THRIFT INSTITUTIONS AND THE INTERNATIONAL FINANCIAL MARKETS

Text of Speech by Mark Boleat, Director-General, The Building Societies Association, at North Carolina League of Savings Institutions Conference, Vancouver, Canada, 30 July 1987

Introduction

"Thrift" is an old English expression but as a noun it is largely applied now to American institutions which are savings and loan associations or mutual or federal savings banks. The word thrift seems to imply saving, and indeed the predominant traditional characteristic of today's thrift institutions is that they have been primarily geared to raising savings from individuals and, moreover, those savings have been predominantly channelled into loans for house purchase.

It might therefore seeem paradoxical that one can make a speech on the subject of thrift institutions and the international financial markets. However, the fact is that market conditions no longer allow traditional thrift institutions to survive. This applies not only in America, but also in most other countries which have had what might be called an Anglo-Saxon financial system with specialist housing finance deposit-taking institutions as well as more wide ranging commercial banks. Technological progress and deregulation have made the traditional thrift an endangered species and they have had to adapt to changing circumstances by widening their sources of funds and also by widening their lending activities and generally the services which they provide.

This paper takes an international view of the development of thrift institutions, particularly how they have been diversifying their sources of finance to make greater use of the wholesale financial markets generally and the international capital markets in particular. The paper concentrates on the American and British situations but also takes in the experience of other countries where similar financial structures apply.

Thrift Institutions and Housing Finance - The Traditional Role

History will show that thrift institutions enjoyed their golden era in the 1960s and 1970s. They were well positioned in rapidly growing markets and often faced little competition. Their raw material, retail savings, proved ideally suited to fund their output, the mortgage loan, and the period was one of uninterrupted growth with generous, if not over generous, profit margins. It is necessary to analyse this somewhat idyllic state of affairs in some detail.

In most countries housing finance markets have been rapidly growing. In some countries, for example the United Kingdom, this reflects a rapid increase in the rate of owner-occupation as part of conscious government policy, or to some extent the accidental effects of government controls on the private rented sector. Even where this factor has not applied, and America and Australia are among the countries where owner-occupation has not been increasing rapidly, then lending on the security of housing has been attractive for many people.

Housing has itself been a good investment, more than keeping pace with inflation, and has been subject to preferential tax treatment. Typically, owner-occupied housing has been exempt from capital gains and wealth taxes. For much of the 1970s the owner-occupied house was the only investment which most people could make which could be guaranteed to keep pace with inflation.

Perhaps more importantly, mortgage loans have also been favourably treated, most notably by interest on them being deductible from income for tax purposes. This has boosted artificially the demand for loans secured on housing, and many people have taken out such loans even when they could have financed a house purchase or improvement by drawing on savings. Certainly in Britain, it has been possible for the past 20 years for most people to borrow from a building society at a lower rate of interest after tax relief than they have been able to obtain on their savings in that same building society. The first law of mortgage lending in Britain is that the market grows by 18% a year regardless of anything else, and this law has held fairly well over the past ten or twenty years notwithstanding the many shocks to the financial system generally.

Faced with such a rapidly growing market, it would be difficult for institutions in it to do badly. Thrift institutions also enjoyed the advantage of raising their funds from the underdeveloped but rapidly growing retail savings market. The great advantage of raising funds from people rather than institutions is that many people are prepared to accept a below market rate of interest either out of inertia or because they value the quality of service more than the rate of interest. Every thrift institution throughout the world is carrying funds at a lower rate of interest than the investors could otherwise obtain, probably in most cases by switching funds within the institution. In Britain, for example, we still have nearly 20% of our funds in old-fashioned passbook accounts even though every society is offering rates of interest up to three or four percentage points higher for accounts with no minimum deposit and no period of notice before withdrawal.

Thrift institutions also benefited by being protected by governments. This protection was in some cases deliberate, and in others accidental. It was deliberate in the United States through Regulation Q which gave the thrifts an interest rate advantage over the commercial banks. In Britain, Australia and a number of other countries, the protection occurred in a quite different way. Increasing emphasis was placed on monetary policy as a method of controlling the economy. Governments everywhere wanted to keep down the rate of growth of money supply and this was equated either with bank deposits or bank lending. Deposits in, or lending by, thrift institutions was not counted as being part of the money supply and therefore was not controlled as vigorously if at all. One therefore found interest rate controls on banks but not on building societies, as happened in Australia, or constraints on the growth of the balance sheet of the banks but not of the building societies, as in the United Kingdom.

Given such a situation it was hardly surprising that thrifts did well. They were able to raise relatively cheap funds from the retail markets and could lend these on the rapidly growing and very profitable mortgage market, and moreover they did so with extensive government protection. There was also the peculiar American situation of borrowing short and lending long. Through a variety of regulatory controls the American

thrift institutions were prevented from making variable rate mortgages until the early 1980s. Funding 25-year fixed rate loans with variable rate deposits was a practice which most institutions would regard as leading to disaster. In America it was not so regarded although, of course, eventually it did lead to disaster. For most of the 1960s and 1970s the fact was that short-term variable rate deposits carried a much lower rate of interest than long-term fixed rate loans so that thrift institutions were inevitably going to make healthy profits.

When institutions are doing well there is little need for them to innovate, to consider new ways in which they might be doing existing business better or indeed to consider whether they are in the right business at all. Many thrifts became complacent, believing that they were doing a splendid job because they were producing splendid results whereas, in reality, those results reflected more very favourable market conditions rather than the expertise of the thrift institutions themselves.

The Rebundling of the Housing Finance Package

All of this has changed dramatically in the past ten years. Thrift institutions the world over face a much more difficult market position. Many are finding it difficult to survive, and either have gone out of business or have converted into more wide ranging financial institutions. It is fair to say that within a few years there will be very few large institutions which have only the traditional characteristics of thrifts, that is raising retail savings and making loans for house purchase. A variety of factors has led to this dramatic change in the situation.

Perhaps underlying many of them has been technological progress. Technology generally breaks down barriers between markets and institutions. It makes it more difficult to protect artificially one group of institutions. For example, it might be relatively easy to protect thrift institutions as a species when people have to pay in and take out savings by means of branches. When this can be done by shared ATM facilities the thrift institutions are ceasing to offer a unique package. American thrifts suffered by the growth of money market mutual funds in the 1970s. These prospered primarily for regulatory reasons, but they were also able to make use of new technology to offer their products. In the mortgage market new computer systems have enabled mortgage loans to be originated from remote locations and to be processed largely automatically, packaged and then resold.

Technological progress coincided with the great shocks to the financial systems of the world in the 1970s resulting from a combination of the oil crisis and American deficit financing. Rates of inflation rose rapidly and interest rates followed in their wake. Administrative controls which previously had protected the thrift institutions became unworkable. It was one thing to operate Regulation Q effectively when money market rates were around the regulated rates, but as money market rates increased towards 15% while regulated rates were still at 5% then, of course, money market mutual funds developed to enable the small investor to be able to take advantage of interest rates payable to holders of larger sums of money. Governments gradually, very gradually in the case of the United States, recognised what was happening. Administrative controls on interest rates were simply unworkable and to the extent that they did work, this was to the disadvantage of the poor

by denying them the most attractive rates of interest in the market place. Steps were therefore taken to deregulate interest rates. However, as other institutions became more able to offer mortgage loans and savings accounts by virtue of technological progress, then in order to allow the thrift institutions to prosper, they too had to be deregulated. This deregulation has occurred in all countries and moreover in very similar ways.

In the United States there was the Depository Institutions Deregulation and Monetary Control Act in 1980 followed by the Garn St Germain Act of 1982. It is fair to say that the American situation is not typical, because of the crisis in the thrift industry caused by borrowing short and lending long and the inevitable result that, as interest rates rose rapidly, so the thrift institutions made massive losses. Responding to a crisis never produces satisfactory results, and it now seems that the deregulation was not as efficient as it might have been. For some thrift institutions the deregulation went too far and the combination of wide-ranging powers for thrift institutions, the federal underwriting of deposits up to $100,000 and the failure of the supervisory system to keep pace with what was going on in the industry has led to the problems which now currently exist with the FSLIC fund in massive deficit.

Other countries have been able to adopt a more leisurely approach to deregulation as for many years they had the variable rate mortgage, although it was not until it was introduced in America that they actually knew what to call this instrument. In Britain, for almost as long as anyone can remember, mortgage loans have carried variable interest rates at the discretion of the lender. There are no such things as teaser rates or interest rate caps. Lenders are free to vary the rate of interest as they wish. This freedom is not, of course, unfettered, because lenders cannot stand out against market rates and if they endeavour to hold their rates above what the market requires, they will not only get no new business but will also lose their existing mortgage loans as other institutions are willing to refinance and to pay all of the fees involved. A similar situation applies in both South Africa and Australia where variable rates have been used for a long time.

All of these countries, therefore, could adopt a more studied approach to deregulation. Committees of inquiry looked at the financial system and recommended deregulation. Draft legislation was discussed between the relevant government departments and the industry groups, presented to Parliament and approved. Unlike in America, the parliaments of most other countries are relatively powerless bodies and once governments have decided to legislate then that legislation will go through.

In each country the legislation is remarkably similar. Thrift institutions are given greater powers to raise funds from the wholesale markets, they are permitted to invest their assets in different ways, including unsecured loans, residential land and limited investment in subsidiaries, and they are empowered to offer a range of financial and house-buying services. In Britain this legislation was the Building Societies Act 1986 which came into effect at the beginning of this year.

The legislation generally also allows thrift institutions to convert from mutual to stock status. In some countries, for example Australia and the United Kingdom, this can occur only through the thrift

institution also converting into a bank and thereby ceasing to be a thrift. In the United States and South Africa it is possible for a thrift institution to have a stock charter while still continuing to operate as a thrift. Most of the South African building societies have taken the route of adopting the stock charter, as indeed have all of the large savings institutions in America.

These legislative changes enable thrift institutions to continue to play a major part in the new housing finance market which has evolved. The major feature of this market is that there has been a rebundling of the package of services which is offered to the consumer. The characteristic of thrift institutions in the past was that they offered a package to the home buyer comprising the origination of the mortgage loan, the servicing of the mortgage loan, and the holding of the mortgage loan. Thrift institutions were good on average at doing all of these and as they had no competitors they were able to do very well. The market now requires these three elements to be separated, and it is technological progress which has made this possible.

The origination of mortgage loans is now most easily done by institutions which are in direct contact with those purchasing homes, that is, house builders and real estate agents. In some countries, because of the particular nature of the financial markets, insurance companies, some of which regularly call on their customers, are also well-placed to originate mortgage loans. When someone purchases a house, they also purchase a range of other financial services including insurance and possibly an unsecured loan. The key to capturing all of this business is to get to the customer first and real estate agents have therefore grown enormously in importance. Thrift institutions have in some countries sought to purchase or set up their own chains of real estate agents, partly to protect their source of mortgage business but also to be able to sell the related products. In New Zealand, for example, the largest building society also runs a very large estate agency, and in Canada the largest trust company runs the largest estate agency.

The real estate business in the United Kingdom has undergone a dramatic change in the past four years. Until four years ago there were no large chains of estate agents. Now, estate agency chains are being formed by financial institutions and four or five already have some four hundred branches each. They are led by the Prudential insurance company and the merchant bank, Hambros, but three building societies, the Halifax, the Abbey National and the Nationwide, also have large estate agency chains as does one of the largest banks, Lloyds.

The servicing of mortgage loans is a relatively mechanical operation that can be done by anyone. Thrift institutions are well placed here, but the market is a relatively easy one to enter for specialist institutions taking advantage of modern computer techniques. Several such institutions have been formed in the United Kingdom.

The greatest change however has come in respect of the holding of loans. It has been assumed in the past that institutions which make loans continue to hold them but there is no necessary reason why the ability to originate a loan should coincide with the ability to hold it. The revolution in the financial markets throughout the world has radically changed the best method of funding long-term mortgage loans. This has applied whether institutions are funded from the wholesale or

the retail markets. There has also been a common trend throughout the world towards the use of variable interest rates for loans, at least on the part of those institutions which are solvent and wish to remain so.

Until five years ago it was difficult to tap the wholesale markets for variable rate funds. Banks traditionally lent at fixed rates and bond issues could also be made for fixed rates only. However, as the financial markets have developed, so variable rate funding instruments have become available. Short term certificates of deposit can provide a huge amount of funds although, of course, they need to be constantly rolled over, but then there has been the opportunity to issue CDs that are automatically rolled over. More importantly, the Eurobond market has spawned a floating rate note allowing institutions to raise long term funds at a rate of interest which floats only a fraction above money market rates. This has been followed by banks being willing to advance loans to thrift institutions on the same basis. Where is all this money coming from?. The answer to a large extent is Japan. Japan is rapidly growing as a world economy and one sees it dominating the financial markets in the years ahead. All the largest banks in the world are now Japanese and the largest Japanese securities firms, Nomura and Daiwa, make Salomons and Credit Suisse First Boston look comparatively small. The huge trade surplus that the Japanese have earnt has led them to invest the funds in other markets, with sterling and dollars being particularly attractive to them. It is estimated that over the past few years Japanese banks have provided perhaps a fifth of the new money flowing into British building societies.

This rebundling of the house purchase package means that it is no longer sufficient to be good, on average, at originating, servicing and holding mortgage loans. Rather, it is necessary to be best at one or more of the functions. Thrift institutions are not desperately well-placed to be best in any of the functions. They cannot originate loans as well as real estate agents and others closer to the market, and they are less able to hold loans because naturally they are not institutions which use wholesale markets for their financing. True, they might be very good at servicing loans but then this is a mechanical operation that can be performed by almost anyone with a limited computer facility.

Thrift institutions have therefore had to adapt, by using the new powers given to them by the various legislative measures. Not all have taken the same routes. Generally, the largest thrift institutions have sought to become full scale retail banks and have run their mortgage business almost as a separate operation. They attract mortgage business perhaps through their contact with customers as part of their retail banking business. Many thrift institutions have set up mortgage banking subsidiaries to generate mortgage business for their own books or perhaps to sell into secondary markets.

For some, these limited powers do not go far enough, hence the need to convert to another status as has occurred with many of the American institutions. It is helpful to look briefly at the position in other countries here. In Australia, the building society industry is rapidly disappearing. Deregulation of the banks put the building societies in an adverse competitive situation and their market share has declined sharply. The banks are regulated on a federal basis while building societies are regulated on a state basis and states have sometimes been very slow to free up their institutions. Several building societies have taken the view that they have no future as building societies. A

few years ago, the second largest, the NSW Permanent, converted to banking status and now operates as a savings bank under the name of Advance Bank. More recently, the United Permanent Building Society, which had become the second largest building society, converted to banking status and was purchased by one of the new foreign banks, comprising the Royal Bank of Canada and National Mutual Life Insurance Company of Australia. The Perth Building Society, the fifth largest, has taken over another large building society and has converted to banking status and now operates as the Challenge Bank.

In Britain, the new Building Societies Act gives societies power to convert to company status. It is, as yet, uncertain as to how many will choose to do so. Arguably, the new Act gives societies sufficient flexibility to operate for a few more years and, in any event, the conversion process will be difficult. However, there are many commentators who think that within five years a number of the largest building societies will have become banks.

The Globalisation of the Capital Markets

These developments have coincided with the globalisation of the capital markets. This is not the place to rehearse the reasons why the Euromarket developed. It is sufficient to say that the market originated in the early 1960s following the imposition by the American government of controls on outflows of capital from the United States. The restrictions led to a transfer of dollar financing activity and expertise offshore, principally to London, and the activity has subsequently spread across borders and across currencies worldwide. The Euromarket has grown because it has not been regulated and it owes its growth to regulations in national markets. It has become extremely efficient, and deregulation of national markets has failed to reverse the trend. The Euromarkets, funded to a large extent by Japanese institutional investors, enable institutions to obtain their financing on the finest possible terms. Strong competition between market makers ensures that this is the case and margins have been driven down.

The Euromarkets were used originally by banks, sovereign states and large industrial companies. Thrift institutions have been relatively new entrants into the market. The way was led by the American quasi-governmental organisations, and individual thrifts have subsequently followed. In Britain the building societies were effectively permitted to use the Eurobond market from October 1985 and they have already raised some £5 billion from this source.

Inevitably, it has taken thrift institutions some time to make maximum use of this new market. They are not familiar institutions to international investors and it has taken time for the investors to be educated. This has been done by road shows and extensive work by thrift institutions and the banks which are advising them. In fact it should not have been too difficult for thrifts to use the international capital markets. Their lending is exceptionally safe and they are highly regulated. More importantly, most of the issues made by American insitutions have effectively been backed by the US government in one form or another and the American government is still regarded as a very safe investment.

It is worth commenting here on the peculiar position of British building societies. They truly are mutual and still at present obtain some 80% of their funds from their members who are called shareholders. When they raise funds from the international capital markets these funds are unsecured but, of course, they rank prior to the funds of the members, that is, the ordinary investors. One therefore has the seemingly perverse situation that in the event of a British building society going bankrupt, something which is unthinkable, then the institutional investors would be paid off first, and ordinary people would be paid off second. This is in total contrast to the American position whereby the Government pays off ordinary investors first and then one has to see what is left for anyone else. In Britain there is no significant investor protection scheme although there is a modest statutory scheme by which 90% of investments up to £10,000 (shortly to be increased to £20,000) are protected. To institutional investors therefore, building societies have 80% capital backing and they have no need to offer security for their international borrowings.

Thrift institutions can raise funds on the international markets unsecured, secured by the whole of their assets through a floating charge, secured by particular assets, for example government securities, or secured by mortgages in the form of mortgage backed securities. There have been only a few true issues of mortgage backed securities in the European markets. Those issues which have been made have generally been underwritten by one of the government agencies.

In Britain the first few issues of mortgage backed securities have now been made, not by building societies but rather through three of the five new mortgage companies which have recently been established by financial groups. They obtain all of their short term funding from the wholesale markets and obtain mortgage business largely through introductions from life companies.

These issues are fairly similar to mortgage backed securities issues in the United States. Some have said that this is the way forward and why don't building societies follow. There are a number of reasons for this. The issues are in fact not only mortgage backed but heavily insured. In Britain the loans which have been securitised in this way cannot be for more than 80% of the purchase price unless there is insurance of the top slice of the loan. More importantly, there is a mortgage pool indemnity insurance covering up to 10% of the entire mortgage pool. What is actually backing the financing is therefore not mortgages but the insurance company concerned and in this case it is one of the largest companies in the world. Not surprisingly, the notes have received an AAA rating from Standard and Poor's.

For the issues made in Britain there is no exact correspondence between the rate paid on the securities and the rate charged on the loans. The issuing institution guarantees to make up any shortfall.

The notes are carrying a rate of interest of approximately 20 basis points over money market rates and, together with the insurance costs, this is quite expensive funding. Building societies have had no need to use this source of funding because they can obtain wholesale money at a cheapter rate on an unsecured basis. Possibly, societies might be driven into using the secondary market for capital adequacy purposes but, in this case, a new instrument would be needed because it would probably not be acceptable to the regulatory authorities for building

societies to be able to sell loans but to guarantee to make up any interest shortfall if the market interest rate on the notes cannot be met from the interest charged on the underlying loans. This is a matter which is currently receiving some attention in Britain.

To many in the thrift industry, what is going on in the international financial markets must be confusing. However, one does not need to understand it to be able to use it. Basically, the Eurobond market consists of extremely intelligent people making a lot of money out of very intelligent people and one wonders how long this can continue. While the opportunity is there to raise funds at a relatively cheap rate it is something that, not surprisingly, thrift institutions should take advantage of. However, there is no guarantee that this situation will apply for all time and it may be that within a few years the retail market will again become the more attractive source of funds for mortgage loans.

British building societies are in a unique position here because they are prevented by law from raising more than 20% of their funds from the wholesale markets. We are hoping that this figure will be increased to 30% with effect from the beginning of next year. If it is not so increased, then societies will be making greater use of secondary market facilities. British building societies have been put in a particularly difficult competitive position over the last few years because of the Government's privatisation share issues and the accompanying increase in popularity of mutual funds as an investment. Societies now find that the retail market is not the most appropriate method of funding mortgage loans, hence their need to make greater use of the wholesale markets including the Eurobond market although, as yet, not through the secondary mortgage market.

Markets change over time and thrift institutions need to be well placed to take advantage of such changes. They certainly need to have power to raise money in the international capital markets but equally they must not turn their back on their traditional source of funds. In five years time it may be the case that these will once again be attractive. Here, however, an international observer must comment that the American situation is very different from that in other countries.

I have commented earlier that there is a general trend towards the increasing use of variable rate mortgages. The fixed rate mortgage frankly has little that can be said for it. It involves the individual who is often fairly ignorant, being asked to gamble on interest rates. In some countries only fixed rate loans are available and prepayments are impossible. This is the case in Denmark. There are people living next to each other, some of whom are paying 22% for their loans and some of whom are paying 12%. How can this be equitable? When the Danish market is deregulated I suspect we will see greater use of variable rates.

In countries where it is possible to redeem, without undue penalty, a fixed rate loan then institutions which have funded fixed rate loans with long-term bond issues at matching rates, can be put into financial difficulty. This is applying at present in France where people are redeeming 15% loans and taking out 10% loans, which is bad news for the financial institutions which have funded the 15% loans with 14% long term bonds.

Borrowing short and lending long, as the American thrift institutions did in the 1970s, is, of course, disastrous, and this is now widely recognised even in the United States. Thrift institutions that are making fixed rate loans are generally laying off the interest rate risk through the secondary market.
However, in Britain life is much simpler. All but a tiny fraction of loans are made at variable rates of interest. All borrowers are paying within one percentage point of each other and any differences now largely reflect risk rather than the policies of individual lenders. There have been slight variations on this theme over the past few years. Some lenders have made fixed rate loans but the rates are fixed for no more than three years at a time. Other lenders are making loans which are linked automatically to money market rates. These last two forms of loan are probably precursors to use of the secondary marketas it is doubted whether the traditional building society mortgage loan which has a rate of interest variable at any time, is truly marketable in the secondary market.

America seems to be combining the fixed rate loan and the variable rate loan. People are not stupid. When interest rates are perceived to be high they are taking out variable rate loans, when interest rate are low they are taking out fixed rate loans and are refinancing variable rate loans at fixed rates. This makes it difficult for thrift institutions to match assets and liabilities. Indeed, it would seem difficult for thrift institutions to hold mortgage loans on this basis at all. Giving the borrower the right to redeem a loan at any time inevitably poses the lending institutions with a major risk which they can hedge against, but never perfectly. If thrift institutions are currently making and holding fixed rate loans then they are very vulnerable to a rise in the general level of interest rates. However, when interest rates are low the consumer wants fixed rate loans. When interest rates are high then it is possible to make variable rate loans funded by variable rate deposits and this can work quite well. It would seem that the peculiar combination of fixed and variable rate loans which has resulted in America and which applies almost nowhere else in the world seems to make thrift institutions inappropriate to hold large volumes of loans.

Conclusionn

Thrift institutions have seen more change in their markets and methods of operation in the past ten years than in the previous fifty. The formula which worked so well in the 1960s and 1970s simply does not work in the 1980s. The consumer has benefitted enormously from this. He now has a greater number of institutions seeking to provide mortgage loans to him and also seeking to provide financial services. Many thrifts have adapted extremely well by widening their range of activities and becoming full scale retail banks, or in some cases by narrowing their' range of activities and becoming mortgage bankers. Some have seen their future as not being thrift institutions and have converted to other corporate forms. Some have simply not found it possible to keep up at all and have allowed themselves to be taken over by other institutions.

Sadly in some ways the traditional thrift is dying. I do not believe this will have adverse effects on the housing finance market generally and indeed, if anything, the greater range of suppliers will actually make for a more efficient market. Still, one cannot do anything but view with sadness market developments which are leading to the gradual dismantling of an industry which has done so much to promote social

welfare in so many countries over a great many years. We might not like the new situation but we have to live with it and the test of success of thrift institutions will be the extent to which they do so, by adapting and finding a new niche in a new market place.