Canadian Banks: Overexposed to Mortgages?

Description

There is a growing fear that the banking system in Canada could be vulnerable in the event of a housing bust. If the once-red hot housing markets are slowing down, would the big banks with significant exposures mortgages be gravely affected?

Royal Bank of Canada (TSX:RY)(NYSE:RY) and **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE: CM) are two of the big six banks in the country. Major credit-rating agencies have downgraded both stocks due to the banks' exposure to the slowing housing markets.

No cause for alarm

RBC is Canada's largest bank in terms of asset size and market capitalization. Residential mortgages account for 66% of RBC's retail loans portfolio, where 3.5% fall under the high-risk classification. There's a possibility that a housing crash could weigh heavily on the top and bottom lines of this banking giant.

I would have to agree in some measure, but not to the point of raising alarm bells. RBC's strong dividend history dating back to 1870 is proof that the bank would be unshakeable regardless of market scenarios. It has witnessed the worst financial crisis and is more than capable of riding out a housing crisis.

Aside from its excellent dividend history, RBC's stable capital position is the result of its record of prudent risk and cost management. You should take comfort in the fact that the Canadian banking system has stricter prudential regulations in place to thwart the proliferation of low quality or sub-prime mortgages.

Equally resilient

The talk of an overheating housing market in Canada began in May 2018. Many were asking whether Canada's biggest mortgage lenders, including CIBC, could endure a severe market meltdown, particularly a mortgage crisis similar to the U.S. in 2007.

Moody's Investors Service simulated various scenarios that show record-high household debts and rapidly increasing house prices. Moody's patterned the situations after the actual events leading to the U.S. sub-prime fiasco.

The results of the simulations by the credit-rating agency are not surprising at all. CIBC and its banking counterparts can easily absorb a U.S.-style mortgage crash without catastrophic losses. Should there be losses, it would take no more than a quarter for CIBC to recover from housing-related losses.

Keep in mind that CIBC has been a top dividend payer since 1868. The bank has been steadily raising dividends except during the financial crisis in 2000 and 2008. The stock's 5.2% dividend is the highest in the banking sector.

High credit quality

RBC and CIBC are top mortgage lenders with a conservative approach. To safeguard mortgage portfolios and contain the risks, every mortgage with a loan valuation ratio (LVR) of more than 80% are covered by mortgage insurance. That has been the practice of all mortgage lenders in Canada.

Because of this insurance requirement, you won't see a deterioration of the housing portfolio. RBC and CIBC could work out alternative ways to recover outstanding balances in case of default.

Your investments in RBC and CIBC are secure because credit quality remains high. Besides, Canada is far from a massive housing bubble. Even if the housing markets were to cool down drastically, RBC and CIBC could still be your best long-term investment options.

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