Canadian banks have made money throughout the credit crisis, but this trend may be about to reverse. The rational supporting this prediction is that revenue has grown despite a declining net interest margin (NIM). It has grown in spite of this fact because Canadian debt (loan lease volume) has risen significantly, as shown in chart 2.

SNAPSHOT OF NIM, RATES, COST OF FUNDS

In 2005, the Canadian bank rate, LIBOR and the Fed rate were on the rise (Chart 1). Net interest margins (NIM) for most banks was shrinking, all the while the cost of funds for Canadian FIs generally crept up (Chart 3, 4 & 7, 8).

By the end of 2007, the Canadian bank rate tumbled in lock-step with LIBOR, dropping from 4.6% to 0.23% by Q4 2009. After which the Canadian bank rate climbed to settle at around 1%.

From 2010, the cost of funds has been generally stable for Canadian banks, all the while NIM has declined incrementally.

US: FED RATE RISE IMPACT OVERVIEW

According to Eric Rosenbaum, a financial writer for CNBC, US banks have indicated that a bank rise could lead to increased profits. Rosenbaum stated that in the short-term, a rate rise can increase bank profits due to increased NIM:

- BofA 100 basis points = $3.7 bn increase
- JPMorgan 100 basis points = $2.8 bn increase
- JPMorgan 200 basis points = $4.6 bn increase
- Citigroup 100 basis points = $1 bn increase & $629 in other currencies.

Rosenbaum indicates that successive rate rises, over a long-term (about 8 quarters) will be positive, after which bank stocks will fall. Bank stocks are currently down 1.5% because investors have priced a hike into bank stock (Rosenbaum, 2015)

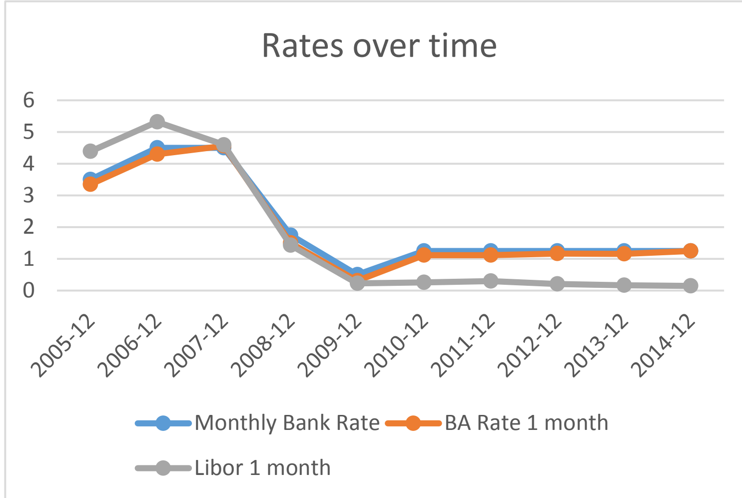

Chart 1, bank rates

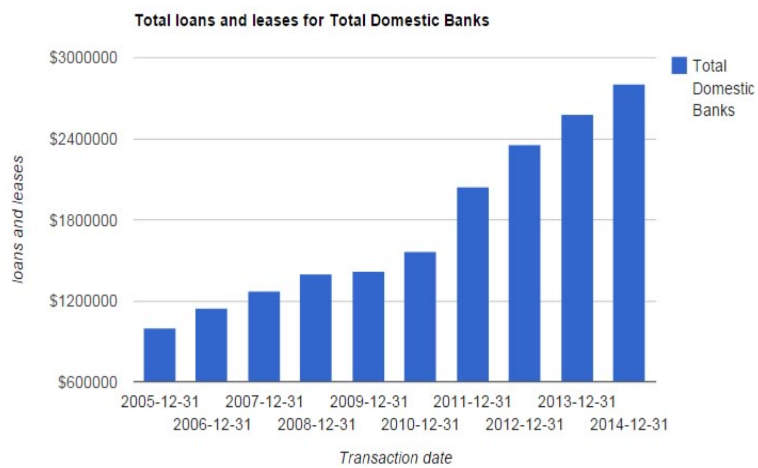

Chart 2, loan lease growth

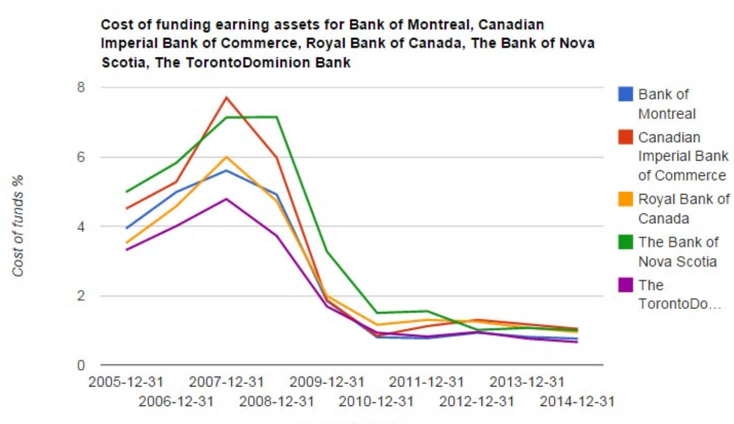

Chart 3, cost of funds

CANADA'S RATE EXPERIENCE EXPLAINED

As discussed, Canadian FIs experienced a reduced NIM between 2005 and 2007 (Chart 7, 8). The data show that the NIM moved in the opposite direction of the bank rate, which increased from 3.5% to 4.5% during this period.

Subsequently, both the NIM and the Canadian bank rate reversed course: the Canadian bank rate plummeted to 0.5% and the NIM increased.

Medium and systemically important banks (SIBs), generally experienced rapidly declining NIM from 2009, reaching a generally stable, incremental YoY declines from about 2011.

The net interest margin (NIM) for Canadian banks has been on the decline since 2009, yet the net income for banks, systemically important banks (SIBs) in particular (chart 9), has rocketed upwards throughout the credit crisis.

Medium sized bank, having a somewhat higher cost of funds, with the exception of Tangerine and National Bank, have still managed net income growth, although more modest. The trend has remained slightly tempered in comparison to SIBs throughout the crisis. National Bank being the exception with growth similar to the SIBs.

One explanation for increased revenue despite lower NIM, is that the lower margin on a much larger debt pool as shown in chart 2.

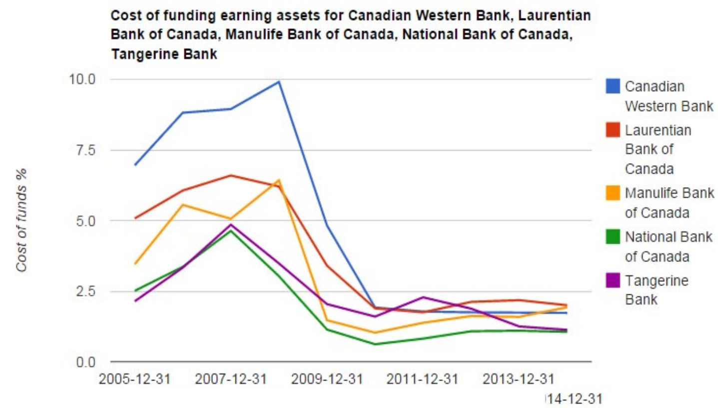

Chart 4

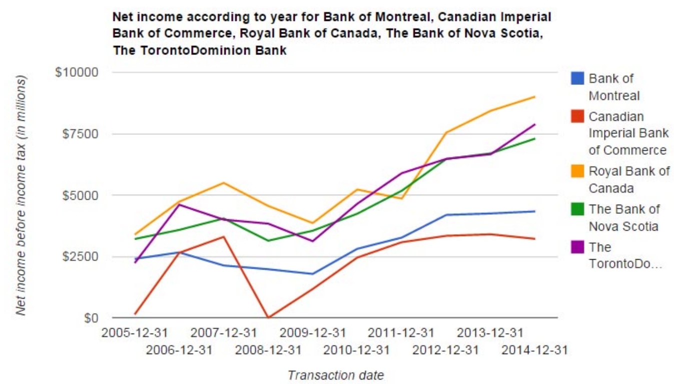

Chart 5

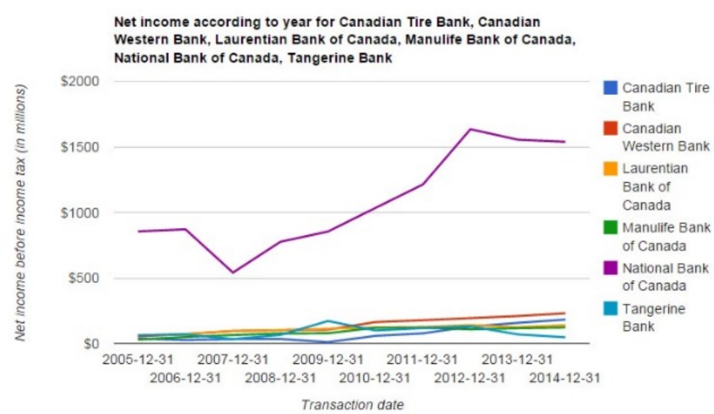

Chart 6

QUANTIFYING THE IMPACT OF A RATE HIKE

A US Fed rate increase is anticipated. As discussed, arguably, this could lead to increased revenue for US SIBs. There are several reasons why the same might not apply to Canadian banks:

1. Potential liquidity issues leading to higher cost of funds (Sibthorpe, 2015);
2. High consumer debt to income ratio 163%, versus 140% for the UK and US;
3. Canadian economy is resourced based and there is an oil glut with no end in sight, this will add to unemployment and NPLs;
4. The housing market appears to be frothy and the BoC Stephen Poloz says it may be 30% over-valued.

Add to these concerns the fact that the majority of Canadian mortgages are linked to the Bank Rate directly or fixed, means that consumers in Canada will experience any change directly. This contrasts with the US, which, according to Ben Homsy, “are more long-term”. (Homsy, 2014).

Also compared to the US, whereas the US debt curve is like an inverted U, Canada, since 2005, is more like a 45 degree angle.

The risk for Canadian FIs, according to Fraser Research, is that 6% of households have debt service ratios above 40%. This group in particular would be impacted by any change in circumstances. Signs of stress are already being seen In Alberta and Saskatchewan, where the amount of loans that were more than 30 days past due rose to 2 percent as of March, compared with 1.8 percent at the end of 2014. That was exceeded only by Quebec, where delinquencies climbed to 3.1 percent. (Adler, 2015)

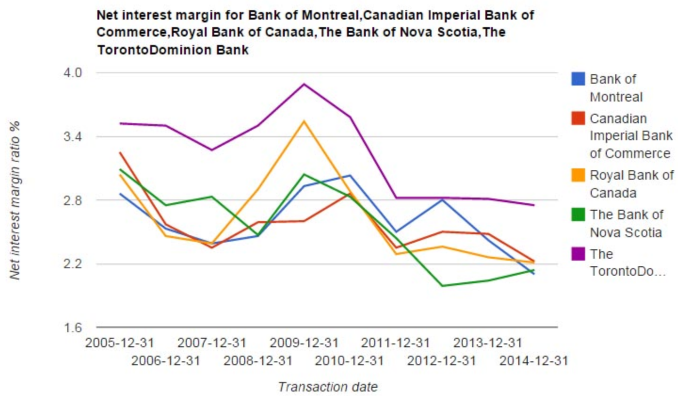

Chart 7

Simulations by the Bank of Canada suggest that a three per cent jump in unemployment could lead to a doubling in the share of households in arrrears of loan payments to just over 1.0%. (Cross, 2015) A rate rise would compound the risk.

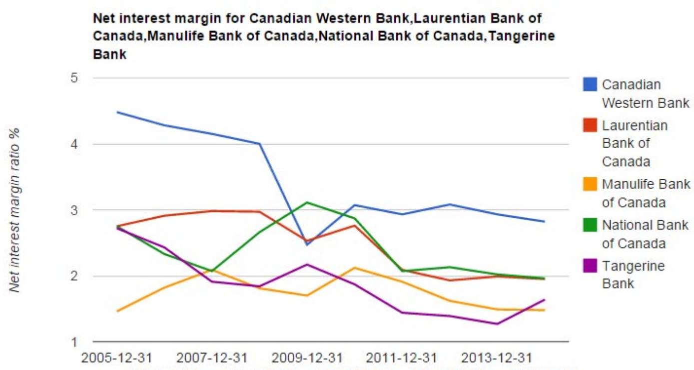

Chart 8

In summary, while a rate rise may contribute to the bottom line for US banks and foreign operations for Canadian SIBs, domestic banks would likely lose revenue. The fact that Canadian SIBs have played up their US operations and increased enphasis on wealth management could indicate that they have already reached this conclusion.

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