Why the Perception of Risk for Canada's Banks From a Housing Correction Is Overblown

Description

Canada's banks remain under considerable pressure as fears of weak Canadian economic growth and the impact of the oil rout weigh heavily on their outlook. A number of institutional investors are making bets that Canada's overheated housing market is set for a U.S.-style meltdown, which they believe will have a sharp impact on Canada's banks.

Despite these concerns, it appears that the perception of risk is overblown and comes from a fundamental misunderstanding of how risk is managed by Canada's banks.

Now what?

At the core of these concerns are fears that Canadian households are heavily indebted with a debt-to-income ratio of 171%, which is one of the highest in the world. This makes them particularly vulnerable to financial shocks including slower economic growth, rising unemployment, and even an eventual increase in interest rates.

The oil rout has already caused Canada's unemployment rate to rise to 7.2% for January 2016, 0.6% higher than the same period in 2015, triggering a rise in loan delinquencies among Canada's banks.

Declining economic growth continues to weigh heavily on the banks' growth prospects with 2015 GDP growing by 1.2%, half of what was recorded in 2014.

Rising unemployment and slowing economic growth will apply pressure to Canada's heavily indebted households and could trigger a correction in an overheated property market.

Nonetheless, these economic headwinds have had little overall impact on housing prices to date; the national average price for January 2016 rose by 16% year over year because of strong gains in a number of regional markets. Key among them were Toronto and Vancouver, where the average house price shot up by 14% and a whopping 30%, respectively.

Despite these risks, it is difficult to see a housing meltdown occurring because the volume of subprime mortgages only make up about 5% of the total value of all mortgages issued. This is significantly different to the U.S. housing market prior to the global financial crisis, where subprime mortgages were in excess of 25% of the total value of all mortgages issued.

There have also been considerable moves among the banks in recent years to tighten lending standards and significantly reduce their exposure to the subprime lending market. The banks have taken a conservative approach to managing credit risk; a considerable volume of mortgages have been insured and the banks have established conservative loan to valuation ratios (LVRs).

Of the total mortgages issued by **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), 55% are insured and the remaining uninsured mortgages have an average LVR of 68%.

Even **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS), which has been roughly handled by the market because of concerns about the quality of its loan portfolio, has 43% of its mortgages insured and an average LVR of 68% for those that are uninsured.

Canadian Imperial Bank of Commerce (TSX:CM)(NYSE:CM), which is one of the most vulnerable to declining economic growth and a housing meltdown because of its focus on the domestic market, has 56% of all mortgages insured.

The majority of Canada's banks have similar figures, highlighting that the impact of a housing correction on the banking industry would be minimal.

So what?

It appears that the market (or more specifically, foreign investors) have overcooked the risk associated with Canada's housing market and banking system. A U.S.-style housing meltdown is essentially unlikely, and the banks' conservative approach to risk management will ensure that if there is a sharp correction, their balance sheets will be shielded from the fallout.

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Date
2025/09/13

Date Created
2016/03/09
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