



Toronto-Dominion Bank vs. Royal Bank of Canada: Which Is a Safer Bet in 2015?

Description

Canadian banks were once lauded globally for their safety and elegant management of the global financial crisis. Lately, however, more and more media reports have surfaced that have questioned this premise. Overall, Canadian banks have slowly been seeing a decline in their return on equity relative to global peers, and a series of challenging economic headwinds threaten the strong results of the past several years.

Toronto-Dominion Bank ([TSX:TD](#))([NYSE:TD](#)) and **Royal Bank of Canada** ([TSX:RY](#))([NYSE:RY](#)) are Canada's two largest banks and the most popular way to play the banking sector. For investors seeking low risk returns, does one bank represent a safer choice? To find out, let's look at how these banks are exposed to each of Canada's economic headwinds.

Major headwind #1: oil price risk

Risk from the recent commodity price slide represents a significant headwind for banks in multiple different segments. Within a bank's capital markets segments, reduced commodity prices for a long period will reduce lending activities, as well as fairly lucrative underwriting activities, where banks assist companies in raising cash for new projects. These types of changes will occur as banks shelve and reduce capital projects.

In addition, capital spending reductions and layoffs in the oil and gas sector can in turn influence consumer borrowing behaviour. Alberta, for example, is anticipating potentially negative economic growth, and as a result, consumers are likely to borrow less and default more on loans.

Which bank is less exposed to this risk? The answer seems to be TD. First, TD has a much lower loan exposure to the oil and gas sector compared with RBC. As a percentage of total loans, TD has a miniscule 0.75% of its total loans that are commercial energy loans. This compares with 2.25% for RBC.

Second, TD has lower exposure to Alberta than RBC, with about 14% exposure, relative to 23% for RBC. Combined, these figures mean that TD has both lower exposure to direct risk from commercial energy loans, and lower exposure to broader consumer borrowing risk in Alberta than RBC.

In addition, TD and RBC have different growth orientations, with RBC deriving growth from its global capital markets division, and TD deriving growth from its American retail banking segment. For RBC, its capital markets division contributes about 23% of earnings, while TD's American retail segment contributes 28% of earnings.

In RBC's case, however, about 28% of its capital markets segment is Canadian and will be exposed to lower advisory fees and corporate banking activity from the oil and gas sector. This gives RBC a far greater exposure to Canada than TD, and therefore, RBC is more exposed to any potential ripple effects from weak oil prices.

TD's growth trajectory through its American banking segment should be able to proceed unaffected by Canadian oil prices, and TD is exceptionally well positioned due to strong American economic performance, its northeastern U.S. geographic exposure (where there is no oil production and consumers will benefit from low gas prices), and a weak Canadian dollar.

Major headwind #2: an overvalued housing market

The second major headwind facing Canadian banks is a housing market that is estimated to be between 10-50% overvalued. In fact, Canadian's are spending on average 5.7 times their incomes on their homes, well above the three times income level, where previous housing bubbles have burst.

A potential housing price crash represents a significant risk for banks, since falling housing prices can cause home values to drop below the value of outstanding loans. If mortgage holders see diminished cash flows to due to job losses or an interest-rate hike, this could easily result in an increase in loan impairments and asset write-downs. This, in turn, reduces bank equity.

Once again, TD bank seems to have a better risk profile in this regard. First, TD has a lower percentage of domestic mortgages as a percentage of total loans than RBC, with only 38% of loans being domestic mortgages compared to RBC's 50%.

Second, TD has far more of these mortgages insured than RBC, with 68.4% of mortgages being insured compared with RBC's 45%.

Further reducing TD's risk is the fact that 32% of its uninsured loans originate in the U.S., meaning TD overall has a very small housing risk compared with RBC.

CATEGORY

1. Bank Stocks
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1. NYSE:RY (Royal Bank of Canada)
2. NYSE:TD (The Toronto-Dominion Bank)

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