Why Bank of Montreal Is Insulated From the Real Estate Bubble

Description

There is very little doubt—arguably none—that the Canadian housing market is in an unprecedented bubble. Most recently, the International Monetary Fund announced that Canadian home prices could correct anywhere from 7-20%.

As dramatic as a 20% correction sounds, this is only in the mid-range. The Bank of Canada warns that home prices are as much as 30% overvalued, and Deutsch Bank suggests that homes are as much as 63% overvalued. If valuations are this stretched, this poses a significant risk for Canadian banks.

Consumers are currently paying 5.6 times their income for homes (well above the 3.5 times income that corrections usually happen at), and should interest rates rise, or incomes decline, many homeowners would find making mortgage payments difficult to finance, which would increase loan impairments for banks, as well as write-downs and write-offs.

With Canadians already holding record levels of household debt and interest rates poised to rise, banks are at serious risk from a decline in housing prices. Fortunately, all banks are not equally affected, and **Bank of Montreal** (TSX:BMO)(NYSE:BMO) has some of the lowest housing exposure of its peers.

BMO has the lowest exposure to mortgages

One way of determining a bank's exposure to the housing market is by looking at its exposure to mortgages as a percentage of total loans. The lower the percent of mortgages, the less risk a bank has from those mortgages being written down or written off. Currently, BMO has the lowest mortgage exposure of its peers. As of Q1 2015, BMO had $102 billion in mortgages, out of $319 billion in total loans, representing about 33% of total loans.

This is fairly low, but it is even lower when it's taken into account that approximately $9 billion of these mortgages are U.S. based. This means that overall, only about 29% of BMO's total loans are domestic mortgages that are potentially exposed to any Canadian housing correction.

This is in contrast to **Royal Bank,** which has nearly half of its total loans being domestic mortgages.

BMO's mortgages are well protected

It is important to note that just because 29% of BMO's total loans are domestic mortgages, it does not mean all of these mortgages are fully exposed to any Canadian housing weakness. Canadian credit regulations require that mortgages with a value of over 80% of the underlying asset are backed by default insurance, usually provided by the Canadian Mortgage and Housing Corporation.

In this regard, an impressive 61% of BMO's domestic mortgages are insured, meaning these mortgages are largely insulated from any potential default risk. This is compared with 60% for **TD Bank,** and 44% for **Royal Bank.**

This insurance means that only about 17% (the uninsured mortgages) of BMO's total loans are exposed to housing risk. Although these mortgages would be adversely affected if home prices were to drop, or if interest rates rose, there is some protection in place.

Currently, BMO's uninsured mortgages have a loan-to-value ratio of 68%. This means that on average, BMO's mortgages cover 68% of the value of the underlying asset. This means that housing prices could potentially drop 32% before BMO would be in a position where it needed to write-down its loans, which provides protection from the type of correction that the IMF and Bank of Canada are predicting.

BMO current has strong credit quality

Currently, BMO's outstanding residential mortgages are of fairly high-credit quality. One way to measure this is by looking at the number of gross impaired mortgages as a percentage of total mortgages. Impaired loans are loans that have payments that are over 90 days past due and the bank has reason to believe they will not be able to collect principle or interest from the loan.

In this regard, only 0.55% of BMO's mortgages are considered impaired. Much of this, however, is American, and only 0.30% of Canadian mortgages are currently 90 days or more past due.

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