Shorting Canada’s Banks: Where Hedge Funds Go to Lose Money

Description

In a somewhat surprising result, the five most shorted stocks on the TSX are Canada’s big five banks. Most short sellers are U.S. hedge funds, which, having missed the U.S. housing meltdown in 2007, have been hunting for the next big short ever since. **Royal Bank of Canada** is the most shorted stock, followed by **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS), **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), **Bank of Montreal** and finally **Canadian Imperial Bank of Commerce**. While Canada’s banks are facing headwinds, it is virtually impossible to see a housing meltdown occurring.

Canada’s housing market is not the next big short

Despite this having been a losing trade for almost a decade, since the global financial crisis ended in 2009, U.S. hedge funds are convinced that they are right and have identified the next big short. They fail to understand the significant differences between Canada’s housing market and the strength of its banking sector compared to the U.S. in the lead-up to the housing calamity that morphed into a full-blown economic crisis.

A key difference is the lack of subprime or substandard mortgages. The U.S. housing bubble, which burst in 2008, was triggered by a massive credit boom initiated by prudential deregulation, which rendered many aspects of financial oversight and regulation ineffectual. That allowed the banks to generate massive profits by underwriting mortgages for just about anyone.

That has in turn caused the quality of home loans to deteriorate to the point that when the housing market began to show signs of instability, somewhere between a fifth and a third of all mortgages issued were rated as subprime. Additionally, many loans were fraudulent in nature and countless households after a period of honeymoon rates were unable to afford built in balloon payments and rate increases. That saw many, especially as the bubble burst and housing prices cascaded lower, simply abandon their properties because the loans were non-recourse in nature.

The exact opposite has occurred in Canada, however.

The prudential regulator the Office of the Superintendent of Financial Institutions (OFSI) has been progressively tightening mortgage underwriting standards. It is estimated that the value of subprime mortgages is less than 5% of all home loans issued. It should also be noted that while many loans are classified as subprime because of less than satisfactory credit scores, the borrowers are still capable of meeting repayments.

Canadian mortgages are recourse in nature, meaning that lenders can pursue borrowers for the balance owed even after the property has been repossessed. This significantly reduces the incentive to simply abandon an unaffordable property and increases the motivation for borrowers to maintain payments or renegotiate loans to manageable levels.

All mortgages in Canada with a loan to value ratio of less than 20% are required to have mortgage insurance, an important backstop for lenders. Essentially, when a borrower defaults, the insurer will continue making repayments.

Those factors mean that banks are not required to scramble and repossess homes where the mortgage is in default and then selling them as quickly as possible at a deeply discounted price to recoup some of the loan. That prevents a vicious cycle of housing prices cascading ever lower as more and more homes are repossessed and sold at fire sale prices, which quickly became a feature of the U.S. housing meltdown.

Notably, all of Canada's big banks have solid balance sheets and high-quality credit portfolios. Toronto-Dominion reported a first-quarter 2019 net impaired loan ratio of 0.41%, whereas for Scotiabank report 0.61%. Those ratios are well below the level that indicates concerns over the quality of their loan portfolios. The health of their balance sheets is further underscored by more than adequate tier 1 capital ratios of 13.5% and 12.5%, respectively, indicating that they are well capitalized.

Furthermore, 31% and 42% of all Canadian mortgages issued by Toronto-Dominion and Scotiabank are insured, substantially mitigating the impact of any uptick in defaults triggered by adverse economic conditions.

Ignore the short-sellers

While a slowing mortgage market, a high degree of household debt evident from the household debt to income ratio hovering at around 175% and softer economic outlook don't paint a rosy picture, it's difficult to see Canada's major banks faltering. The strength of Canada's banks and their long history of earnings growth as well as dividend hikes means that at least one should be a core holding in every portfolio. Scotiabank stands out because of the considerable growth opportunities created by its substantial international exposure in Latin America.

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2. NYSE:TD (The Toronto-Dominion Bank)
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