
Should You Buy Big Canadian Bank Stocks Going Into 2023?

### Description

The Big Six Canadian bank stocks are often core holdings in diversified investment portfolios. Let's see why that may be the case and whether you should buy the bank stocks going into 2023.



The Big Six Canadian banks are categorized as Domestic Systemically Important Banks (D-SIB) by the Office of the Superintendent of Financial Institutions (OSFI), which regulates the financial system to ensure its resiliency through economic cycles, particularly in recessions. The Canada Deposit Insurance Corporation (CDIC) explains that these large banks could disrupt the Canadian economy should any one of them fail.

Earlier this month, OSFI discussed a couple of ways it helps improve the safety of our banks and the resiliency of our financial system.

## Capital requirement safety buffer for upcoming recession

In 2018, OSFI launched the Domestic Stability Buffer (DSB), which currently encourages the D-SIB to "maintain their Common Equity Tier 1 (CET1) capital above 11% of risk-weighted assets," which provides a safety buffer above the minimum requirement of 8.0% for capital adequacy. Indeed, the Big Six Canadian Bank stocks all had CET1 ratios of between 11.5% and 16.2% when they reported earnings this month.

OSFI's press release noted, "During economic downturns, bank loan losses rise, and bank capital ratios fall, " which is "a normal characteristic of this part of the business cycle." The idea is that in the next recession, as many economists expect to come in 2023, OSFI can lower the DSB to 8.0% and allow the "banks to use this 'rainy day fund' to help weather the storm."

## Mortgage stress test stays in place

Another safety measure OSFI has kept in place is the Minimum Qualifying Rate (MQR) for uninsured mortgages. The MQR is more commonly known as the mortgage stress test that applies to Canadian residential mortgages to improve the safety of the system.

Under this guideline, the Big Six Canadian banks can only lend to mortgagors only if these borrows can handle the higher interest rate of 1) mortgage contract rate plus 2.0%, or 2) 5.25%. The Department of Finance has the same mortgage stress test in place for insured mortgages.

OSFI explained, “As a result, throughout the recent period of very low interest rates (2020 through the first quarter of 2022), these lenders usually qualified their mortgagors at a minimum rate of 5.25%, despite the fact that the contract rates of these mortgages were often below 2.0%. This margin of safety made it easier for Canadian homeowners to continue to pay their mortgages and stay in their homes when rates rose later in 2022. That is one reason, we believe, why residential mortgage defaults remain at, or are near, historic lows.”

## The Foolish investor takeaway

OSFI ensures the Big Six Canadian banks are adequately capitalized. For example, it’s getting the banks ready for the expected recession in 2023 by asking them to achieve a CET1 ratio of 11.0% by February 1. All banks have reported a capital ratio of higher than 11.0% this month in their quarterly earnings reports. It has also stayed firm on the mortgage stress test that helps maintain the resiliency of our housing market, which is “the largest exposure Canadian lenders have on their books,” including the big Canadian banks.



Because the macro outlook is generally negative, the bank stocks could experience more pressure going into 2023. That said, they pay safe and stable dividends with dividend growth potential in the long run. Long-term investors should accumulate bank shares opportunistically at good valuations.

Currently, **Bank of Montreal** (TSX:BMO) has the greatest leeway with the highest CET1 ratio of 16.7%. At $121.60 per share at writing, it trades at about nine times earnings, which is a discount of 19% from its long-term normal valuation. Analysts have a consensus 12-month price target of $142.74 on the stock, which suggests a discount of 15% — a near-term upside potential of approximately 17%.

At the recent quotation, the undervalued stock yields 4.7%. Its payout ratio is estimated to be 43%. So, it has adequate dividend coverage. Other than for passive income, BMO stock could potentially deliver north of 12% per year in total returns over the next five years from its dividends, valuation expansion, and earnings growth.

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