Canada’s big banks could withstand a severe housing crash

By David Berman
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Amid a chorus of concern about Canada’s overheated housing market, Moody’s Investors Service says it believes the country’s biggest lenders can easily withstand a severe market downturn, after the credit-rating agency simulated a U.S.-style mortgage crisis.

However, Moody’s raised concerns about the big banks’ vulnerability to broader issues, such as record-high consumer indebtedness and the knock-on effects from less-regulated lenders.

“Although increasing household debt and rapidly increasing house prices in Canada demonstrate conditions similar to those in the U.S. prior to the financial crisis, the seven largest Canadian mortgage lenders have the capacity to absorb a similarly pronounced mortgage loan shock without catastrophic losses,” Moody’s said in its report.

Its simulation employed a 25-per-cent slump in house prices nationally, along with an additional 5-per-cent depreciation in the supercharged markets of Ontario and British Columbia. Foreclosure and collection costs were assumed at 10 per cent. Under these conditions, Moody’s estimated total system losses would be $18-billion, of which about two-thirds would be borne by banks. Moody’s said bank capital levels would slump, likely prompting regulators to require banks to issue additional shares.

But in a nod to the banks’ earning power and diversification, Moody’s believes lenders would recover from losses associated with a sharp housing downturn in as little as three months.

“The majority of banks would be able to absorb losses within one quarter of earnings or, assuming the current average dividend payout ratio of 45 per cent, two quarters of retained earnings,” Moody’s said. “Therefore we believe that while a U.S.-severity mortgage event would lead to substantial losses, it would not threaten rated bank solvency.”

There would be differences among the banks, though. Given its size, Royal Bank of Canada would suffer the biggest overall losses. Canadian Imperial Bank of Commerce, though smaller, has a somewhat tighter focus on Canadian retail lending and would suffer the biggest hit to its capital levels.

The assurances come as a number of observers have expressed concern about Canada’s housing market.

The Bank of Canada said recently that markets in Vancouver and Toronto are “unlikely to be sustained” and the chief executive officer of Bank of Nova Scotia called house prices in both markets “frothy.” The Organization for Economic Co-operation and Development warned of a disorderly correction.

Nevertheless, Moody’s expects that the pain to Canadian lenders would be mild compared with the drubbing taken by U.S. lenders during the housing downturn that preceded the financial crisis.

Moody’s noted that Canadian lenders benefit from key differences with their U.S. peers.

For one, the Canadian government essentially guarantees mortgage insurance through the Canada Mortgage and Housing Corp. As well, there are lower rates of risky subprime lending in Canada and stronger lending practices, and authorities have already reduced risks by raising minimum down payments and bolstering underwriting practices.

However, Moody’s warned that the banks are not immune to losses that could arise from other factors.

High levels of consumer debt would become a big problem if rising interest rates drove up borrowing costs – and the challenges would be greater if job losses rose during an employment shock, increasing mortgage delinquencies.

Riskier loans made by smaller lenders, which are subject to less-stringent underwriting standards, form a small part of the market but could exacerbate price declines during a housing market downturn.

The agency also noted that the government could require lenders to share more of the risks associated with mortgages – an idea given life after CMHC said it would explore the possibility of making lenders pay a deductible on mortgage insurance claims.

"In the aftermath of the U.S. mortgage crisis, many banks were forced to repurchase mortgages sold to the Federal Home Loan Mortgage Corp. (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) owing to inadequate origination documentation," Moody's said.

"We do not believe Canada is immune to such risk: in a stressed mortgage environment, mortgage insurers may increase claims rejection for purposes to preserve capital, and the political environment could prompt a shift of the risk-sharing burden to the banks and away from taxpayers."