Risky paper bound to stick to banks' heels

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Three years ago, the men in pinstripes at **Bank of Montreal** thought they'd hooked a swell new customer. A U.S. mortgage company, **FMF Capital**, needed to raise money, and wouldn't you know it, turning it into a Canadian income trust seemed like just the ticket.

BMO won the right to lead the $198-million offering. Within nine months, FMF was on the brink of collapse, its name a Bay Street synonym for shoddy deals. Investors sued. About a year later, BMO and several other banks settled for about $3.8-million, less than their commissions on the deal.

FMF may have stained their reputations, but it did not create a massive liability. Perhaps that's the way it should be. The principle is supposed to be that the investor, not the seller, gets the rewards and takes the risk. Even in outright frauds, including large-scale ones such as Bre-X Minerals or Livent, bankers may get sued, but rarely do they agree to repay anyone's losses. Read the prospectus. It's buyer beware. At least, it was. In the credit crisis, you can throw out the old rules.

It's all too easy to bash BMO. In the gilded world of Canadian banking, it's a laggard, and on the heels of the FMF debacle, it suffered the embarrassment of a huge trading snafu, in which it managed to blow some $850-million on natural gas contracts. After Tuesday's disclosure of another $490-million in writeoffs, it's tempting to conclude BMO is run by klutzes who would be on the B-team anywhere else, except CIBC, and that their errors have no implications for the other banks and their shareholders. That would be wrong. What's happening there might represent the beginning of a major change in how banks operate.

To understand why, let's drill down into how BMO lost that $490-million. It was a grab bag. The bank wrote down $25-million on two SIVs, or structured investment vehicles. It took a $160-million hit because of now-worthless derivatives it bought from ACA Financial, a troubled bond insurer. More significantly, it lost $130-million on something called Apex/Sitka Trust, a conduit for commercial paper.

What do all of these have in common? Each represents something the bank did to cut its own risk. SIVs are nothing more than specialized companies set up to hold loans and other interest-paying securities. Ditto for asset-backed commercial paper (ABCP). The ACA hedges were meant to shift the risk of losses away from the bank.

That's not new. Banks long ago began moving away from the old deposits-in, loans-out model. They've been packaging and selling mortgages, credit card loans and corporate debt for ages. Even funkier securities, such as collateralized debt obligations, have been around for a while. In 2004, long before CDOs were front-page news, financial institutions created and sold $158-billion (U.S.) of them.

One reason for this trend – separating the banker from the borrower – is capital. If you're a banker and you can capture $50-million in deposits for 3 per cent, then lend the money out for 7, well, that's a nice piece of business. But you'll need about $5-million of equity to back up that loan; the regulators will insist on it, to protect depositors.

Suppose, instead, you sell that loan to a SIV and take a fee for the privilege. You have just changed the math. Yes, the bank has given up the chance to earn the interest income – but it has also obviated the need to have that huge slice of equity capital. Result: Its return on equity rises (usually, the stock price follows). When it can make a profit with no equity at risk, the ROE is infinity.

But what if *you haven't really sold the risk at all*? What if, when things get rough, the investors come running back and expect you to compensate them for their losses? That's happening with BMO and other banks now.

Take the Apex/Sitka trust. The bank has not said who owns the paper. But it has suggested that it's a small number of investors – likely, companies with a bit of extra cash to invest, or wealthy individuals. Those are the kind of customers banks don't want to anger. That would explain why BMO's exposure to this trust is rising – in addition to the $210-million it has written off, it owns nearly $500-million of the paper. “It looks to me like they're buying their clients out,” says ***Ohad Lederer***, an analyst at ***Veritas Investment Research.***

Here's the rub: BMO is not the only bank with this stuff – they all have it. In the future, they may find it tougher to sell loans into SIVs and similar entities. They'll do the business, but more of it will stick to their books. That means three things: more capital, lower returns, and tough slogging for bank shareholders.