Why Canada Will Avoid a U.S.-Style Housing Meltdown

Description

Canada's banks are garnering considerable negative press because of a growing chorus of market pundits claiming the banks are dangerously exposed to Canada's property bubble and an impending housing meltdown. This is creating considerable nervousness among investors, homeowners, and policy makers alike.

The way some pundits tell it, Canada's housing market is in a worse state than that which existed in the U.S. in the run-up to the 2007 subprime crisis. When the bubble bursts, it will trigger a financial meltdown that will wipe billions off the value off the banks. This couldn't be further from the truth because Canada's mortgage market is fundamentally different from that which existed prior to the U.S. housing collapse.

Now what?

Contrary to popular belief, Canada is not caught in a nationwide housing bubble. According to the Canadian Real Estate Association, the national average house price for August 2016 rose by just over 5% year over year. Much of this was driven by the red-hot market of Toronto, which posted an almost 18% gain compared with a year earlier according to the association.

Other major urban centres such as Montreal, Ottawa, and Calgary posted far more modest year-over-year gains with the average house price rising by 5.2%, 4.2%, and 1.4%, respectively. There are even signs that a number of markets are cooling. Edmonton's average house price remains unchanged, and Vancouver's dropped by almost 10%.

This is in stark contrast to the U.S. housing bubble, where prices grew at a scorching double-digit pace annually across several major metropolitan areas between 2001 and 2006.

Then there is Canada's compulsory mortgage insurance for all loans with a loan-to-valuation ratio, or LVR, of greater than 80%, which forms an important backstop for the banks.

Mortgage insurance is a powerful tool for minimizing losses. The insurer agrees to reimburse the bank for the difference between the funds recoverable when a borrower defaults and those owing under the terms of the contract.

The majority of the mortgages issued by Canada's major banks are insured.

In the case of **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) 51% of its Canadian residential mortgages are insured, whereas for **Royal Bank of Canada** (TSX:RY)(NYSE:RY), it comes to 48%. Even **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM), which is considered by analysts to be the most vulnerable of the Big Six, has 57% of its residential mortgages insured.

It is also important to consider that along with far stricter prudential regulation, Canadian banks have taken a more conservative approach to lending.

Consequently, there is a distinct lack of subprime mortgages. Subprime mortgages comprised 21% of all U.S. mortgages originated by 2006 and were a leading cause of the U.S. housing crash.

In fact, subprime loans only form about 5% of all mortgages issued in Canada at this time–well below the level that poses a risk to housing prices or the financial system.

In the case of uninsured mortgages, the average LVR for the major banks is at about 70%, providing plenty of wiggle room should housing prices fall sharply. This number is even lower for the two major banks believed to be the most exposed, Canadian Imperial and **National Bank of Canada** (TSX:NA), which have an average LVR of 57% and 59%, respectively.

So what?

These often overlooked characteristics will shield Canada's housing market from a catastrophic meltdown. After all, in the U.S., it was the perfect storm created by a combination of extensive subprime lending, non-recourse loans, and lack of mortgage insurance that triggered an alarming cascade of lower house prices once the bubble started to deflate.

CATEGORY

1. Bank Stocks
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TICKERS GLOBAL

1. NYSE:CM (Canadian Imperial Bank of Commerce)
2. NYSE:RY (Royal Bank of Canada)
3. NYSE:TD (The Toronto-Dominion Bank)
4. TSX:CM (Canadian Imperial Bank of Commerce)
5. TSX:NA (National Bank of Canada)
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