A Major Risk for Canadian Banks: Real Estate

Description

The major Canadian banks all have considerable exposure to the Canadian real estate market, either through residential mortgage lending, housing equity loans, or various forms of commercial lending, including development and project finance.

When the real estate market crashes, banks hurt

The Canadian real estate market, at the broad overall level, is considered by many analysts to be overvalued. Given the traditional deep links of banks to the real estate market, there is really nowhere to hide for banks when the real estate market goes into a tailspin.

The real estate exposure of the major Canadian banks is considerable

The table below indicates that the two largest banks, **Royal Bank of Canada** (TSE: RY)(NYSE: RY) and **Toronto-Dominion Bank** (TSE: TD)(NYSE: TD), have the largest portfolios of Canadian real estate-backed loans — no surprise here. What is surprising is that RBC also has the largest exposure when Canadian real estate loans are measured as a proportion of the total loan portfolio, currently at 64%.

On the other hand, **Bank of Montreal** (TSE: BMO)(NYSE: BMO) has a much smaller portfolio of $109 billion, representing 45% of the total loan portfolio. Should things go wrong in the real estate market, BMO will be less vulnerable.

A further point to note here is RBC's level of diversification. While a considerable portion of the loan book is exposed to Canadian real estate, RBC has the lowest proportion of total revenue coming from interest income. TD Bank has the highest reliance of interest income while **The Bank of Nova Scotia** (TSE: BNS)(NYSE:BNS) and BMO are in the middle of the group.

		TD Bank	RBC	B
Canadian Real Estate Lending	$ Billion	255	275	208
Canadian Real Estate Loans % Total Loans	%	54%	64%	49%

Net Interest Income/Total Revenue	%	58%	43%	51%

Risk-mitigating factors are in place

The banks employ various measures to mitigate the risks of their real estate lending activities. In the first instance, loans can be insured by the government-backed CMHC reducing the risk to the lenders. RBC has the lowest portion of their Canadian residential portfolio insured while TD Bank has almost two-thirds of the residential portfolio insured.

A second risk management technique is the loan-to-value ratios, which indicates the value of the loans compared to the value of the property lending book. Here is not much to choose between the banks, but the ratios below do indicate that property prices can drop a long way before the real estate backing the loans will become a concern to the banks.

		TD Bank	**RBC**	**BNS**
Canadian Residential Real Estate Loans Insured	%	63%	45%	47%
LTV of Uninsured Residential Portfolio	%	61%	55%	55%

A substantial reduction in residential real estate prices would impact the banks mainly through an increase in provisions for credit losses as defaulting borrowers will increase during a market downturn. These provisions for the real estate portfolios are currently at extremely low levels supported by the real estate bull market. A further impact could be a decline in interest income from real estate lending should further growth in real estate lending activity dry up.

Banks are performing well but real estate remains a major risk

The Canadian banks are performing well at the moment with the core lending businesses growing steadily and wealth management and investment banking activities providing some impetus. The real estate risk is mitigated through insured mortgages and relatively low loan-to-value ratios for the uninsured components.

However, should the Canadian real estate market go through a deep and extended correction, there will be a negative impact on the banks, with RBC more exposed and BMO somewhat less exposed than the other major banks.

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2. NYSE:TD (The Toronto-Dominion Bank)
3. TSX:BMO (Bank Of Montreal)
4. TSX:BNS (Bank Of Nova Scotia)
5. TSX:RY (Royal Bank of Canada)
6. TSX:TD (The Toronto-Dominion Bank)

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