Warning: Canada’s Bank Stocks Face a Deferral Cliff

Description

Canada’s bank stocks have staged a modest recovery in 2020 despite the pandemic. Canadian bank exchange-traded funds (ETFs) are down just 10% year to date and still offer dividend yields around 3.6%. In other words, Canadian bank ETFs have served as a safe haven for investors struggling to tackle this year’s volatile market.

However, these steady stock prices and robust dividends mask an emerging risk: the deferral cliff. If you have a Canadian bank ETF in your portfolio, here’s what you need to know about the future of the banking industry.

The deferral cliff

Canada’s federal banking regulator implemented a special rule to allow banks to offer mortgage deferrals to homeowners early this year in response to the health and economic crisis we faced. Under these rules, banks could offer mortgage deferrals for up to six months and not report the deferred amounts as non-performing loans.

At the end of June, the six largest banks in the country collectively held $170 billion in deferred mortgages on their books. These assets are not yet considered “bad loans.” Now that the economy is on the upswing and the health crisis has been controlled, the regulator is rolling back these provisions. The special rules for deferred mortgages expire in October 2020.

This means that banks could face defaults and a drop in book value in 2021.

Canadian bank ETF valuations

The price-to-book (P/B) ratio is a critical valuation metric for financial institutions. A Canadian bank ETF, such as the **BMO Equal Weight Canadian Banks Index ETF** (TSX:ZEB), would be considered fairly valued if it traded at a P/B ratio of 1 or under. It currently trades at 1.62 at writing.

That means that Canada’s bank stocks are overvalued in aggregate. However, the ratio could move much higher if book value is expected to deteriorate. In other words, as banks hit the deferral cliff and have to consider deferred mortgages as non-performing loans, their book value per share could dip and the P/B ratio could rise higher.

Meanwhile, banks could get more cautious, as this transition has an impact. If the economy hasn't fully recovered by next year, they may have to become more conservative with their cash flow, which could have an impact on the dividend yield.

What can you do?

There are two ways to tackle this issue: invest in undervalued banks directly or pick non-bank dividend stocks.

A Canadian bank ETF tracks the whole sector. However, individual banks may have better prospects and valuations than their peers. **Bank of Montreal**, for example, currently trades at a P/B ratio of 1.06, far lower than its rivals. The bank's dividend payout ratio is also reasonable at 60.5%, which could mean less downside risk in BMO stock.

However, the best way to mitigate this deferral cliff threat is to diversify away from Canadian banks entirely. Other sectors of the economy, such as telecommunications and energy, offer better valuations and comparable dividend yields.

BCE Inc., for example, offers a 5.9% dividend yield and has seen a surge in data consumption since the pandemic hit. It's in a better position than most Canadian banks. BCE has also outperformed the banks in stock price.

Its stock is down 6% year-to-date, compared with the average 10% drop for Canada's banking stocks over the same period.

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