Intelligence MEMOS

From: Jeremy Kronick

To: Maureen Jensen, Chair of OSC

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Re: **Home Capital - How did we get here?**

Housing market news over the last couple of weeks has zeroed in on Home Capital, an alternative mortgage lender that is bleeding deposits. There are obvious concerns of contagion, but perhaps the bigger question is how and why did we end up here, when at the end of the day, there appears to be little concern over the quality of the underlying mortgages on Home Capital's book?

Investor Protection is in the first sentence of the OSC mandate, therefore it is appropriate that it hold any institution that plays fast and loose with regulatory requirements to account. The OSC has alleged that Home Capital, and many of its current and former executives, did not disclose to shareholders the fact that they knew of fraud within their mortgage broker network prior to announcing this to the public in the summer of 2015, and that once disclosed, disclosure did not go far enough. So far so good, but banks and trust companies are institutions relying on confidence and regulators must show care and attention in framing their public statements so as not to cause unnecessary market uncertainty. This is not to absolve Home Capital itself, who has badly misjudged public confidence, however, the extraordinary public nature of this OSC-Home Capital case has led to an erosion of confidence and with it a massive withdrawal of deposits. An ordinary compliance action has morphed into a full scale liquidity crisis.

The result has been a loss of liquidity for Home Capital that has led it to require a $2 billion line of credit, at an effective interest rate that appears crippling. Additionally, we have seen the share price of other alternative lenders, such as Equitable Bank and Street Capital, decline amidst concerns of similar practices within their organization - indeed, Equitable Bank had to quickly establish its own backstop facility to restore confidence.

The irony in all this is the underlying assets of Home Capital, i.e., their mortgages are safe according to most analysts.

What are the lessons for regulators from all this? First is the importance of the deposit base in determining a company's liquidity risk. Research at the IMF has shown that the larger the share of deposits considered sticky, i.e., withdrawals are stable, the more likely a financial institution will be resilient to shocks. Wholesale deposits, while generally considered more volatile, are far stickier when tied up in GICs than those in high-interest savings accounts – a fact surely not lost on Home Capital. In fairness, this is likely an issue for Mr. Rudin at OSFI. So let's turn to the second lesson.

While regulatory non-compliance cannot be accepted, in dealing with issues that may affect public confidence in institutions, regulators must have a longer term public messaging game plan for the inevitable public fallout. Given the ripple effects that started to cascade through the sector earlier this month, revisiting how best to disclose regulatory non-compliance is a logical next step.

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