Is Royal Bank of Canada Becoming Too Comfortable With Risk?

Description

For quite some time now the **Royal Bank of Canada** (TSX: RY)(NYSE: RY) has been seen as the top bank in the country. Since the 2008 crash the bank has been aggressively pushing its North American consumer banking, along with its international wealth management portfolios, which as a segment grew by 25% in the last quarter. The expansions have paid off with two successive quarters with over $2 billion in profits.

But is there a cost to maintaining these types of returns, which investors have begun to be accustomed to? There is still a strategy that the company has yet to fully unleash, one that it has previously capped off in the name of stability.

The capital markets gamble

Out of the ashes of 2008, RBC has substantially built up its capital-markets unit, which is tasked with lending to larger companies. As well as providing advice to companies looking to engage in acquisitions and advises on how to best raise money from stock and or debt sales.

RBC is coming close to hitting its self-imposed cap of 25% of total revenues, this cap was put in as a way to manage the overall risk faced by the bank. Time is running out for RBC, as it hit the 23% of total revenues mark in its previous quarter.

The risk involved here is that this division of the bank has very unpredictable earnings and can be more susceptible to the waves of the market. But this division has been one of RBC’s top performers, boosting its profits by 32% between 2010 and 2013. To give some perspective, RBC’s wealth management division has only seen its profits grow by 9% during the same period.

Risk is no game

With this combination of portfolio growth and profit increases it must look mighty tempting to theleaders of the bank to lower the floodgates and embrace this riskier market. That would put the bankagainst its current track record of lower risk, which has become a hallmark of Canadian banking ingeneral.

But now investors have gotten a taste of multi-billion dollar returns and are quite used to the current 3.4% yielding dividend. For investors of RBC, the capital markets division should be the first thing you check when you go over quarterly reports, as this division is quickly doubling as RBC's risk tolerance meter.

If RBC does decide to forgo the 25% cap, it could make for some interesting times for RBC. It could push profits even higher but it would also make the bank more dependent on a healthy economy. That may worry investors who use banks as a portfolio stabilizer. Either way the bank decides to go, it would take years to fully realize the effects. Much like the board game *Risk,* a quick aggressive expansion will give you more of the board. But it also leaves your borders weak and prone to attrition.

As this bank is such a key part of so many funds, portfolios, and pensions, any adjustment to its risk level will be felt from coast to coast. However if RBC can properly manage the expansion of its capital markets division, it would put the bank further ahead of its Canadian counterparts.

CATEGORY

1. Investing

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1. NYSE:RY (Royal Bank of Canada)
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