Will Canada’s Red-Hot Housing Market Trigger a Financial Crisis?

Description

The red-hot housing markets of Toronto and Vancouver coupled with high levels of household debt are keeping policy makers awake at night. They believe these economic elements pose a significant threat to the stability of Canada’s financial system.

Some pundits have gone as far to claim that the crisis at **Home Capital Group Inc.** (TSX:HCG) is the canary in the coal mine, indicating that a housing bust is looming, and that it will be a catastrophe for Canada’s financial institutions. Others have gone as far to claim that Canada will be rocked by a U.S.-style housing market collapse that will trigger a financial meltdown.

These views are based on the belief that Canada’s financial system is loaded with substandard mortgages that many households are incapable of affording should they be exposed to financial shocks. Many hedge funds and other institutional investors that missed out on profiting from the U.S. housing implosion are betting on a similar event occurring in Canada.

As a result, there is considerable short interest in Canada’s major banks. **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) is the second most shorted stock on the TSX, and **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) is the 13th.

Now what?

The likelihood of a U.S.-style housing meltdown and the near collapse of the financial system occurring in Canada is remote.

You see, there are distinct differences between the situation that exists in Canada today and that which existed during the great U.S. housing boom which began at the start of the millennium.

Key among the differences is the lack of subprime mortgages, which are those mortgages that don’t meet standard underwriting criteria and consequently are higher risk.

According to analysts, subprime mortgages make up roughly 5% of all mortgages, but in the U.S., at the peak of the housing boom in 2006, they made up over a third. A large portion of those subprime mortgages were fraudulent or had been provided to borrowers who would not normally qualify for a loan. This made those borrowers extremely vulnerable to external shocks such as higher interest rates at the end of the honeymoon period.

Credit quality among Canada’s financial institutions remains high.

The value of gross impaired loans as a proportion of total loans under management for all the major banks is 1% or less. Toronto-Dominion’s ratio at the end of the first quarter 2017 was 0.85%, and for Bank of Nova Scotia, it was 1%.

As a result, there would need to be a massive increase in delinquencies for impaired loans to rise to dangerous levels.

Then there are the conservative loan-to-valuation ratios, or LTVs, of the banks’ portfolios.

For the uninsured portion of the major banks’ mortgage portfolios, this ratio on average stands at about 50%. In the case of Toronto-Dominion, it comes to 53%, and for Bank of Nova Scotia, it is at 51%. This gives the banks considerable wiggle room should they need to renegotiate and recover uninsured mortgages that have fallen into arrears, preventing the need for them to foreclose on the properties used as security.

That in conjunction with compulsory mortgage insurance for all loans with an LTV of greater than 80% forms an important backstop for the banks.

These factors reduce the rate at which mortgages will fall into default, reducing the need for lenders to rapidly repossess and sell those properties to recover the balance outstanding. It was the rapid rate of defaults coupled with lenders moving to sell repossessed properties as quickly as possible in an oversupplied market that caused prices to spiral ever lower in the U.S.

So what?

A sharp decline in housing prices won’t have the same impact on Canada’s banks and trigger a financial meltdown as the epic housing bust 10 years ago in the U.S. For the reasons discussed, there are a range of factors that will not only slow the decline in housing prices, but will also protect the banks from financial catastrophe.

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