Forget Home Capital Group Inc.: Here's Why You Should Worry About the Banks

Description

If you're a long-time shareholder of **Home Capital Group Inc.** (TSX:HCG), I feel your pain. In the span of a week, you've lost 60% of your capital, rendering seven years of positive returns over the past decade meaningless.

Now that its share price has recovered from hitting a five-year low of $5.68 — a level it hasn't seen since 2003 — investors can rest a little easier knowing it has a $2 billion line of credit to lean on should it need the cash, albeit at 20% interest.

As a result of the hysteria surrounding Home Capital's business and corporate governance practices, deposit holders with the alternative mortgage lender have demonstrated ruthless efficiency withdrawing funds from Home Trust, Home Capital Group's principal operating subsidiary.

It seems a 1% high-interest savings account at a trust company, whose very future is still suspect, isn't a very attractive offer for most savers; nor should it be.

The other day I was communicating via email with a close friend who works for one of Canada's big banks and has lots of experience with mortgages; of course, we discussed Home Capital's situation.

My friend was concerned that the collapse of Home Capital and any other alternative lender could put the banks in the driver seat when it comes to average Canadians accessing mortgages. Furthermore, if those ordinary Canadians don't fit into the bank's little boxes, a term my friend used to describe the "perfect" customer, residential real estate prices could finally turn for the worse.

Fool.ca contributor Jason Phillips recently discussed what the fall of Home Capital means for the Canadian housing market. He points out that Home Capital accounts for just 1% of the entire Canadian residential mortgage market and of that group of mortgages, only 0.3% is delinquent.

So, you can either view Home Capital's situation as a one-off, isolated incident or interpret this to be the inevitable beginning of the unraveling of the great Canadian real estate bonanza — a situation where everyone, including the big banks, gets hurt.

I've been saying for some time that the CMHC, in conjunction with the Federal Government, is a willing accomplice to the crazy real estate prices paid in Canada's largest cities. The mortgage insurance rules, despite tweaks to the system in the last few years, have made it easy for buyers to get in on the action. All the while, the CMHC was raking in huge premiums for its insurance.

My biggest issue with mortgage insurance is it puts the ultimate onus on Canadian taxpayers and not the banks who lend the money. The Federal Government has proposed that banks pay part of the insurance deductible, but industry insiders are loath to adopt such a policy, preferring other less disruptive ideas, such as requiring mortgage insurers to buy reinsurance.

It's going to take a lot of convincing by Bill Morneau and company to get the banks to give up their printing presses.

Beyond the CMHC, my friend mentioned automation as a big reason why housing prices have risen so fast. Here's a scenario.

You own a house in Hanover, Ontario. The average price in the area is $250,000. So, you list your house for 90 days at $330,000, way above any industry norm for the area. After the listing expires, you take it off the market, deciding to remain in Hanover instead of moving to Prince Edward Country to enjoy the wine lifestyle. When your MPAC assessment arrives the next year, you notice that your house is assessed at $330,000, the same price you'd listed your house only months before.

How does that happen?

It's the result of automated systems like CMHC's Emili, which evaluate an application's likelihood of default. Included in this evaluation is a quantitative-based analysis of the home in question as well as the area where the home is located. There is no human appraisal. Whatever information is fed into the computer dictates Emili's evaluation.

Why does that matter?

It artificially pushes housing prices higher, which increase the amount you can borrow against your home; lo and behold, Canadians are one of the most indebted nations in the developed world.

It's not a problem for banks yet. But, if you own bank stocks, you should consider lightening your weighting until the residential mortgage market sorts itself out.

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