Should Toronto-Dominion Bank Shareholders Be Concerned About Stratospheric Home Prices?

Description

It's no secret that Canada is experiencing an unprecedented housing bubble, with home prices soaring to stratospheric new highs year after year. In 2014 alone, home prices advanced a significant 7% on average—twice the pace of income growth, leading to record home resale values of $401,000, with detached homes in Toronto exceeding $1 million.

In Canada, **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) has the largest domestic retail exposure as a percent of total earnings out of its peers. Should TD Bank shareholders be concerned about a potential correction in the housing market? Let's take a look at the current risk present in the housing market and TD's exposure to this risk to determine the answer.

Homes are significantly overvalued

The gap between incomes and home prices continues to widen, with the average Canadian's home being worth 5.7 times their income—well above the recommended level of three. This measure is a common method of valuing the housing market, and with previous housing bubbles bursting at prices approximately 3.5 times income, Canada's housing market seems extremely stretched.

In fact, home prices are double U.S. prices, despite similar incomes, and analysts at Deutsch Bank estimate the housing market is 63% overvalued—ahead of the **Royal Bank of Canada's** estimate of 10-30%. Although the 63% figure is on the high end of analyst estimates (for example, TD analysts estimate 10-15% overvaluation), it is safe to say with certainty that the housing market is overvalued by *at least* 10%.

The good news

Fortunately, TD appears to be in a healthy position according to several factors. First, although TDdoes have the largest domestic retail exposure out of its peers (nearly 70% of earnings), TD has arelatively small amount of domestic mortgages as a percentage of total loans compared to peers. ForTD, mortgages represent about 38% of total loans compared to 50% for the Royal Bank of Canada.

This means that TD has a smaller portion of its loan book vulnerable to a fall in housing prices than its peers. Most of TD's loans are personal loans, credit cards, and commercial loans.

However, 38% of mortgage loans is still a fairly significant proportion. Fortunately, Canadian banks are subject to strict lending rules, and are required to purchase insurance for loans that are greater than 80% of the value of the underlying asset at origination. TD however, has been extremely prudent with regards to managing risk, and also purchases insurance for some loans that are worth less than 80% of the value of the underlying asset.

The result has been that TD has the largest portion of insured real estate loans in the business. Currently, an impressive 68.4% of Canadian residential mortgages are insured compared to only 45% for RBC, and 47% for **The Bank of Nova Scotia**.

This means that not only does TD have a fairly small exposure to domestic mortgages compared to its peers, but most of those loans are also insured, meaning that TD bears absolutely no risk, should the value of home prices dip below the value of the loan.

What about the uninsured loans?

However, TD does still have 31.6% of their mortgages uninsured, and therefore are exposed to risk. The best way to look at the risk inherit in these mortgages is by using the loan-to-value ratio (LTV), which looks at the percentage of the underlying asset the loan represents.

TD's average LTV was 70% for newly issued loans in Q1 2015, and 65% for total uninsured loans. This is slightly high compared to peers. For example, RBC has an LTV of 56% for its total uninsured loans.

65% is still a fairly healthy figure, as it means that housing prices could theoretically drop 35% before TD would need to begin to write down its loans, assuming the underwater mortgage holders are unable to continue payments.

Most importantly, 32% of TD's uninsured mortgages are American, insulating them from a weak Canadian market.

TD is well protected from a housing downturn

With only 38% of total loans being mortgages, 68.4% of those being insured, and the remainder having decent LTV values, or being American, TD shareholders are well protected from a potential correction.

CATEGORY

1. Bank Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:TD (The Toronto-Dominion Bank)
2. TSX:TD (The Toronto-Dominion Bank)

Category

1. Bank Stocks
2. Investing

Date
2025/08/26
Date Created
2015/03/09
Author
amancini