3 Reasons Every Canadian Bank Shareholder Should Be Worried About the Housing Market

Description

The group of experts sounding the alarm over the rapid price appreciation in key Canadian housing markets is growing by the day. The Bank of Canada recently listed a correction in housing prices as the most severe risk to the Canadian economy, and analysts at Capital Economics stated that the Canadian housing market is in a historic bubble that is "going to end in tears."

The Bank of Canada's recent Financial System Review stated that the potential for a downturn in prices in the key Toronto and Vancouver housing markets is growing; the current pace of price appreciation is unsustainable and demand ultimately will not be able to continue supporting it.

Canadian bank shareholders would be one group to lose in the event that home prices pull back 10-30%, which is the general range for how overvalued housing is in Canada. **Royal Bank of Canada** (TSX:RY)(NYSE:RY) and **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) have the most to lose in this scenario, because they have the highest exposure to uninsured real estate loans in Ontario and Vancouver (the areas where price growth has been the most rapid).

Royal Bank currently has 21% of uninsured mortgages and HELOC's in Ontario and B.C., and Bank of Nova Scotia has 16.5% in Ontario and B.C. (compared to the average of 16% for Canada's Banks).

Here are three reasons why every bank shareholder should keep an eye on housing risk.

Canadian household debt is growing out of control

Currently, household debt to disposable income in Canada is on the uptrend, rising from 163% to 165% in 2015. This gives Canada the highest personal debt levels out of all the G7 economies and makes Canada's debt levels 17 percentage points higher than the United States's household debt ratio of 147% that it experienced before its massive housing crash in 2008.

Most of this is mortgage debt, and mortgage debt has been exceeding income growth by a fair margin. This is a major risk factor, since it makes Canadian households extremely vulnerable to any type of economic shock such as an increase in interest rates or any type of economic slowdown that causes an increase in unemployment or a weakening in wages.

An increase in unemployment would lead to more difficulty in servicing high debt levels, which would in turn lead to more foreclosures and selling. If a sell-off is rapid, loan values could exceed home values, which puts banks in a position of needing to hike provisions for credit losses (which harms earnings) and write down assets. This could erode banks' capital ratios, which would certainly spark a sell-off in bank shares.

While a recent report by **Moody's** found that Canadian banks could withstand a 35% decline in housing prices, significant declines in share prices would be expected. RBC is expecting to see the largest losses of the group.

Household debt is increasingly concentrated among riskier borrowers

It is clear household debt is growing, but which groups are the source of the growth? The Bank of Canada stated that most of the debt growth has been concentrated among younger households (under 45) with higher debt levels, which are much riskier and more vulnerable to economic shocks.

While debt among households with lower debt-to-income ratios (under 250%) has been fairly stable since 2002, debt among individuals with debt-to-income ratios over 450% has been growing. Canada-wide, this number has been growing steadily; in 2015 alone, uninsured mortgages with debt-to-income ratios of over 450% were 15% of total mortgages compared to 12% in 2014.

In areas like Toronto, it grew from 30% to 40%.

Price growth is out of control

In the past year alone, home prices in Vancouver are up 30% and home prices in Toronto are up 15%. Vancouver home prices are up 172% over the past 15 years, despite the fact that incomes have only risen 10%. This is an unsustainable situation driven by historically low interest rates and foreign demand, but it is ultimately unsustainable as higher home prices reduce affordability, which in turn affects demand.

It is almost certain that home prices will decline to some extent, and while Canadian banks have healthy loan-to-value ratios, large percentages of insured mortgages, and good capital ratios, even a mild slowdown in the housing market is bad news for loan growth as Canadians focus on deleveraging and the construction sector slows.

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