Buy or Sell Bank Stocks? Surtax Is Coming

Description

Most Canadian banks quickly raised their prime lending rates when the Bank of Canada began its rate-hike cycle early this month. However, bank stocks could lose their drawing power with investors if profits were to decline. A 3% surtax is on the table as part of the campaign promise of Prime Minster Justin Trudeau and the Liberals.

Nothing is certain at the moment, although it could become a reality, says a Bay Street analyst. The so-called surtax targets profits in the financial sector. According to Nigel D'Souza, an investment analyst of financial services at Veritas Investment Research, the impact on earnings growth or return on equity might not be material going forward.

However, D'Souza said, "To me, the bigger concern isn't this tax rate itself, but whether it sets a precedent for more onerous taxation on bank profits in the future." The elected government plans to raise the tax rate on banks and insurance companies from 15% to 18% if their profits exceed the $1 billion threshold.

By imposing the 3% surtax, the government expects to collect an additional $2.5 billion in revenues over the next four years. The move has the support of the New Democratic Party, as evidenced by the confidence arrangement with the current administration.

Potential response

Prime Minister Trudeau confirmed in a recent news conference that implementing the surtax remains a priority. Since the surtax would reduce big banks' bottom lines by only 1% to 2%, D'Souza doesn't suggest to investors to lighten up on their bank holdings because of this new potential tax.

D'Souza said, "The tax rate increase by itself, I don't think is a sufficient enough reason to have a more bearish or concerned outlook for the banking sector." He adds, however, the additional tax might prompt banks to change the way they deploy capital. Some might even reduce lending activities or dividends if the surtax will impact on profitability.

Second-liners

Most investors have their eyes on the Big Six banks. However, **Canadian Western Bank** (TSX:CWB) and **Laurentian Bank** (TSX:CWB) are exciting picks in the financial sector. Both banks reported profits in Q1 fiscal 2022, but their overall income might not touch $1 billion for the full year.

CWB reported increases in revenue (9%) and net income (10.6%) versus Q1 fiscal 2021. The $3.37 billion bank showed its recurrent strength once more. Branch-raised deposits increased 12% to $19.7 billion compared to the same quarter in fiscal 2021. President and CEO Chris Fowler, said the bank is on track to deliver double-digit loan growth in 2022 because of strong lending pipelines.

Laurentian Bank reported $55.5 million in Q1 fiscal 2022, a 23.9% increase versus Q1 fiscal 2021. Its president and CEO, Rania Llewellyn, said fiscal 2022 is a year of execution, and the $1.86 billion bank is off to a good start. The Commercial Banking segment delivered the strongest performance, while management remained focus on cost management and sound credit quality.

CWB and LB trade at $37.45 and $43.12 per share, respectively. The former pays a 3.12% dividend, while the yield of the latter is 4.07%. Investors in both banks are up year to date.

Serious risk

Market observers hope the surtax won't pose a serious risk to banks. They need to generate higher profits to endure economic downturns.

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1. Bank Stocks
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