Why we are still not owners of Canadian banks

Stephen Groff, June 14, 2018

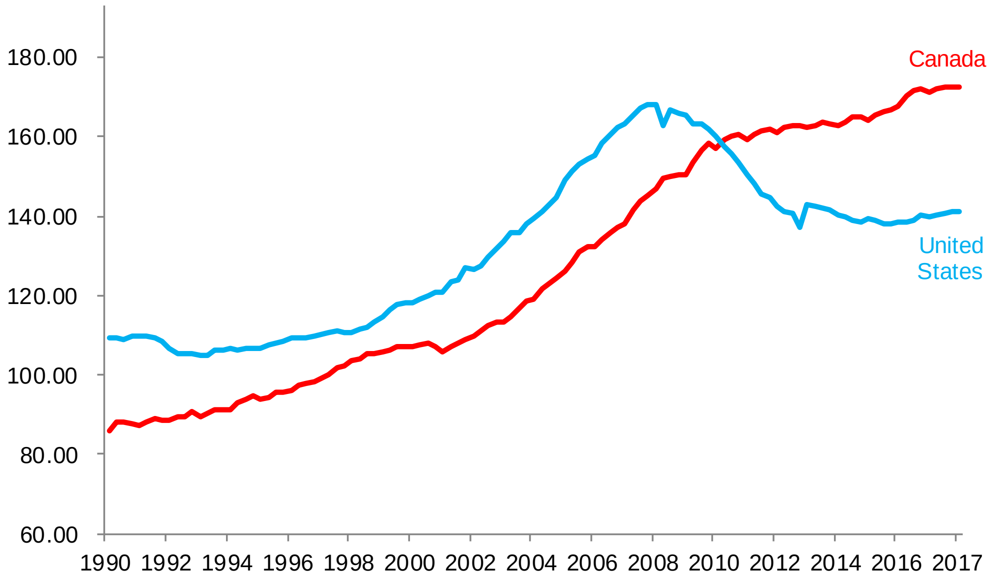
Early last year we published "Why we are not owners of Canadian Banks today," which summarized our rationale for avoiding investing in the industry. Now, nearly 18 months later, we thought it was a good time to provide an update. We will touch on what has changed and then review capital levels, which we believe are important but less frequently discussed. Again, special thanks to our global financials analyst Danesh Rohinton on our team for providing much of the data and insights.

In providing an updated view on Canadian Banks, let's start with changes that have occurred in the past year and a half. Have fundamental factors altered or reinforced our view? We believe the data has reinforced our concerns and, while we are not predicting Armageddon for the banking sector or the economy, we do see a number of risks. In line with our investment philosophy, risk must be compensated for with an appropriate potential return. We do not believe this is the case for Canadian banks today. First, an update on two key variables mentioned in the prior blog.

Consumer leverage in Canada

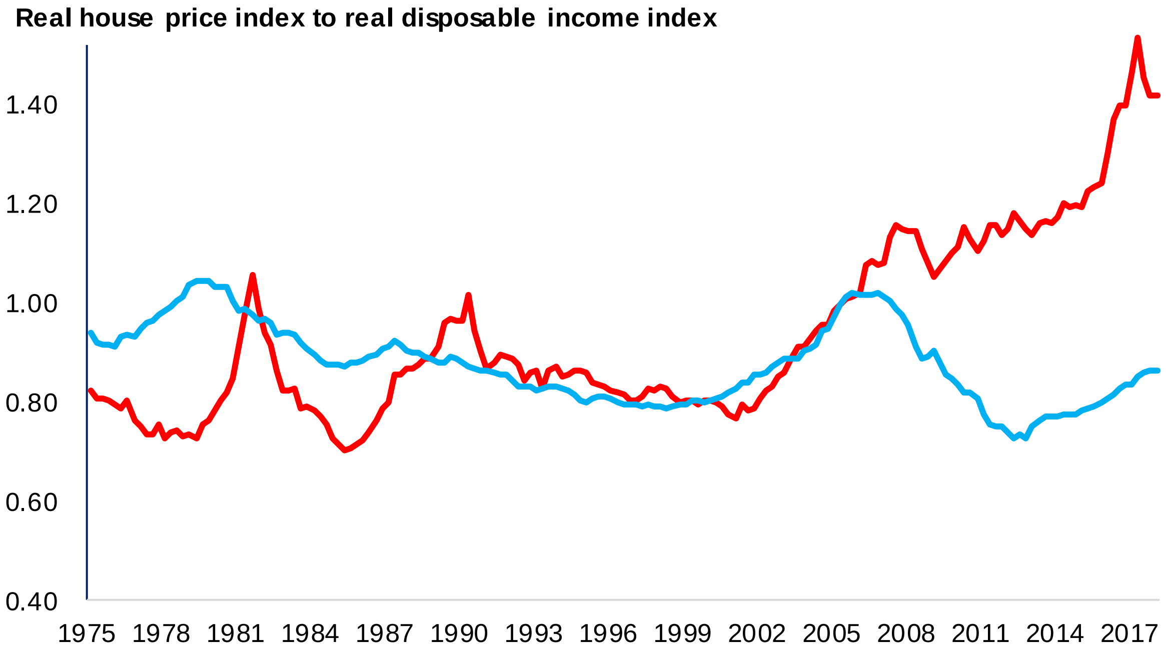
Canadians continue to add to their already elevated level of consumer debt. The ratio of debt to personal income now stands at over 172%, with the highest rate of debt growth concentrated, not surprisingly, in Toronto and Vancouver (Equifax March 2018). While the ability to service higher levels of debt had been aided by falling rates, this is no longer the case. Posted rates are now on the rise and directly impact both the cost of borrowing and the level of credit availability.

Household debt to disposable income ratio (%)



Source: Macquarie

The housing market
Following the housing frenzy that took place in the spring of 2017, the aggregate market has shown signs of cooling. While it is impossible to isolate which specific factor has driven the change, there is little doubt that contributors include tighter mortgage-qualifying regulations (which came into effect in January 2018), targeted government intervention, poor affordability in many regions and now rising mortgage rates.



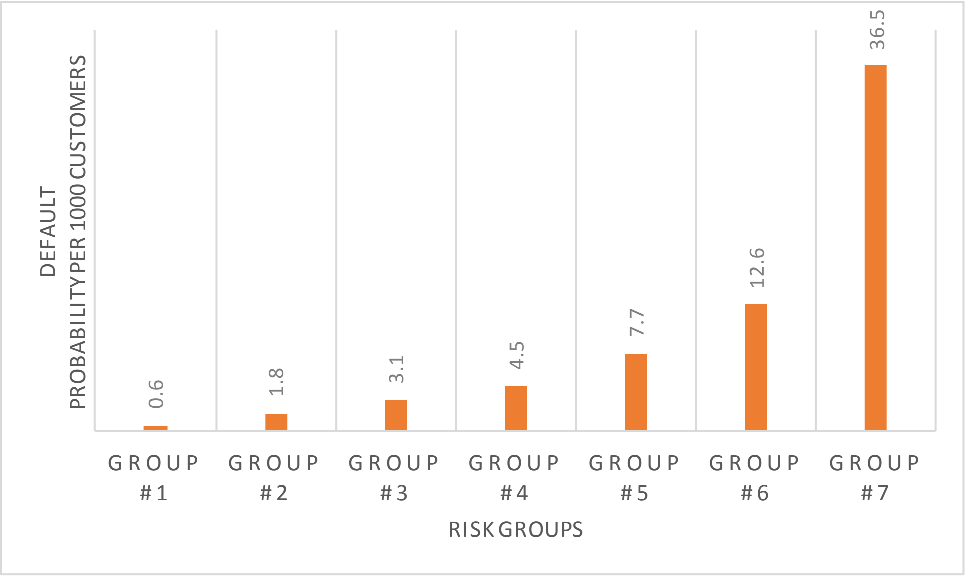
Source: Macquarie

While calling inflection points in either of the variables above is exceptionally difficult to do with precision, our view is that the historical rate of growth in both housing prices and consumer leverage is unsustainable. We believe that absent a material economic expansion from current levels (which would be inflationary), higher rates is just one of multiple risks an indebted consumer is exposed to, which can have a direct impact on housing values and consumer spending.

Capital – the money held aside for when things go wrong
A dimension to our view that we believe is underappreciated (and seldom discussed) in the market is the level of capital that is set aside by various parties. Capital is held for the sole purpose of providing a cushion in the event that a loan is not repaid. Someone always foots the bill, whether it is a shareholder, debtholder or tax payer. Please refer to the prior blog to review the concepts behind risk-weighted assets (RWA) and Common Equity Tier 1 Ratio (CET1).

Part of determining a sufficient level of capital to hold requires an understanding of how calculations are made, what assumptions are used and then deciding whether or not you believe those assumptions are reasonable. In the case of a bank, the first step in determining how much equity to hold begins with assigning a probability that a client will default; this places them in a risk group. A borrower with a lower probability of default gets placed into a lower risk group and vice versa. Here is an example of a major Canadian bank's uninsured mortgage and home equity line of credit (HELOC) portfolio.

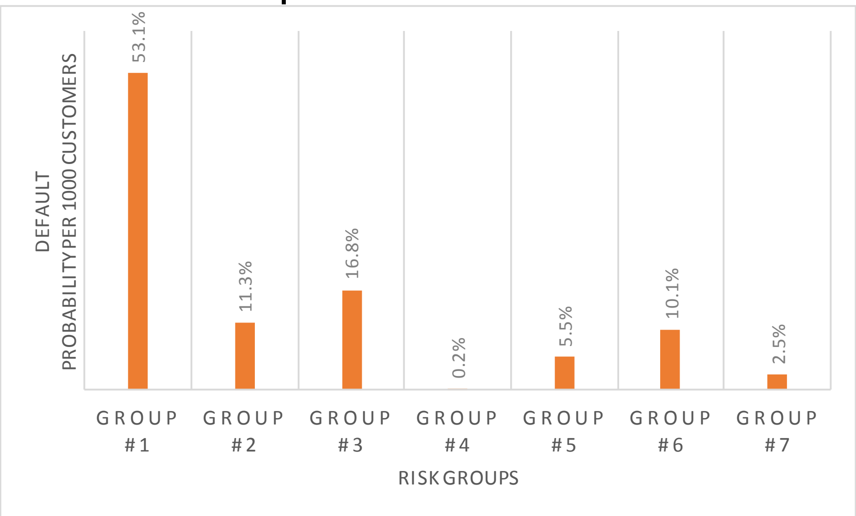
Exhibit 1: Probability of Default by Risk Group



Source: Quarterly disclosure of a large Canadian bank.

As seen in Exhibit 1, a borrower in Group 1 is estimated to have a 0.6 out of 1000 probability of defaulting. Put another way, if we hypothetically applied these probabilities to a group equal to the size of the population of Cambridge, Ontario (130K), assuming 3 people per household, less than 30 households would default on their loan. In all of Canada (36 million), less than 7,500 households would default on their loan. This ratio may be appropriate if it applied to a select group of high-credit-quality borrowers; however, as Exhibit 2 shows, this bank is classifying over half of its loans as Group 1 and over 80% of its portfolio in Groups 1-3. **This bank is telling us and regulators that 80% of their customers have an average probability of defaulting of 0.13% (or 1.3 out of 1000 customers)**.

Exhibit 2: Risk Group Mix



Source: Quarterly disclosure of a large Canadian bank.

When one considers the entire Canadian population across all regions, income levels, levels of consumer debt, rising interest rates and the ability for unplanned life events to happen (i.e. job loss, divorce, etc.) we believe around one in a thousand for 80% of the population is not realistic under any but the most constructive long-term economic backdrop.

The group classification of a borrower is relevant because it impacts the amount of capital that must be held against the loan irrespective of the amount of interest that is generated. A higher equity requirement is a cost to the bank and increases the denominator in calculating its Return on Equity (ROE). By Dan's (the Cambridge analyst's) math for this particular bank: in this portfolio alone, which accounts for 7% of its risk-weighted assets, moving customers from Group 1 to Group 2 in isolation would require 9% of total 2018 profits to build capital to required levels. Again, this is assuming this cohort of individuals goes from 0.6 loans defaulting per 1,000 to 1.8 per 1,000 – hardly draconian in magnitude. In this environment, the bank would likely also be facing adverse migration within other loan portfolios, lower loan growth and higher charge offs, all of which would likely pressure profitability and ROEs.

While timing a cycle is challenging, one will ultimately materialize. While some cycles can be very long in nature, assuming cyclicality no longer applies can be hazardous to your wealth (for a great book on cycles I would recommend "Bull! A History of the Boom and Bust"). The state of consumer balance sheets combined with the fact that rates are no longer falling and housing is less of a tailwind, leads us to believe there will be greater pressure on consumers in the coming years. This has the potential to drive higher levels of charge offs, raising the amount of capital required to be set aside, depressing profitability and ROEs. Let's now touch on another part of the portfolio to gauge where capital levels stand.

Insured mortgages

All else being equal, an insured mortgage carries less risk for a lender than an uninsured one. It also means that someone else is providing that protection and therefore assumes that risk. Insured mortgage and HELOC portfolios add up to a combined $500 billion for Canadian banks. Against this $500 billion, approximately $600 million (0.12%) is held by the banks to protect against default. The clear majority of the equity cushion is therefore provided by the government-backed mortgage insurer CMHC (75%) and two private operators (25%) as seen in Exhibit 3. Needless to say, we as taxpayers backstop this risk. Given continued public deficits at this point in the cycle despite where tax rates already stand, as a tax payer I am not encouraged. (This can be a blog for another day!)

The Government of Canada is aware of this risk and has implemented a variety of measures over the past few years with the objective of both reducing overall systemic risk and transferring a greater portion of the risk to the private sector. We applaud these moves, however question if it is too little too late.

Exhibit 3: Mortgage Insurance Industry Breakdown

	2015	2016	2017
Public Sector	81%	80%	75%
Private Sector	19%	20%	25%
Total Sector Tangible Equity ('000s)	$21,793	$23,453	$20,280

Source: CMHC & Genworth Canada.

In addition to rising rates, decreasing the availability and increasing the cost of mortgage insurance has the effect of raising borrowing costs and lowering credit availability for consumers. A lender offering an uninsured versus insured loan will be required to hold additional capital, making the lender more selective when extending credit and the rate by which they price the loan. These factors tend to have a dampening effect on asset values, which have historically acted as a buffer against loan losses. Furthermore, this can push borrowers to non-traditional channels where they will likely face higher rates.

Conclusion

To be clear, we are not predicting an imminent end to the cycle which has continued nearly unabated for almost 30 years. We simply caution investors that there are a number of concerning signs today and many of the underlying assumptions used to determine capital levels seem aggressive should the cycle enter a more challenging phase.

Investing is a marathon not a sprint. We aim to reduce the risk of permanently impairing capital even if it means looking different. At Cambridge we will only invest client capital when we believe we are being well compensated for the risk being taken. At present we are finding a wide range of other opportunities that appear more attractive from a risk/reward perspective than the Canadian banks, and will invest accordingly. We appreciate your continued support.

Stephen Groff