Is Canadian Western Bank's Mortgage Portfolio Really High Risk?

Description

Regional lender **Canadian Western Bank** (TSX:CWB) garnered considerable negative attention because of what many pundits perceive to be an increasingly risky loan portfolio. While the bank has had to weather its fair share of headwinds in recent years, much of that attention is arising from a misunderstanding as to how risk is measured.

Now what?

A key fear being expressed about the bank is that its lending portfolio is comprised of high-risk subprime loans. Since the U.S. housing meltdown and near collapse of its banking system, the term *subprime loan* conjures up an image of fraudulent mortgages, jingle mail, and borrowers that, under normal circumstances, would never qualify for a loan.

While the volume of subprime mortgages in Canada has grown in recent years, they certainly don't possess the same characteristics as those that existed in the U.S. in the lead up to the housing crisis.

You see, Canada's prudential regulations are far stricter than those which existed in the U.S. prior to the housing bust. This means those mortgages labelled as a subprime typically fail to meet the exacting standards of Canada's Big Six banks. They are not fraudulent and, in many cases, are solely classified as subprime because borrowers have little to no credit history and/or are self-employed.

One of the major headwinds impacting Canadian Western has been the oil slump**,** because the majority of the bank's business is focused on western Canada and the oil patch.

To mitigate the impact of the economic downturn in the energy patch and boost its growth prospects, Canadian Western acquired the Maxium Group of companies in 2015. This boosted its presence in the eastern provinces and growth opportunities by expanding its broker-driven alternate mortgage business.

It did not, however, equate to Canadian Western accepting U.S.-style subprime mortgages or taking on significantly more risk in its loan portfolio.

This becomes quite apparent when we take a closer look at the numbers.

Mortgages from the Optimum portfolio make up only 11% of the total value of the bank's loan book. While some pundits claim this has increased the level of risk in its loan book by lifting the average LTV, this couldn't be further from the truth.

Prior to the acquisition, Canadian Western's mortgage portfolio had an average LTV for uninsured loans of 1%. Since the deal was completed, that has fallen to 68%; along with a 4% reduction in the value of uninsured mortgages, this indicates a lower level of risk.

While there has been a decrease in credit quality reflected by the ratio of gross impaired loans to total loans rising from 0.48% to 0.62%, much of that can be attributed to deteriorating economic conditions in western Canada.

There are also the disturbing claims that the bank is not provisioning adequately because the ratio of provisions for credit losses to average loans does not reflect the ratio of gross impaired loans. These claims are simply not true. Let me explain why.

There is no requirement to provision for the full value of impaired loans. The value of provisions is determined by allowing for the value of any underlying security pledged as collateral, costs of realization, observable market prices, and expectations about the future prospects of the borrower and any guarantors.

When assessing if a bank has adequately allowed for credit losses, it is more important to examine the coverage ratio. This measures its ability to absorb lending losses by comparing the value of allowances for credit losses against the value of gross impaired loans.

In the case of Canadian Western, this ratio currently stands at 99%, indicating that it is capable of absorbing current recognized credit losses. It is, however, 23% lower than it was prior to the Maxium purchase, indicating that the bank has reduced the capital tied up in allowing for credit losses.

This is a smart move, because credit loss allowances come with an economic cost by diverting capital away from revenue-generating activities.

So what?

Canadian Western Bank is experiencing a significant uptick in risk in its loan portfolio, but this is because of western Canada's weaker economy rather than its move into alternate mortgage lending.

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