HOUSING FINANCE IN DEVELOPING AND INDUSTRIALIZED COUNTRIES

Text of Speech by Mark Boleat, Secretary-General, IUBSSA,
at Inter-American Housing Union Conference,
Cartagena, Colombia, 27 May 1987

Introduction

The housing finance industry the world over is in a state of rapid change, some might say rapid decline. The traditional building society or savings association is fast disappearing and such institutions are either transforming themselves into banks or are adopting many of the functions of banks. The inevitable conclusion seems to be that in the retail financial market at least, the role of specialist institutions is declining and that of general financial institutions is increasing. This paper examines new directions taken by housing finance institutions at the international level, concentrating predominantly on the position in industrialized countries.

Housing Finance Institutions in National Financial Markets

In Britain we like to say that building societies are a peculiarly British institution. This is not strictly true, of course, but it is fair to say that building societies originated in the United Kingdom, and in the other countries where they exist they were either imported from the United Kingdom, or, alternatively, the idea was largely borrowed from the UK. Not suprisingly one finds that there are building societies only in English speaking countries. However, the savings associations in the United States and South America have been similar in concept to building societies. The continental European countries and Japan tend not to have specialist housing finance deposit-taking institutions. There, the commercial banks, savings banks, cooperative banks and mortgage banks (often connected to these institutions) tend to be much stronger. Indeed, in the whole of the continent of Europe one will not find any specialist housing finance deposit-taking institution that has a significant share of its mortgage market.

The Historic Position

Building societies (the term here including savings associations) have been fairly easy to define in the past. Basically, they have been institutions owned by their members which have obtained their funds from the retail market and the assets of which are predominantly loans for house purchase. Balance sheets typically have shown over 90% of liabilities in retail deposits and about 80% of assets in loans for house purchase. Mutuality would seem inherent in the name "building society", and indeed most building societies still are mutual although the concept of mutuality has had less and less meaning as societies have become larger and moved away from operating in single towns or regions.

Until the late 1970s building societies tended to thrive in all the countries where they existed. They were helped in this respect by a combination of factors. The first was that they were lending in favoured markets. The owner-occupied housing market generally has favourable tax treatment, and this has meant that the demand for the major product of building societies, the housing finance loan, has been artificially boosted. This has been particularly true in the United Kingdom where a mortgage loan is a desirable product in its own right regardless of whether one is actually needed in order to purchase a house. The same applies in the United States.

More importantly, building societies benefitted from the techniques of control of monetary policy which were implemented between about 1960 and the late 1970s. The basic philosophy was that the economy could best be controlled by controlling the rate of growth of money supply, and that the latter equated with the bank deposits or bank lending (the two can be seen as opposite sides of the same variable). Therefore, controls were imposed on the banking system to constrain the rate of growth of money supply. Also, in some countries there was a feeling that specialist housing finance deposit takers had to be protected because unlike other financial institutions, they were lending to home buyers, and home buyers deserved low interest rates. One therefore had the imposition of interest rate controls specifically designed to protect the specialist institutions.

Given such a favourable market and legislative framework, it is not surprising that building societies grew very rapidly and the general experience in the English speaking countries was that they took market share away from the banks and from other institutions. However, this success laid the path for the subsequent developments. While building societies were relatively small institutions, engaged only in the financing of house purchase, then their activities tended to have little effect on the rest of the economy. As they became larger institutions then by definition their activities spread beyond house purchase. The larger they were in relation to the banks the more they could influence the general level of interest rates and the more that they lent in relation to bank lending, the more that they were capable of creating credit.

By the late 1970s there was a general realisation that the situation was not a healthy one. Banks had been constrained and this had affected the quality of service which they gave to the public, while monetary policy was being frustrated by uncontrolled institutions. Several countries had enquiries into their financial systems - in Australia, the Campbell Report and subsequently the Martin Report, in the UK the Wilson Report, in South Africa, the De Kock Commission, and in the USA a variety of never ending enquiries and reports. All of these reports had a fairly common theme, that is, that market forces should be allowed to operate and that particular types of institutions should not be given protection. If it was wished to help housebuyers then this should be done by helping all housebuyers not by helping the institutions which lent predominantly to housebuyers.

More importantly, market developments made lines of demarcation between institutions and markets increasingly unsustainable. The United States illustrates this vividly. In order to protect the savings associations, they were allowed to pay a higher rate of interest on deposits than the banks through what was known as Regulation Q. This worked quite well when market interest rates were very similar to the regulated rates. However, in the late 1970s, market interest rates climbed into double figures while Regulation Q maintained the savings rate at about 5%. The result was not that savings associations continued to get their funds cheap, but rather that new institutions, money market mutual funds, rapidly developed which allowed small investors to take advantage of money market rates. Eventually, of course, the system of controlling interest rates broke down.

Similarly, technology has made entry into the mortgage market easier and has also made entry into the retail banking market easier. Until the late 1970s branch networks were regarded as essential in order to run a retail financial operation, but modern computer technology means that the retail banking service can be provided largely through automated teller machines while mortgage business can be obtained through intermediaries, in some cases using advanced technology to originate mortgage loans from remote locations.

The market developments and the freeing of commercial banks have threatened the position of building societies and they have been unable to respond as much as they would wish because they have been constrained by legislation restricting, for example, the sources of their funds or the manner in which they could invest those funds, or their ability to raise capital. Consequently, over the last few years, in South Africa, Australia, New Zealand, the United Kingdom and the USA there has been a succession of laws all of which have had the same effect, broadly speaking, of removing many of the constraints on building societies. Generally, they can now offer a complete retail banking service and services related to house buying and in some countries they can also convert to company status while retaining their status as building societies.

Recent Developments - United Kingdom

In the United Kingdom perhaps the most significant market development was the abolition in 1980 of the last constraint on the balance sheet of the banks. The banks, over the previous ten or even twenty years, had gradually withdrawn from the retail market leaving building societies virtually alone in the markets for mortgage loans and for savings. However, the banks still had huge branch networks and realised that they had to recapture some of the retail business. They reacted to the removal of constraints on them by vigorously attacking the mortgage market, at one time in 1981 accounting for 40% of new mortgage business. Societies previously had operated a cartel but this has gradually been dismantled, partly because of competition from banks but also because some of the more aggressive building societies have been unwilling to be constrained by the needs of those less efficient.

The Building Societies Association carefully examined the need for new legislation and published a discussion document early in 1983 and definitive proposals in February 1984. The Association stressed that societies did not wish to depart from their primary function but argued that new powers in relation to financial services and housing were necessary. The government responded in July 1984 with a consultative document which seemed broadly in tune with what the Association had proposed and legislation went through Parliament in the 1985/86 session. The legislation was not contentious, received all-party support and completed its parliamentary passage without difficulty becoming law at the end of July 1986. The Act establishes a completely new legal framework for building societies for the first time since 1874. The supervision of building societies has been moved from the Registry of Friendly Societies to a new Building Societies Commission, although in reality the two institutions are much the same.

The most important part of the legislation is the granting to societies of new powers to hold assets. Previously societies could lend only on the security of land. Under the new Act they are permitted to make unsecured loans although these are limited to £5,000 per case, and they can also hold land for residential development. However, only about 4% of their assets can be held in these forms.

The Act also introduces a significant constraint. Building societies must raise at least 80% of their funds from the retail markets.

A significant part of the Act is Schedule 8 which provides for societies to be able to offer a range of services. These include money transmission services, making or receiving of payments as agents, management as agents of mortgage investments, management as agents of land, arranging for the acquisition or disposal of investments, arranging for credit, administration of pension schemes, insurance intermediation, estate agency, surveys and valuations of land.

The Act provides for building societies to retain their mutual status although a procedure is provided by which a society could convert to a bank. However, the present view is that the hurdles placed in the way of a society attempting to convert are so great that few will attempt to follow this course of action. In particular, a society has to persuade at least 20% of its eligible members to vote on the resolution to convert to company status and if the society wishes to transfer its engagements to an existing company, then 50% of all qualifying shareholders must vote in favour.

For the most part the provisions of the Act came into effect at the beginning of this year. Societies have positively had to adopt, through a memorandum, the use of new powers, but in fact most have adopted a standard package drafted by the Association. Societies are differing as to what new powers they are exercising.

Generally, however, all building societies, or at least all larger ones, now accept that they are now in the money transmission business. All the large societies have automated teller machines and all but the Halifax are in one of two shared networks, one of which, Matrix, involves building societies only, while the other, Link, includes a variety of other financial institutions. The larger societies are also either committed to, or are seriously considering, the issue of cheque books.

Unsecured lending is proving one of the most popular new powers and several societies have announced new products in this area over the last few months. Some societies are offering them on their own account, while others are arranging unsecured loans to be held by other institutions or are using the other institutions to service those loans.

On services, an extension of the range of insurance services is popular with most societies.

An important new product for building societies from 1988 will be personal pensions. In Britain, the Government is privatising almost everything and this includes pensions. From 1988 individuals will be allowed to opt out of occupational pension schemes or the state earnings-related scheme and instead put money in their own personal pension account which will have the usual tax advantages which pension funds enjoy. Building societies lobbied hard to be given power to operate such pension schemes (similar to the IRA accounts in the USA) and this power was legally given in the Act. We believe this will be a major source of new business.

On the housing side several of the large societies, in particular the Halifax, the Nationwide and the Woolwich Equitable, are becoming involved in innovative schemes to provide housing for sale and rent. Most societies, however, are keeping clear of this particular market.

The estate agency market has been changing rapidly aided by the change from a shortage of mortgages to a surplus which, in turn, has placed much more power in the hands of real estate agents who effectively can channel mortgage business to one lender rather than another and who can sell ancillary services. A few years ago there were no large estate agency chains in the country but now there are five each with more than 200 outlets headed by the Prudential Insurance company and Hambros Bank. The third largest network is that owned by the Nationwide Building Society which now runs to over 300 offices. A couple of other societies have also made the move into estate agency.

The mortgage market has not been standing still while building societies have been taking on new powers. The clearing banks now have a steady 20% of the market and a number of American banks and other foreign banks are also significant lenders. In addition, there are four mortgage corporations. One of these, National Home Loans Corporation is a publicly quoted company, another, The Mortgage Corporation, is a wholly owned subsidiary of Salomon Brothers International, and the other two are both backed by major financial institutions. These corporations see the mortgage market as being a very profitable one because of the security of mortgage loans and the fact that the yield is consistently above money market rates. All of these institutions have as their objective the creation of a secondary mortgage market. Within the past two months there have been two issues of mortgage backed securities, one in respect of the Mortgage Corporation and one in respect of National Home Loans. In both cases the issues have been led by Salomon Brothers International. Arguably, what is being offered are insurance company backed loans because of the heavy insurance involved in the securities, but nevertheless it is clear that mortgage loans in the United Kingdom can now be securitised.

Building societies therefore need to take account of a rapidly changing market as well as the new powers which they have and it is not surprising that they are moving in different directions to some extent. It is also not surprising that the pace of mergers is quickening. In 1985, two of the largest ten building societies, the Alliance and the Leicester, merged to form the Alliance & Leicester. The Nationwide, the third largest, has been looking for partners and after an abortive attempt to merge with the Woolwich it will now be merging with the Anglia, the seventh largest, later this year. It is widely believed that other societies immediately below the three giants, the Halifax, the Abbey National, and the Nationwide, are also looking at mergers. Further down the scale, regional and local societies are combining to form more effective units able to better compete against national societies in their particular market places.

Generally, it can be said that British building societies are broadening into all purpose retail financial institutions and within a few years one expects that the individual will be able to obtain all of the financial services that he requires from a building society. There is a strongly held view that the 1986 Building Societies Act will not have a very long life, perhaps less than ten years. As building societies become more like banks and as the supervision of them tends to converge, then the case for separate building society legislation and separate supervisory systems is diminished. It could be that within ten years or so the special category of a building society, as a mutual institution that concentrates on deposit taking and mortgage lending, will disappear.

Recent Developments - South Africa

The South African building society industry is very similar to the British industry and certainly more similar than it is to the Australian industry. South African societies have dominated their mortgage market in much the same way as British building societies, and there are no savings banks in South Africa as there are in Australia. Following the report of the De Kock Commission, two building society acts become law in July 1986. One of these provides for building societies to convert to stock status and the other provides for societies which wish to remain as mutual. However, the broad content of the legislation is much the same. Societies' powers to lend are liberalised and they are permitted to invest a proportion of their assets in banking and other subsidiaries. It is generally expected that most of the societies will take advantage of the legislation to convert to company status. This would be achieved by the creation of a building society holding company or by the conversion of the existing mutual society into a company.

Building societies are already heavily involved in wider financial markets in South Africa and the legislation is likely to accentuate this trend. One society has bought a bank, and others have strong connections either with other banks or with insurance companies.

It is significant that in South Africa, as in the USA, legislation is providing for building societies to have either stock or mutual status, a pattern which has not been followed in Australia or the United Kingdom. What this could mean in South Africa is that building societies will cease to exist in all but name although whether this will actually be the case remains to be seen.

Recent Developments - USA

Deregulation of savings associations came earlier in the United States than in the other English-speaking countries. This was largely precipitated by the financial crisis which afflicted the American industry in the late 1970s. Notwithstanding the immense sophistication of the American financial markets, and the pride of the Americans in doing everything best, they managed to make all of the fundamental mistakes in respect of operating their savings institutions. They were limited to operations within states which meant that their risks were heavily concentrated, usury ceilings were applied to mortgage-lending rates in some states, and most importantly they were confined to lending at fixed rates of interest. Borrowing short and lending long is never a very sensible policy and the American savings institutions paid the price when the general level of interest rates rose rapidly in the second half of the 1970s. The resultant financial crisis precipitated legislation which probably would have occurred in any event, albeit much later. The first major legislation was the Depository Institutions Deregulation and Monetary Control Act of 1980. This provided for the phase out of interest rate ceilings, but also significantly increased the powers of the savings associations, in particular by authorising them to invest up to 20% of assets in consumer loans, corporate debt securities and commercial paper. They also had expanded authority to invest in service corporations and were allowed to invest in mutual funds, to issue credit cards and to engage in trust operations. Two years later came the more far reaching Garn/St Germain Depository Institutions Act. This further expanded authority to invest in consumer, commercial and agricultural loans and other investments. Perhaps a more important part of this Act was the easing of requirements for conversion from state to federal charter and vice-versa and also from savings association to savings bank charter. A new type of institution, the federal savings bank, was created.

Over the past few years, there has been a major change in the structure of the American industry. Many of the institutions have gone out of business and others have been merged, often with the help of the regulatory authorities. Many associations have converted from mutual to stock status and there are no very large mutual institutions left. Many have also converted from savings association to federal savings bank charter. Indeed, in America, the term "savings association" is now no longer widely used; rather, one refers to savings institutions or thrifts. The large American thrifts now have little in common with the traditional building society. They may have over 50% of their assets in mortgage loans but the general scope of their activities is much wider than that of a traditional building society. They are full service retail financial institutions and many also have significant commercial operations. Also, the American mortgage market is now dominated by the secondary market. The origination of loans is now a function in its own right as is the servicing of loans, and many thrift institutions concentrate on making and servicing loans which they immediately sell into the secondary market.

The American experience has valuable lessons for Britain and indeed for other countries. Some of the lessons are positive but others are negative. In America the deregulation went too far too fast and the supervisory system could not keep up with it. As a result, the industry is still in severe difficulty but not from the problem of borrowing short and lending long but rather from the problem of bad loans, risk investments and fraud which the system has not been able to detect. The transition from a closely controlled, highly-specialised industry to an industry operating in a free market without great constraints, carries with it big dangers. This has been recognised in the United Kingdom by the fairly cautious approach which has been taken to legislation and the carefully considered proposals which have now become law. In America the crisis which afflicted the industry in the late 1970s meant that the luxury of taking time to work out a new system was simply not available and in the circumstances the American thrift industry has done remarkably well over the past few years in very difficult circumstances. The successful institutions are very successful, while those that have been inefficient have run into great difficulty.

Recent Developments - New Zealand

New Zealand has not only had a regulated building society industry but regulated financial markets generally. Perhaps paradoxically, under a Labour Government, there has been extensive deregulation. In particular, interest rate controls on mortgages and on interest rates paid by banks have been eased. The Government has agreed to radical changes in building society legislation, the effect of which is to remove all constraints on the activities of societies. The legislation, in effect, governs only the constitution of societies, and not their powers. The New Zealand industry is dominated by two societies. The largest, the United, intends to remain, constitutionally, a building society but is becoming a diversified retail financial institution with interests in mortgage insurance, real estate brokerage, and the provision of retirement homes. The second largest, the Countrywide, intends to convert into a bank, supported by two British institutions, General Accident Insurance Company and Bank of Scotland.

Recent Developments - Australia

The building society industry in Australia is relatively new, having developed largely in the 1960s and 1970s. Now, the industry seems to be on the verge of decline. The societies were able to gain market share partly because of constraints on the interest rates of their major competitors, the commercial banks and the savings banks. There has been deregulation of interest rates and the financial system in Australia generally as in other countries, and this has put the building societies, constrained by outmoded state legislation, at a disadvantage.

A number of societies have taken the view that the legislation is not adequate for building societies as such to survive and have converted into banking status. The first society to do this was the second largest, the NSW Permanent, which now operates under the name of Advance Bank and has a savings bank charter. More recently, the United Permanent Building Society converted into a bank and was purchased by the Royal Mutual National Bank, one of the new banking institutions, owned by the Royal Bank of Canada and National Mutual Life of Australia. This society has in turn purchased another building society which has also converted into banking status. Last month, another large building society, the Perth, having previously acquired the Hotham Building Society, also converted to banking status and now operates under the name of Challenge Bank. Within the industry there has also been further mergers, notably that between the two largest remaining societies in Victoria, the RESI and the Statewide, to form the RESI-Statewide. The building society industry has therefore been loosing both market share and members and it remains to be seen whether a significant number of substantial building societies will remain in existence.

Recent Developments - Other Industrialized Countries

Few other industrialized countries have specialist housing finance deposit taking institutions. On the Continent of Europe the normal pattern is for loans to be made either by co-operative or savings banks or by specialist mortgage banks, most of which are linked with other institutions. However, such institutions have not been immune from the competitive forces sweeping the world's financial markets. Mortgage banks have often been protected by being the only institutions allowed to raise long-term finance or make long-term loans. In Sweden, for example, housing loans benefitted from preferential tax treatment and financial institutions were forced to purchase bonds issued by the various mortgage banks. Recent legislation has changed all of this and the traditional mortgage banks now have to face open competition for mortgage business from savings banks and commercial banks which previously had no choice but to direct their customers wanting mortgage loans to the specialist mortgage banks.

Another general trend is the increasing use of securitization techniques and the emergence of secondary markets in a number of countries. The major investment banks, such as Salomon Brothers and Credit Suisse First Boston, are playing a part here using techniques developed in one country to increase their business in others.

Recent Developments - Developing Countries

Developments in the United Kingdom and other industrialized countries are largely irrelevant to what is going on in the poorer countries in

Africa and Asia. There, the problem is not as much the means by which savings are transformed into long-term mortgage loans, but rather the difficulty people have in affording housing, and when they can afford housing the lack of an adequate financial mechanism to enable them to effect house purchase efficiently and cheaply. While many attempts are being made to establish building society type institutions, it has to be said that these have not been very successful. Experience has shown that, in practice, institutions concentrating on house purchase activities in the poorest countries have to fund their activities, at least initially, through the wholesale markets although if they can develop a deposit taking function this is desirable in the longer-term through helping to mobilize savings.

Sadly, also there are comparatively few examples of successful housing finance institutions in the poorest countries. The outstanding example here is the Housing Development Finance Company in India. This is led by an outstanding team of executives who have done much to build a financial institution, and also to influence the financial structure of India and to pass on their experience to housing finance institutions in other developing countries. The experience of developing countries generally suggests the following major priorities -

(a) A land tenure system which gives security of tenure to owner-occupiers, but recognises the right of lenders to take possession in the event of default of a borrower. This is probably the single most important area where progress can be made which would promote the development of both housing conditions and housing finance institutions.

(b) Building on the efforts of poor people to house themselves, rather than attempting to use limited public resources to house to an unreasonably high standard a small minority of people.

(c) Providing a financial framework which allows housing finance institutions to develop and to operate in a way which will be viable in the long term. This means not controlling interest rates and as far as possible conducting macro economic policies such that rates of inflation are at a low level.

Conclusion

The world of housing finance is changing very rapidly. Different countries are experiencing different trends, but there is a common theme of the breaking down of barriers between financial institutions and markets, and in the industrialized countries the increasing internationalization of the financial markets. The role of specialist institutions in industrialized countries is declining, because those institutions are reacting to market pressures by developing into general financial institutions. In developing countries there is still a desperate need for specialist institutions because of the peculiarlarly difficult nature of mortgage lending. Middle income countries, such as those in Central and South America and the Caribbean, are at varying stages in development. In some countries the most satisfactory way to develop a housing finance system is through specialist institutions while in others more wide ranging institutions might have the leading role in the provision of housing finance. There is not a "right" or "wrong" approach in this respect; rather, each country must adopt the system most suited to its own situation.