Coming to Grips with Home Capital Group Inc.'s Latest Crisis

Description

When it comes to Canada's largest non-bank mortgage lender, **Home Capital Group Inc.** (TSX:HCG) investors are stampeding for the exits. The stock has plummeted by 50% over the last year, as the mortgage origination scam initially uncovered in 2014 has made it to the front page. It has triggered an investigation by the Ontario Securities Commission and sparked a class action lawsuit.

As a result, the board is doing everything in its power to calm nervous investors, including pre-announcing its first quarter 2017 results. While the situation may appear dire, it is not as bad some pundits are claiming, especially those who are making erroneous claims regarding the health of Home Capital`s balance sheet.

Now what?

The major headwind facing Home Capital is the fallout from the mortgage origination scandal. This broke when it received a letter from an anonymous whistle-blower claiming that income information was being falsified by some brokers in order to ensure the mortgages were accepted.

This has been a common problem within the industry and is certainly not restricted to Home Capital. It typically arises because of the hefty commissions paid to brokers but only upon the mortgages being originated.

Because of the scandal, Home Capital severed ties with 45 brokers but on a positive note after stressing testing those mortgages**,** it announced that the falsified applications would not lead to any credit losses.

It is here where the crux of the problem lies.

The Ontario Securities Commission investigation is focused on the company's disclosure practices as well as in some instances, share trades made by current and former directors.

If the Commission finds any evidence of wrong doing it could lead to fines and other sanctions.

However, contrary to some claims it does not constitute an investigation into the company's lending practices because it is solely focused on alleged breaches of securities law.

Then there is the erroneous assertion that the cash totalling $1.2 billion on Home Capital's balance sheet represents a massive liability. Those making this claim believe incorrectly that this cash balance includes customer deposits on which Home Capital is obliged to pay interest.

However, in accordance with generally accepted accounting principals or GAAP**,** as well as the law, financial institutions must treat customer deposits as liabilities. Home Capital has done exactly that, recording all its almost $16 billion in deposits as a liability on its balance sheet.

It should not be forgotten that Home Capital is more than adequately capitalized. The non-bank lender has a common equity tier 1 ratio in excess of 16% which is almost triple the minimum 6% required by the Canadian prudential regulator. This indicates that is has sufficient capital to meet its regulatory requirements, operational needs and any fallout from the mortgage scandal.

That huge cash sum is shaping up as a tremendous advantage at this time. It endows Home Capital with considerable financial flexibility at a time when it is exposed to significant risk. Not only does it mean that it has the financial resources required to manage the Ontario Securities Commission's investigation**,** including paying any subsequent fines and defending itself against the class action**,** but once the dust settles can fund acquisitions or internal programs aimed at strengthening its broker network.

A sharp expansion of non-performing loans because of the scandal is weighing heavily on the minds of many investors despite Home Capital's affirmations that it will not suffer any credit losses.

Nonetheless, its extremely low non-performing loan ratio of 0.30% means that there would need to be a significant increase in bad loans in order to affect the integrity of its balance sheet.

Furthermore, that large cash holding even after allowing for the securities investigation, class action and regulatory requirements, is more than sufficient to cover any required lending loss provisions.

So what?

Home Capital's situation is certainly grave and clearly the worst of it has yet to be played out, meaning it could take further hits on its earnings and stock price. Even so, its considerable capital adequacy and large cash balance indicates that Home Capital should be able to weather the worst of the storm, making it imperative for investors to ignore the sensationalistic and, at times, erroneous claims regarding its state of affairs.

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