Fitch Ditches Canadian Imperial Bank of Commerce: Should You?

Description

We've seen this movie before. Spoiler alert: it ends well.

The analysts have been complaining for years about **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) and its exposure to Canadian housing. Now Fitch, the credit rating agency, has decided to jump on the bandwagon, lowering its outlook for CIBC's debt from stable to negative on concerns it's the most exposed to the Canadian housing market.

Fool contributor Joey Frenette discussed this very subject in early September, suggesting the bank isn't nearly as worried about its mortgage growth as organizations as Fitch seem to be.

"We're very comfortable with our mortgage growth. We've been growing faster than the market and that may continue for a little while longer," CIBC CFO Kevin Glass said after reporting Q3 earnings. "We are not at this point anticipating any sort of hard landing. I think there may be some moderation."

Why do you think this is?

There are only two explanations for CIBC's nonchalant view of its mortgage situation. Either it's putting on a brave face to keep its inexpensive stock price from getting any cheaper, or it really is confident about its underwriting and understands the risks aren't nearly as high as Fitch and others would like us to believe.

+90-day delinquency rates

Overall, its +90-day delinquency rate is 0.23%, three basis points fewer than in the third quarter a year earlier and two basis points fewer than in Q2 2017. That includes both insured and uninsured mortgages. The +90-day delinquency rate for uninsured mortgages is 0.17%, or six basis points fewer than overall. Even better, the +90-day delinquency rates on uninsured mortgages in Vancouver and Toronto are 0.07% and 0.06%, respectively, or about one-third its overall average.

The +90-day delinquency rates for Toronto and Vancouver are lower than the national average.

So, what is it that's got Fitch and the analysts so bent out of shape?

CIBC has 44% of its mortgage balances in Toronto and Vancouver. Because of price appreciation in the two cities, mortgages with loan-to-value (LTV) ratios of above 60% in Toronto and Vancouver are just 16% and 15%, respectively. For all of Canada, that jumps to 34%, or double the amount. CIBC's average LTV ratios for uninsured and insured mortgages is 52% and 54%, respectively. Forget the insured mortgages for a moment, and let's focus on the uninsured ones.

At the end of July, CIBC had $106 billion in uninsured mortgages. If you apply the 44% number from above, Toronto and Vancouver mortgage balances accounted for $47 billion, and the rest of Canada, $59 billion.

So, that means Toronto and Vancouver uninsured mortgages with LTV ratios greater than 60% is $7 billion. For the rest of the country, it's $29 billion, or just less than half the uninsured mortgages.

Do you get where I'm going with this?

If the average price of a house in both cities is $1 million, and the average uninsured mortgage is $700,000, and if the price of a home drops 20% in a year, the LTV ratio goes from 70% to 88%, becoming a significant problem.

Fitch thinks this is far more likely in Toronto and Vancouver's overheated markets than anywhere else in Canada.

The problem with this rationale

The bigger issue is the HELOCs held by Toronto and Vancouver mortgage holders. As interest rates rise, those ATM-like loans will be harder to maintain. Of the $22 billion of HELOCs outstanding with CIBC clients, $9 billion is held by people living in Toronto and Vancouver, or about 41% of the total.

But even here, the rest of the country is in worse shape than in Toronto and Vancouver. HELOCs in Toronto and Vancouver are equal to 19% of the uninsured mortgages compared to 22% for the rest of the country.

Last October, I highlighted the bank's arguments as to why it thinks its Canadian mortgage portfolio is doing just fine, especially in Toronto and Vancouver. I don't believe anything has changed to alter that opinion.

If CIBC gets taken down, it won't be because of its exposure to Toronto and Vancouver. It will be because it has a whole lot of mortgages in small towns across the country that won't get paid if the economy stops growing and we move into a recession.

If that happens, all the banks will suffer greatly.

Until then, I have no hesitation recommending CIBC stock over the rest of the banks.

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