A Sobering Outlook for the Canadian Banks

Description

Canadian investors love their bank stocks, and for good reason given the long-term returns generated by holding these names through thick and thin.

At least one U.S. based investor however has a less-than-rosy outlook for these bluest of the Canadian blue chip names.

Saturday's Globe and Mail featured an article about a small San Francisco based hedge fund that has staked 95% of his investor's assets on a wager that will pay off if this country's banking sector stumbles.

Unlike others who argue an eventual slowdown in our housing market will take a bite out of the banks, the argument presented related to the "risk-weight" of 9.9% that the Canadian banks put on mortgages. And more specifically, how out of line this weighting is with much of the world.

According to the article, U.S. banks apply a risk-weight of 35 to 75% to mortgages, banks in Australia use 15 to 20%, and Europe averages 20%.

So What?

In the homogeneity seeking world that we live, there is a risk that at some point OSFI, the Canadian financial regulator, will be asked to bring this figure more in line with other jurisdictions. The implementation of a "risk-weight floor" of 15% by OSFI is suggested.

If this change occurred overnight, an infinitely small probability in my mind, several banks could fall below the minimum capital requirements (currently 4.5% but expected to level off at 6.0% by 2015), forcing them to issue equity or cut their dividends. Tabled below is the current Tier 1 Capital ratio (Tier 1 Capital/Risk-Weighted Assets) for each.

Company Name	Tier 1 Capital Ratio

CIBC (TSX:CM,NYSE:CM)	12.0%
Royal Bank of Canada (TSX:RY,NYSE:RY)	11.5%
Bank of Montreal (TSX:BMO,NYSE:BMO)	11.1%
TD Bank (TSX:TD,NYSE:TD)	10.9%
Bank of Nova Scotia (TSX:BNS,NYSE:BNS)	10.3%

Source: Capital IQ

While these figures don't take into account the percentage of risk-weighted assets that is comprised of mortgage loans, you can at least see that if mortgages were to require a risk-weight of say 15% vs. 9.9%, the denominator in this ratio (RWA) would go up, bringing the Tier 1 ratio down. With mortgage loan exposure factored in, Citigroup expects a higher risk-weight would have the biggest impact on CIBC, Royal, and Scotia.

The Foolish Bottom Line

To bolster the argument against Canadian banks, a negative view on emerging markets and therefore commodities is also expressed by the fund's manager. I'm not sure betting 95% of a fund's assets on what a country's regulator and commodity prices might do is overly prudent, but if these views come to fruition, the fund's investors are likely to be a happy bunch.

Canadian banks are a favourite for this country's dividend investors. If you're looking to diversify your dividend exposure simply **click here** to receive our special FREE report "**13 High Yielding Stocks to Buy Today**". **This report** will have you rolling in dividend cheques before you know it!

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Fool contributor Iain Butler does not own shares in any of the companies mentioned at this time. The Motley Fool does not own shares in any of the companies mentioned.

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TICKERS GLOBAL

1. TSX:BMO (Bank Of Montreal)
2. TSX:BNS (Bank Of Nova Scotia)
3. TSX:CM (Canadian Imperial Bank of Commerce)
4. TSX:RY (Royal Bank of Canada)
5. TSX:TD (The Toronto-Dominion Bank)

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Date
2025/07/19
Date Created
2013/04/29
Author
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