The 3 Biggest Headwinds Facing Toronto-Dominion Bank

Description

It would not be inaccurate to say that Canadian banks will be facing a drastically different environment, not only in 2015, but going forward. Banks are facing a low-interest rate environment, a faltering Canadian economy, low crude prices, an overextended housing market, and unprecedented competition from new competitors like **Apple** and **Google,** which are entering the payment space.

Toronto-Dominion Bank (TSX:TD)(NYSE:TD) has acknowledged the difficulty of the current operating environment and has responded with an organizational review, which has resulted in an unspecified number of layoffs with possibly more on the way as the bank looks to increase efficiency and reduce costs.

TD's CEO Bharat Masrani has stated the recent layoffs are a function of needing to adapt to "today's slower growth world," and while TD has been a spectacular investment over the past 20 years (returning almost 1000%), investors need to understand the key challenges going forward and how they will affect future returns.

1. TD Bank is facing risk from a prolonged period of low oil prices

In a recent interview, Bharat Masrani stated that low oil prices were a top concern and a key headwind for TD going forward. Broadly speaking, oil prices can affect TD in two ways—directly through the bank's exposure to oil & gas loans, and indirectly through a broader effect on the Canadian economy.

With regards to the direct exposure, TD currently has relatively low exposure to oil & gas loans relative to its peers. TD currently has about $4.4 billion in loans to the energy sector (which includes oil, gas, and pipelines), which in total represents 0.85% of the bank's total gross loans and acceptances.

This exposure is well below the peer average, and this, combined with TD's large U.S. and Ontario exposure, should help temper the effects of low oil prices in the short term. It is important to note, however, that prolonged periods of oil price weakness will likely adversely affect the bank. The bank could see more impaired loans and reduced loan growth, especially in commercial and consumer loans from Alberta.

2. An overvalued housing market puts TD's mortgage portfolio at risk

The recent period of unprecedented low interest rates has represented both risk and opportunity for the bank. On one hand, lower interest rates compress net interest margins for banks, which has resulted in the kinds of cost-cutting measures TD has recently announced. On the other hand, low interest rates have resulted in huge volume increases for the bank's loan portfolios, which has offset lower margins.

The problem is that the growth in loans has resulted in the Canadian consumer debt being at a record 163% of disposable income, most of which comes from mortgages. This, in turn, has propelled the

Canadian housing market to record highs as well, with the average home costing 5.6 times income, well above the 3.5 times income that marked the point that previous housing bubbles collapsed at.

Currently, the Bank of Canada is estimating the housing market is 30% overvalued, with some estimates coming in that are significantly higher. Should a 30% correction occur, this would put stress on TD’s earnings and capital.

Should interest rates increase and housing prices decline, TD could see mortgage holders being unable to absorb the impact of higher monthly payments, which could result in more impaired loans. This results in more provision for credit loss charges on the bank’s income, and could lead to the bank needing to write-down or charge-off loans, which could harm the bank’s capital.

3. TD faces risk from new competitors in the payment space

TD is facing increasing competition from the likes of Apple and Google, both of which are creating mobile payment systems that enable consumers to make purchases with their mobile phones by loading debit, credit, and loyalty cards onto an app, and swiping near a payment terminal.

This represents a huge risk for TD, since, in the case of Apple Pay—which is expected to launch in Canada later this year—banks pay fees to Apple in exchange for having their cards on the app. In addition, TD would lose a direct connection with its customers.

TD has responded with its own mobile payment app, called UGO, but it still limited in terms of card selection compared with what Apple is offering.

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