

RBC WEALTH MANAGEMENT

Global Insight

Special Report



Canadian banks – A penny saved is a penny earned

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All values in Canadian dollars and priced as of October 31, 2016, market close, unless otherwise noted.



**Wealth
Management**

Canadian banks

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Canadian banks have come through the trough in oil prices better than feared by many investors. While regulatory tightening in the housing market may pressure growth, better Energy sector credit trends and judicious expense management put the banks on a more-solid footing.

Housing – The regulatory hammer drops

Canadian banks have over \$1T invested in residential mortgages. Credit issued to individuals represents the lion's share of bank loan portfolios including roughly 45% in mortgages and 25% in personal loans. With affordability concerns running high for the largest urban centers, investors remain squarely focused on housing as a key risk for Canadian banks.

Vancouver and Toronto – First shot at foreign buying

Vancouver and Toronto represent roughly half of the dollar value of all existing home sales nationwide. Arguably, prices have decoupled from the traditional market foundation in local income levels, and continue to climb. For a typical (median) Toronto household, the cost of owning a single family detached home has reached 72% of pre-tax income, while Vancouver is at 127%. Vancouver's new 15% tax on foreign buyers has sharply reduced sales activity, but prices continue to climb. Its benchmark prices were up 28% y/y in September, with Toronto up 18%.

Whether the initial government measures prove effective in the long-run has yet to be seen; however, the foreign buyer tax signals that policymakers are responding to public outcry. If needed, there is considerable scope for more to be done. In Australia, for example, there is an outright ban on foreign purchases of existing real estate (new homes permitted). Other measures in Australia have included an absentee owner land tax, higher stamp duties, withholding taxes, and proof of residency and citizenship when buying property in Sydney. In June, Vancouver received legislative clearance to impose a tax on empty housing units, with a new tax to this end expected in January 2017.

National policy tightening

At the national level, policy tightening has been ongoing for years. Last month, regulations changed to rein in stretched buyers with the most impactful, in our view, being the new “stress test.” Now, all insured mortgages must be qualified at the Bank of Canada's (BoC) posted five-year rate, which at 4.6% sits some 200+ basis points (bps) above current market rates for strong borrowers. Immediately following this announcement, Canada's largest private mortgage insurer indicated

Housing credit risks in Western Canada remain benign.

that slightly more than one-third of the mortgages it has insured this year would have had difficulty qualifying under the new rule.

The new rules temper the outlook for Canada's housing market with buyers likely forced to increase down payments or reduce purchase prices. Immediately following the announcement, RBC Capital Markets revised its Canadian banks' mortgage growth forecast to less than half of its prior level.

Putting housing risks in context

While prices and affordability are concerns, several factors mitigate the risks for Canadian banks.

First, Canadian banks only compete in the prime mortgage market (no sub-prime) and have had a very strong track record. Residential loan losses increased only minimally for Canada's largest six banks to 6bps in the 1990s housing downturn when prices fell by 13% nationwide, 31% in Toronto, and 24% in Vancouver. In 2009, loan losses reached just 3bps for the group, up from 1bp in 2007.

Second, home equity levels are solid thanks to rising market prices. Just over 90% of mortgage borrowers who bought from 2011 to 2015 have at least 10% home equity and three-quarters of them have at least 25% home equity.

Third, insulation from rising interest rates is provided by the primarily fixed rate structure of the market with about two-thirds of mortgages on five-year fixed rate terms.

Finally, mortgage default insurance backstops losses. Depending on the individual bank, between one-third and about one-half of bank mortgage exposure is insured.

While credit risks appear well protected, we believe the real risk for shareholders is in the potential impact on earnings should housing trends decline. A meaningful housing downturn may be coincident with, or bring about, a period of economic slowdown given the residential construction and real estate industries represent about 15% of the national economy. The impact on bank earnings in past housing downturns has been significant. Canadian bank earnings declined during the early 1990s real estate slump by about one-third from the peak to trough quarter (1989–1993). In the global financial crisis, Canadian bank earnings fell by about one-quarter from the beginning of 2008 to the end of 2009.

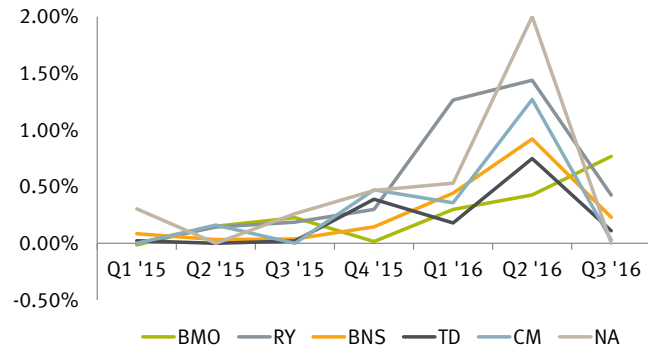
Oil & gas exposure

Direct Energy credit trends improving

Nearly two years of low oil prices has resulted in a meaningful supply response and solid demand growth that has, as of mid-2016, returned the market to a broadly balanced condition.

Direct oil & gas loans represent just 1%–3% of total loans amongst Canada's six largest banks, but that translates into 15%–37% of equity capital, making the improvement of these trends meaningful. Given better market fundamentals and a bottoming in oil prices, we are optimistic the recent recovery in Energy credit trends may continue.

Loan losses as a % of loans (Oil & gas sector)



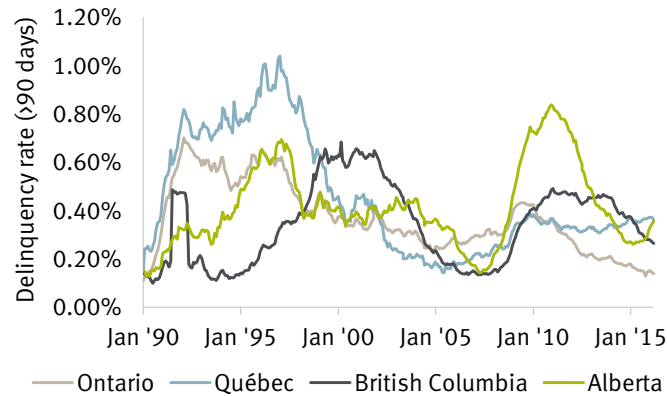
Loan loss ratios improving for oil & gas exposures

Note: Q2 '16 loan loss ratio for National Bank is beyond the scale of this graph
Source - RBC Capital Markets, RBC Wealth Management

Indirect consumer credit trends benign

As for broader consumer credit trends, deterioration in Western Canada has been offset by improvements in other regions. Housing credit risks in Western Canada remain benign with home prices in Calgary and Edmonton down just 5% and 2%, respectively, from peak levels. Delinquency rates (>90 days in arrears) in Alberta have risen but remain modest in the historical context.

Mortgage delinquencies



Mortgage delinquencies remain low in Alberta versus historical levels

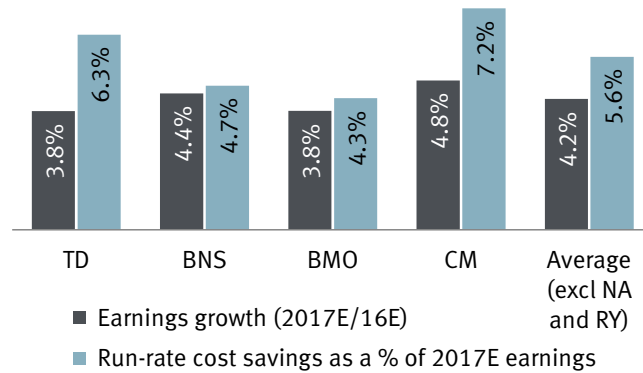
Source - RBC Capital Markets, RBC Wealth Management

Margin improvement potential

Cost savings programs – A penny saved is a penny earned

The industry has been engaged in substantial restructuring programs over the past couple of years. The anticipated run-rate savings resulting from these efforts are meaningful in the context of current earnings forecasts. As banks continue to invest in technology-based solutions, we would expect further cost saving opportunities in the medium term.

Cost savings programs in context



Technology investments are allowing for cost reductions, providing a longer-term source of earnings growth potential

Note: 1) Cost savings are estimated run-rate savings divided by RBC Capital Markets' 2017 core cash net income forecasts; 2) National Bank has been excluded because of one-time charges in 2015 which skew the ratio; RY has also been excluded.

Source - RBC Capital Markets estimates, RBC Wealth Management

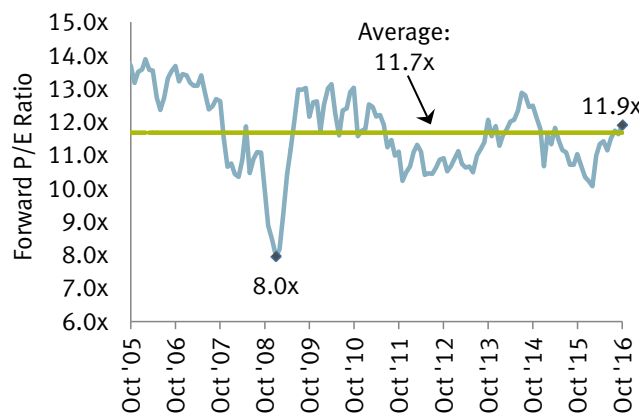
Net interest margins

In the longer term, the potential for rising interest rates may provide significant upside to bank earnings. Bank of Montreal, for example, reports that a 1% increase in interest rates would add \$136M to its net income, or 2.7% to RBC Capital Markets' 2017 forecast for the bank. While rising interest rates provide upside optionality, the current forecast from RBC Economics is for the BoC to hold its overnight rate steady throughout the next year.

Short interest and valuation

Short interest levels on Canadian bank stocks remain elevated. Average short interest for the six largest Canadian banks rose from about 4% to 5% over the last year. Valuations on a P/BV and P/E basis are largely in line with historical averages.

Canadian bank sector historical price-to-earnings ratio



Sector valuations remain modest

Source - RBC Quantitative Research, Bloomberg, RBC Capital Markets, RBC Wealth Management

The key risk to banks remains a hard landing for housing.

Conclusion

In the medium term, Canadian banks are facing various headwinds including slower mortgage growth amid regulatory tightening, extended housing and consumer credit, and a protracted low interest rate environment. The key risk to banks remains a hard landing for housing which appears a low probability event in the near term given robust urban markets in most centres and only modest price declines in Alberta.

As the oil market rebalances, we see the potential for improving credit trends to result in lower loan loss charges. Combined with expense management programs, we believe there is potential for solid earnings growth ahead. Capital appreciation potential driven by mid-single digit earnings growth combined with historically average valuation multiples and roughly 4%–5% dividend yields offer an attractive total returns opportunity for investors.

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			Count	Percent
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