Why Royal Bank of Canada Is in Trouble if This Latest Report Is Accurate

Description

There has certainly been no shortage of bearish reports on the Canadian housing market. The Bank of Canada recently stated that housing price gains in Vancouver and Toronto were unsustainable, and that the risk of a material correction is growing. Late last year the bank stated the housing market was overvalued by as much as 30%.

A recent report by Capital Economics, however, found that the risk in the Canadian housing market is even more severe than the Bank of Canada assumed. The report stated that the Canadian housing market is in a "very big bubble," and based this conclusion on several different facts.

The report cites growing levels of household debt (currently at a high of 165% of income in Q1 2016), which has been fueled by declining interest rates; this means that Canadians can take on growing debt levels without needing a higher income. With the price of real estate constantly appreciating, the debt required to own real estate is only growing, which only encourages more debt growth.

The report described how it isn't just debt that's growing, but it's mostly mortgage debt, and, more specifically, higher-risk mortgage debt. This largely refers to uninsured, long-amortization mortgages to individuals with high loan-to-income ratios. This is fine as long as real estate prices are appreciating, but should they pull back dramatically, Canadians with precarious economic positions will be stuck with falling home values and fixed debt costs.

Not only do Canadians lose in this scenario, but so do the banks, and **Royal Bank of Canada** (TSX:RY)(NYSE:RY) is the most exposed.

Canadian banks are lending out riskier mortgages

Similar to what happened in the U.S.—where banks began lending to higher-risk individuals—Canadian banks have been originating higher-risk mortgages, albeit to a lesser degree. One measure is the proportion of loans being originated to borrowers with high loan-to-income ratios. For example, looking at insured mortgages (mortgages with a down payment of 20% or less, typically), 21% had a loan-to-income ratio of over 450% in 2015 (compared to only 16% in 2014).

More concerning, however, is that these numbers are rising among uninsured mortgages as well. These are mortgages without federal government guarantees, and they typically have down payments of more than 20%. While these mortgages are considered lower risk because they have more equity, a severe enough housing correction could still take these loans underwater.

In the uninsured loans category, 24% of total loans had loan-to-income ratios of over 450%, compared to only 19% in 2014. Even more troubling is the fact that amortization periods are also being stretched out among uninsured loans. Amortizations of over 30 years are considered riskier, since they allow borrowers to take larger loans and stretch their repayment over longer time frames, allowing for smaller monthly payments.

Between 2014 and 2015 the percentage of borrowers without insurance that had amortizations of over 25 years grew 10%, and this number is expected to grow again in 2016.

Royal Bank is the most exposed of the Canadian banks

A recent **Moody's** report that tested a 35% decline in Canadian housing prices confirmed that Canadian banks would suffer losses of $18 billion, and that Royal Bank would be the hardest hit.

It is fairly easy to see why.

Royal Bank has the highest exposure to uninsured mortgages and HELOCs in Ontario and British Columbia. This is where the largest price declines would occur. Currently Royal Bank has 20.7% of total loans as mortgages and HELOCs to these regions (the highest of the Big Six banks and five percentage points above the group average).

Currently, 54% of Royal Bank's domestic residential mortgages are uninsured with an average loan-to-value ratio of 70% for newly originated mortgages in 2016. These mortgages could withstand a 30% decline in housing values before Royal Bank wouldn't be able to recover the full value of the loan by selling the underlying property.

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