Toronto-Dominion Bank vs. Royal Bank of Canada: Which Is More Recession-Proof?

Description

Over the past five years, **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) has outperformed **Royal Bank of Canada** (TSX:RY)(NYSE:RY) with five-year total annual shareholder returns of 16.5% versus 12% for RBC.

The past five years, however, have been a period of fairly decent economic growth. Currently, Canada is in a recession with two quarters of negative GDP growth, and even if growth is restored next quarter, Canada appears to be in for a period of economic weakness thanks to weak oil prices and overly indebted consumers.

A bank's performance is determined by the state of the underlying economy, and with Canada bracing for some economic headwinds, Canadians should own shares in the bank that can best withstand weakness.

Comparing TD's and RBC's capital ratios

When looking at a bank's ability to handle economic stress, capital ratios are the first place to look. A bank's capital is essentially its ability to absorb losses. Banks generally make money by borrowing from depositors and lending to borrowers, and in the event that outstanding loans are defaulted on, or need to be written down, a bank needs a way to absorb these losses so it can pay back its depositors.

This is why banks do things like retain earnings and issue shares, which allows them to effectively own some of their assets. When hard times fall on a bank, they can let shareholders take some of the impact, so depositors are protected.

Capital is measured using the common equity tier 1 ratio (CET1), which is basically a bank's capital divided by its total assets. In Q3 2015, both TD and RBC had a CET1 ratio of 10.1%.

Over time, both have had similar capital ratios, which are well above required amounts. TD, however, does have a better liquidity coverage ratio, which is a new measurement that banks are required to report as of January 2015. This measures a bank's ability to meet its cash requirements (by holding enough liquid assets) over a 30-day stress scenario.

TD can meet 122% of its liquidity needs versus 111% for RBC.

Comparing credit quality

During periods of economic stress, many borrowers may be unable to pay back all or part of their loans, and banks with poor credit quality are more affected by this.

The first way to measure credit quality is by looking at the percentage of gross impaired loans to total loans. In this regard, about 0.5% of RBC's loans are currently impaired as opposed to 0.57% of TD's loans.

While TD's impaired loans are slightly higher, TD's loan book has been weathering the current economic weakness, especially in the oil patch, much better than RBC. RBC saw a 10% increase in its impaired loans from the previous quarter, which included a huge four times increase in its impairments from the oil and gas sector.

TD saw a slightly lower increase in total impairments (8%), but most importantly, it only had a 59% increase in oil and gas impaired loans compared to the 300% increase RBC had.

Over the past several months of economic weakness, TD's loan book has been much more resilient because it is well diversified geographically with very small exposure to the energy sector compared with RBC.

Comparing the banks by diversification

Having solid diversification across geographies and business segments is an important aspect to being able to withstand a recession.

TD has an edge here. RBC has deep Canadian exposure, with 85% of its loans in Canada, 8% in the U.S., and 7% internationally. This is compared with TD, which has 68% in Canada, 30% in the U.S., and 2% internationally.

This U.S. exposure insulates TD from Canadian weakness and exposes it to the U.S. economy, which is currently the strongest growing developed economy.

While both banks can be considered safe, TD's strong credit quality and diversification make it a safer bet in a recession.

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

4. TSX:TD (The Toronto-Dominion Bank)

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