the calls to cause concern. At the end of the first quarter, Danske said that its "risk-weighted" assets footed to 22.8% of its overall assets, down from 25.7% a year earlier. Begging to disagree, the Danish Financial Supervisory Authority ordered management to boost its tally of such assets—risky by some definitions—by 12.5%. On June 17, a huffy press release issued from corporate headquarters under the signature of the CFO, Henrik Ramlau-Hansen.

"At Danske Bank," Ramlau-Hansen led off, "we find it very important to ensure that we measure the risks we incur accurately. We generally wish to make a conservative assessment, but we must also be able to support business growth by providing financing on competitive terms. . . . We do not agree with the FSA that the suggested adjustments would give a more accurate picture of Danske Bank's risks. For that reason, we have proposed to the FSA that an independent third party be asked to validate our risk models."

The trouble with risk models is that someone must design them. The modeler has a boss, and that boss, in turn, reports to someone, perhaps to a committee. Committees deliberate, but they do not often imagine, and here the rubber, or model, meets the road. The interesting and costly kind of risk that can send a bank to the bottom is rarely the kind that's tipped on CNN. You can't see it coming, but you can imagine it coming. Committees, being inherently unimaginative, rarely see it coming. The assets they judge to be innately risky or innately safe may be nothing of the kind (after all, to quote some wise old head, there are no bad bonds, only bad prices). In calculating financial leverage, the choice comes down to models or long division, to higher math or lower. For us, for reasons both of aptitude and conviction, the latter is better than the former. To calculate true leverage, we say, just divide equity by assets.

In the case of Danske, the answer to the problem is 4%, which, in our opinion, presents another problem. It is a very thin membrane of protection for the liability holders. At the close of the 18th century, Alexander Hamilton and Adam Smith separately advised banks to meet ratios of capital to liabilities of 1:4 or 1:5. Danske's ratio can be expressed as 1:25. Hamilton and Smith were not constitutionally gloomy. Neither have the financiers of the 21st century cracked the code of credit analysis. What accounts for low 21st-century capital-to-assets ratios are sweeping 21st-century bailouts.

Maybe Ramlau-Hansen would see things the regulators' way if he were helping to run Denmark's FSA instead of his optimistically capitalized megabank. While at Danske nonperforming loans amount to 5.7% of total loans, provisions for loan losses cover only 40% of those duds, down from 41% in the first quarter of 2012.

Nor could a savvy regulator (as Ramlau-Hansen would certainly be) ignore the fact that Danske is funding itself in the not invariably accessible capital markets. Loans amounted to 205% of deposits at the end of the first quarter; deposits funded just 23% of the balance sheet.

"You are overlooking one very important factor: Our mortgage exposure is within a company called Realkredit Danmark," Danske chief investor relations officer, Claus I. Jensen, rejoined on a Tuesday telephone call. "It is a subsidiary that is a specialized mortgage bank. They are doing mortgage lending on a totally match funded basis, meaning that they cannot provide a loan to a customer without funding in the market at the same time."

Very well, we rejoin, this lowers Danske's loan-to-deposit ratio to 115%. However, deposits plus mortgage bond sales plus equity only fund 45% of Danske's assets, which is to say the bank is heavily reliant on the capital markets for funding.

Perhaps no harm will come from this bull-market style of bank management, but Danske is dealing with a series of wobbles. Though the bank does 62% of its lending in Denmark, it also has important credit exposure to the other Nordic countries, some of which are showing worrying signs of economic weakness. Finnish GDP fell 4.2% year-over-year in April, the steepest decline since December 2009.

Then, too, as noted here a year ago, Danske has lent heavily against the collateral of Danish residential real estate. On its balance sheet resides 734 billion kroner of home loans vs. shareholders' equity of 139.6 billion kroner. As of Dec. 31, 55% of these loans were interest-only.

Now, 2013 is a red-letter year in Denmark. It is the 10th anniversary of the debut of the interest-only, adjustable-rate mortgage. For the first 10 years of the life of these loans, the borrower pays interest only. "After that," explains Andreas Hakansson, bank analyst with Exane BNP Paribas in Stockholm, "you have to start paying down principal. Given you've had a 10-year period with no amortization, you now have to amortize your loan over 20 years instead of 30 years. If you are going to pay down over 20 years, the amount you pay every year is around 5%. If you had an adjustable-rate mortgage that was interest only that was taken out in 2003 or 2004, then you are paying 1.5% in interest, but you also have to pay down 5%. So, you effectively go from paying 1.5% to 6.5%. That's huge. If you then have interest rates rising as well, let's say you go from paying 1.5% to 3% plus 5% of principal amortization, you are talking about very big changes in cash flow for many households."

The Danish banks are well aware of this problem. Earlier this year, they sought approval from regulators to carve out whatever portion of interest-only loans were below 80% LTV into a new, interest-only loan that would not amortize for a decade. Lorenz asked the man from Danske how big the payment increases might be for resetting loans. "As a starting point, the customer has to start amortizing once the 10-year, interest-only period ends, but it will be up for negotiation between the bank and the customer," Jensen replied. If the customer has a strong personal economy with good equity and an LTV below the legal limit of 80%, then it would be possible for the customer to get a new loan with an interest-only period. However, these loans have become more expensive over the last couple of years."

Last summer, Denmark was a haven for money in flight from the euro zone. Ten-year Danish sovereigns yielded as little as 97 basis points as money coursed into the kingdom. Today, the Danish 10-year fetches 1.79%, and money, if not coursing out of Denmark, is at least seeping away. True, Danish house prices are registering small gains today rather than last year's small losses. "But despite the recent uptick," Lorenz notes, "house prices are still 18% below their peak and many borrowers are, in the American expression, underwater with respect to their equity position. In Denmark, the law of the land stipulates that no first-lien mortgage loan may be in excess of the *market* value of the collateral. And when, in a weak market, the LTV does slip below 80%, the lender must add enough collateral into the relevant covered-bond pools to restore the LTV ratio to 80%."

Danske would therefore seem to be vulnerable either to an inflationary rise in interest rates or a deflationary fall in house prices. A fall in house prices compounded by an unscripted rise in interest rates (sometimes rates just do go up) would, of course, be especially unwelcome. The stock, which pays no dividend, is quoted at 18.2 times trailing net income and at 74% of book value. It is just the right valuation for a world in which absolutely nothing deviates from management's most hopeful plan.

"Private consumption has been very sluggish over the last couple of years, and one of the few growth areas we've had in Denmark has been the export sector," Jensen remarked. "So the Danish economy has benefited very much from having a high proportion of exports to Germany and also Sweden and the U.K." Tuesday brought news that U.K. factory output fell 0.8% between April and May vs. expectations of a 0.4% increase. Germany announced that industrial production dropped 1% over the same period vs. expectations for a decline of half that amount. Exports are nice if someone's buying them.

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