Can Canada’s Big Banks Survive a Coronavirus Recession?

Description

One of the sharpest and swiftest economic downturns witnessed in modern times is bearing down on Canada’s banks. The market has punished the Big Six banks after the coronavirus pandemic triggered a meltdown. Fears of a deep recession, which some economists believe could dwarf the 2008 Great Recession, is weighing heavily on banks. The Big Six have already experienced a sharp decline in their market value. Canada’s largest lender, **Royal Bank of Canada** (TSX:RY)(NYSE:RY), has suffered the least, losing 17% for the year to date.

A deep recession is looming

A looming property crash, sharp rise in unemployment, and extreme levels of household debt will spark a surge in loan defaults. That will apply considerable pressure to the banks. Many are already facing headwinds because of fallout from the coronavirus pandemic and an emerging recession. Surveys indicate that Canadian households are particularly vulnerable to external economic shocks. This is because they have one of the highest ratios of debt to income in the developed world. As coronavirus layoffs, notably across the hospitality, entertainment, and hotel industries, gain momentum, many will face unprecedented financial pressure.

According to a recent *Financial Post* article, almost half of all Canadians are on the brink of insolvency. A quarter of respondents claimed that they were already unable to meet their financial obligations. That points to the growing likelihood of a sharp increase in loan defaults for Canada’s banks. A substantial increase in impaired loans will have a marked impact on the balance sheets and earnings of the Big Six banks. It will force them to redirect capital from productive revenue-generating activities to provisions for impaired loans.

There are fears that a coronavirus-induced recession could be longer and deeper than the Great Recession. That would force the banks to protect their balance sheets through a range of measures. These include controlling costs by reducing their employee head count, dialing down spending on growth initiatives, and potentially even cutting dividends.

Mitigating risk

The Big Six banks have implemented strategies to mitigate the risks associated with an economic downturn. Key is that all mortgages with a loan-to-value ratio (LVR) of less than 80% require mortgage insurance. In the case of Royal Bank, that means 34% of its Canadian residential mortgage portfolio is protected by insurance. That shifts the financial burden for those mortgages, if the borrowers default, to the insurer.

Royal Bank’s Canadian residential mortgage portfolio has a conservative LTV of 53%. This indicates that it would take a considerable decline in property values to impact the bank’s mortgage portfolio. It also illustrates that there is plenty of room for Royal Bank to restructure impaired loans.

Importantly, each of the Big Six have low gross impaired loans ratios, highlighting that it would take a significant surge in defaults to have a material impact on their balance sheets. Royal Bank finished its fiscal first quarter 2020 with a gross impaired loans ratio of 0.45%, which is one of the lowest among the Big Six, underscoring the quality of its loan portfolio.

The Big Six banks have considerable assets and are well capitalized. That helps to protect them a sharp economic downturn and decline in credit quality. Royal Bank reported a first-quarter common equity tier one capital ratio of 12%, which is well above the regulatory minimum and one of the highest among its peers.

Looking ahead

Canada’s Big Six banks are well capitalized and capable of weathering a deep recession triggered by the coronavirus. While overextended borrowers do pose a hazard, a combination of mortgage insurance, low LVRs, and quality credit portfolios will mitigate that risk. Despite a decline in growth, it is likely that the Big Six will maintain their dividends because of low payout ratios and the ability to reduce costs.

Royal Bank’s dividend-payout ratio of 46% indicates that there is plenty of room to accommodate lower earnings before a cut would be considered. For these reasons, Royal Bank’s recent decline in value and juicy 5% yield, along with its solid fundamentals, make it an attractive stock to buy.

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