Debunking 3 Myths About the Risks Faced by Canada’s Banks

Description

Investors are concerned about Canada’s banks because of weak economic growth, their exposure to a deeply troubled energy patch, and an impending housing slump. This has led to heavy shorting of Canada’s banks with **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) and **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) being among the most shorted stocks.

It’s as if these investors are only chasing bad news, basing their decision to short what were described by the World Economic Forum in 2015 as the world’s best-managed banks on a fundamental misunderstanding of Canada’s financial system.

Now what?

A primary reason for the considerable short interest is that U.S. hedge funds are betting on a U.S.-style housing meltdown sweeping Canada’s real estate market. They believe this would take Canada’s banks to the brink of collapse because of their considerable exposure to housing.

However, there are a range of fundamental differences between Canada’s housing and mortgage markets and the U.S. housing market in the run up to its meltdown.

Firstly, Canada’s households are not as vulnerable to economic shocks as the extremely high household debt-to-income ratio of 171% indicates. This is because the risks are offset by a significant increase in net wealth among Canada’s households.

Furthermore, on average, Canadian households have 73% equity in their homes, giving them considerable wiggle room if they experience financial difficulties.

Secondly, Canada’s banks have substantially less exposure to high-risk mortgages than their U.S. counterparts did in the run up to the housing crisis.

This is because of stricter regulations, which means that there is a distinct lack of subprime mortgages; they only make up about 5% of all mortgages issued in Canada at this time.

Furthermore, all mortgages with a loan-to-valuation ratio of 80% or greater must be insured for the full value and length of the loan. As a result, just over half of Toronto-Dominion's mortgages are insured, whereas it comes to 48% for Bank of Nova Scotia, then 46% for **Royal Bank of Canada** (TSX:RY)(NYSE:RY), and 61% for **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM).

These factors coupled with the banks' conservative lending criteria significantly mitigate the financial impact on Canada's banks if there is a sharp or protracted downturn in the housing market.

Finally, Canada's banks have not invested in high-risk collateralized debt instruments.

It was these heavily marketed investments composed of high-risk subprime mortgages that brought the U.S. banking system to the verge of collapse almost overnight.

So what?

The short sellers are convinced that Canada's banks aren't prepared for the wave of bad debts that's coming with slowing economic growth, the protracted slump in crude, and a soon to burst housing bubble set to apply considerable pressure to their finances.

However, the characteristics of Canada's housing market, the structure of its financial system, and management of risk within Canada's banks are very different to what was witnessed in the U.S. during the run up to the housing meltdown. Claims that Canada is heading for a massive housing meltdown that will push the banks to the brink of collapse are fanciful at best.

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