Don't Panic! Eisman and Other Short-Sellers Are Wrong About Canada's Banks

Description

Considerable hype is being generated after legendary investor Steve Eisman of *Big Short* fame announced he is targeting Canadian banks. He believes the major banks will tumble in value as the bad credit cycle worsens because of poorly underwritten mortgages, heavily indebted households, and as tepid economy which will cause more borrowers to default.

The largest lender, **Royal Bank** (TSX:RY)(NYSE:RY), is attracting the most negative attention. It's ranked as the most shorted stock on the TSX. It is followed by **Bank of Montreal** (TSX:BMO)(NYSE:BMO) in fourth place, **Toronto-Dominion** in seventh, and **Scotiabank** (TSX:BNS)(NYSE:BNS) as the ninth most shorted stock on the exchange.

Shorting Canada's banks is risky

It isn't only Eisman shorting Canada's banks; they have long been targets of U.S. hedge funds and traders all betting on a housing meltdown and imploding credit bubble. So far, those short-sellers have lost tremendous amounts of money with Canada's banks going from strength to strength since the global financial crisis, which was triggered by the U.S. housing and credit bubbles bursting.

Undeniably, there are headwinds facing Canada's banks, key being a lack of growth prospects domestically because of a softer housing demand and a saturated financial services market.

Nonetheless, there is little to no evidence to indicate that a catastrophic decline in credit quality will occur, nor that a U.S.-style housing meltdown is likely. This is because of stricter prudential regulation in Canada, especially in relation to the underwriting of mortgage, which has prevented even a moderate volume of subprime loans being underwritten.

In fact, the Big Five possess high-quality credit portfolios, as underscored by their low gross impaired loan ratios. For the latest quarter, Royal Bank reported a ratio of a mere 0.46%, whereas for Bank of Montreal it was 0.48%. Even Scotiabank, which has established a sizable footprint in the high-growth but risky Latin American markets of Mexico, Colombia, Peru, and Chile, disclosed a ratio of 0.9%.

Those ratios are well below the level required to indicate there are issues with credit quality and illustrate that it would take a substantial, if not unimaginable volume of defaults to seriously damage what are sound, high-quality balance sheets.

Then you have compulsory mortgage insurance for all loans underwritten with a loan-to-value ratio (LTV) of less than 20%. During economic downturns and times when loan defaults are rising, this forms an important backstop for lenders with the insurer taking over payments when borrowers default. At the end of the first quarter, 38% of Royal Bank's Canadian mortgages were insured, whereas for Bank of Montreal and Scotiabank, that was even higher at 44% and 42%, respectively.

The conservative nature of the big bank's approach to credit management is underscored by the low LTVs for the proportion of their mortgage portfolios which are uninsured. Royal Bank's uninsured housing loans, including HELOCs, had an average LTV of 51%, whereas for Bank of Montreal and Scotiabank it was 50% and 64%, respectively. Such conservative ratios indicate that there is plenty of room to maneuver should dire economic conditions trigger an uptick in defaults from already financially stretched households.

Furthermore, because of stricter prudential standards, all of Canada's major banks are more than adequately capitalized with common equity tier one capital (CET1) ratios well in excess of the regulatory minimum. Royal Bank finished the latest quarter with a CET1 of 11.4%, which was higher than Scotiabank's 11.1% and equal to Bank of Montreal's ratio of 11.4%.

For these reasons the banks won't suffer as substantially as Eisman and other short-sellers believe if there is a decline in the credit cycle sparking a greater surge in default and impaired loans.

Scotiabank, which has established a sizable presence in Latin America, won't be as sharply impacted by the headwinds facing those banks that are more domestically focused. Scotiabank generates 40% of its net income from international banking and is experiencing strong growth in Latin America, where first quarter loans grew by 44% year over year. Revenue earned by the bank's operations in those nations surged by a remarkable 31%. This robust growth will continue for the foreseeable future, as Scotiabank beds down recent acquisitions that were completed in the region and unlocks further efficiencies.

Putting it together

The banks most vulnerable to an economic slowdown and uptick in impaired loans are those with the greatest domestic focus. Despite the views expressed by Eisman, who is, by all accounts, a legendary investor, I believe that Canada's major banks will continue to deliver value for the foreseeable future. Of the Big Five, it is Scotiabank that stands out as having the strongest growth potential because of its extensive Latin American exposure.

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Author
mattdsmith