Why Canada's Banks Could Make History

Description

The concept of a dividend cut by a major Canadian bank like **Royal Bank of Canada**, or one of its "Big Six" peers, may seem insane. Canada's largest institutions have an astonishing track record of holding or raising dividends each year. This is a somewhat sacred and undisputed truth in the financial community.

I'm about to make a sacrilegious claim now. So stop reading if you're uneasy. I really do believe Canada's banks could be at risk of dividend cuts, or worse, due to the current economic situation.

Federal Finance Minister Bill Moreau has made a claim that Canada has the "best," most stable banking system in the world. In my view, this is questionable statement. Canadian banks hold a high number of risky loans, including residential mortgages.

We've heard this line before

Moreover, this is the same kind of rhetoric stated by U.S. Federal Reserve personnel a little more than a decade ago. Soon afterward, Lehman Brothers and Bear Sterns collapsed and the U.S. financial sector had to be bailed out. Canada's banks are on shaky financial ground. Further, this shaky ground continues to shift, and now requires quantitative easing (QE). Canadian banks may even require a bailout to get back on their feet.

The long-term future is bright

Before I begin talking about Canada's current financial state, I do want to state that two Canadian banks, **Toronto-Dominion Bank** and Royal Bank of Canada, are among my top picks for investors with a long-term investing horizon. TD has done a great job of diversifying its holdings, both internationally and away from residential mortgages. In the next section, I'll explain more why this diversification away from residential mortgages is a smart move. TD has also aggressively invested in technology that makes it stand out from its peers. This will pave the way for longer-term growth.

Likewise, RBC is likely to outperform compared to its peers. RBC's size, as measured by market capitalization, and loan diversification as well as loan quality, make this company a great long-term pick.

Canada's current financial state

We will now circle back to talk about the current financial state in Canada. Right now, Canadians hold a lot of debt. This includes more than household debt. Corporate debt, government debt, and municipal debt all play a part in increasing the sensitivity of Canadians and Canadian businesses to bankruptcy. This scenario would obviously have a severe negative impact on Canada's biggest banks, which hold most of this exposure.

The reason that I recommend investing in Canadian banks that are diversifying their portfolio away from residential mortgages is due to the inherent risk with such loans. These residential mortgage loans that banks are making have net interest margins that are razor thin.

Bottom line

Canada's financial system could be in trouble this year. If things get really bad, dividends will be the first thing to get cut as banks look for liquidity and stability. Some may be tempted by Canadian banks being cheap right now and want to scoop up yield. For anyone wanting exposure to Canadian banks, I recommend waiting until at least the end of the year.

Stay Foolish my friends.

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