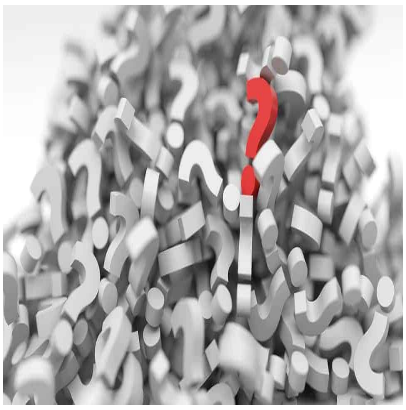

Higher Interest Rates: Are They Good or Bad for Canadian Lenders?

Description

Canada's central bank, the Bank of Canada, made the formal announcement on July 12 that it was raising the official policy rate by 25 basis points, or 0.25%, from 0.50% to 0.75%.

It didn't take the Canadian banks very long to follow suit.

Only a couple of hours after the announcement, the "Big Five" Canadian banks also announced their own rate increases, led by **Royal Bank of Canada** (TSX:RY)(NYSE:RY), which was the first to act.

Toronto-Dominion Bank (TSX:TD)(NYSE:TD), **Bank of Montreal** (TSX:BMO)(NYSE:BMO), **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS), and **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) all raised their rates later that day, also by one-quarter of a percent.

This puts the prime rate offered the major Canadian banking institutions at 2.95%.

For the consumer, obviously, the move is an unwanted one as it raises the price for Canadians to buy a home or obtain a line of credit.

But is it good for the banks?

Yes and no.

The good news

The most obvious impact is that for every $1 the bank loans, the bank receives more money in exchange in terms of the interest it charges on those loans.

When you consider that Toronto-Dominion Bank, for example, has approximately $22 billion worth of loans on its books as of the end of 2016, that one-quarter of a percent increase in the rate it charges can certainly add up to a lot.

Keep in mind too that the additional interest income flows directly to the bottom line, as the bank doesn't have to spend any additional money to earn it.

Royal Bank, for example, has seen estimates for this year's earnings per share increase by 9% in the weeks since the announcement was expected to be made.

It's basically like free money for the banks.

But it's not all good

At the same time, however, keep in mind what spurred the rate increase in the first place.

Since the last U.S. financial crisis, much has been made of the increasing levels of indebtedness among Canadian households.

For years now, experts and analysts have been suggesting the situation in Canada is eerily similar to the state of affairs in the U.K. prior to that country's housing collapse, not to mention what was going on in the U.S. just over 10 years ago.

The central bank has been vocal about the need to curb consumer lending for years, but it only recently felt confident enough to act.

The recent rate increase is all about making money more expensive for Canadians to borrow in hopes that it will help to deflate some of the asset bubbles — most notably, the housing market in Toronto and Vancouver — that have been brewing over the past decade.

Making money prohibitively expensive — which is essentially what the Bank of Canada is doing — is not good for the Canadian lenders.

What should I do?

Shares of the Canadian banks may get a boost owing to higher earnings estimates, yet if Canadian households can no longer afford to borrow, or worse, if they stop making payments on their outstanding debt, that period of optimism may prove short-lived.

In the meantime, Canadian investors may do well to look for companies that are expected to outgrow the economy in good times and bad. E-commerce success stories **Shopify Inc.** (TSX:SHOP)(NYSE:SHOP) or **Tucows Inc.** (TSX:TC)(NASDAQ:TCX) may be good places to start.

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