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Securitisation and the building societies

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Introduction

Building societies are the principal residential mortgage lenders in the United Kingdom. At times in the past 15 years they have totally dominated the market with as much as 95% of new business. Their market share has averaged around 75% and currently their share of outstanding loans is a little below this level at 72%. Building societies' dominance of the market went hand in hand with the nature of the market, which was one where mortgage rates were more stable than other interest rates, often remaining below market rates for considerable periods of time. The mortgage market has become much more competitive over the past few years, and this has been reflected in the building society share of new mortgage lending falling significantly, and in the mortgage rate settling down at a fairly steady margin over money market rates of interest. These developments have allowed the emergence of a secondary mortgage market, but as yet building societies have not been significant participants in this market.

This paper describes recent developments in the primary mortgage market and the emergence of the secondary market, and then deals in detail with the relationship between building societies and the secondary market. The paper concludes that at present the true secondary market has little to offer building societies, although this situation could change, but that societies will exploit the growing fragmentation of the housing finance process, in particular by offering origination and servicing facilities to institutional investors wanting to hold mortgage loans.

The primary mortgage market

The British mortgage market, like those of most other countries, has been a fairly simple one in which institutions have originated, held and serviced mortgage loans throughout their duration. The British market has differed from most other markets in that one type of institution, the specialist building societies, have dominated the market.

Three other features of the British primary mortgage market also merit comment —

a) All but a very small fraction of loans have been at variable rates of interest, with the lender having discretion as to when rates can be changed and by how much. Of course, this discretion can be exercised only within a market, and as borrowers generally have a right to redeem their loans at any time without penalty it is not open to a lender to charge a rate of interest significantly above the prevailing market rate.

b) Borrowers expect to be able to obtain further advances on their existing loans at any time, provided that there is adequate security in the property. Given the increase in house prices in recent years, there has been such security.

c) Mortgage lending is extremely safe. In most countries mortgage lending is safer than other lending, simply because the security is property. In Britain, however, added to this security has been the fact that house prices have risen steadily, well in excess of the rate of inflation. This in turn can partly be attributed to the lack of a market rented sector, which means that there is not the possibility for people to opt out of owner-occupation into another sector. In addition, borrowers who are unemployed can qualify for government assistance to pay the whole of their mortgage interest. These factors are reflected in the building society loss statistics. During 1986 building societies had mortgage losses of just £20m on a mortgage portfolio at the end of the year of £120bn.

Table 1: The primary mortgage market, 1987

Institution	Loans outstanding – end year £m	%	Net advances in year £m	%
Building societies	132,148	72	15,210	51
Monetary sector	35,811	19	10,030	34
Monetary sector subsidiaries	4,117	2	1,568	5
Other financial institutions	3,377	2	2,384	8
Insurance companies and pension funds	3,905	2	769	3
Other	4,553	2	–410	(1)
Total	183,911	100	29,551	100

Source: Financial Statistics, April 1988, Table 9.4.

It will be seen that building societies, at the end of the year, accounted for 72% of outstanding loans, with the monetary sector (that is banks) accounting for a further 19%. The share of other lenders, including the new

mortgage companies (classified here as other financial institutions), in total was no more than 8%.

However, the figures for net advances show a very different position, with the building society share being 51% the banks 34% and monetary sector subsidiaries and other financial institutions 13%. It is the change in the nature of the primary mortgage market which has allowed other institutions to increase their market share, and which has paved the way for the emergence of a secondary market.

The British mortgage market began to change in the late 1970s and early 1980s. Technological development contributed to the breaking down of artificial barriers between markets and constraints applied to institutions rather than to markets. Added to these forces was the wish of the newly elected Conservative government to deregulate. In 1979 the government abolished exchange controls, and this necessitated the abolition of the final balance sheet constraints on the banks in 1980. For the first time banks were free to compete on equal terms with building societies.

At the same time some building societies were becoming restive with their cartel which, for many years, had controlled interest rates and had led to them being much more stable than the general level of interest rates. Societies found ways around the cartel, by offering higher rates of interest on particular savings accounts and by charging higher than the normal mortgage rate on loans above a certain size. As the clearing banks aggressively entered the mortgage market, their market share rising to 40% in the Autumn of 1982, so pressure on the building society cartel increased. By 1986 the cartel had broken down completely with building societies being free to set their own interest rates in response to market conditions.

By this time the mortgage market had become very competitive. New funding instruments, in particular the Eurobond market, had meant that no longer were retail deposits the only sensible way of funding long term mortgage loans. The mortgage rate became increasingly related to the cheapest funds, whether retail or wholesale, and gradually settled down at a steady margin over money market rates of interest.

When mortgage loans had been in short supply the process of originating loans was an administrative one. There was no point in marketing a product for which demand exceeded supply. Building societies therefore had administrative systems to ration the available supply of loans. Intermediaries needed to persuade building societies to lend to their clients, and this was sometimes done in exchange for introducing investments to the society. The point is that the building societies, as providers of the scarce commodity, effectively could determine the nature of the relationship with intermediaries.

As the mortgage market became more competitive so this situation changed. Estate agents, which previously had had to persuade building

societies to give them a special allocation of funds, realised that they had tremendous power in that competing lenders wanted their customers. Estate agents responded by setting up financial services subsidiaries, which would introduce their clients to particular mortgage lenders and which would arrange endowment policies and other ancillary services for which they could take commission. The importance of estate agencies was realised in the financial markets generally and a number of financial institutions, led by Lloyds Bank and the Prudential Insurance company, began to establish their own chains of estate agencies. Building societies have joined this trend since they were empowered to do so at the beginning of 1987.

The primary mortgage market is now a very competitive one, and there is every reason to expect that this will continue. Mortgage rates are determined by the market, and there is comparatively little scope for lenders to charge significantly above market determined rates for anything other than a short period. Because there is little differentiation between the mortgage products of particular lenders, distribution channels are all-important, hence the enhanced role of intermediaries, in particular estate agents and insurance intermediaries, in the mortgage market.

The secondary mortgage market

The secondary mortgage market has emerged only because of the way the primary market has developed. Basically, the secondary market entails the sale of loans or the sale of securities backed by mortgage loans, and a purchaser would wish to acquire mortgage loans or mortgage backed securities only if the yield on them is higher than, for example, the yield on gilt-edged securities. A secondary market would not have been feasible in the late 1970s when for long periods of time the mortgage rate was below the yield on gilts. It is the competitive mortgage market, with the mortgage rate being at a steady margin of between 100 and 150 basis points above money market rates, that has made the mortgage loan an attractive instrument for institutional investors.

The secondary market has also been made possible by the greater role which intermediaries have in originating loans and by the wider powers held by building societies. If an intermediary introduces a loan to a building society, then the society is likely to want to arrange the insurance and now societies will also look to their mortgage applicants as sources of demand for other new products which they might offer, including, for example, unit trusts and banking services. If an insurance company introduces a client to a building society then it may well be giving that society a customer for whom it can compete against the insurance company to provide other services.

As the nature of the mortgage market changed a number of people saw

the opportunity to create new mortgage lenders, able to exploit the new position. Building societies and to a lesser extent banks, raise their money on the retail markets and over recent years the cost of retail funds has been bid up by aggressive competition between building societies which resulted from restrictions on the amounts of wholesale funds which they were allowed to raise and also the increasing attractions of equity investments. As new wholesale instruments have developed so it has become possible to fund mortgage loans entirely from the wholesale markets and to market loans through intermediaries. A niche therefore developed for specialist mortgage lenders raising their funds on the wholesale markets, operating with low administrative costs, and obtaining mortgage business through introductions from intermediaries. Three large new lenders have been established, National Home Loans Corporation, the Household Mortgage Corporation and The Mortgage Corporation. The first two obtain their business entirely through intermediaries while The Mortgage Corporation also obtains business directly through advertising. In addition, Mortgage Funding Corporation has been established as a funding vehicle which can be used by originators.

The new lenders have grown rapidly as they have offered a competitive mortgage product. However, the growth of any financial institution is limited by its capital. The new lenders all had capital initially subscribed either by financial institutions or, in the case of National Home Loans, through a stock exchange flotation. But institutional investors are obviously concerned about gearing, and these three institutions were all specifically established with the objective of securitising part of their mortgage portfolios, thereby enabling them to continue turning over funds and earning income from administering the loans and also from any difference between the interest rate they charge and the yield on mortgage backed securities.

The first issue of mortgage backed securities was in May 1987 when a £50m portfolio of loans made by National Home Loans was securitised. By the end of April 1988 a further 13 issues had been announced, with the total value of all of the issues being about £1.8bn. The Mortgage Corporation has been the leading institution in this field with six issues of mortgage backed securities, accounting for nearly half the total. National Home Loans has made three issues, the Household Mortgage Corporation two issues and Chemical Bank, the Mortgage Funding Corporation and Bank of Ireland one issue each.

The issuing of mortgage backed securities has, therefore, grown rapidly from nothing to nearly £2bn in less than a year. However, there is little sign of the rate accelerating and as yet the market remains very small. Table 2 compares issues of mortgage backed securities with net advances.

Table 2: Mortgage backed securities

Quarter	1 Net advances for house purchase £m	2 Issues of mortgage backed securities £m	2/1 %
1987 Q1	5,675	–	
Q2	7,158	250	3.5
Q3	8,295	450	5.7
Q4	8,423	300	4.7
1988 Q1	7,380 (est)	475	6.4

Source: Financial Statistics, April 1988, Table 9.4 and BSA.

The figures for mortgage backed securities shows significant fluctuations with a peak being recorded in the third quarter of 1987, then a fall, then a further increase in the first quarter of 1988.

As yet neither of the two principal groups of mortgage lenders, banks or building societies, have issued mortgage backed securities. This is not because they are backward, but, rather, because at present mortgage backed securities have little to offer them. Most of the remainder of this paper examines the reasons for this, and how matters might change.

It is necessary to conclude this section on the secondary mortgage market by pointing to the fact that public issues of mortgage backed securities are merely one form of securitisation. There is a great deal of information about mortgage backed securities because a public prospectus has to be issued (these prospectuses also give otherwise unavailable information on the new mortgage lenders themselves). There are two other forms of secondary market operations about which little is known, but where there has certainly been considerable activity, perhaps approaching that for mortgage backed securities:

a) The sale of whole loans. There has been one publicised sale of a mortgage portfolio, that is from the Bank of America to the Bank of Ireland, with a second similar sale by Chemical Bank to BNP recently having been announced. However, it is also understood that there have been other sales of loans, about which no information is available.

b) Public issues of mortgage backed securities are expensive, and it is known that there have also been several private placements of securities. These follow much the same format as the public issues, but are less costly to arrange. It is known that Citicorp arranged such a private placement for The Mortgage Corporation and it is also understood that the Household Mortgage Corporation has securitised part of its mortgage portfolio in this way.

Until statistics are developed which show such activity information about the secondary market, other than public issues of mortgaged backed securities, will remain very sketchy.

Trends in building society regulation

Until a few years ago it would not have been possible for building societies to participate in any way in a secondary mortgage market, yet at the same time they had a statutory straightjacket which posed a threat to their continued dominance of the primary mortgage market. Under the Building Societies Act 1962 societies existed for the purpose of raising savings from members to lend to members on the security of mortgage. Societies were actually prohibited from lending other than on mortgage. Until the early 1980s societies were also effectively prevented from raising funds on the wholesale market. Potentially this could have put building societies in a very difficult competitive position, as wholesale funds have been an increasingly attractive method of funding variable rate mortgages. Building societies began to be deregulated in the early 1980s. In 1980 a number of societies began to issue negotiable bonds in the wholesale markets, although in quantitative terms these were very small. The 1983 Finance Act allowed building societies to pay interest gross on certificates of deposit, and later that year societies were also empowered to pay interest gross on time deposits. Previously, societies had to pay interest net of tax, which was not attractive to wholesale investors.

Until 1983 societies had to show separately on the liabilities side of their balance sheet "loans from banks", and for the purposes of calculating net liquidity for trustee status the total amount of liquid funds held by a society had to be reduced by bank loans. This meant that this form of financing was inappropriate, but in 1983 the trustee status regulations were amended, such that borrowing from banks no longer counted as a deduction from liquidity. Subsequently, building societies have used bank loans as a major source of funds.

The Finance Act 1985 allowed building societies, from October 1985, to issue Eurobonds and societies have made extensive use of this source of funds subsequently. Tables 3 and 4 show how building societies have made increasing use of wholesale funds, and also the composition of the wholesale funds as at the end of 1987.

Table 3: Change in building society funds, 1978–87

	Percentage of building society funds						
End-Year	Ordinary accounts	Short notice and immediate access accounts	Term accounts	Regular savings	Other	Total retail	Non-retail
1978	83		10	3	4	100	
1979	81		13	3	3	100	
1980	79		15	3	3	100	
1981	67	10	17	3	3	100	
1982	53	17	23	3	3	100	0
1983	44	26	23	3	2	99	1
1984	43	25	23	3	2	98	2
1985	20	58	15	1	1	93	7
1986	13	64	11	1	1	90	10
1987	11	65	9	1	1	88	12

Source: The Building Societies Association

Table 4: Wholesale funds held by societies, end-1987

Category	Balance £m	Percentage of total
Certificates of deposit	3,870	21
Time deposits	4,150	23
Eurobonds	5,420	30
Negotiable bonds	360	2
Loans etc from banks	2,610	14
Index-linked bonds	50	–
Other	1,820	10
Total	18,280	100

Source: The Building Societies Association

The Building Societies Act 1986, the main provisions of which came into effect at the beginning of 1987, radically changed the regulatory framework for societies. The Act provided that building societies remain as mutual specialist housing finance institutions. A number of provisions were made relevant to secondary market operations:

a) The amount of money which building societies could raise from wholesale funds was limited to 20% of their total interest bearing liabilities.

b) Societies were permitted for the first time to borrow on the security of their balance sheet. Previously, all of their borrowing had to be unsecured.

c) Societies were given specific powers to manage mortgage loans, and to arrange for the provision of loans.

It rapidly became clear that these provisions were not adequate given the growing competition in the mortgage market. In particular, the 20% limit on wholesale funding, at a time when societies were struggling to attract retail funds given opposition from a bull market in equities with wholesale funds being both cheap and plentiful, was seen as being a major constraint on societies — possibly forcing some to convert to banking status and at the least encouraging societies to sell mortgage loans so as to free funds for further lending. (The issuing of mortgage backed securities would not achieve the same objective, as these would still be counted as wholesale funds.)

The government responded to representations by The Building Societies Association by increasing the wholesale funds limit to 40% with effect from the beginning of 1988. In effect this is no limit as on average societies have no more than 12% of their funds from the wholesale markets, and probably no society has more than about 18%. In addition, the stock market crash changed significantly the balance of advantage between using retail and wholesale funds. In the months immediately prior to the crash building society net receipts had been running at under £500m a month, while unit trusts were taking nearer £1bn a month. In the six months after the stock market crash building society net receipts averaged £1bn a month while unit trust net receipts fell to £125m per month and societies were able to attract huge volumes of retail funds at a cost less than money market rates. The funding constraint on building societies has, therefore, been removed by a combination of regulatory action and market developments.

As the secondary market began to develop it was also clear that building societies did not have sufficient powers to participate fully in the market. They were empowered to arrange credit, but only for certain types of institutions, not including secondary market vehicles. This was subsequently rectified by statutory instrument.

In October 1987 the government began a major review of building society powers. The results of this were announced in February 1988 and were implemented in the Summer of 1988. Societies have a new power to purchase and hold mortgage backed securities. Also, the power which societies have to arrange loans on behalf of other institutions is being considerably liberalised and in effect there will be no constraints. Building societies are, therefore, now equipped with all the powers necessary to participate in the secondary mortgage market.

Building societies funding through the secondary market

The point has been made that as yet no building society has sold mortgage loans or issued securities backed by loans. It is necessary to consider in detail why this is the case, and what circumstances might cause a change in the situation.

One objective of secondary market operations for a portfolio lender, such as a building society, is likely to be to increase the funds available for lending. If a building society, therefore, had difficulty raising adequate funds, securitisation might represent a viable option. In reality, however, building societies have no difficulty raising whatever funds they require. Their success in the retail savings market depends partly on prevailing economic conditions and the most recent six months have in fact been the most successful in the entire history of building societies. This has partly been influenced by the stock market crash, which has encouraged people to invest new sums which become available in building societies, rather than in equities or unit trusts. Currently, building societies hold considerable amounts of retail savings at rates of interest less than money market rates.

Building societies also have the option of going to the wholesale markets. They offer excellent security to institutional investors, partly because of the safe nature of their lending. Their mutual status is also relevant, as wholesale borrowing by building societies ranks before shareholders' funds, which in most societies still account for well over 70% of total liabilities. Certainly the wholesale funds which building societies have been able to attract have been considerably cheaper than the cost of mortgage backed securities. Eurobonds, syndicated bank loans and certificates of deposit generally cost societies no more than 20 basis points over Libor, including all costs, whereas the yield alone on mortgage backed securities is now a minimum of 32.5 basis points over Libor and the all-in costs are probably considerably higher than this. Indeed, by using swap techniques some societies have been able to raise funds at sub Libor.

Societies are more likely to be encouraged to use the secondary market by capital requirements. Broadly speaking, building societies need capital of around 2.25% (including a 0.5% contingency margin) to back their mortgage assets. However, they also hold liquid assets and fixed assets and these (taken together) have much higher capital requirements. Generally, societies have minimum capital requirements of around 3.75%. The average capital ratio is around 4.5% of shares, deposits and loans and most societies, therefore, have a reasonable cushion over the minimum required for regulatory purposes. However, there is increasing emphasis on capital adequacy and some societies wish to use their capital to diversify in other

directions, for example, to purchase estate agencies or to engage in other forms of lending with higher capital requirements such as unsecured lending.

A building society faced with a market in which it could significantly expand mortgage lending, but where it had a capital constraint, does, however, have an option other than securitisation or the sale of loans. It can take advantage of new provisions allowing building societies to issue subordinated debt. Through such instruments societies may increase their capital ratios by up to 50% and accordingly their mortgage portfolios by a similar amount. So far, two issues of subordinated debt have been announced at no more than 65 basis points over Libor, probably less than the average annual cost of mortgage backed securities. For most societies this represents a preferable alternative to expensive secondary market operations. An example can illustrate this. Assume that a large society wished to expand its mortgage lending portfolio by £1bn with the constraint being its existing capital ratio. It could seek to sell £1bn of loans, or securitise £1bn of loans. In the case of securities the yield it would have to pay would be a minimum of 32.5 basis points over Libor, with all in costs of nearer 80 basis points. The alternative would be to issue £50m of subordinated debt at, perhaps, a total cost of 70 basis pints over Libor and then to raise £1bn of wholesale funds at, perhaps, 20 basis points over Libor. Clearly, in present market conditions the second option is preferable.

Building societies would also have difficulty in issuing mortgage backed securities of a type which has so far been seen in the market. It has already been noted that these do not provide for an exact correspondence between the rate of interest on the securities and the rate of interest charged on the mortgage loans. The lender has a contingent liability to make up any shortfall through making advances to the issuer. In October 1987 the Building Societies Commission published a consultative paper on capital adequacy requirements for off balance sheet lending by building societies and a definitive paper was published in May 1988. This states that in order to satisfy the Commission that no capital need be held for a particular group of loans, a society must demonstrate that it is absolved from any continuing credit risk and that it will not in practice feel compelled to support a vehicle if difficulties arise. Where loans are transferred to a finance vehicle, and there is a service agreement between the vehicle and the society (the format adopted for existing securitisation issues), then it will be a requirement that the vehicle should not lay off any interest rate risk with the society and the society cannot offer any guarantees to the vehicle.

In effect, this would mean that a society could issue mortgage backed securities of the kind presently known in the market only if the interest rate

on those loans was firmly linked to Libor. In fact a number of societies have made mortgage loans linked to Libor and it could well be the case that portfolios are being built up which could, if necessary, be sold or securitised.

With present market conditions it is clear that there is no advantage for the majority of building societies to sell mortgage loans or to issue mortgage backed securities. Whatever can be achieved in these ways can be achieved more efficiently in other ways. However, what is true for the majority of societies at present may not be true for the majority all the time or indeed for all societies at present. Certainly in the longer term the requirements for higher capital ratios generally or the need for building societies to use capital in other directions, might encourage some to seek to get some of their existing loans off their balance sheet for capital adequacy purposes, while maintaining the income from servicing the loans.

One recent development is significant here. When the Building Societies Commission announced an increase from 20% to 40% in the maximum proportion of non-retail funds which societies could raise, it simultaneously said that it expected societies to try to raise wholesale funds on terms which ranked equally with shares, whereas previously wholesale funds had always been raised as deposits and therefore effectively had up to 80% of a society's assets backing them. This has contributed to the cheap rate at which building societies have been able to raise wholesale funds. If the effect of raising wholesale money on pari passu terms with shares is to increase the rate of interest, then obviously this makes the option of raising funds through selling mortgage loans or mortgage backed securities more attractive. However, at present most societies are well below the 20% threshold for non-retail funds at which this would apply and even if the cost of wholesale funds increased substantially, it could well be the case that the option of issuing subordinated debt and gearing up on the basis of this, would remain preferable to the option of issuing mortgage backed securities or selling loans.

Building societies and the quasi-secondary market

The effect of the secondary mortgage market is that an institution, other than a lender, holds a portfolio of mortgage loans either in the form of whole loans or securities backed by loans. A secondary market should be seen as a means to this end, rather than as an end in itself. There are other ways in which the same end can be achieved, possibly more economically.

Institutional investors wish to hold mortgage loans because they offer a better yield than comparable securities, such as gilts. Building societies and mortgage originators generally may have a capacity to originate and service loans in excess of their capacity to hold them. The origination of loans can

be profitable because it brings the opportunity to earn ancillary income, in particular fees for arranging endowment assurance policies, and, possibly also, other financial services, such as unsecured loans. Because an institutional investor is unlikely to want to service loans a mortgage originator which continues to service loans can charge a fee for so doing significantly in excess of the marginal cost of the servicing.

There is the simple option of a building society originating loans on behalf of an institutional investor. The building society would do all the work involved in assessing the adequacy of the security and the status of the borrower, undertaking all the necessary legal work, advancing the funds on behalf of the institutional investor, collecting the repayments and passing them through to the institutional investor, arranging for the insurance of the property and handling any administrative difficulties that arise. The role of the institutional investor would simply be to set the interest rate on the loans (which might be Libor linked) and then to collect the regular payments of principal and interest from the agent building society. For the building society this achieves exactly the same end as secondary market operations, but without the attendant costs. The institutional investor acquires a portfolio of loans to criteria which it has stipulated and without the need to do any administrative work. It may be argued that this portfolio is not as liquid as mortgage backed securities. However, it is understood that there is comparatively little liquidity in the mortgage backed securities market and that most investors which have purchased the securities intend to hold them until redemption. In this case there is little difference between actually holding a portfolio of loans and holding the securities. Moreover, if the loans themselves have an acceptable standard of quality (for example if they meet the requirements that Standard and Poor's have laid down for loans which may be securitised) then no doubt the institutional investor could, if it so wished, sell the portfolio of loans.

This mechanism will be most attractive to medium sized building societies. Larger ones can generally build up their capacity to hold loans to whatever extent their capacity to originate loans may increase. In the case of medium sized building societies, where there is the opportunity to increase substantially originations, this is not the case. In February 1988 several medium sized societies revealed plans to originate loans on to the balance sheets of foreign banks:

a) The Sussex County Building Society intends to lend £100m over a year for the National Commercial Bank of Saudi Arabia. Interest rates will be roughly linked to Libor. The society is having talks with a Dutch and a German bank and by the end of the year intends to offer loans for three or four major foreign banks.

b) The Skipton Building Society intends to lend £50m a year for five years for a Dutch bank and it also has plans to market loans for a French bank.

c) The Leamington Spa Building Society is planning a joint venture with Chemical Bank and other foreign banks and has a target of £250m of new business in 1988.

d) The Scarborough Building Society is to process £50m of loans for the Dutch bank, Algemene Bank Nederland.

e) The Mornington Building Society has set up a subsidiary to process £60m of loans in its first year for French, Swiss and Japanese banks.

It is likely that this sort of business will increase, and the volume of it might even begin to rival the volume of mortgage backed securities. However, at present there is no mechanism for recording statistics for business done in this way.

Building societies may also expect to have a role in the emerging mortgage servicing market. There is already one specialist company, Mortgage Systems Limited, in this market and National Home Loans has come to a number of arrangements to service loans on behalf of lenders. In February 1988 the Bank of Ireland (which in 1987 brought the mortgage portfolio of Bank of America) which administers £1bn of mortgages, announced that it was offering a specialist mortgage processing service for lenders which did not wish to administer their own portfolios. Also in February 1988 the Skipton Building Society announced the establishment of a wholly owned subsidiary, Home Loan Management Limited, to provide services in the mortgage administration market. Other building societies could well move into this market, building on their existing expertise.

Building societies as purchasers in the secondary market

At present building societies have no power to purchase mortgage backed securities. Broadly speaking, the assets which a society may hold are classified as follows:

a) Commercial assets, which are divided into class 1, class 2 and class 3 assets. Class 1 assets are first mortgage loans to owner-occupiers of residential property. Class 2 assets are other loans secured on land. Class 3 assets are other loans (up to a maximum of £5,000 — shortly to be increased to £10,000), ownership of land and property for residential purposes and investments in subsidiaries and associates.

b) Liquid assets, which must be of an authorised character with the principal qualities of liquidity and capital certainty.

c) Fixed assets.

Societies are also prevented from purchasing loans from other lenders, as they are required to have a valuation of each property which they take into mortgage.

These obstacles to building societies participating in the secondary market as purchasers of loans or mortgage backed securities have been addressed in the recent review of building society powers, undertaken by the Building Societies Commission and the Treasury. As a result building societies will be enabled to purchase and hold mortgage backed securities.

Mortgage backed securities will count as class 3 assets. In the longer term, if a genuine market does develop in mortgage backed securities, then there is the possibility of these securities being counted as liquid assets, although no doubt with a fairly extensive capital requirement, at least in the early years.

It remains to be seen to what extent building societies will use these new powers. Mortgage backed securities could well be an attractive instrument for some societies depending on the mix of their assets and their liabilities and its capital. In particular the subordinated tranches might be a very attractive investment for a society with a high capital ratio (as no doubt the capital requirements for the subordinated tranche will be very high) and looking for a high yield on relatively short term assets.

It will be necessary for the Building Societies Commission to publish details of capital requirements for this new type of asset before building societies will be able to acquire them.

Conclusion

Building societies are at the periphery of the secondary mortgage market. In the very long term the emergence of securitisation and other secondary market operations must threaten portfolio lenders as has been the case in the USA. However, building societies have been very alive to the changing nature of the mortgage market and the financial markets generally, and have positioned themselves to take maximum advantage of the new situation. Societies have reacted to the more competitive mortgage market by pricing their mortgage products accordingly and by developing new distribution channels, including direct advertising and estate agency networks. Unlike the new mortgage lenders, they have the maximum flexibility in raising new funds and can use the whole range of instruments in both the retail and the wholesale financial markets. A number of

societies are taking advantage of the fact that institutional investors now wish to hold mortgage loans by arranging programmes to originate loans straight on to the balance sheets of those institutions. Several societies are also looking at exploiting the mortgage servicing market.

Building societies have not sold mortgage loans or issued mortgage backed securities, not because they have failed to realise the potential of this market, but rather because the market to date has little to offer societies. They are not constrained in their ability to raise funds, and generally capital requirements are also not a constraint. To the extent that they might be, then building societies have other options such as issuing subordinated debt and gearing up on this with wholesale funds. For most societies this is a more attractive option than selling mortgage backed securities.

Markets can, of course, change quickly and building societies have positioned themselves to be able to respond to any change in market conditions. Societies now have all the powers necessary to participate in the secondary market as mortgage originators, processors and purchasers of mortgage backed securities. They have also researched the market and in many cases have held exploratory talks with other market participants. The building societies have no natural aversion to securitisation or selling loans, and if circumstances make this appropriate they will no doubt be very active in this market.

Mark Boleat is director general of The Building Societies Association. This chapter draws heavily on his book New Lenders and the Secondary Mortgage Market, BSA, 1988.