Canadian Bank Stocks: Could They Survive a Housing Market Crash?

Description

Canadian banks have been hit hard by COVID-19. Forced to grant mortgage deferrals, and facing a wave of oil and gas loan defaults, they've been justifiably beaten down in the markets. For years, investors have depended on banks for stable, reliable dividend income. Their loss of interest revenue in the COVID-19 era puts all that in jeopardy.

Just recently, **JP Morgan Chase** saw its earnings decline 70%. It's likely that Canadian banks will post similar results. While most of JPM's Q1 loss was from PCLs (to cover losses that may or may not materialize), it was still a big bite out of earnings. It could therefore trigger dividend cuts in the future. Again, it could be the same situation for Canadian bank stocks.

On top of all that, there's the possibility of a housing market crash. In Canada's biggest cities, home sales have slowed to a crawl. That means fewer people taking out mortgages, which means fewer new mortgage loans for banks. That will hurt bank revenue in a big way. Not only that, but some economists are predicting house prices will decline. So far that hasn't materialized, but if it does, banks will have to contend with *fewer* mortgage loans being issued at *lower* dollar amounts. This could make the problems the banks are already facing even worse. Here's why.

Canadian banks have heavy exposure to housing

All Canadian banks are heavily exposed to mortgages. As an example, **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) had $75 billion in insured mortgages and $163 billion in uninsured mortgages at the end of Q4. The vast majority of insured and uninsured mortgages were issued to Canadians.

Generally, TD has a good amount of geographic diversification, owing to its U.S. retail business. However, at least when it comes to mortgages, it's still heavily Canadian. That's bad news because Canadians' credit scores are deteriorating rapidly. In September 2019, Canadians' debt-to-income ratio sat at 177%. That was a record high.

This was already a problem before COVID-19; now it's becoming a real concern. With millions of Canadians out of work, mortgage defaults could climb. If that happens at the same time as new home sales slow, banks like TD are really going to suffer.

Mortgage deferrals

As previously mentioned, current economic conditions could easily lead to a wave of mortgage defaults. Banks seem to know this, as they've been granting six-month mortgage payment deferrals. For borrowers, this move will help soften the blow of being out of work. For the banks themselves, it's still lost income. While deferred mortgage interest has to be paid back, it's far from a foregone conclusion that people will be ready to start paying after six months. A wave of defaults could therefore occur after the grace period has passed.

Of course, banks can always make up for lost interest income by issuing new loans. But a housing market crash would put all that in question. Fewer home sales means fewer mortgages to issue. And if prices start to fall, then the loans that are issued will be smaller. Both of these factors combined would mean less interest income for banks.

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