Which Big Banks Could Survive a Housing Market Correction?

Description

With Canadian housing prices continuing to spiral skyward, there are growing fears among analysts that the domestic housing market will crash. As of June 30, 2014, the national average housing price has shot up 7% compared to the same period in 2013. Also alarming is that Canadian housing prices have almost tripled since 1999, seeing housing affordability fall to new lows.

Of even more concern is that Canadian household debt is close to record levels and now represents 164% of disposable income. This indicates that even a mild slowdown in the economy could be enough to trigger a collapse in housing prices. Other signs the housing market is overvalued include the fact that Canada's gap between housing prices and rents, as well as incomes, is the second largest in the world, while the gap between house prices and income is the third worst in the OECD.

All of these things indicate a correction is imminent, and while prices won't come crashing to earth with an almighty bang, there will be considerable pain for those who are overleveraged in their exposure to the housing market.

Which big banks are best positioned to maintain growth even if there is a correction?

Since Canada's domestic banks have significant exposure to the housing sector, with the majority of their assets being made up on mortgages, any correction could have a significant impact on their earning potential. However of the six largest Canadian banks, two stand out as being well positioned to minimize the impact of a correction and continue growing earnings by virtue of their diversified growth strategies.

These two banks are **Toronto Dominion Bank** (TSX: TD)(NYSE: TD) and the **Bank of Nova Scotia** (TSX: BNS)(NYSE: BNS). Both have focused on investing in offshore operations as a means of continuing to grow their earnings and reducing their overall exposure to the domestic financial services market.

For the fiscal second quarter of 2014, which equates to the first quarter of the calendar year, Toronto Dominion acquired 65% of its net income from Canadian retail banking, whereas Bank of Nova Scotia obtained a mere 32% of its revenue from domestic retail banking. This compares to the **Canadian Imperial Bank of Commerce**

(TSX: CM)(NYSE: CM), which is the most heavily exposed of the top five banks to the domestic market, obtaining 67% of its net income from Canada for the same period.

Both Toronto Dominion and Bank of Nova Scotia have adopted very different strategies for developing their offshore operations.

Toronto Dominion has chosen to focus on growing its exposure to the U.S., the world's largest banking and financial services market, and those operations contributed 24% of total net income for the same period. It is expected that this proportion of its net income will continue growing as the U.S. economic recovery gains further traction, with recent industrial activity and employment figures being stronger than expected.

However, this strategy does not come without risk, as in the past a number of foreign banks, including CIBC, have been burnt in what can be a fickle and difficult market to operate in, given the level of competition.

In contrast, Bank of Nova Scotia has focused on building its presence in emerging markets, particularly in the fast-growing Latin American economies of Chile, Colombia, and Peru. For the second quarter of 2014, international banking contributed 23% of its total net income. This is expected to grow, with those economies expected to experience GDP growth over the next year of between 4% to 5%, more than double Canada's.

Furthermore, both Colombia and Peru are heavily underbanked, meaning that there are considerable growth opportunities available for Bank of Nova Scotia in the areas of retail banking, wealth management, insurance, and capital markets. This, coupled with ongoing strong growth of the middle class in the region, will see demand for banking products and services grow, boosting revenue as well as the bank's bottom line.

What are key risk indicators telling us?

Even more importantly, just like all of the major banks in Canada, Toronto Dominion and Bank of Nova Scotia have very conservative approaches to risk. They are both well capitalized and their key risk indicators are well within acceptable parameters.

This includes having Tier 1 capital ratios of 9.2% and 9.8% respectively, coupled with very low impaired loans ratios of 0.48% and 0.45% respectively. This indicates that even a housing market correction will have little significant impact on their operations other than seeing the end of a key growth driver.

However, this is offset by their international growth strategies, both of which hold considerable potential. These findings indicate that both banks are well positioned to continue growing their revenues and bottom lines even if the dreaded housing market correction occurs.

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1. Investing

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2. NYSE:CM (Canadian Imperial Bank of Commerce)
3. NYSE:TD (The Toronto-Dominion Bank)
4. TSX:BNS (Bank Of Nova Scotia)
5. TSX:CM (Canadian Imperial Bank of Commerce)
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