Great Western banks on the adjustable rate mortgage

By Lynn Taylor

MANY American financial institutions are now originating some form of adjustable rate mortgage, thanks to deregulation in the early 1980s. However, few believed so earnestly in the success of this loan instrument as Great Western, now the number one originator of home financing in the state of California and the third largest in the United States.

In 1988, Great Western originated 86,000 mortgages, of which more than 95% were adjustable rate. At the same time, the company's total capital reached $2 billion which, at 6.04% of assets, is a ratio superior to the nation's 15 leading commercial banks. Total assets are approximately $33 billion.

Great Western began to take a leadership role in adjustable rate lending nearly two decades ago when company executives saw that a viable home loan instrument tied to changes in interest rates would be critical to survival and profitability. The company committed itself to the concept then as a part of a long-term growth strategy and, where other institutions have been tentative or come late to the marketplace with a product, Great Western's commitment has never wavered.

Pioneering the variable rate

In the early 1970s, Great Western was in the forefront of efforts to overcome both consumer and industry objections to development of the ARM predecessor, the variable rate mortgage. Stuart Davis, chairman and chief executive of Great Western from 1964 to 1980, was a tireless advocate of the variable rate instrument in California. In 1978, as chairman of the U.S. League of Savings Institutions, he made national acceptance of the VRM a top priority.

By 1979, less than five years after introducing the mortgage, Great Western had transformed its portfolio into 58% VRMs, a step the company viewed as essential to building a solid, variable rate asset-liability mix designed to withstand the pressures of fluctuating interest rates and the uncertainties of future deregulation.

The instrument of the 1980s

While not completely insulated from the losses incurred by the thrift industry in 1981 and 1982, when interest rates climbed towards 20%, Great Western was in a better position to weather the storms than many others.

'Very strong capital base'

The company had an exceptionally strong capital base to help sustain it, a healthy percentage of variable rate loans already on the books, and a firm commitment to restructuring its balance sheet with a new generation of flexible rate mortgages. What management learned from writing VRMs in the 1970s and early 1980s it now applied to developing a product that would balance the interests of both lender and borrower under deregulation. And when the Federal Home Loan Bank Board lifted restrictions in 1981, Great Western was prepared to begin offering a new kind of home loan to the consumer.

The product — a monthly adjustable loan with a six months introductory rate — floats over the cost of funds index of the 11th District of the Federal Home Loan Bank. In its popular form, it has both an annual payment cap of 7% and a lifetime interest rate cap of 500 basis points. Since 1981, Great Western has succeeded in converting 90% of its portfolio to adjustable rate mortgages and short-term loans and investments.

The mortgage factory

Great Western's ability to originate and service ARM loans in large volume has been likened by many to a high-efficiency "mortgage factory". Led by a network of commissioned loan agents who work exclusively for the company, the system uses in-house appraisers and has a support operation that provides quick, efficient service in loan processing.

In the late 1970s, the company originated about a billion and a half dollars in loans per year. Today, Great Western is generating that loan volume in just one month.

In 1988, the company originated

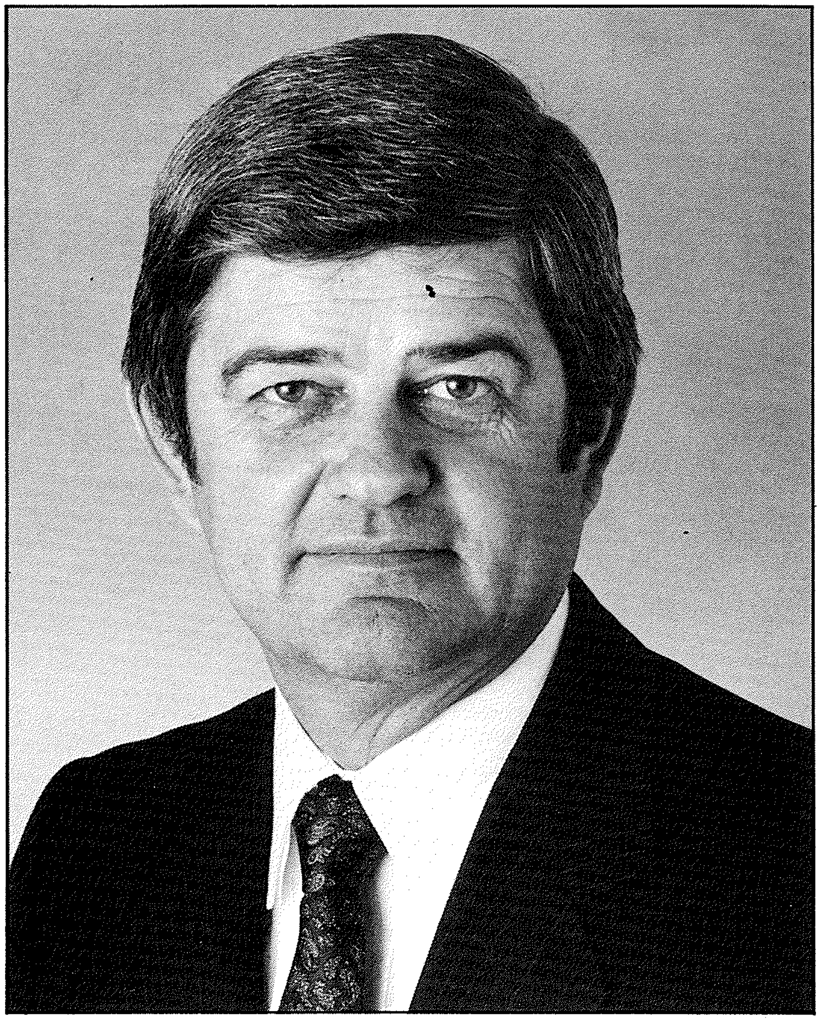
$11.5 billion in mortgages. In terms of market share, it made 6.3% of all residential loans in California, the nation's premier lending market, and garnered a 3% share of the huge $350 billion national market — a mark reached by only two other institutions in the country.

A patient approach to new markets

While Great Western has been among the most aggressive of all U.S. financial institutions in its pursuit of the ARM and the restructuring of its loan portfolio, the company has taken a more patient approach to expanding beyond its traditional California borders. Where others have rushed to take over failing institutions to gain entry into new markets, Great Western has pursued a strategy of focused expansion designed to avoid adding significant amounts of goodwill to the balance sheet.

Currently, the company is concentrating on expanding its full-service banking operations in Florida, New York, Washington and Arizona, and its growing network of real estate lending offices in prime markets in the nation's 17 leading mortgage markets. In 1988, out-of-state loan volume was nearly $1.5 billion, 13% of the company's total real estate lending.

'A strategy of focused expansion'



James F. Montgomery, chairman and chief executive.

Four core businesses

The past decade has seen rapid diversification of the U.S. financial services industry and Great Western is one of the institutions that is growing beyond the parameters of the traditional savings and loan. Deregulation opened up myriad possibilities and lured some institutions into a wide variety of new businesses. Characteristically, Great Western chose not to stray too far afield from what it knows how to do best.

As a result, the company devoted its energies to four core businesses: real estate finance, mortgage banking, retail banking and consumer finance.

Mortgage banking

Aided by a steady stream of loans produced by Great Western's mortgage factory, the company's mortgage banking operation packages and sells those loans in large quantities to the seconday mortgage market and provides several significant sources of revenue: profits from sales, long-term income from servicing, and cash that can be profitably employed in new mortgage lending.

During the past three years, the amount of mortgages Great Western has sold, and continues to service for other investors, has nearly tripled from $3.7 billion to $9.7 billion.

The off-balance sheet servicing income Great Western derives from its portfolio of loans sold into the secondary market acts like an annuity. The company's long-term goal is to increase that portfolio to the same size as its own $29 billion lending portfolio.

26 →

← 25

Retail banking

Underlying Great Western's strength in real estate finance is its 287 retail banking branch network, which provides a $22 billion deposit base that serves as a major source of funds for lending.

In addition, the branch network offers some 30 different financial products from certificates of deposits and securities products to VISAs and checking accounts. While in past years the retail bank was viewed primarily as a cost centre, today it is a growing profit centre, having contributed more than $45 million in fee and commission income in 1988, compared with $47 million the year earlier. Out-of-state branches accounted for 43% of the company's increase in consumer accounts in 1988.

Consumer finance

The Consumer Finance Group, acquired in 1982, was Great Western's first major foray into markets outside California. It is a key part of Great Western's efforts to generate short-term, high-yielding, high-quality assets.

'Record year for loan volume'

Profitable for 61 straight years, the Consumer Finance Group concentrates on selling a product mix of personal loans, sales finance contracts and real estate-secured loans, with an average yield of 20% and an average term of four years. In the past three years, pre-tax earnings have grown more than 50% to $57.4 million and net receivables have increased by about 65% to $1.2 billion.

Outlook for the 1990s

Great Western management believes the company emerged from the turmoil of the 1980s in a sound, profitable position largely because it adhered to certain well-founded principles, not only in financial integrity but also in common sense. These are: a strong capital base, balanced assets and liabilities, and a clear focus on core businesses with excellent near- and long-term growth potential.

In the next decade, Great Western expects to continue to emphasise residential mortgage lending, with the single family residential mortgage remaining one of the safest investments a financial services company can make. It keeps the balance sheet "clean" and provides the mortgage banking operation with investment grade assets that can be sold in the secondary market.

Great Western's headquarters. The statue is of John Wayne, the legendary film star.

Great Western has just recorded a record year of loan volume and demonstrated convincingly that it can gain market share even in a stable market. And, while the company's current 3% share of the national market is about the best any one financial institution has been able to do nationally thus far, it would appear that Great Western is well positioned to increase its share of the market quite handsomely in the 1990s. ■

LYNN TAYLOR is director of public relations at Great Western Financial Corporation.