Dispelling 3 Myths About Toronto-Dominion Bank

Description

Canadian banks continue to garner considerable negative attention from investors, and now **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) is the most shorted stock on the TSX. The negative attention it and its peers are receiving is understandable given the harsh operating environment, fears of a housing meltdown, and the sharp collapse in crude.

In fact, most of the shorting is due to U.S. investors betting on a U.S.-style housing meltdown that would cause the share prices of Canada's banks to tumble.

Nevertheless, it appears that the significant volume of negative attention that Toronto-Dominion is receiving is unjustified.

Now what?

Firstly, fears of a U.S.-style housing meltdown and the considerable impact this would have on Canada's banks is unwarranted.

Many of the conditions that triggered the U.S.-housing meltdown in 2006 just don't exist in Canada. Canada has a significantly lower level of subprime mortgages, tighter lending standards, stricter regulation, and the existence of recourse loans.

This means that the mortgages issued by Toronto-Dominion allow it to not only foreclose on a borrower's home in the event of default, but it can seek financial damages if the value of the home is not enough to extinguish the liability. As a result, the bank's financial exposure is minimized.

You see, many of the mortgages issued in the U.S. were non-recourse, meaning that borrowers could walk away from their homes and related mortgage debt, leaving lenders with no recourse beyond the property, and thereby increasing the financial exposure of the banks that issued those loans.

Nonetheless, there are signs that the market is overheated, and this has led to a number of economists claiming that a cyclical decline or correction is likely. This, however, is not a bubble bursting in a disorderly manner, but rather a gradual correction over time.

Secondly, Toronto-Dominion employs a range of measures to manage credit risk and minimize the impact of a housing correction. The bank has 54% of its mortgage portfolio insured; the remaining uninsured loans have a conservative average loan-to-valuation ratio of roughly 68%.

It should also be noted that residential mortgages only make up 38% of its total loan portfolio, and the diversification of its portfolio also helps to mitigate the risks associated with a housing correction.

Finally, its exposure to oil is relatively low compared to the other major banks.

Toronto-Dominion's total exposure to the energy patch, including drawn and undrawn loans, comes to just over $15 billion, or less than half of that for **Bank of Nova Scotia**.

More importantly, of those total commitments, only $4.5 billion is drawn, which represents less than 1% of the value of its loan portfolio.

Accordingly, even if all of these borrowers defaulted, the impact on Toronto-Dominion's balance sheet and earnings would be minimal. The bank even estimated that if oil prices had remained around US$35 per barrel, its provisions for credit losses would only have increased by a maximum of 10% over current levels.

So what?

There are certainly a range of headwinds facing Toronto-Dominion, but the heavy shorting of the bank appears unwarranted. The risk of a U.S.-style housing meltdown occurring in Canada is extremely unlikely because of fundamental differences in the structure of Canada's financial system. Meanwhile, Toronto-Dominion's exposure to a housing correction is minimal, while its exposure to the beleaguered energy patch is quite low and is the second lowest of the Big Six banks.

All of these factors highlight that the degree of attention from short sellers is unjustified.

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