The US Example

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A lesson in how to avoid shockwaves

THROUGHOUT THE industrialised countries, the retail financial markets are changing rapidly, and the same trends are apparent in most countries. The lines of demarcation between the various institutions are breaking down.

Specialist institutions are tending to adopt a wider role while more general institutions are seeking to encroach into areas previously the domain of specialists. Nowhere is this more true than in the housing finance market. These trends owe their origin to a number of common factors, including technology and deregulation.

In this area, as in so many others, the US has led the way, and the Building Societies Bill can be seen as a muted version of legislative measures enacted by the US Congress at the beginning of this decade.

The Earnings Crisis in the USA

About ten years ago, it was fair to say that the savings and loan associations in the US were very similar to British building societies. They were largely mutual, although even at this time there were some with a stock form of ownership. They raised their funds almost entirely from the retail market, and over 80 per cent of their lending was for house purchase.

However, there were also differences compared with the situation in Britain; in particular the associations, like American financial institutions generally, were largely confined to operating within individual states and more importantly, they were not able, with a few limited exceptions, to lend other than at fixed rates of interest.

They therefore broke the cardinal law of banking by borrowing short and lending long, and the geographical restriction on their operations left them exposed to the effects of a change in local market conditions.

It was these last two factors that precipitated the deregulation of the savings and loan associations, even if they were not the ultimate cause. As interest rates rose rapidly towards the end of the 1970s, so the cost of funds overtook the yield on loans, and by 1981 the industry as a whole recorded a massive deficit.

This position worsened in 1982. One response was to permit the associations to offer variable rate loans, the major regulatory change being made in April 1981.

However, this was not sufficient to restore the thrift institutions, as they are now commonly known, to health. In 1980, the Depository Institutions Deregulation and Monetary Control Act provided for the phasing out of interest rate ceilings on deposit accounts and also the differential which the "thrifts" had enjoyed over the commercial banks.

This was little more than a recognition of reality, as the previously controlled rates had effectively been bypassed by institutions such as money market mutual funds. The DIDMCA considerably deregulated the industry and:

(a) Authorised interest-bearing chequing accounts.

(b) Authorised investment of up to 20 per cent of assets in consumer loans, corporate debt securities, and commercial paper.

(c) Eased or removed lending restrictions.

(d) Expanded authority to invest in service corporations from 1 per cent to 3 per cent of assets.

(e) Granted authority to invest in mutual funds, to issue credit cards and to engage in trust operations.

The combined effect of this and the introduction of adjustable rate mortgages was not nearly sufficient to counteract the draining effect that existing low interest rate loans was having on the profitability of the associations, and in 1982 came the far-reaching Garn/St Germain Depository Institutions Act. Among the main provisions of this were:

(a) The authorisation of new forms of savings account.

(b) Capital assistance for institutions with deficient net worth.

(c) Expanded authority to invest in consumer, commercial and agricultural loans and other investments.

(d) The removal of loan to valuation ratio limits and the restriction to lending on first mortgage.

(e) The permitting of investment in tangible personal property for lease or sale up to 10 per cent of assets.

A major consequence of the legislation, together with the earnings crisis, was that most savings and loan associations converted to the stock form of ownership, which was made considerably easier under the Garn/St Germain legislation.

Almost all of the large thrifts are now stocked owned, and most have adopted the new Federal Savings Bank charter, which gives them even greater investment powers.

The thrift industry is now enjoying its most profitable period for years, and most associations have relatively healthy balance sheets, although this can partly be attributed to some imaginative accounting techniques. However, while deregulation has helped some institutions survive, for many others it has led them down a dangerous path, which has resulted in massive losses.

Customers stand in line at a branch of Community Savings & Loan in the US, after a real estate subsidiary defaulted on payments due on mortgages and mortgage-backed securities

Inexperienced, and in some cases dishonest, management, has taken advantage of the more liberal framework, and many bad loans have been made and unnecessary risks taken. The largest savings association in America, owned by the Financial Corporation of America, probably continues in existence only because it is too big to be allowed to fail. Smaller institutions have failed, with the resultant heavy cost to the Federal Savings and Loan Insurance Corporation, which insures deposits 100 per cent up to $100,000.

Lessons for the UK

It is easy to misinterpret the American experience, and already it has been said that in the US deregulation has resulted in disastrous consequences for the thrift institutions and for the housing market. This is the opposite of the truth. Deregulation in the US was essential, because the thrift institutions needed wider powers in order to survive.

Because the introduction of the adjustable rate mortgage had been so long delayed, when deregulation came, it went too far for management in many Associations, hence the problem.

Had the necessary deregulation steps been taken at an earlier stage, then it might have been possible to ease the transition into the new market environment.

There is, therefore, much to learn from the American experience in a negative, rather than positive way. Deregulation must come at the right time, rather than wait for crisis to force reform. In Britain this has been done.

The Building Societies Bill is the result of several years of extensive debate and consultation, not only within the building society industry, but also in a much wider field. If enacted, the Bill allows a modest expansion by building societies in new areas, subject to necessary prudential constraints.

The regulatory system is to expand to accommodate the new powers which building societies will have; again, avoiding a mistake which occurred in America.

Generally, the American experience is instructive, showing what happens when an obviously untenable position is allowed to be maintained for too long. When deregulation came, it was too hurried, ill-considered, and in some respects went too far; hence current arguments about reregulation. None of this applies in the UK.

The lessons of the American experience have been learned, and indeed have been closely studied. The shockwaves that have hit the American savings association business over the past few years will, if nothing else, have contributed to sounder legislation for British building societies.

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