Why Home Capital Group Inc.'s Large Cash Balance Is a Massive Liability

Description

In this article, I'll attempt to shed some light on the banking industry for new investors and those who are interested in learning how to read the balance sheets of lending institutions at a basic level.

First of all, the financial statements of many firms, including **Home Capital Group Inc.** (TSX:HCG), are very difficult to fully understand. Securitization of mortgages through the Canada Mortgage Bond program, mortgage-backed securities, and the company's off-balance sheet activities are all topics for another day.

What I will talk about, however, is how cash is viewed from a financial institution's point of view and how analysts tend to treat cash reserves on lenders' balance sheets.

Assets minus liabilities equals equity

This is the most fundamental equation in accounting.

Let's look first at what "cash" really is for a bank.

For a non-financial institution, cash is generated through some value-added activity that results in a sale of a product or service at a markup from its cost base. For a bank, however, cash is generated through deposits via locked-in guaranteed investment certificates (GICs) or through demand deposits (what would amount to a typical personal or business chequing account).

These deposits cost money. When looking at Home Bank's list of deposit rates on the Home Trust website (the operating subsidiary of Home Capital), we can see that a five-year locked-in GIC pays out a rate of 2.1%. Compared to other financial institutions, these rates are very attractive for depositors, but they also represent a significant cost to Home Capital for borrowing money.

Over 80% of Home Capital's deposits are locked in, and of those, the vast majority have terms less than five years. In fact, 59.6% of Home Capital's borrowings (or cash) from deposits have terms of less than one year, meaning they could be called by depositors in the short term and would be considered current liabilities.

The majority of the deposits (cash) borrowed from depositors at a rate of interest have been reinvested in mortgage assets; however, a large chunk of the money ($1.2 billion) is still sitting on the company's balance sheet unused. This money could be used to generate new mortgages at higher rates of interest; the average interest rate of a residential mortgage for Home Capital is 4.63%, meaning that excess cash sitting on Home Capital's balance sheet is a massive liability, costing the company money and lowering its overall returns.

A specific amount of cash needs to be kept on hand to meet the regulatory burdens placed on lenders, including the newly introduced Basel III capital requirements. As it stands, Home Capital currently carries approximately double the required cash on its balance sheet to meet these reserve requirements, meaning that a combination of two likely scenarios is at play here.

First, Home Capital has been having difficulty originating new loans due to various scandals of late. This cash may represent a lack of deal flow coming in. Second, management may realize that the high-risk non-prime loans given to immigrants and those with low or no credit may require more cash in case of a loss, leading to the cash pile up.

Other Fool contributors, such as Ryan Goldsman, have talked at length about Home Capital's large cash balance as a source of balance sheet strength; however, I view it as a *massive liability*.

Stay Foolish, my friends.

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