Will Rising Interest Rates Provide the Next Leg Up For the Canadian Banks?

Description

Last week, RBC Capital Markets hosted its annual Canadian bank CEO conference. The big Canadian banks are obviously at the core of this country's financial industry and we were lucky enough to be in attendance.

A great summary by my fellow *Stock Advisor Canada* analyst Karen Thomas about some of the big picture issues that were discussed by all participants can be found here.

In this post however, we're going to zero in on one of the more positive themes that was discussed. The issue – the impact that rising interest rates could have on this group.

Banking 101

Much is currently being made of the potential headwinds that the Canadian banks face if/when our housing market slows. Growth is going to be especially impacted, and investors are concerned. A potential white knight however that all of the CEOs expect will help to at least partially offset the headwinds created by a slowing housing market is rising interest rates.

To understand why this is so, let's go right to the core of banking. In its most pure form, banking is all about borrowing at one rate (low), and lending at another (high). The bank takes in money from you and I in the form of a deposit, pays us virtually nothing, and lends this money at a rate that is higher than what it's paying us – pocketing the difference.

If you've paid any attention at all to the world of banking in recent years, you know that things have gotten WAY more complicated than this relatively innocent relationship. However, we're going to focus on this simple principle to outline how a rise in interest rates can help this group.

Net Interest Margin (NIM)

It comes down to how rising rates might impact a commonly followed metric known as the net interest margin or NIM. The NIM is calculated using the following formula:

Interest income – Interest expense

Interest earning assets

Essentially, we're dealing with the difference between the interest a bank pays out and the interest it brings in and divides by the interest earning asset base – that is, the loan portfolio (to a bank, a loan is an asset).

If the bank can hold the interest expense relatively stable, while increasing its interest income, it should be good for the net interest margin, and therefore, the bottom line.

This is the exact scenario that the bank CEOs envision developing in the coming years. They expect that deposit rates will more or less remain right around where they currently sit, while longer dated interest rates – the rates at which they invest our deposits – rise. Nice work if you can get it!

Who Wins?

Nobody knows the actual impact that this scenario might have because of all the moving parts that go into a bank. However we can consider it in a hypothetical bubble, and at least get some indication as to its impact on the respective banks. The following table illustrates what a net 10 basis point increase on what the banks earn on their assets might look like:

	TD (TSX:TD)	**Scotia** (TSX:BNS)	**BMO** (TSX:BMO)	**CIBC** (TSX:CM)	**Royal** (TSX:RY)
Avg. Int Bearing Assets	$542,530	$514,900	$331,843	$260,986	$463,905
EPS Impact	$0.06	$0.04	$0.05	$0.07	$0.03
2013 EPS	$6.93	$5.19	$6.27	$8.24	$5.60
% Impact	0.9%	0.8%	0.8%	0.8%	0.6%
2014 EPS(exp)	$8.03	$5.45	$6.33	$8.69	$5.89
Exp. Growth	15.9%	5.0%	1.0%	5.5%	5.2%

Source: Capital IQ

This scenario could lead to an approximate +0.5% to +1.0% or so impact across the board on the bank's EPS. The "street" expects most earnings to grow by about 5% (with TD and BMO as the outliers) during 2014, therefore, this is something that could make a reasonable contribution to overall expected growth.

Bottom Line

Rising rates aren't all good for the banks as slower loan growth and higher loan losses could negate much of the benefit that an improved NIM may have. However, a move higher is inevitable at some point and given the comments made by their respective CEOs, the banks are looking forward to it.

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