Why Now Is Not a Good Time to Be Investing in Lending Companies

Description

A rising interest rate environment is very appealing to banks and other lending companies, since there is an opportunity for lenders to take advantage of higher margins, but it isn't without risk. Higher rates of interest can also put a lot of pressure on borrowers and will also increase the risk of default, which in turn could create a lot of instability for lenders.

A report by **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) recently found that nearly half of existing mortgages will be up for refinancing in 2018, and that could spell trouble for many homeowners and lenders. As consumer debt levels continue to rise, a higher rate of interest will make it harder for borrowers to pay minimum payments on debt while also staying on top of rising mortgage costs. CIBC's estimate of 47% of mortgages being refinanced in 2018 is well up from the 25-35% that the bank says is typical in any given year.

While mortgages are normally held for five-year terms, Ian Pollick of the CIBC states that "Over the past two to three years, as home prices have risen unchecked, you've had people trying to get into the housing market unable to afford longer term mortgages and taken out short-term mortgages." This could be a recipe for disaster, as borrowers that secured short-term financing likely weren't anticipating that rates would increase so quickly, and with more increases expected this year, many borrowers could be in big trouble.

It will also be tougher for borrowers to shop around, as tighter mortgage rules will make it only more difficult to find better rates, and consumers may be left with little choice but to stay with their current lender.

How this will impact lenders

These developments could have an adverse impact on banks as well as on other lending companies, like **First National Financial Corp.** (TSX:FN). The danger is that lenders will struggle to collect on existing loans, and it will also be harder to grow mortgages amid tighter rules and more stringent financial requirements for borrowers. **Home Capital Group Inc.** (TSX:HCG) is another company that could feel a lot of pain as a result of this, as the company is still looking to rebuild to where it was before a big scandal rocked the alternative lender last year, which resulted in a big sell-off of the stock.

While rising interest rates will certainly help offset some of these headwinds, I'm not overly optimistic that the Canadian economy will have a strong 2018, and the TSX's performance so far this year also suggests things are not off to a good start.

Bottom line

Borrowers are likely to feel their wallets tightening, and financial institutions could see some adversity come their way as mortgages come to be refinanced. Although it's not quite doom and gloom for lending companies just yet, it's a sector that investors might be wise to avoid today. However, one way investors can hedge their position is by investing in companies that have operations that go beyond just Canada and that are diversified enough that domestic issues won't heavily weigh down their share price.

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3. TSX:FN (First National Financial Corporation)
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