Structural change in housing finance

Addressing IUBSSA's Congress in Vienna, the Governor of the Bank of England, Robin Leigh-Pemberton, urged mortgage lenders to avoid letting borrowers become over-extended.

IT IS commonplace to remark on the present state of flux in the world's financial markets, and on the way in which these changes are impinging on people's lives. The origins of these changes are well-documented:

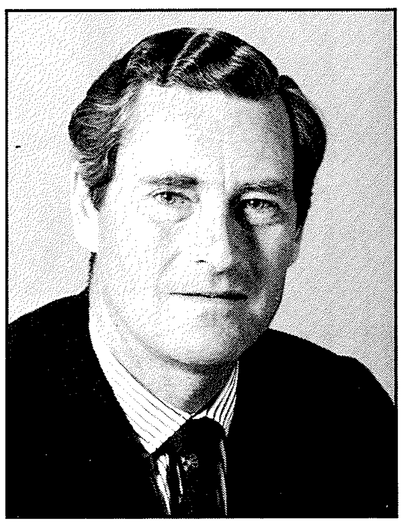
technological advances in communications and computation have made it possible to link financial markets more closely around the world, and have reduced the cost of financial transactions generally;

the need to cope with the problems of more variable interest rates and exchange rates, the gradual realisation that this is likely to remain a way of life, and the lower costs of transacting have all led to a flurry of interest in financial products designed to alleviate these risks;

and, finally, the easing of regulatory prohibitions in a number of countries has stimulated competition which, in some cases, has fed on itself and led to yet further regulatory changes. This too has served to reduce transaction costs.

As a consequence, financial markets across the world have evolved in a number of ways and taken on a new set of characteristics:

more intense competition has led to a compression of margins on conventional forms of financial intermediation, and lent urgency to the search for new and more sophisticated financial products



on which better margins can be earned;

financial markets have also become more integrated; and the erosion of traditional demarcations between markets, at least in some financial centres, has led to a blurring of traditional boundaries between capital and banking markets, and a process of diversification by a number of financial institutions.

Housing finance has not been immune from the pressures of new technology, greater interest rate volatility, and deregulation. In the United Kingdom, as in many other countries, new technology is revolutionising the market for retail deposits on which many housing finance specialists depend. In order to maintain their competitive position, they are beginning to offer increasingly sophisticated facilities for money transmission, including the whole panoply of services that make up electronic banking.

The need to cope with more volatile interest rates has, of course, posed a number of problems for housing specialists around the world. The financing of fixed rate mortgages with variable rate deposits gave rise to serious difficulties in the United States when interest rates rose. In Canada, five year mortgage loans at a fixed rate were funded more or less on a matched basis, thereby protecting the intermediary. But rolling over loans of this kind could, and did, pose difficulties when rates were volatile.

In countries such as West Germany and Austria, where inflation has remained low and interest rates relatively stable, traditional methods of finance have been able to survive for a longer period. The system of contract saving operated by the Bausparkassen has survived, and householders save for a number of years and then have a right to a mortgage loan at a low rate of interest. It is notable however that, even in West Germany, contract saving now takes a declining share of the market and depends to some extent on tax incentives.

In the UK, the building societies have been able to cope with more volatile interest rates in large measure because mortgage deeds have, for some time, granted the lender discretion to vary the rate charged. But the transfer of interest rate risk from the intermediary to the borrower is not without its problems. A rapid rise in rates, dictated by market factors, can give rise to problems of growing arrears, if the borrowers themselves are highly geared.

Regulatory changes have also impinged on the provision of housing finance, although the catalyst for change can often be traced back to regulatory changes in a quite different market. This point is well-illustrated in the UK, where the abolition of exchange controls in 1979 rendered direct controls on the growth of banks' balance sheets ineffective, and these controls were subsequently abandoned in 1980. Freed from controls on their sterling lending, the major retail banks felt less inhibited about entering the mainstream mortgage market, which they duly did in 1982. The building societies' response to the competitive challenge led to the ending of the previous system of queues and mortgage rationing, and the setting of lending rates at market-clearing levels.

What has been the impact of these changes on the provision of housing finance? In a number of countries new intermediaries have entered the market for housing finance, which in many cases has traditionally been dominated by specialists. A range of factors has encouraged the newcomers to enter the field. The difficulties encountered with international lending, in particular lending to less developed countries and for oil-related projects, has encouraged some major international banks to concentrate more heavily on personal banking — a key element of which is seen to be the provision of loans secured on first mortgage. Mortgage lending for owner-occupation is seen as highly attractive in view of the security offered by the underlying asset, and the favourable tax treatment and social security safety net offered in many countries.

Diversification has not, of course, been a one-way street. Some specialists in housing finance have come to the conclusion that diversification into personal banking and consumer lending is the key to maintaining their competitive position. In the United States, Australia and the United Kingdom legislators have accepted the case for diversification into these areas, and this, in turn, is likely to give rise to a further turn of the competitive screw.

It would seem that, in these countries, a diminishing role is likely to be taken by specialist savings institutions, with an increasing share of the market going to institutions that attract retail funds by offering comprehensive personal banking services, or tap the wholesale and capital markets. Some specialists in housing finance are likely to become increasingly indistinguishable from their banking cousins.

'Diminishing role for specialist institutions'

As in the other financial markets, diversification and the erosion of traditional demarcations has led to more intense competition. In the UK, the initial impact of increased competition — and the breakdown of cartelised rate-setting arrangements — was for lending rates to *rise* from artificially low levels to a market-determined rate. Since then, competition has tended to compress margins, but the realignment of mortgage lending rates has nevertheless made it attractive for a number of institutions other than banks to enter the fray with the intention of originating mortgages and then marketing them, in one form or another, as securities. In a number of countries these institutions would be called mortgage banks but, in the UK at least, they are neither authorised banks nor building societies: and they can operate with little direct supervision.

To the extent that these new institutions fund themselves from the monetary sector, the commercial banks involved will have to make a judgment about credit risk in much the same way that they do for other companies. The main purpose of these institutions will be to issue securities which are backed by their underlying mortgage assets, possibly combined with some private sector insurance against default. The introduction of these new techniques is another consequence of the recent opening-up of the financial markets.

Securitisation of mortgages is, of course, in its infancy in the UK; indeed, a full-fledged secondary market has yet to emerge. If a liquid and sound secondary market does develop, a wide range of mortgage lenders of all types may find it advantageous to tap this market as an additional source of finance; and we may well see a blurring of the boundary between traditional deposit-taking sources for the provision of housing finance, and capital market sources of finance.

It is nevertheless of critical importance that the design of the mortgage-backed instruments be fully thought through. The marrying up of the capital markets with the mortgage market in the United Kingdom — and anywhere else for that matter — does not just involve the import of well-tried techniques from the US. Conditions in each country vary — in the United Kingdom for example, reliance will have to be placed on private insurance, whereas in the US public sector guarantees play an important role. Considerable reliance may be placed by the market on the rating agencies and the credit insurers, and it is important that these bodies make careful and informed judgments, based on a full apprecia-

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tion of the facts and implications of the new arrangements.

What, then, are the implications of all these changes for borrowers, for intermediaries and for economic management? In the UK, increased competition has generally acted to the benefit of new homebuyers and depositors: queues for mortgages are no longer evident and competition for retail savings has increased deposit rates. Existing borrowers' privileged access to finance at submarket rates has been eroded, however, as competition has forced intermediaries to be more attentive to the providers of funds.

In an environment where the balance of advantage shifts in favour of the saver, borrowers need to be warned that lending rates will have to track market rates quite closely. This is particularly true where heavy reliance is placed on wholesale funding. Tight margins may also compel intermediaries — however well-meaning — to take a more hard-nosed approach to arrears and, in these circumstances, the protection of borrowers is likely to be a highly sensitive social issue.

'Narrowing of margins is to be expected'

It is important that the leaders in the mortgage field ensure that high standards of behaviour are maintained towards borrowers facing difficulties. In this regard, it would be preferable if practitioners devised and enforced their own standards of acceptable behaviour, rather than wait for the imposition of more cumbersome statutory requirements.

Turning to the intermediaries themselves, it is clear that they face greatly compressed risk/reward ratios. To some extent a narrowing of margins is to be expected as competition intensifies, but it is important that this process does not overshoot. It is much better if margins narrow steadily, and in an orderly way, to an equilibrium level leaving sufficient intermediaries to meet demand at least cost. Disruptive competition could force too many intermediaries out of the market too rapidly so that an initial abrupt narrowing of margins might be followed only by a widening of margins at a later stage.

As far as risks are concerned, the maintenance of an orderly market depends critically on the care and self-restraint of intermediaries. Institutions must resist pressures to allow lending criteria to become excessively lax. In the UK, income multiples available to borrowers have tended to edge up from between 2 and 2½ to 3 or more over the last four years. This liberalisation has occurred at a time when low inflation and high real interest rates might suggest that more exacting conditions should be applied. It would certainly seem unwise, in the present economic climate, for mortgage borrowers — and their creditors — to rely on inflation to reduce the real cost of servicing the mortgage.

Indeed total household sector debt in the UK as a proportion of disposable income has increased from around 40% to 70% since 1979, and the proportion of disposable income devoted to debt service has nearly doubled. It is true that householders' financial assets have also risen relative to income, and one might derive some comfort from this: a similar trend seems to be unfolding in the United States. But we are in uncharted waters as far as the UK household sector's balance sheet is concerned.

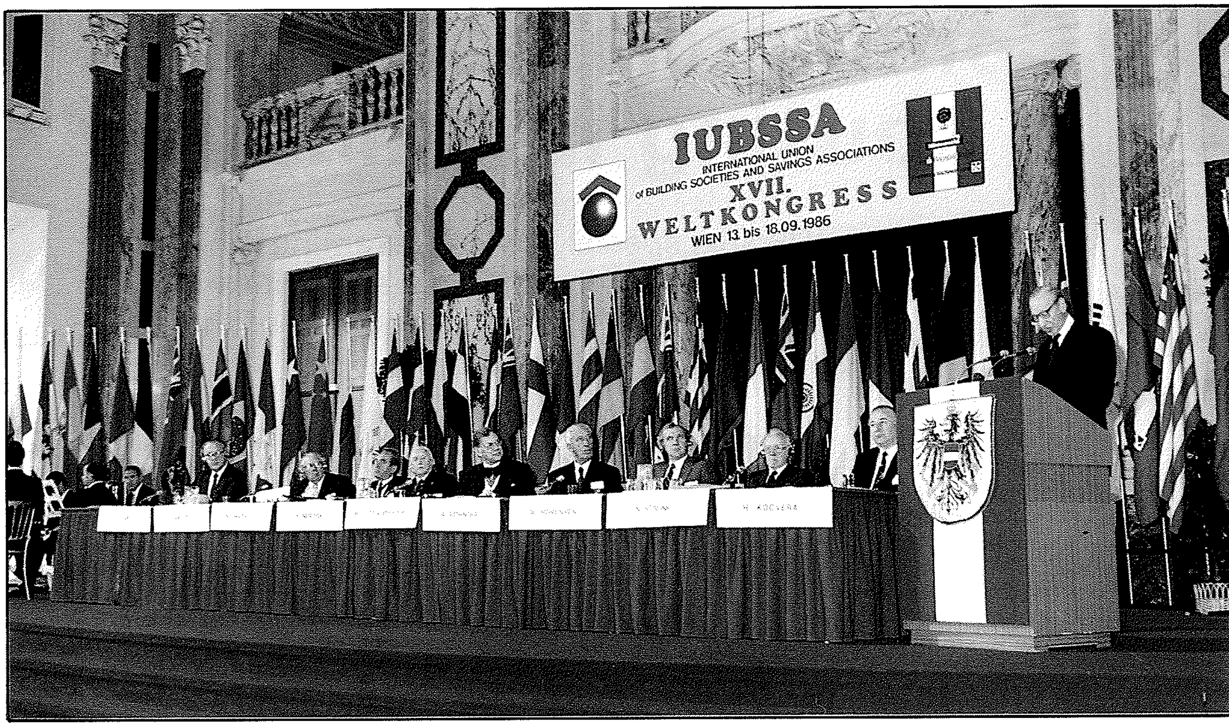
Competitive pressures have also encouraged mortgage lenders in the UK to increase the amount they are willing to lend as a proportion of the value of the property against which the loan is secured. Despite lower inflation, 95% loan-to-value ratios are not unusual for new mortgages, and the growth of top-up loans for other consumer spending may also tend to keep loan-to-value ratios at generally higher levels throughout the life of the loan.

It is important that mortgage lenders think carefully about the adequacy of the safety margin provided by the value of the underlying property relative to the loan outstanding. Arrears and defaults on first mortgages remain low, but do appear to be on an upward trend. Even if defaults do not rise siginificantly, it may become necessary to devote more money and staff time to the chasing up of arrears, a cost that will have to be covered by margins. Those involved in the mortgage market and their research organisations should perhaps devote considerable attention to these trends.

'House prices may not always rise'

In the UK, house prices appear to have followed an inexorable upward path over the last three decades. The two house price booms in the 1970s dramatically reduced loan-to-value ratios on outstanding loans, and conferred siginificant capital gains on homeowners. But there is no economic law that dictates that house prices will necessarily travel in an ever-upward direction. Indeed, mortgage lenders in a number of continental European countries are only too well aware of the difficulties encountered as a consequence of the weakness of house prices during the early 1980s.

While house prices remain buoyant in the UK, lending policies should not be based on the premise that house price rises will continue apace. Increases in house prices and nominal earnings do, of course, ease bad debt problems, but lenders and



IUBSSA's Vienna Congress is opened by Dr Kurt Waldheim, the Austrian president.

borrowers must not allow themselves to be lulled into the belief that their problems will all come out in the inflationary wash. The authorities in the major industrialised countries have set their face against accommodating monetary policies and will continue to resist inflationary impulses to the system.

Rapidly increasing house prices can pose an inflationary threat, as can the strength of mortgage lending. In the UK at present, monetary growth is being driven to a considerable extent by the strength of lending to the personal sector in general, and by mortgage lending in particular, and a considerable stock of unencumbered property assets remains potentially available as security for mortgage lending.

It is difficult to interpret the extent to which this poses an inflationary threat because some of the personal sector's increased borrowing appears to be matched by increased holdings of financial assets. The matching of mortgage loans with endowment policies and pension-linked policies are examples of this building-up of the personal sector's financial balance sheet, possibly without threatening inflationary consequences.

But some mortgage lending in the UK could give rise to inflationary pressures by accommodating house price increases. Moreover, the leakage of lending secured on a first mortgage, but used for other purposes, may well play a significant role in fuelling the expansion of consumer spending; and the entry of the building societies into the unsecured consumer lending market next year is likely to intensify competition in this area yet further.

I will conclude, as central bankers are prone to do, by urging the need for caution and *self*-restraint. Recent changes in financial markets do, of course, offer considerable opportunities and present practitioners in all financial markets with great challenges. In the mortgage market it is particularly important that lenders follow a course that avoids borrowers becoming over-extended: lenders should be wary of borrowers becoming unduly exposed to a rise in interest rates, or holding insufficient equity in their property. In the new, more liberalised, environment the onus is placed on lenders to make their own judgments about risk/reward ratios. The soundness of their judgment is critical to the success of the freer system. ■

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