



Royal Bank of Canada Investor Alert: Do Big Profits Come With Higher Risk?

Description

Royal Bank of Canada ([TSX: RY](#))([NYSE: RY](#)) came out of the great recession reasonably unscathed because it had little exposure to the high-risk elements that decimated banks in the U.S. and Europe.

Investors who still think the bank is a low-risk investment should take a closer look.

Royal Bank of Canada has truly become a global banking giant with a market capitalization of more than \$100 billion. Shares of Royal Bank have risen 44% in the past two years alone, primarily driven by growth in its wealth management and capital markets divisions.

In its Q3 2014 quarterly report, Royal Bank announced record earnings and investors should be asking if the profit party is being financed with high-risk revenue.

Here is a look at Royal Bank of Canada's fantastic capital markets results as well as an analysis of some risks for investors.

Capital markets

Profits in the capital markets division of a bank's business come from wholesale banking activities catering to corporate, government and institutional clients. One area of focus is investment banking where companies and institutions pay the bank fees for an array of advisory services including those connected to merger and acquisition activities. Other revenue in the capital markets unit comes from debt and equity underwriting as well as trading.

In the most recent quarter, earnings from Royal Bank's capital markets group surged 66% to a record \$641 million. This represented about 27% of the bank's total earnings.

Historically, the bank has maintained an internal earnings limit of 25% for the capital markets group as a means of controlling risks.

The reason the capital markets revenues are considered risky is they can be very volatile. When times are good, the banks can earn a lot of money from capital markets services. When economic conditions

get ugly, earnings from the capital markets side of the business can fall off a cliff.

David McKay, Royal Bank of Canada's new CEO, appears to be comfortable with the higher risk profile. During the Q3 2014 conference call he told analysts that the 25% limit is a "strategic guideline".

Investors should be cautious about the capital markets revenues moving forward.

"Overall it was an outstanding quarter for Capital Markets. Clearly the segment benefitted from a number of factors which are unlikely to be repeated to the same degree, but the success of the repositioning of the business in recent years is undeniable and I remain confident in the long-term strategy," McKay said on the earnings call.

With shareholders expecting bigger profits and more dividend increases, I think it is unlikely Royal Bank of Canada's management team will move to restrict the amount of capital-markets business the company takes on.

Canadian mortgage exposure

Royal Bank of Canada also has some risks sitting on the retail side of its balance sheet.

Dan Werner, analyst at Morningstar, wrote in a July report that he expects house prices in Canada to drop by 30% once they finally peak. The decline will be triggered by an increase in interest rates that will force home and condo owners to sell because they will not be able to afford the higher mortgage payments.

In the analysis he said that Royal Bank and Canadian Imperial Bank of Commerce (CIBC) would be hit the hardest by a housing crash because they have the largest percentage of residential loans to tangible common equity ratios.

Common equity ratio

Royal Bank's Basel III common equity Tier 1 (CET1) ratio dropped in the second quarter to 9.5% from 9.7%. The ratio is an indication of the bank's financial strength. Royal Bank of Canada is still well capitalized but its CET1 ratio is lower than the 10.1% reported by CIBC.

The bottom line

Given the current risk environment, I think it is advisable to take a cautious approach with Royal Bank of Canada. The earnings party might continue for another couple of years, but the possibility of a big shock is also increasing.

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