3 Reasons Bank Investors Don't Need to Worry About a Housing Crash

Description

If you are a shareholder of **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), **Royal Bank of Canada** (TSX:RY)(NYSE:RY), or another one of Canada's large banks, the recent news out of Canada's economy and housing market may have you concerned.

The average Canadian home is currently worth five times the median income, levels not seen before in history. The historical average is about 3.5 times incomes, and this is the level prices have typically reverted to after previous housing bubbles burst. A recent OECD report indicated that home prices are 30% overvalued relative to Canadian income, with the Bank of Canada echoing a similar 30% overvalued figure last December.

A correction seems almost certain

A look at the supply and demand situation reveals a correction may not be far off. Canada is currently building 2.1 houses for every new individual being added to the working-age population, which is a historically unprecedented level of housing construction. With the working-age population growth set to dwindle, interest rates set to rise, and Canadian debt-to-household income ratios at record levels, demand is at risk of dropping off at a time when there is record oversupply.

The combination of these statistics have lead major U.S. hedge funds to begin betting against Canada's big banks as a proxy for the housing market, and TD Bank, Royal Bank, and **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) are some of Canada's most shorted stocks.

How could a correction harm Canada's banks? The main concern is losses on residential mortgages. A sudden decline in housing prices combined with economic weakness could lead to mortgage values that exceed home values, which would in turn require banks to incur a loan loss, or write-down the value of the loan in the event that the buyer could not continue paying.

Canada's banks are well diversified

Fortunately, there are good reasons for bank shareholders not to worry. The first is that Canada's banks are, for the most part, very diversified. Today a smaller portion of revenue than ever comes from loans and interest income, with more coming from fees related to wealth management businesses, wholesale banking, or retail banking fees.

Non-interest income represents about half of Canadian banks' revenues on average, with wealth management, capital markets, and retail banking/insurance contributing an average of about one-third each. For the half of revenues that do come from interest income, a safe portion comes specifically from domestic mortgages

Looking to the balance sheet, about half of Royal Bank's total loans are domestic mortgages, compared with about 35% for TD Bank and Bank of Nova Scotia, and less than 30% for **Bank of Montreal** (TSX:BMO)(NYSE:BMO).

Mortgages are mostly insured

While the fairly small portion of the loan book occupied by domestic mortgages would be at risk from any housing downturn, the risk is much smaller than it seems thanks to the fact that most mortgages are insured.

Canadian banks are required to have insurance on any mortgage that has a loan-to-value ratio of greater than 80% on origination. These are ultimately the highest-risk mortgages, since a less than 20% drop in housing prices could but the bank at risk for loan losses on these mortgages. Mortgage insurance would guarantee the entire principle of the mortgage back to the bank in the event it cannot be recovered by selling the underlying home.

Currently, 68% of TD's domestic mortgages are insured, compared with 45% for Royal Bank, 52% for Bank of Nova Scotia, and 62% for BMO. The end result is that only a very small portion of these banks' loan books are exposed to risk, and the mortgages that are exposed would be lower-risk ones.

A crash would likely not lead to more defaults

Ultimately, falling housing prices are only a problem for banks if borrowers stop paying their mortgages. This would happen only if borrowers were unable to afford payments due to job losses, or due to inability to afford payments due to excessive debt.

Fortunately, in order to obtain a mortgage in Canada, payments must be 32% or less of income, and lenders also take into consideration total debt payments. The end result is that Canadians can afford their mortgages, meaning an increase in rates or declining prices is unlikely to lead to hugely increased defaults.

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Date
2025/08/26
Date Created
2015/07/31
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