Is Laurentian Bank of Canada a Home Capital Group Inc. 2.0?

Description

Headline news of “bad mortgages” gives many investors the heebie-jeebies, considering the fact that the Global Financial Crisis, which gripped the U.S. banking industry, is only a decade old.

In 2017, a run on deposits held at alternative mortgage lender **Home Capital Group Inc.** (TSX:HCG) due to improper income disclosures on a significant portion of the company’s mortgage portfolio led to a sharp decline in the company’s share price and sent shock waves within the alternative lending and conventional lending spaces.

More recently, shares of Canadian lender **Laurentian Bank of Canada** (TSX:LB) have dipped more than 5% over the past two weeks, as investors continue to re-evaluate the lender’s risk profile after an announcement that the bank would be buying back $392 million of problematic mortgages from a third party. The announcement followed an initial assessment of the total amount of “mis-flagged” mortgages more than a month ago at much lower numbers. With the number of problematic mortgages climbing, concerns that we have only seen the tip of the iceberg have led to a general sell-off over the past two weeks.

A common practice in the mortgage industry is for lenders to originate mortgages and subsequently sell off the debt instruments at a profit to other large financial institutions, which may then turn around and package said mortgages into securities which can, in turn, be sold for a profit. While Laurentian does not necessarily fall into the category of a “non-prime” lender like Home Capital, the bank is competing with a handful of other very large and powerful competitors and is often seen as a go-to lender for those without the ability to be serviced by Canada’s largest banks.

Whether or not the mortgage brokers originating loans on behalf of Laurentian acted in such a manner that would constitute “willful wrongdoing” remains to be seen; however, Laurentian does not believe this is the case. Despite more than half of Laurentian’s B2B mortgages sold to an unnamed third party containing “documentation issues,” ($392 million out of $655 million in loans audited), the company believes this issue is not widespread and will not have a material impact on earnings moving forward.

Bottom line

The reality remains that Laurentian bank is a niche lender in the Canadian mortgage scene, and while $392 million in loans is a drop in the bucket for banks such as **Royal Bank of Canada** (TSX:RY)(NYSE:RY) with a market capitalization of more than $156 billion, for Laurentian, a lender with a total market capitalization of only $2.2 billion, I believe this situation may be more serious than initially indicated, given the percentage of loans which were found to be inadequate in the aforementioned isolated audit.

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