Could a Rising Interest Rate Environment Hurt Canada's Banks?

Description

The question of how financial stocks perform in a rising interest rate environment is an interesting one. The overwhelming consensus on how banks are expected to perform in such an environment is positive, due to key factors such as a widening interest rate spread and increased lending margins over time.

While this certainly holds true in the early days of a series of interest rate hikes, as interest margins improve and lending growth continues to progress forward, I believe that we may be approaching a point during which rising interest rates will begin to hurt Canada's largest banks for a few reasons.

Loan origination and volume

As interest rates rise, the percentage of Canadians who can qualify for mortgages or loans at higher rates will decrease as a mathematical certainty. Instead of Joe the Plumber applying for a loan at one of Canada's largest banks such as **Royal Bank of Canada** (TSX:RY)(NYSE:RY), Joe may be forced to take a look at alternative lenders such as **Home Capital Group Inc.** (TSX:HCG), decreasing the rate at which lenders such as Royal Bank will be able to generate new mortgages over time.

Higher interest rates are unlikely to hurt loan origination volumes at the front end of the curve (hey, what's another few basis points?), but as overnight rates increase toward what most central banks refer to as a "neutral rate" (somewhere around 3%), nearly a decade of near-zero interest rates will be replaced by an interest rate environment that may preclude Joe and others from pursuing their dream homes.

Increased risk profile across loan portfolio

As rates rise, Canada's large banks may also be exposed to risks in other business segments other than traditional mortgage lending. Commercial lending is one area that's likely to exposed to macro economic risks, which may not have been as readily apparent previously. While interest rate increases obviously affect consumers, businesses also need to contend with higher lending costs, as these costs raise the debt service costs of companies in the Canadian economy.

Some of these costs can certainly be passed down to the consumer to the extent that consumers will be willing to pay a premium for services rendered, but in many cases, earnings growth and profitability are likely to take a hit in the medium term as companies seek to maintain profitability levels – a reality that will affect the willingness and ability of lenders such as Royal Bank of accepting new business loans from clients.

Bottom line

In a broad sense, the profitability of large lending institutions such as Royal Bank are affected by two key metrics: margin and volume. As interest rates rise, the margin banks receive rises in lockstep; concurrently, volume can be expected to decrease in such an environment given a decrease in loan quality and increase in risks associated with loan applicants given higher debt service needs in such an environment.

I’s my view that we may be approaching the tipping point in which lenders will be hurt more than they are helped by rising interest rates. Investors interested in Canadian banks ought to take caution in this current environment and choose their investments wisely.

Stay Foolish, my friends.

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