The owner-occupied market in the Netherlands

By Hugo Priemus

TOWARDS greater stability in the Dutch owner-occupied market: that is the theme of this paper. In the first part we look back, analysing some recent developments in that market. In doing so we devote attention to the background to these developments and above all to the role of financing and government policy on that point. This analysis forms the starting point for an outline of the trends to be expected in the years to come. We consider the policy that the Memorandum on Housing in the Nineties by the Dutch State Secretary, Heerma, has in store for the owner-occupied sector. We make a number of comments on the intended policy, in which we emphasise the need to promote a certain stability in the housing and housebuilding markets. By giving the housebuilding programme in the social sector a task-setting character and by building buffer mechanisms into the subsidy technique for both rented and owner-occupied dwellings, a contribution can be made to a stable development in the housing and housebuilding markets. Finally, in contrast to the Heerma norm — of 55% owner-occupied dwellings in the year 2000 — we introduce the Priemus norm: the height of equilibrium, viz. 50% owner-occupied and 50% rented dwellings.

THE owner-occupied market in the Netherlands has followed anything but a uniform trend in the past 20 years. The tempestuous development of the owner-occupied market in recent years has been described and analysed by many authors: Van Beuzekom *et al,* 1980; Engberts and Happel, 1980; De Groot *et al,* 1980; Van Dongen *et al,* 1982, 1983; Hartog *et al,* 1981; Zwinkels, 1980; Van de Schaar, 1987; Kersloot and Dieleman, 1988.

In the period 1947-1985 the proportion of owner-occupied dwellings increased from 28% to 42%. This increase was spectacular especially in the second half of the sixties and the first half of the seventies. In the period 1947-1967 an average of 6,000-7,000 rented dwellings in the stock were converted annually into owner-occupied ones. In the period 1967-1975 this proportion was much higher: 24,000 to 30,000 conversions per year (Van der Schaar, 1987, p 309).

In new construction the proportion of houses for sale increased from 10% in 1948 to more than 60% in 1979 (Fig. 1).

This growth was not completely linear. There were also periods (e.g. after 1955 and after 1963) in which the percentage of owner-occupied dwellings in new construction declined, but viewed in the somewhat longer term the growth of the owner-occupied sector in this period is patently obvious.

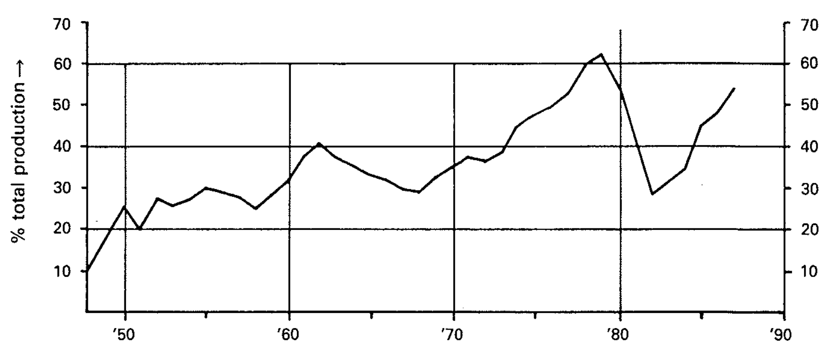

Fig 1. Number of completed dwellings for sale and their proportion of total building production, 1948-1987

House prices fluctuated violently in the period after 1965. Fig. 2 (opposite) shows us the trend of the indices (1965 = 100) of purchase prices of single-family houses with vacant possession, compared with those of contract wages and building costs.

In the period 1965-1973 purchase prices still reasonably paralleled the development of building costs. Both variables grew in this period by nearly 30%. In 1973 the first oil crisis broke out. As a result, wages and building costs came to a standstill, whereas inflation increased further. Real estate was then regarded as the protection *par excellence* against erosion of capital as a result of inflation.

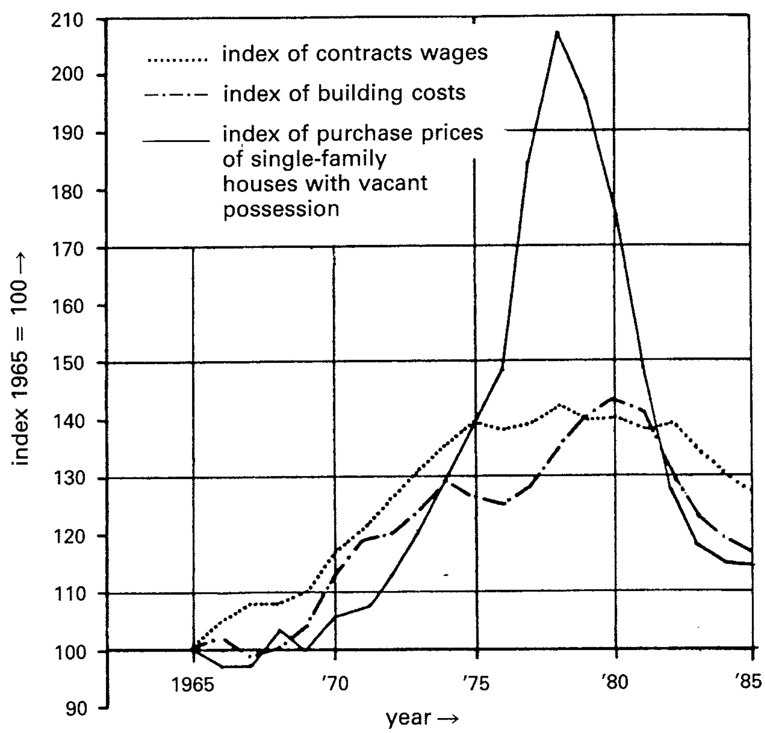

Fig 2. Indices (1965 = 100) of the purchase prices of single-family houses with vacant possession, building costs and contracts wages, 1965-1985

From then on the demand for dwellings for sale soared. In the period 1973-1978 the expansion of the supply could not keep up with this increase in demand. The result was that the prices in the real estate market shot up, sometimes by 20-30% a year. In 1965 2% plus of the housing stock was offered annually on the housing market. By 1971 this proportion had risen to 2.7%, and by 1976 to 4.1%. In the seventies speculative transactions probably contributed to the overheating of the owner-occupied market.

After 1979 an exceptional development occurred. As a result of the second oil crisis in 1978 the Netherlands sank into an unprecedented economic slump. Unemployment rose quickly, incomes fell and the Government's financing deficit rapidly increased. The mortgage rate was high and the consumers' expectations for the future were sombre. Many newly built houses for sale remained empty. The proportion of houses for sale in the new construction programme tumbled from over 60% in 1979 to less than 30% in 1982. Since then a clear recovery has taken place.

The supply of dwellings for sale in the stock declined quickly again after 1978 and by 1981 had already returned to its old level (2.4%). Prices fell strongly after 1978 and caused great problems for owner-occupiers, property development companies and mortgage banks. Between 1972 and 1978 registrations of new mortgages had quadrupled; thereafter these numbers declined to less than half.

The very pronounced drop in sales prices continued until 1983, after which these prices remained at a low level compared with the indices of wages and building costs. The situation at the beginning of the seventies has thus returned in recent years.

Table 1 shows the price trend of dwellings for sale in relation to inflation in the period 1975-1988. We see the greatest price increases in 1976 and above all in 1977. The period 1979-1982 displays a considerable real fall in price. Van Herwijnen (1988) remarks that the average dwelling price in 1987 should have been f.168,600 if inflation had been consistently followed since 1975. In reality the average price in 1987 was f.153,300. However, if we compare two other years, it can be demonstrated that the growth of house prices exceeds inflation. It is therefore justified to conclude that a house of one's own does maintain its value in the long term, but that in the short term inflation and prices of owner-occupied dwellings may differ considerably.

The expansion of the owner-occupied sector until 1978 is connected

6 ⟶

Table 1. Development of the value of dwellings for sale, 1975-88

Year	*Average prices (×f.1,000)*	*Inflation (%)*	*Real increase in value (%)*
1975	102.6	10.2	–
1976	131.9	8.8	+19.8
1977	184.2	6.4	+33.3
1978	198.8	4.1	+3.8
1979	187.3	4.2	−10.1
1980	171.1	6.5	−15.1
1981	153.5	6.7	−17.0
1982	138.1	6.0	−16.0
1983	142.1	2.7	+0.2
1984	139.6	3.3	−5.1
1985	140.1	2.2	−1.8
1986	147.2	0.2	+4.9
1987	153.3	−1.1[a]	+5.2
1988	159.8[a]	0.9	+3.3[b]

Source: NVM.
a: First six months.
b: Second quarter of 1988 compared with second quarter of 1987.

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by Van der Schaar (1987, p 314) with a number of factors:

a. Demographic factors: the first-time appearance on the housing market of a large group of young people forming part of the post-war birth bulge.

b. The strong income growth and the expectation of a continuing increase. Income expectations are of great importance to the decision whether or not to buy a house.

c. Closely connected with income expectations is consumer confidence (Van den Brink *et al,* 1988; Gianotten *et al,* 1987; Van Raay and Van Wijk, 1985).

d. The high inflation and the attraction of an inflation-proof investment.

e. The interest rate falling since 1974 supplied an additional incentive until 1978. The real interest rate had been low since 1971.

f. The abolition of credit control by the Netherlands Bank in 1972.

The slump in the owner-occupied sector after 1978 is attributable to the following factors:

a. The strong increase in unemployment and insecurity of one's economic position. In addition, the falling purchasing power, the unfavourable income expectations and the waning consumer confidence played a major role.

b. Interest rates reached a very high level after 1978, as a result of which capital charges rose to great heights.

c. Property prices fell and the selling risk for owner-occupiers increased.

d. compulsory selling-up increased, because more and more owner-occupiers had difficulties in meeting payments. Mortgage terms became stricter. Owner-occupiers became alarmed.

e. Partly as a result of the standstill in the labour market, mobility on the housing market decreased. The demand for houses for sale fell.

Financing of home ownership

Every year there is a turnover of some f.18,500 million in funds for financing in the owner-occupied sector. Of this, some f.16,000 million consists of mortgage loans.

According to internal calculations by the Vereniging Eigen Huis, in the period 1984-1986 there was a turnover of some 6,000 million guilders in mortgages in new construction, and a further almost 10,000 million guilders in the stock (Van Herwijnen, 1988). Yet another 2,400 million guilders for the purchase of owner-occupied homes was financed in another way.

For the developments in the owner-occupied sector the links with the capital market are of very great importance. Capital market developments determine the financing possibilities. In this connection the development of the mortgage rate is of decisive importance.

Fig. 3 illustrates the trend of the mortgage rate since 1956.

Table 2 (opposite) shows the trend of the mortgage rate alongside the rent trend in the same period: 1966-1988.

In the development of the mortgage rate we see a reflection of the above-mentioned effects of the oil crisis of 1973 and that of 1978. In 1974 the rate shot up to more than 11% on average. Thereafter the mortgage rate quickly recovered to 8-9% in the period 1976-1978. The consequences of the second oil crisis were more drastic. After 1978 unemployment increased quickly, the financing deficit soared and incomes fell for several years. For three years (1980-1982) the mortgage rate then averaged double figures on an annual basis. Since 1982 the mortgage rate has been falling. The question, of course, remains whether this fall will continue in the years to come or whether a new increase will become apparent.

The comparison with the rent trend in the same period is interesting. The rent trend was high in 1966 and 1967 and in the period 1975-1978 (inflation). Above all since 1982 the rent trend has been falling steadily, to not more than 2% in 1986 and 1987. In 1988 and 1989 a 3% rent trend has been adhered to. The housing costs reports by the Housing Ministry show that the development of housing costs for tenants and that for owner-occupiers display entirely individual dynamics.

The consequences of changes in

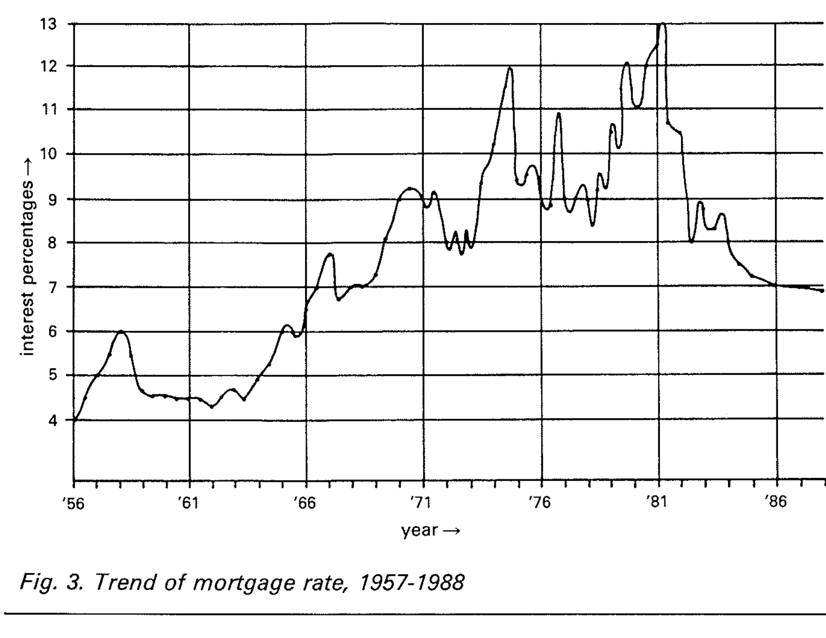

Fig. 3. Trend of mortgage rate, 1957-1988

Table 2. Development of rent trend and mortgage rate (%), 1966-88

Year	*Rent trend %*	*Date*	*Mortgage rate %*
1966	10	1.7	7.70
1967	10	1.7	7.25
1968	4	1.4	7.31
1969	6	1.4	8.42
1970	6	1.7	9.44
1971	7	1.4	9.05
1972	6	1.4	8.43
1973	6	1.4	8.91
1974	6	1.4	11.23
1975	8	1.4	9.91
1976	8	1.4	9.37
1977	7	1.4	8.92
1978	7	1.7	8.61
1979	5	1.7	9.64
1980	6	1.7	11.39
1981	6	1.7	12.71
1982	6 (4)	1.7	11.05
1983	5	1.7	9.13
1984	3	1.7	8.99
1985	3	1.7	8.36
1986	2	1.7	7.26
1987	2	1.7	7.12
1988	3	1.7	7.12

Source: VROM/DNB.

the mortgage rate are partly compensated for by changes in real estate prices. Roughly speaking, it is true to say that real estate prices in the owner-occupied sector rise as the mortgage rate falls, and that the prices of owner-occupied dwellings fall if the mortgage rate rises.

The lenders of money on the mortgage market reacted creatively to the upsetting rise in the mortgage rate after 1978.

After a considerable time in which the annuity mortgage, the level repayment mortgage and the endowment mortgage had been the only forms, the crisis in the owner-occupied market induced the mortgagees to come forward with some forms of mortgage directed towards stabilisation of capital charges (Dijkman and Dreuning, 1983; Kool, 1984; Van Herwijnen, 1988). The PGGM pension fund presented the "wage-proof" mortgage. The Bouwfonds Nederlandse Gemeenten propagated the "interest rest" mortgage. Other forms to appear were the deposit mortgage, the stable interest mortgage, the Roparco mortgage and the free mortgage.

The Association of Owner-Occupiers, Vereniging Eigen Huis, is remarkably enthusiastic about the Saving mortgage. However, it greatly depends on individual circumstances as to which type of mortgage is the most favourable one. The variety of types of mortgage loan is to be applauded and contrasts sharply with the uniform way in which up to now loans have been granted in the subsidised rented sector.

For the consumer the mortgage market by no means offers the solution to all his problems. The relation between a mortgage loan and the market value of the mortgaged property is in many cases highly unfavourable for the occupants. A mortgage loan can in general be given up to about 75% of the foreclosure value of the dwelling to be purchased. This foreclosure value is in general 80% of the value of the real estate with vacant possession in private sale. The buyer of a house must therefore manage to finance a considerable amount of the purchase sum himself without the cover of a first mortgage. No wonder people with a low income will not be in a hurry to buy a home these days.

The so-called Arbitrating Bodies, which advise local authorities on giving municipal guarantees, apply norms that establish a relation between gross annual income and the maximum permitted gross monthly mortgage charge.

The following relation is established (Van Herwijnern, 1988):

At a given mortgage rate the maximum borrowing capacity can be determined per income category. The borrowing capacity is an important factor in establishing the size of the demand for dwellings for sale and the price of these dwellings. The income determines the maximum loan, given the mortgage rate, and the maximum loan is connected with the purchase price. In this way income and purchase price are closely connected.

The Heerma Memorandum and the owner-occupier

The current government means well by the owner occupier. One of the priorities in government policy for the nineties is the "promotion of home ownership" (Heerma, 1988, p 76). More than before, policy is directed towards making investments in housebuilding more attractive, even without extensive public support being necessary. It is expected that the demand for owner-occupied dwellings will increase accordingly as the real disposable income of households grows.

Under the heading "Promotion of home ownership" (p 79) the State Secretary reports that the rents of more expensive dwellings will be liberalised and that a firm trend rent policy will be followed. As a result, the members of the public with considerable purchasing power will concentrate more on the free sector, notably the owner-occupied sector. Here the State Secretary is therefore remarkably clear: by worsening the situation in the rented sector for tenants, home ownership is promoted. This theme returns with regard to the proposed encouragement of the sale of housing association dwellings to the occupants. Here the promotion of the owner-occupied sector proceeds directly at the expense of the social rented sector.

In the owner-occupied sector itself the Heerma Memorandum does not in fact offer new positive incentives. The premium B sector has meanwhile been done away with, in the wake of the Oort Commission for tax reform the rateable value is to be increased considerably, the premium A scheme has not improved and the suggestion to reduce the

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transfer tax on housing sales is mentioned in such a whisper in the Heerma Memorandum that the other members of the Cabinet probably did not hear this pronouncement. I quote (p 83): "By and large, the tax aspect is outside the scope of this memorandum. Consequently, no proposals for amendment of broad outlines are made."

If the future for home ownership looks rosy, that is not the result of a direct, positively encouraging policy in that respect, but of the favourable economic prospects, the increased consumer confidence (1980 = index 65; 1987 = index 99; 1988 = index 102), the reasonably favourable mortgage rate and the systematic way in which the rented sector is in danger of being stricken by increased housing costs and erosion of legal protection.

The policy for the promotion of home ownership, as unfolded in the Heerma Memorandum, consists of four parts (p 145):

generic measures in rent and subsidy policy, making purchase of a dwelling more attractive;
specific subsidisation of owner-occupied dwellings for the lower-income groups;
aid with financing;
the sale of rented dwellings.

According to the Heerma Memorandum the owner-occupied sector in the year 2000 will comprise more than 50% of the stock if economic growth steadily continues at 23%. This percentage is based on the preferences gauged in 1986; a further shift in demand in the direction of the owner-occupied sector may be expected in the nineties, the Heerma Memorandum states. For 2000 a target of 55% is mentioned.

"The expansion of the owner-occupied sector will (. . .) above all be to the benefit of the higher-income categories," the Memorandum says (p 145). This conclusion agrees with the results of the 1985/1986 Housebuilding Survey and with the following table published by Kersloot and Dieleman (1988), taken from the 1985 Collective Banks Survey.

The higher the income, the larger the proportion of owner occupiers. For young people, single persons, incomplete households and tenants older than 45 years the owner-occupied sector is relatively inaccessible or unattractive (Pas *et al,* 1983).

The large proportion of households with a high income that are expected to profit from the promotion of home ownership is at variance with the priority that is given to aid to the below-modal category. Heerma endeavours to reconcile these two trends by easing access to the owner-occupied sector for lower-income groups. In this connection the social owner-occupied sector is introduced. This sector is nurtured by sale of social rented dwellings and by the invention of a new name for the premium A scheme. On the latter point the policy of the Home Ownership Memorandum (1983) is prolonged. In the premium A sector the net-present-value method is continued, which entails a pleasant manageability of cash expenditure for the national budget.

Housing tenure and net income of households

Net income (guilders per month)	*Number of households (×1,000)*	*% Owner-occupied dwellings*	*% Rented dwellings*
Up to 1,400	1,010	18	82
1,400-2,200	1,757	32	68
2,200-3,600	1,844	50	50
More than 3,600	763	66	34
Total	5,374	43	57

The mortgage guarantee in its existing form is maintained for the time being, now that the creation of an Intermunicipal Risk Fund proves unattainable. An evaluation study of the mortgage guarantee is announced, whereby for the future a combination is envisaged of saving in advance (whether or not with a fiscal incentive), the granting of premiums and the provision of guarantees.

On the one hand, the State Secretary wishes to make home ownership more accessible to the lower-income categories by lowering the maximum income limit in the premium A sector. On the other hand, he wants to restrict risks to the government from mortgage guarantees, *inter alia,* by more stringent standards of the Arbitrating Bodies. On balance the position of the lower-paid in the owner-occupied sector is not improved. The combination of low income and home ownership remains a precarious one, because the risks of a rise in the mortgage rate, capital risks and selling risks are not limited and cannot really be borne well by low-income categories.

Not only will social rented dwellings be sold; it is expected that more and more private rented dwellings will also be affected. Above all, when dwellings in blocks of flats are involved, this may lead to complicated management situations. In such cases Associations of Owner Occupiers, which often lead a sorry existence in practice, are obligatory (Van Weesep, 1986). Experiments and information activities in this field are announced, but the prospect of concrete policy measures is not held out.

It is striking that the Heerma Memorandum does not alter the fact that in the Housing Ministry sphere aid to owner-occupiers is strongly directed towards new construction.

10 →

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The following situation remains in force:

new construction: fairly considerable centrally allocated Housing Ministry subsidies, notably in the premium A sector;

dwelling improvement: no central government involvement; in some cases fairly considerable local government subsidies, paid out of the municipal urban renewal fund;

stock (purchase and management): apart from aid with the disposal of dwellings with a dynamic cost price rent by housing associations, no subsidies.

More strongly than in the rented sector Housing Ministry premiums in the owner-occupied sector are above all building subsidies, which it is becoming increasingly difficult to justify theoretically.

Towards greater stability in the housing market

For the years to come it seems that an increase in the demand for a home of one's own may be expected. Partly on account of demographic factors, unemployment will gradually decrease in the nineties. A modest growth of national income is expected. Moreover, the expectation is that the interest rate will not rise spectacularly. Because interest in general proves to be a quantity that is hardly predictable, if at all, the predictions with regard to it must be taken with a pinch of salt. Precisely on this point surprises may manifest themselves.

The owner-occupied sector can be made to grow by a greater proportion of owner-occupied dwellings in new constructions and by a greater number of transactions converting rented dwellings into owner-occupied ones in the stock. It seems that a new wave of division into apartments may be expected in the stock, although the management of mixed blocks is accompanied by great problems. Partly through the planned decrease in the proportion of social rented dwellings and the reticent attitude of investors, an increasing percentage of owner-occupied dwellings may be expected in the new construction programme, irrespective of the political colour of forthcoming cabinets.

If we try to picture the development of home ownership in the nineties, then, just as in preceding decades, market development will probably be more of a determinant than policy development.

If the purchasing power of households, in conformity with the assumptions of the Heerma Memorandum, grows in real terms by 1% per year, and if the capital market interest rate remains about 7%, the circumstances are favourable to a structural expansion of home ownership. If fiscal aid to owner-occupiers, apart from a sharp increase in rateable value, is maintained, everything in the garden is lovely. As the result of a highly restrictive policy in the rented sector, the pressure on the owner-occupied sector might become too great on occasion. At the present time excessive price increases in the owner-occupied sector are still absent, because of the fact that the free sector has been given a clear field and in this sector all production records are now being broken. By sale of rented dwellings the price-increasing effect of the growth of demand in the somewhat less expensive parts of the stock can be curbed to some extent.

However, the question is whether the development of purchasing power and the trend of the mortgage rate will be as favourable and as stable as the Heerma Memorandum assumes. It seems more obvious to assume that economic fluctuations will occur in the nineties as well. Anticyclical programming of social rented dwellings is no longer available. Housebuilding programming is no longer task-setting, but only indicative. Housing associations are faced with increasing interest risks and will become subject to the same considerations as promoters in the maket sector. In the social rented sector a procyclical discontinuity in the nineties must be feared, which may considerably intensify the ups and downs in the owner-occupied sector. This introduces a new source of unrest into the Housing Ministry's budget.

The period 1975-1988 was characterised by extreme differences in the field of regulation between the rented and the owner-occupied sector. In the rented sector rises in the interest rate were almost automatically compensated for by a great increase in the building subsidies. Here the central government bore the risk of setbacks on the capital market almost entirely alone. Landlords and tenants were almost completely safeguarded against these threats. In the owner-occupied market the premiums were in fact adjusted somewhat if the interest rate increased, but in general the cost increases as a result of a rise in the mortgage rate were borne almost entirely by the owner-occupier.

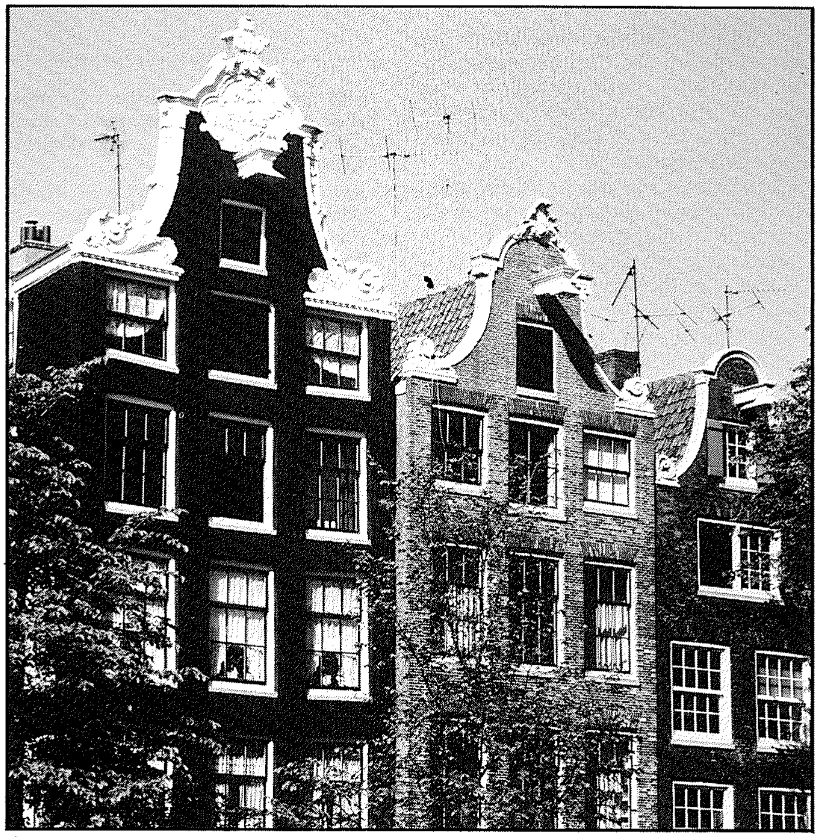
The combination of these two systems led to an unstable equilibrium between buying and renting. If the interest rate rose strongly, the demand shifted from buying to renting and the Housing Ministry budget was disproportionately burdened by an increase in the number of rented dwellings in new construction and an increase in the building subsidies per dwelling. If the interest rate fell strongly, the demand shifted from renting to buying. The prices in the owner-occupied market rose and the market had every chance of becoming overheated after a few years. The purchase premiums were often adapted too late and inadequately to the falling interest rate.

For the years to come there is a need for subsidy schemes in the owner-occupied and rented sectors to be designed in such a way that a contribution is made to a more balanced treatment of tenant and buyer and a more stable development in the housing market and housebuilding market is promoted. The principle of a desirable subsidy system is simple.

If the interest rate rises, part of the additional costs in the rented sector should be borne by the tenant and/ or the landlord. With the introduction of the Standard Costs System on 1 January, 1988 and the announced net-present-value method, steps are being taken in this direction in the social rented sector. The way in which the net-present-value method is being designed probably introduces too may risks in the social rented sector. The building subsidy scheme will be less of an open-ended scheme in the nineties than previously.

It may, incidentally, be that as a result expenditure on housing allowances becomes less controllable. Through the higher interest rate the demand for rented dwellings *(ceteris paribus)* is checked somewhat. As a result the controllability of the building subsidy expenditure increases somewhat for the central government. In the owner-occupied sector the premiums would have to be raised somewhat in the event of a rise in the interest rate, in such a way that the additional costs are borne partly by the central government and partly by the occupant. In this way the drop in demand in the owner-occupied market as a result of the rise in interest rate is somewhat mitigated. The equilibrium in the choice between buying or renting is not too strongly tilted in the direction of the rented sector in the event of a rise in the interest rate.

If the interest rate falls, the premiums in the owner-occupied sector should go down, so that not only the owner-occupier but also the government profits from this decrease in cost. In the rented sector the building subsidies decrease, in such a way that both the government and the tenant receive the benefits of the fall in interest rate. In this way a fall in the interest rate is prevented from disturbing the equilibrium too greatly in the direction of the owner-occupied sector.



Ornate 18th-century houses in Amsterdam.

The system outlined damps down fluctuations in demand as a result of changes in the interest rate. If the interest rate rises, the government stimulates both the owner-occupied and the rented sector with additional subsidies. If the interest rate falls, the government mitigates the demand-encouraging effect by reducing the subsidies in both sectors. Accordingly, as buffer mechanisms are also incorporated in the mortgage forms and if possible the types of loan in the rented sector ("wage-proof", "interest-rest"), the financing can also contribute to the stabilisation of the housing market and the housebuilding market.

In the years to come the housing market will exhibit more chance of destabilisation through the withdrawal of the government than in the recent past. Precisely the owner-occupied market demands a limitation of risks and a prospect of stability. It is to be hoped that by adjustments to the subsidy system in the owner-occupied and rented sector the government makes a contribution to this stability and that the financiers also try to limit the mortgagor by the modes of their credit.

The fact that State Secretary Heerma cannot guarantee any continuity in building is regrettable but understandable. However, the housebuilding programming now being presented is not worthy of the name. Serious consideration will have to be given to making the programmes in the social sector task-setting, and for the rest a certain (partial) compensation will have to

12 →

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be offered in the financial aid to the market sector for possible setbacks. In that way overheating of the owner-occupied sector, a danger that is now very real for the nineties, can be avoided.

A balanced and pluriform situation in the housing market is most fostered in Dutch conditions if, in conformity with the preferences now gauged, a fifty-fifty ratio between buying and renting on the housing market is aimed at. Such a ratio allows both the owner-occupied and the rented sector to prosper. A sound rented sector is essential to public housing. A flourishing owner-occupied sector is equally of great importance to the housing market. It is fruitless if political factions and pressure groups keep on setting the owner-occupied and the rented sector against one another and advocate facilities for the one sector at the expense of developments in the other sector. A flourishing owner-occupied sector can contribute to the promotion of housing only if the rented sector prospers too. ■

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The crisis in the US thrift industry

By Mark Boléat

IN THE United States, thrifts (or savings institutions, savings associations or savings and loans as they used to be called) are the largest specialist housing finance lenders. Traditionally, they operated by collecting deposits and making long-term fixed-interest loans. For nearly a decade now the thrift industry has been in crisis, caused initially by borrowing short and lending long, and more recently by a combination of unwise deregulation, lax supervision and sheer dishonesty and fraud. This article briefly describes how the situation has developed, and the steps being taken to deal with it.

UNTIL recently American thrifts were similar in concept to building societies, with their primary functions being to collect retail deposits and to make mortgage loans to finance house purchase.

America does not have a nationwide banking system, but, rather, banks and other financial institutions are largely confined to operating at the state level, and many are regulated by state supervisory authorities rather than by federal authorities. The result has been a much more fragmented industry than is the case, for example, in the United Kingdom. At the end of 1985 there were over 3,000 individual thrifts.

In collecting retail deposits thrifts have been assisted by federal government guaranteeing of deposits, something introduced following the experience of the great depression in the 1930s which led to the collapse of many financial institutions. That insurance now covers deposits up to $100,000 and means that individual investors need have no concern about the soundness of individual institutions in which they place their money.

The traditional method of operation of the thrifts was to raise money through the short-term deposits, but make loans for long terms at fixed rates of interest. This does, of course, breach one of the cardinal principles of banking, that is, that institutions should match the maturities of their assets and liabilities. In practice, the thrifts were able to thrive while borrowing short and lending long, because throughout most of the 1950s, 1960s and 1970s, the long-term fixed rates at which they were able to lend were substantially above the short-term variable rates which they had to pay for their deposits. In addition, interest rates varied comparatively little.

The first crisis — the earnings squeeze

In the late 1970s and early 1980s interest rates became more volatile and the general level increased sharply, largely in response to inflation. These developments put the thrifts in a very difficult position. They were limited by regulation as to the rates of interest they could pay on deposits, and were forced to make loans at fixed rates of interest. Progressively, action was taken to deal with the liabilities side of the balance sheet with the thrifts being allowed to offer accounts carrying money market rates of interest.

However, while this solved the cash flow problem it worsened the earnings problem. The cost of liabilities had risen sharply in relation to the yield on assets, which could be increased only as existing low-rate mortgage loans were replaced by new higher-rate loans. The result was that the industry as a whole incurred a substantial deficit in 1981, and a further deficit in 1982. The average net worth ratio declined by a third in 1981 and 1982.

Many institutions ceased to exist, either by failing or through merging. Of the 4,002 institutions in existence at the end of 1980, no fewer than 843 had disappeared by the end of 1982. (Thrifts have subsequently been allowed to make adjustable rates loans, but even this power has often been misused, with unrealistically low pricing policies being adopted.)

The second crisis — unsound deregulation

The earnings crisis was accompanied by increasing competition in financial markets generally, as has been the case throughout the world. A general tendency has been for constraints on commercial banks to be removed, enabling them to compete more effectively in the mortgage market. Conversely, specialist housing finance institutions have been freed to diversify into related financial and housing services.

In the USA the combination of these two factors, together with the American political system which makes change very difficult, produced a new regulatory environment which, far from dealing with the

14 ⟶

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problems caused by the earnings squeeze, made the problems very much worse.

The first response was the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980. This provided for the phasing out of interest rate ceilings on various categories of deposit, increases in the powers of thrifts, and an increase in the ceiling for insured deposits from $40,000 to $100,000. In 1982 this was followed by the more far-reaching Garn/St. Germain Depository Institutions Act, which greatly expanded authority to invest in consumer, commercial and agricultural loans and other investments. It removed loan to valuation ratio limits and the restriction to lending on first mortgage, and it permitted investment in tangible personal property up to 10% of total assets.

This deregulation was fundamentally faulty, and the way it was introduced made disaster virtually certain. Perhaps the key to the current problems has been federal government guaranteeing of deposit accounts up to $100,000, meaning that neither individual investors, nor intermediaries need have any regard for the financial soundness of institutions with which they were investing. Even relatively new savings institutions found it possible to attract huge volumes of deposits through the broker market very quickly. Some of these deposits went to institutions which were being managed in an unsound way, and in some cases in a totally crooked way.

Given federal government guaranteeing of deposits, together with deregulation of activities, it is reasonable to assume that there should be much stricter supervision, paying regard in particular to the quality of management, the quality of assets, capital adequacy and so on. However, the opposite occurred. Indeed, there was competitive deregulation with some states deregulating their institutions much more than the federal authorities were prepared to do for federally chartered organisations.

This put the regulatory authorities in an impossible position. Thrifts were being freed, by law, to engage in a wide range of risky business, but their deposits were guaranteed by the federal government which was technically responsible for supervising them. Congress and the administration failed to give the supervisory authorities the staff or the powers they needed to deal with the new situation. As a result unsound practices were allowed to go undetected for long periods of time; even when they were detected often little could be done to stop them, and in any event by that time the damage had been done.

The nationalisation of housing finance

It is worth pausing here to consider the nature of the housing finance system that had been allowed to develop in the United States. While America may be seen as being the home of free enterprise, in effect what had been created was a nationalised housing finance system with both assets and liabilities being guaranteed by the government, and therefore in effect being government assets and liabilities. However, private sector institutions were responsible for making the assets and liabilities, and could benefit accordingly, but without suffering any risk.

On the liabilities side, the point has already been made that for most practical purposes, all deposits in thrifts were guaranteed by the federal government up to $100,000. Naturally, individual investors and intermediaries normally ensured that no one person had more than $100,000 invested in any institution, and where large sums of money were available for investment, these were split between a number of institutions. Neither individual investor, nor intermediary, needed to have any regard as to the safety of the institution with which they were investing, and indeed many continued to invest with institutions which were substantially insolvent, notably the largest thrift, American Savings, a subsidiary of Financial Corporation of America.

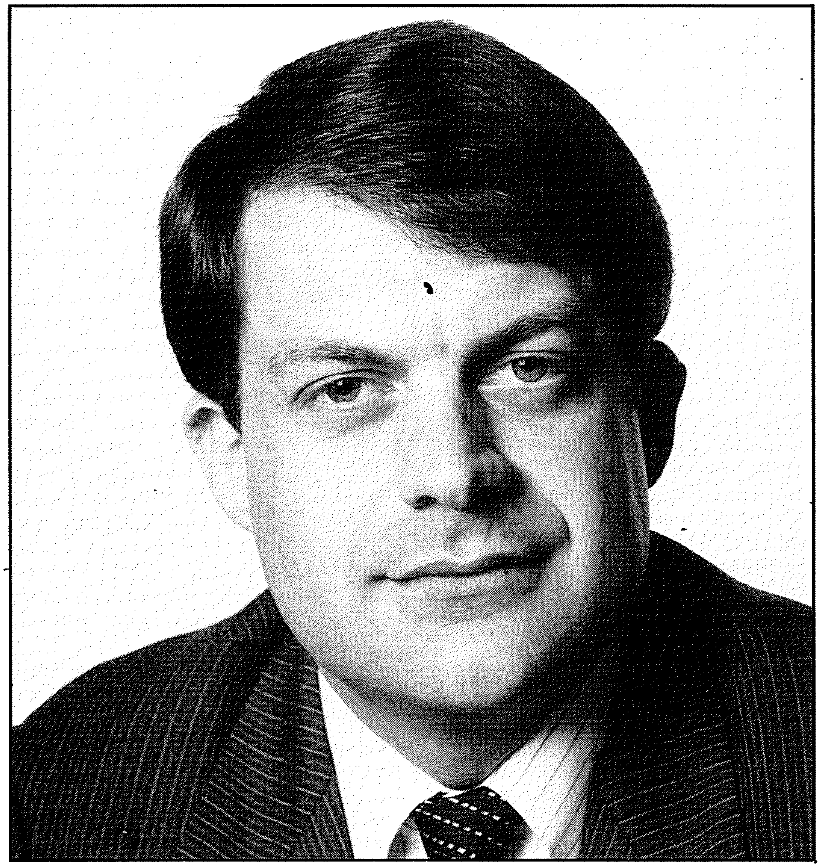
In effect investments were placed not with individual institutions, nor with the nominal insurance fund (the Federal Savings and Loan Insurance Corporation — FSLIC), but rather with the federal government itself, as it put the full faith in credit of the US government behind the insurance fund. Arguably the insurance fund has been an irrelevance and the fact that it has been wiped out has not prevented the government having to stand behind institutions. (Normally the reference is to the insurance of deposits, but as the government stood behind the insurance fund it is more proper to refer, as has been done in this article, to the government guaranteeing deposits.)

What has perhaps been less notable is the extent to which the federal government also dominates the assets side of the balance sheet. As institutions realised the dangers of borrowing short and lending long, so the secondary market agencies increasingly relieved them of the interest rate risk by buying their mortgages and selling mortgage-backed securities. This had a great deal of financial sense in it, as it enabled thrifts, which could not safely hold fixed-rate mortgages, to transform them into securities which could then be held by institutions, such as insurance companies and pension funds, better able to hold long-term fixed-rate assets in their portfolios.

However, the three principal secondary market agencies, the Government National Mortgage Association, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, not only did that, but effectively added a government guarantee as they transformed loans into securities. Institutional investors were therefore not purchasing mortgage-backed securities, but rather government-backed securities, and the only relevance of the mortgages was that they affected the repayment profile. This has now been formally recognised in the proposed capital adequacy requirements for different forms of security following the Group of 10 proposals. Mortgage loans will carry a 50% weighting, but mortgage securities backed by the government agencies will carry just a 20% weighting.

In addition to this, the government agencies themselves carry only minimal capital to back their contingent liabilities. Both the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association have contingent liabilities over 100 times their assets.

The effect of the government guarantee, plus the minimal capital actually held by the federal government agencies, has been to drive down the yield on mortgage-backed securities and, therefore, on the mortgages themselves from a level appropriate to mortgage loans to one more appropriate to government securities. This yield in turn has not been adequate for portfolio lenders. Opinions differ as to the extent of this effect, and generally it seems that the government secondary market agencies have driven down mortgage rates by, perhaps, 25 basis points, and given a very tight margin and a risky business, that is a very major impact.


Mark Boléat: Some 500 savings institutions were insolvent.

The extent of the crisis

There are widely differing figures on the extent of the thrift crisis. This is because attempts to deal with the crisis have included various accounting devices, and also some of the solutions used so far have entailed tax breaks and other incentives which cannot be fully quantified, and which also have implications the full affects of which will not be known for a very long time.

However, there are some basic figures which show the extent of the crisis. Thrift collectively lost $7.8 billion in 1987 and $12.1 billion in 1988. 12% of savings institutions at the end of 1988 had no capital, and well over half had capital which fell short of what would be required of banks. Some 500 savings institutions, with total assets of $150 billion, were insolvent even allowing for the generous regulatory accounting practices, and a further 100 institutions with $300 billion of assets were insolvent if the generally accepted accounting principles are used.

In 1988 alone, the cost of merging and selling insolvent institutions was some $28 billion, and at the end of the year the Federal Savings and Loan Insurance Corporation had a deficit of $27 billion.

The present best estimate is that over 10 years, dealing with the thrift problem will cost $126 billion, although a subsequent estimate, by the House of Representatives Banking Committee, has put the figure at well over $300 billion over 30 years.

That there was a major crisis was evident throughout most of 1988, but recognition of this was largely confined to the financial pages, and it seemed not to be taken seriously as a national problem. Certainly it did not feature in the Presidential election campaign. The issue has achieved much greater prominence as the new administration has taken office, and also as the extent of the problem has grown according to the official figures.

The first obvious question to ask is whether the government need do

16 →

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anything to deal with the crisis. There are some who argue that this is a crisis of the thrift industry, and there is no need for the federal government to take any action other than to let the bankrupt institutions go bankrupt. However, the existence of the federal government guarantee of deposits makes this not possible. If an institution was declared insolvent and closed down, then the government would immediately have to make up any shortfall, so as to allow depositors to be repaid in full. Moreover, if a large number of institutions were closed down simultaneously, particularly in parts of the country such as Texas where land values have been severely hit by the fall in oil prices, then the likely realisation of assets would be substantially less than their book value, and quite possibly less than could be realised over a period of years.

Put very simply, FSLIC has not been able to afford to close down insolvent institutions. Rather, it has had to seek ways of minimising the cost to itself and the government, and although this has meant closure of small institutions, in the case of larger ones, what has often been necessary is a merger into a larger group, or outright sale to a new institution, with a complicated financial package involving a capital input from FSLIC together with some guarantees and perhaps a share of any profits in the long term. This was done, for example, when the Robert Bass Group acquired Financial Corporation of America, the parent of the largest thrift with assets of over $30 billion. The cost to FSLIC of resolving this particular problem is estimated at $1·7 billion.

Reform

On 14 February, 1989, the Bush Administration outlined its proposals for reform, and these were followed by proposed legislation, entitled the Financial Institutions Reform, Recovery and Enforcement Act 1989 (FIRREA). It must be noted that merely because the government has proposed the legislation does not mean that the legislation will be enacted in anything like its present form. Already there are alternative plans, and past experience shows that the Administration has a very difficult task in persuading Congress to act on its recommendations.

The Act envisages the dissolution of FSLIC as a corporate entity. Its deposit insurance, conservatorship and receivership functions would be transferred to the equivalent corporation for banks, the Federal Deposit Insurance Corporation (FDIC). The FDIC will thus insure deposits of all insured financial institutions, but it will operate two separate funds, the Savings Insurance Fund (SAIF) for thrifts and the Bank Insurance Fund (BIF). The funds will not be merged and will be separately maintained.

Beginning with the fiscal year 1991 the Treasury will pay into SAIF a total of $32 billion over nine years. Where necessary the Treasury will pay any additional funds to ensure that SAIF has an adequate reserve ratio.

A new Federal Home Loan Bank System (FHLBS) would be created, to assume primary responsibility for the examination, safe and sound operation and regulation of savings institutions. The current independent three person Federal Home Loan Bank Board would be abolished and replaced by a single chairman of the new FHLBS who would be subject to the direction of the Secretary of the Treasury.

A Resolution Funding Corporation (RFC) will be created to provide funds to the Resolution Trust Corporation (RTC) which will manage and resolve supervisory institutions previously insured by the FSLIC. The RFC will be authorised to issue obligations not exceeding $50 billion, and to use the proceeds to purchase capital certificates issued by the RTC.

SAIF insured institutions will have to pay substantially higher insurance premiums than the BIF members. For 1990 the BIF members will pay 0.12% of deposits annually, and from the beginning of 1991 they will pay 0.15%. By contrast, thrifts are already paying 0.21%, and this will rise to 0.23% between 1991 and 1993 before falling back to 0.18% from the beginning of 1994.

The Act contains several provisions which would significantly limit the new activities of savings institutions:

(a) Whenever a thrift proposes to establish or control a company, or to conduct any new activity through a company it controls, it would be required to give the appropriate notice to the regulatory authorities, and to deduct from its capital its entire investment in the company.

(b) The asset growth of any thrift not in compliance with its capital requirements could be limited. Also the asset growth of any thrift taking excessive risk, or paying excessive rates for deposits, could be limited.

(c) The FHLBS would have authority to require a thrift to cease undertaking certain activities.

(d) The FDIC would have authority to promulgate regulations that would limit the ability of state chartered thrifts to engage in activities beyond those allowed for federally chartered institutions.

The Act requires that regulations for thrifts conform to specified requirements applicable to banks, including accounting standards and capital standards.

Generally, the big loser from this plan is the Federal Home Loan Bank Board which would lose most of its powers, and be placed under direct Treasury control. The main winner is the Federal Deposit Insurance Corporation which will take over the bankrupt FSLIC fund, and also take on responsibility for regulating thrifts.

One interesting point in the proposals is that the $50 billion of bonds intended to be raised by the Resolution Funding Corporation would not count in the federal budget, as they would not, strictly speaking, carry a government guarantee, although they would be regarded as government backed. This is likely to remain a controversial point.

A point of particular concern to thrifts is the requirements on capital adequacy. By June 1991, thrifts will have to meet the capital requirements applicable to FDIC insured banks, which means doubling their required capital ratio to about 6%. It is estimated that there are currently 1,300 thrifts only which satisfy the 6% level. If interest rates rise this figure could increase significantly.

The Economist, on 11 February, 1989, suggested that the unspoken goal of the Bush plan would be for the FDIC to force the weaker institutions into stronger hands, and the outcome would be a massive consolidation of what is now an absurdly fragmented industry. *The Economist* went on to say that the long-term effect of the plan, if implemented, would be the demise of a separate thrift industry in America.

There seems to be a general impression that what is being proposed, together with the crisis which the industry has experienced, will lead to the demise of a separate thrift industry, something which the industry is fighting against. Typical views were expressed in a leader in *The New York Times* on 20 February, 1989:

> "And who needs thrifts anyway? Even though neither the President nor Congress will raise the question publicly, it may be the most important of all. Thrifts were a special creation, to gather in local deposits and lend them out for local home mortgages. They held almost 60% of all mortgages 20 years ago; today they hold about a third. Unleashed by deregulation in the past decade, they spread their risks, often too far.
> Some managers gambled on windmill farms, casinos and other risky ventures; others bilked their institutions for personal gain. That's not reason enough to condemn the entire industry, but even the healthiest thrifts must share blame for fending off sane supervision that could have kept the problem from exploding.
> Thrifts' push into non-mortgage lending has narrowed the difference between thrifts and banks substantially. And new standards they must meet under supervision by the Federal Deposit Insurance Corporation — historically a strict bank regulator — will narrow it further. There are no longer compelling economic reasons for a separate thrift industry.
> Still, the thrifts have muscle on Capitol Hill, well toned by a constant flow of contributions to members of Congress, especially those on banking committees. It's now given that the industry's separate identity will be preserved.
> The President's immediate strategy is to plug the gushing losses and to impose closer supervision with every detail of his plan, but most of the objections are self-serving. S & Ls don't like losing a cosy relationship with regulators who didn't regulate; the FDIC is in charge now. And while banks and thrifts protest the higher insurance premiums ahead, politicians and public interest groups object to taxpayers footing half the bill.
> Mr Bush showed courage in coming to terms with the crisis so quickly; wisdom in offering a substantive plan, not a Band-Aid; and political savvy in spreading the pain. Let Congress now do the same."

'A failure of supervision'

The unique American position

It is, perhaps, tempting to extrapolate the American position to other countries. This would be misleading. There is virtually nothing in the American experience which has any relevance to any other industrialised country. The American experience was caused by a combination of circumstances unique to that country. The fragmented nature of the industry is perhaps an underlying cause, making supervision and sound banking practices more difficult to impose.

Government guaranteeing of deposits has undoubtedly been one of the major factors by allowing, and indeed encouraging, unsound thrifts to continue in operation. The transformation of mortgages into Government-backed bonds has, probably, also been a contributory factor.

However, the failure has essentially been one of supervision, and for this the authorities (widely defined) must take the blame. Here the position in America is quite unlike that in other countries. In most countries, there is a regulatory authority with considerable powers in respect of financial institutions. In America the Federal Home Loan Bank Board, and its off-shoot, the Federal Savings and Loan Insurance Corporation, have had responsibilities but inadequate powers. They have been forced to insure and to supervise institutions with powers granted by different authorities, the States, and have not been given the means to conduct that supervision.

The separation of powers, one of the fundamental principles of the American constitution, may have great advantages in terms of democracy, but in respect of the thrift industry a heavy price has had to be paid for this. ■

MARK BOLÉAT is director-general of The Building Societies Association, secretary-general to the International Union of Housing Finance Institutions and editor of "Housing Finance International".

The Halifax — the world's largest building society

By Jim Birrell

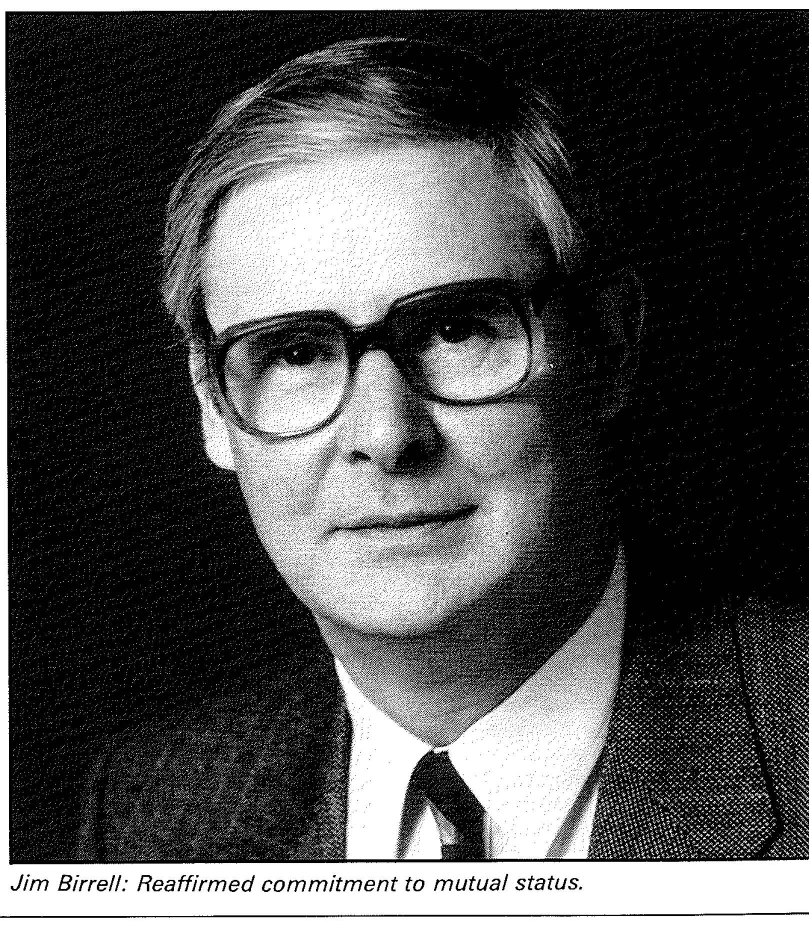
THE Halifax is the world's largest building society, with assets of over £40 billion. It has mortgage assets of over £33 billion and in 1988-89 lent £10.6 billion for the purchase or improvement of homes in the UK. Almost 280,000 people bought their homes with a Halifax mortgage last year, over a third of whom were first-time buyers, and the Halifax made a further 147,000 loans to people who wished to improve their homes in some way. At the end of the year, over 1.6 million people had mortgages with the Halifax.

Most of the remainder of the Halifax's assets are invested in short-term liquid funds, with over £6.5 billion invested in bank deposits, certificates of deposit, Treasury bills and gilt-edged securities. On the other side of the balance sheet, the Halifax is the home for over £33 billion of personal savings with a further £5 billion raised from wholesale markets. The Halifax has almost nine million investing members with over 13.5 million accounts, giving it some kind of relationship with around one out of every three households in the UK.

These figures give some indication of the scale of the Halifax's traditional business which, with 745 branches throughout the UK and almost 16,000 employees, continues to be controlled from its home town of Halifax in West Yorkshire where it was founded in 1853.

Over the past year the society has reaffirmed its commitment to keep the head office in Halifax for the foreseeable future and this is reflected in continued significant investments in the Halifax area, including a major extension of the head office building and new data centre and warehousing facility within two miles of the centre of Halifax costing over £30 million. This latter, together with the existing parallel data centre 20 miles away near Wakefield, will provide for all our business information system needs to beyond the year 2000.

Over the past year the Halifax has also reaffirmed its commitment to mutual status — it has decided, at least for the foreseeable future, not to convert into a public limited company. Following the passing of the 1986 Building Societies Act, building societies in the UK have been permitted, with the approval of their members, to transform themselves into companies with share capital —



Jim Birrell: Reaffirmed commitment to mutual status.

in effect, become banks. This option has been chosen by the Abbey National and several other large societies have indicated they are giving the matter careful consideration.

The Halifax carried out an exhaustive study in 1988 into the option of converting into a bank. At the outset, we were concerned about the limits to our powers under the 1986 Act and about our abilities to raise capital and therefore about our longer-term future as a mutual. However, during the course of the study, it became clear that building society powers would be widened and that new forms of capital would become available. Although the twin issues of capital and powers remained dominant, our board was unanimous in its decision that the increased powers given to building societies would allow us to fulfil our plans and meet customer needs as a mutual society.

The availability of subordinated debt (of which £350 million was raised in 1988) and certain other capital raising options would ensure that capital does not constrain our plans as a mutual. By the 1990s we would expect to have to revisit the mutual/plc decision, but there is certainly no evidence of any strong trend pointing in the direction of company status.

Despite our being, and remaining, a mutual society, profitability plays a crucial role in planning. Although alternative sources of capital are now available, retained profits will continue to be our primary source of new capital. Thus, if we are to continue to expand our traditional business, diversify into the new areas permitted to us, and provide the products and services demanded by our customers, there is a constant need for strong profit growth. This we certainly achieved in 1988 with pre-tax profits of £461 million, a rise of 32% on the previous year, giving a gross return on mean assets of 1.26% and on mean reserves of 34.0%. Although market conditions

20 →

Halifax Building Society — Five-year Progress

	1988-89	*1987-88*	*1986-87*	*1985-86*	*1984-85*
Profits					
Pre-tax profit	£461m	£350m	£309m	£251m	£223m
Post-tax profit	£291m	£225m	£205m	£151m	£170m
Assets and capital					
Total assets	£40,400m	£33,035m	£28,690m	£24,365m	£20,490m
General reserves (after goodwill write-off)	£1,470m	£1,245m	£1,120m	£920m	£765m
Gross capital (including subordinated debt)	£1,820m	£1,245m	£1,120m	£920m	£765m
Ratios					
Gross capital ratio (including subordinated debt)	4.79%	3.99%	4.13%	3.95%	3.91%
Return on mean reserves– pre-tax	34.0%	29.6%	30.3%	29.8%	32.8%
post-tax	21.4%	19.0%	20.1%	18.0%	24.9%
Return on mean assets– post-tax	0.79%	0.73%	0.77%	0.67%	0.91%
Increase in total assets	22.3%	15.1%	17.8%	18.9%	22.1%
Liquidity ratio	16.1%	16.2%	15.8%	16.9%	15.9%
Mortgages					
Amount advanced on mortgage (including further advances)	£10,600m	£7,345m	£7,165m	£5,270m	£5,350m
Further advances for home improvements (included above)	£950m	£665m	£580m	£385m	£375m
Number of mortgage advances (excluding further advances)	278,000	224,000	271,000	235,000	255,000
Number of further advances	147,000	150,000	142,000	106,000	108,000
Number of loans to first-time buyers	107,000	88,000	110,000	102,000	115,000
Mortgage balances	£33,355m	£27,405m	£23,975m	£20,080m	£17,065m
Number of borrowers	1,608,000	1,536,000	1,490,000	1,396,000	1,307,000
Investments					
Net new inflow–retail	£3,170m	£1,530m	£1,580m	£1,765m	£1,970m
Net receipts–non-retail	£1,675m	£1,000m	£935m	£575m	£540m
Balances–retail	£33,040m	£27,985m	£24,805m	£21,910m	£18,785m
Balances–non-retail	£5,075m	£3,400m	£2,400m	£1,390m	£815m
Number of investing members	8,790,000	8,280,000	7,980,000	7,722,000	7,301,000
Number of accounts	13,556,000	12,534,000	11,648,000	10,766,000	9,715,000
Customer offices					
Number of branches	745	745	735	725	685
Number of estate agency offices	611	343	–	–	–
Number of agencies	2,072	2,277	2,537	2,604	2,318

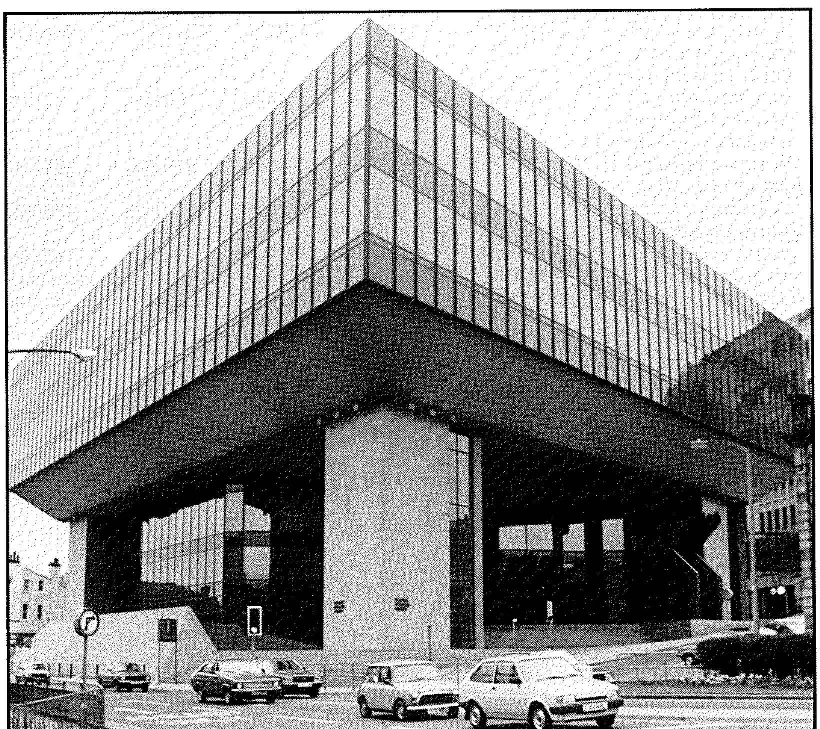
← 19

will be less buoyant in 1989 than they were in 1988, we expect to see further, if less strong, growth in our profit performance.

The principal goal of the Halifax is to be a leading retail financial services group, concentrating on housing finance and on the personal sector, and providing a range of financial products and services profitably and well, so as to meet customer needs. The success of the Halifax in achieving this goal in its traditional markets of mortgage loans and personal savings was described above. But our customers are demanding a far wider range of financial services and products which we have met with a number of new products and services introduced in 1988 and will continue to meet in the future.

Even in our traditional markets, competition ensures that we need to have the products available the customer wants. During 1988 we launched our Apex mortgages offering discounts on larger loans and two tranches of fixed rate mortages. This year we have on offer a further tranche of fixed rate mortgages and have introduced our "Easy Start" package aimed at first-time buyers who are struggling to enter the housing market.

Also, new sources of demand continue to appear in traditional markets. Long-term finance for housing, both for sale and rent, is sought by housing associations and we have provided a range of innovative products, including index-linked finance, to these bodies. Demands for such finance for housing development will continue to increase, particularly if the trend of local authorities selling off their rented stock to both existing and newly formed housing associations continues. The society has also been actively involved with housebuilders and developers providing innovative funding for major schemes for housing for the elderly, urban renewal, etc.



The Halifax head office in Yorkshire.

In the market for personal savings, the Halifax continues to attract large flows of long-term savings from investors, searching for high rates of interest and long-term capital security. This was particularly the case in the UK in 1988 as the collapse of the Stock Market late in 1987 illustrated the risks of equity-based investments. But savers also will increasingly desire more sophisticated investments, whether they be modelled on more "wholesale" type investments or whether they include some form of possible capital appreciation. The Halifax will gradually extend its product range into such areas.

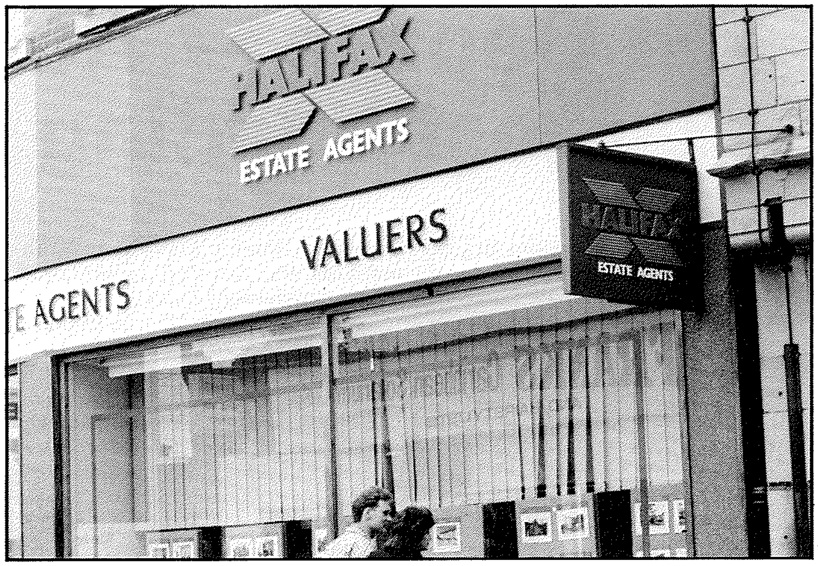
In the area of short-term savings or transaction accounts, the market has recently been dominated by the introduction by each of the major banks of interest-bearing current accounts. The Halifax will be launching its own interest-bearing account with cheque book later in 1989, in addition to our successful Cardcash account which already offers most of the features of a current account through well over 1,000 dedicated ATM's throughout the country. By the end of 1989, our customers will have access to a further 2,500 machines when we become members of the LINK network.

Also in 1988, the Halifax became the first building society to offer its own credit card when the Halifax Visa Card was launched and it has already gained more than 150,000 cardholders. The Halifax — with a major long-term strength in the field of information technology — has been firmly committed to a plastic card-based money transmission strategy and this will continue. We will offer a cheque book because this is clearly desired by our customers, but we will be at the forefront in offering plastic-card-based means of payments, whether these be credit cards or debit cards.

Our credit card, in addition, extends our ability to offer personal loans to our customers. Our personal lending was originally launched to our existing borrowers only from February 1987, but this has gradually been extended to all our members and even, more recently, to non-members. We now offer a range of both secured and unsecured personal loans and our lending has been expanding rapidly over the past year, with minimal bad debts.

The Halifax has for some time been the largest broker of insurance services to the personal sector in the UK, mainly as a result of sales of mortgage-related life policies, mortgage guarantee policies and buildings and contents cover. We have recently announced our decision to become a tied agent of Standard Life, the largest mutual life company in Europe, under the polarisation requirements of the Financial Services Act. This will allow us to offer our customers products from a life company with one of the strongest track records of policy performance, and will enable us to have products tailored to the needs of our customers. We thus see a very exciting future in the sale of insurance products as we offer, through Standard Life, a much wider range of policies, both geared to the mortgage — Personal Equity Plan or unit trust linked mortgages are interesting products for the future — and to the investment needs of our customers.

In 1988, our mortgage business benefited from the Halifax estate agency network. Our investment in the estate agency business has been our most significant diversification, certainly in terms of size of investment, and it is crucial to our longer-term strategy of remaining the leading mortgage lender in the UK. Our chain of over 600 outlets, which has recently been rebranded as Halifax Property Services, now provides a nationwide network providing uniformly high levels of service and, increasingly, the wide range of financial and house purchase services demanded by their customers, including a one-stop house purchase package. Halifax Property Services is also expected to become profitable during 1989, despite the poorer market conditions forecast, after making a small loss in 1988 due to the high cost of opening new agency outlets.



". . . Our investment in the estate agency business has been our most significant diversification."

Other significant features of 1988 included our continuing successful Branch 2000 programme. This major investment programme involves refurbishing our branches to make them less formal and more friendly, backed by a unifying design approach and corporate colour scheme to make them instantaneously recognisable in the high street. The open-plan design makes use of all available space for customer sales and service with administration taken away from the sales area.

We have also appointed a senior manager responsible for European operations which clearly indicates our serious intent to extend many of the services we currently offer in the UK to markets elsewhere in Europe. We aim to have an operational presence in key member states at the completion of the internal market by the end of 1992.

The Halifax remains committed to offering housing finance in the UK. We fully intend to remain the largest mortgage lender. But we will also be offering to our customers, both in the UK and, eventually, in other European countries, a wider range of financial and house purchase services where we detect a demand which we can profitably meet. Over the past year or so, our efforts have concentrated on adapting to the new powers conferred on us by the Building Societies Act and the Financial Services Act. Although our attitude to change remains evolutionary rather than revolutionary, these powers have given us the opportunity to offer a wider range of services and to target those services more precisely. It is doing just this which offers the exciting opportunities in the future. ■

JIM BIRRELL is a director and the chief executive of the Halifax Building Society.

St George — Australia's largest building society

CURRENTLY Australia's largest building society by a factor of three times its nearest competitor, the St George began as a group of small, terminating building societies in 1937. It was not until 1951 that a permanent building society (called the St George and Cronulla Permanent Co-operative Building and Investment Society Limited) was formed. During the 1950s and early 1960s the operations and assets of the Society were minimal. As recently as 1964, total assets were under A$10 million.

From these relatively humble beginnings, St George has grown to be one of Australia's largest financial organisations. With total assets exceeding A$6.5 billion, it ranks second only behind the Government-owned Commonwealth Savings Bank in terms of deposit levels and home loans outstanding among the retail financial institutions in New South Wales.

If the Society were compared directly to the banks, it would easily rank in the top 10 in Australia in terms of total assets, notwithstanding its concentration in the New South Wales and Australian Capital Territory market only.

As a building society, however, St George maintains a strong commitment to the housing industry. Its mission statement reads:

"The aim of St George Building Society is to consolidate its leadership as a retail financial services group, concentrating on housing and personal investment facilities. It has developed and will maintain this premier position by continuing to provide an innovative range of profitable, well-targeted products and services, tailored to suit the varied and changing needs of customers.

'High customer approval rating'

"St George's leadership in this sector of the finance industry is the result of a deep and long-standing commitment to home ownership for its members and the provision of secure investment opportunities."

This statement suggests that the "core" retail business of St George will remain the single most important aspect of the society's operations. This is its niche in the broad financial services market. The society has, over the years, developed particular skills in this field and recognises that they are not necessarily suitable to other markets, such as commercial banking, insurance and the like.

St George relies very heavily on fostering an image of providing efficient, friendly and personalised service. This marketing forte has been jealously guarded by staff training schemes, branch design, product selection and features heavily in media advertising. A certain corporate culture has arisen, one that is unique to St George. The society has the highest customer approval rating of any retail financier in the state.

In order to provide efficient customer service in this day and age, modern computer technology is essential. St George has over $40 million invested in hardware and 130 people in the data processing area. Most software application systems are written in-house, unlike the case of many competitors who buy a package and modify existing systems to suit it.

Similarly St George has a policy of owning its branches and head office properties whenever possible. This gives the society greater security of tenure and, with the recent boom in the property market, a boost to its asset revaluation reserves.

With the merger in October 1988 with the State Building Society, St George took the opportunity to improve the basic deposit accounts on offer. The aim of the exercise was to more clearly distinguish the transaction, saving and investment needs of customers and to provide them with products that would satisfy them far better than any similar products currently available in the market place.

For instance, the society's major transaction account ("Freedom") was heavily modified. It went to daily interest in part balances, with significant increases in interest rates. The account offers a range of benefits, including a personal cheque facility, ATM and EFTPOS access, direct credits, free programmed payment facilities, VISA card, choice of passbook or statement, linkages to other accounts (including a sweep facility) and an

Table 1 — Total Assets of St George Building Society

As at May	A$ (billion)
1982	1.6
1983	1.9
1984	2.2
1985	2.7
1986	3.2
1987	3.7
1988	4.6
November 1988	6.5

ability to use the interest in the Freedom account to reduce the mortgage loan amount.

There were significant changes to the Permanent Building Societies Act in 1987. St George was able to issue permanent share capital to its members to bolster the society's capital ratio and expand its funding options. An initial A$53 million was raised and this has subsequently been expanded to around A$117 million. Capital adequacy issues are increasingly important for all financial institutions in recent times and the society easily meets both the existing building society regulations and those proposed for the banks under the Basle Supervisors' Agreement.

Table 3 — Balance Sheet, 30 November, 1988

Liabilities	A$m	Assets	A$m
Deposits	5,398	Loans secured by mortgages	4,425
Borrowed funds	616	Liquid assets	1,424
Other liabilities	167	Fixed assets	152
Share capital	77	Goodwill	19
Share premium reserve	39	Other assets	467
Other reserves	190		
Total	6,487	Total	6,487

Other fund raising methods and investment alternatives that have been adopted recently include Euronote issues to the Asia-Pacific market and the launch of an Approved Deposit Fund for superannuation based funds. The society also began operations in the Australian Capital Territory with the opening of St George Permanent Co-operative Building Society (ACT) Limited. A separate society, rather than a branch, was set up due to the restrictions on building societies from operating interstate.

As noted earlier in the mission statement, lending for housing plays a crucial, strategic part in the society's overall operations. St George has a home lending portfolio exceeding A$4 billion, most of which is to owner-occupiers. The society in recent years has adopted a policy of matching, if not beating, the lending rates charged to home buyers by the major banks. An "open door" approach to lending volumes is also adopted. St George also administers various loan schemes of the State Government through its Co-operative Housing group.

The home loan market has undergone a major cyclical upturn over the past two years. Reflecting the sharp pick up in the demand for housing, the number of loans approved in the second half of 1988 was 30% higher than in the same period in 1986. for St George, the comparable increase was a far higher 60%.

With a tightening of monetary policy and subsequent increase in interest rates, home lending approvals have since fallen away from their peak levels.

In 1984, St George introduced personal loans. They are now run through a subsidiary, St George Finance. Selected insurance products were marketed through the branch network from 1985 and a year later saw the introduction of St George Financial Planning Services, providing customers with comprehensive investment and financial planning advice. These services were added to expand the range of retail services available to the customer base, essential in today's competitive environment.

Commercial loans have been an increasingly important investment outlet for St George in recent years. A subsidiary company (St George Commercial Credit) now markets a range of products for hire purchase, leasing and real estate finance.

'Commercial loans more important'

A number of new products are planned to be introduced over the next year or so. These include:

- expansion into the superannuation market, at both the corporate and individual levels,
- a managed trust for managing funds held in solicitors' trust accounts,
- operating a "friendly society" and issuing investment bonds and other products relevant to this type of organisation.

These developments should further boost the society's reputation in the retail financial market place. As noted earlier, however, the society recognises the importance of its core business and the need to service the more basic financial needs of its customers efficiently. These additional services will serve to build on this solid foundation. ■

Table 2 — Retail Financial Institution's Deposit Growth Rates (% p.a.)

Year to mid	St George	Savings Banks and Building Societies	Broad Money
1983	19.6	17.3	na
1984	14.9	14.8	na
1985	20.0	10.0-	12.7
1986	16.7	9.1	13.4
1987	12.6	13.2	9.9
1988	23.7	17.5	12.7
Half year to end			
1988	39.4	7.5	11.3

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.

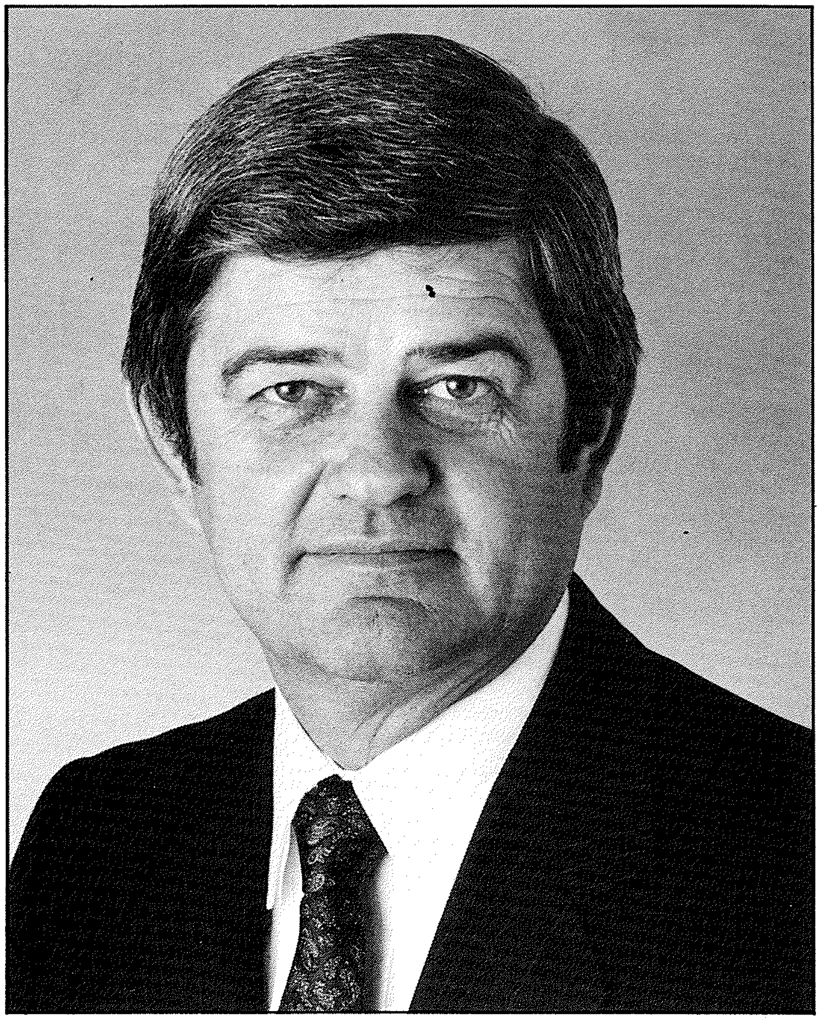
Currently, the company is concentrating on expanding its full-service banking operations in Florida, New York, Washington and Arizona, and its growing network of real estate lending offices in prime markets in the nation's 17 leading mortgage markets. In 1988, out-of-state loan volume was nearly $1.5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

'A strategy of focused expansion'

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.



James F. Montgomery, chairman and chief executive.

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 →

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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

'Record year for loan volume'

short-term, high-yielding, high-quality assets.

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 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. ■

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

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

The challenge for savings banks in the changing financial environment

By Jean-Marie Pesant

THERE should be consensus that the financial environment is changing and that it causes a challenge for savings banks. This situation is hardly surprising as over the past two decades there have been changes in the international economy in the fields of trade, payments, indebtedness and exchange rates. As far as the financial sector is concerned, new legislation has been enacted with far-reaching reforms allowing institutions to respond to the challenges in the world economy. In addition, we must bear in mind the impact of technology on the changes we propose to discuss.

A tradition of alliances has already been established and I am sure that in time we will achieve the full potential of the savings banks sector with the benefit of an increasing market share nationally and internationally.

The changing financial environment

Deregulation and competition

In looking at the savings banks sector, we must recognise that while savings banks have originally been retail banks and this is a role that they wish to continue to play, it has been a question of survival that has obliged them to diversify their operations and become universal banks. This increased competition within domestic markets was the consequence of deregulation and, in the case of Europe, the prospect of a unified market.

If we look at the competitive aspect, it will be easily recognised that in addition to competition from the rest of the banking sector, competition from non-banking institutions in the financial market has taken on new dimensions in the deregulated environment. The origin and nature of this competition can be traced to the overall increase in the volume of transactions on the financial market and the growing despecialisation of several non-banking intermediaries. This competition is characterised by the fact that it puts the banking sector at a disadvantage since non-banking institutions benefit from privileges whereby they carry out banking operations without meeting the legislative restrictions to which banks are subjected.

It is therefore a consequence of these developments that the business structure of the savings banks and their business policies follow more the requirements of their customers rather than any traditional demarcation of activities.

Equity capital and costs

The expansion of business, and the often substantial investments that have to be made in equipment and technological adaptation, have placed a new burden on savings banks for capital. Some savings banks have been able to respond well to these new demands as they have changed their statutes and become joint stock banks, as is the case in the United Kingdom. Others will be able to choose this option in the near future, for instance in Denmark. Yet elsewhere, savings banks have raised capital by issuing participation certificates. These institutions can turn directly to the public and raise capital to meet the needs of their growth and their enhanced competitiveness. In the context of a single European market, banks will find themselves subject to the EC's own funds directive and its solvency ratios directive which will harmonise capital adequacy rules throughout the banking sector.

These directives which are still in draft stage are expected to conform to the Cooke Committee requirements of 8% of total capital to risk adjusted assets. The implications of the completion of a single market will be significant increase in competition in the domestic market together with greater opportunities for corresponding expansion of activities throughout the European Community. All banks face this challenge and I believe we can identify three specific components:

Financial margins will be under increased pressure as more players compete for deposits and loans.

Control of operating costs will be crucial and will determine which banks come out as efficient and profitable.

A comprehensive package of financial products and services will be required from banks.

The strategies

In view of the situation in Europe, but also taking into account the banking sector throughout the world, it has been necessary to look at the options available. From an analysis of the strategies of different types of banks, it is hardly surprising that the approaches they find appropriate are quite similar, as they operate in a global environment and the rules are the same for all the players. These are:

To create bigger pools of capital and achieve economies of scale through mergers.

To gain a foothold across the market through acquisitions abroad which include non-bank financial institutions and expansion of networks by setting up branches in other countries.

Establishment of alliances to build a network of partners chosen on the basis of a common corporate culture and converging management goals.

Let us now look at each of these separately with examples as to how various institutions in the savings banks sector have adopted these strategies.

Mergers

Size will have a crucial influence on savings banks as it will determine the level of overall resources that will be available. It will only be the largest institutions, the best structured organisations and those that can establish solid ratings and become fully-fledged members of the international banking community that will succeed. It will be important not to be too small to meet competition and savings banks in many countries are engaged in the process of mergers in order to attain the required strength and volume. Here are a few examples.

Germany. In 1987 alone, the number of savings banks was reduced by three including a well publicised merger between two savings banks in the Frankfurt area, one of which was a large private savings bank. The new bank, which became operational on 1 January, 1989, is number four in terms of balance sheet in the ranking of German savings banks. This year the focus has shifted to the central institutions known as the Landesbanken. The first such merger was between the Badische Kommunale Landesbank (BAKOLA) and the Landesbank Stuttgart GZ. The resulting institution is called the Baden-Württemburgische Landesbank and serves 92 savings banks.

There is also the suggested grouping of the Landesbanken of the four northern states of Schleswig-Holstein, Lower Saxony, Hamburg and Bremen. A merger between the Bayerische Landesbank GZ and the Landesbank Rheinland-Pfalz has also been talked about. The principal case with profound ramifications is a planned merger between the Westdeutsche Landesbank GZ (WestLB) and the Hessische Landesbank GZ (HELABA). WestLB is the largest Landesbank and overall the third ranking bank in the country. The merger with HELABA would bring with it a strong footing in Germany's dominant financial centre of Frankfurt as well as access to the fast growing economy in the southern part of the country.

According to an analysis carried out by a prestigious consulting group, the synergy of the merger would increase earnings by some DM200 million and possibly DM500 million. The merged bank would rank only second to Deutsche Bank and have assets of about DM230 billion and would strengthen the competitive position of the savings banks sector against the aggressive private banks in the private banking market of high net-worth individuals and that of medium-sized businesses.

Italy. In Italy, for instance, mergers between the savings banks of Prato and Florence and later with Bologna are on the cards. If this should come off, it will form the second largest savings bank in the country after CARIPLO. According to an Italian savings banker, the country is gripped with merger mania. For instance, a merger is planned among 11 small savings banks from the Piedmont and Liguria areas to be called ACROPOLI. It will have 250 branches.

The Emilia region is also in the process of having a merger between the local savings banks with grouping having a network of 200 branches.

Spain. The process of mergers is also taking place in Spain. In the Basque country a merger is pending between the Caja Vizcaina and Caja Municipal de Bilbao. Regional mergers are likely to continue and according to views of the Spanish Savings Banks Association, the ultimate result could be 16 or 17 regional savings banks.

United Kingdom. The list of examples is long and interesting, but I will just mention the TSBs in the UK which are the most striking example of successful mergers. The number of savings banks was reduced by amalgamations from a 19th-century peak of over 600 to 73 banks in the early 70s. In 1976, they merged into 19 regional institutions. In 1983 further substantial mergers took place, reducing the number to four. Now, the group has transformed itself from savings banks status into a leader in the United Kingdom's financial services sector.

Acquisitions and network building

Acquisitions of other financial institutions and expansion of the network of branches represent the second possible strategy. The objective of acquisitions can be summarised quite simply in the words of Mr Hubert Detremmerie, chairman of the BACOB Savings Bank of Belgium: "We envisage the establishment of a conglomerate of specialised financial institutions that can furnish a full range of high quality financial products and services throughout the European Community and beyond".

This objective defined by BACOB has been translated practically with

30 ⟶

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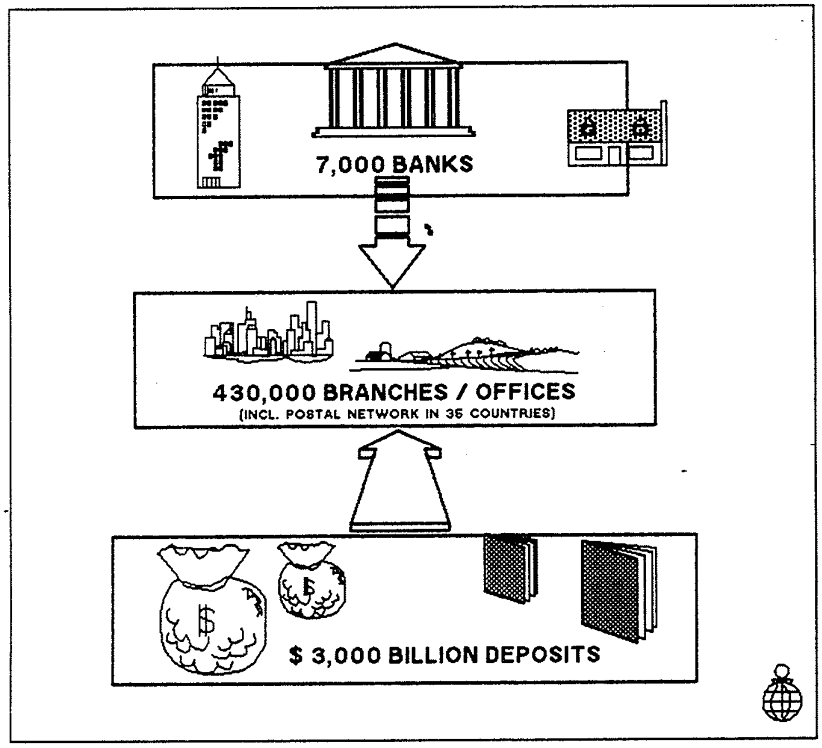
the acquisition of Banque UCL in Luxembourg together with other Belgian savings banks. In the field of securities trading BACOB has a participation in the London-based IFMT (International Financial Markets Trading) as well as a Dutch subsidiary BACOB Finance NV.

BACOB Delaware Inc has also been established to issue commercial paper in the New York market. Finally, it has acquired 25% of the capital of Continental Bank (Belgium), a subsidiary of Continental Illinois, and will use it as a dealing and merchant bank.

Other examples that bear witness to this strategy of acquisitions abound. One interesting situation is the merchant banking venture whereby Italy's ICCRI got together with the Banque Bruxelles Lambert to form ICCRI-BBL. The objective of ICCRI-BBL is to trade Italian and foreign securities, money market instruments and provide M & A advice. Further, the largest Italian savings bank CARIPLO is giving up a 30% stake in Istituto Bancario Italiano for an equivalent participation in Banco Jover of Barcelona which belongs to Banco Santander of Spain. CARIPLO has also bought Compagnie Internationale de Banque in Paris from the Société Financière Globe in order to have a more complete presence than a branch alone can provide in Europe.

In the UK, the TSB Group acquired a finance house, UDT, in 1987 and last year the merchant bank, Hill Samuel. Through Hill Samuel, the TSB Group can build upon a network of offices and associates in Europe as well as in New York, Hong Kong, Sydney and Tokyo. It has diversified through acquisitions into such areas as insurance, corporate banking, consumer finance, transport and offshore business. The Group is a volume banker in certain parts of the market and a niche player in others aims to be a major force in the financial sector in the UK. An institution of this nature is the response to the changing conditions and can be termed as a global approach and is called a group for its functions go way beyond that of a traditional bank.

SAVINGS BANKS - A FORCE



In view of this increased international presence of savings banks, the International Savings Bank Institute (ISBI) has published a Savings Banks Foreign Business Directory as a useful tool for all banks actively engaged in international business, enabling easy identification of more than 500 foreign contacts. In the 1988 edition of our savings banks foreign business directory, the banks listed are those which have links to SWIFT or which have foreign representative officers, branches or subsidiaries. The information in the directory covers 364 addresses of 176 savings banks or affiliated banking institutions in 38 countries.

Alliance strategies

Savings banks' organisations from different countries have responded to market forces according to the volume of their business and their size in order to have an international presence. The big German Landesbanken have been present in the major financial centres since the early 70s and have principally done so independently. Other institutions that have entered international markets more recently have started out with representative offices and later with branches and subsidiaries. These have been done essentially in co-operation with other similar institutions from the home country such as the joint representative offices of Italian savings banks in London, or through joint representation with other friendly savings banks.

Examples of this would be the former representative offices in Singapore of SDS Copenhagen and the Caisse d'Epargne d'Etat de Luxembourg, or in the case of private banking a partnership of savings banks in TSB International Luxembourg. Another interesting example is the agreement among savings banks central banks in the Nordic countries to represent each other in their respective markets.

However, with the approaching unification of the European market, agreements across frontiers such as between the Savings Bank of Barcelona, the Savings Bank of Paris and CENCEP of France could become common. Maintaining offices abroad is a costly business and a more economic way is for several banking institutions to pool their resources. Within the savings banks sector, co-operation agreements are common because of close ties between the institutions in different countries.

Another area where savings banks have used alliances is in the field of underwriting. Whenever a savings bank has been influencial in an underwriting syndicate, other savings banks have regularly been invited to participate. Until recently, there were two savings banks consortia to underwrite loans for the World Bank, one led by the Bayerische Landesbank and the other by the Deutsche Girozentrale.

These two have recently been merged but the idea of a savings banks consortium continues to play its role. The strength of the savings banks sector has been recognised in the field of capital markets and it intends to be a strong competitor in the future. This strategy of alliances serves to increase profitability by modifying investment structures from the long term to the shorter term, to seek new customers and product strategies in order to secure better yield. It is essential to act with speed in order to identify those market niches, modest but still profitable, which savings banks, by acting quickly and in co-operation, can exploit first.

A global approach

The Institute has members in some 75 countries all over the world, but the major financial force of savings banks remains in Europe. The ISBI is the world-wide representative of this community of savings banks and operates as a centre for information and communication. It endeavours to promote the exchange of experience and to facilitate practical co-operation among its membership on a global basis.

In talking about globalisation, we should remember that there is a vast world market. I wish to make the point that the Asian Pacific Rim countries are the fastest growing and the largest developing region in the world. Also, in many of the Advanced Developing Countries (ADCs) the gross domestic savings rate exceeds 25% of GNP: Korea (35%), Taiwan (40%), Singapore (25%), Thailand (25%), Hong Kong (27%), Indonesia (24%), Malaysia (32%) and China (36%).

While Asian ADCs benefit from exports to the United States, it is Japan which has the largest share in their imports, and while the United States has managed to increase its share of exports to Asia even as its share of world exports has declined, the major area to lose out in sales to the Asian market over the past 25 years has been the countries of the Common Market. Another important area not to be neglected for the future is Eastern Europe. Here, too, the process of deregulation of the financial sector has resulted in reforms in many countries such as Bulgaria, Hungary, Poland, Romania and the USSR. The market has enormous potential and savings banks central banks such as Skopbank and Swedbank from Finland and Sweden have already established representative offices in Moscow.

In addition to these, representative offices are also maintained there by the WestLB, the ZBank of Vienna and the Ljubljanska Bank from Yugoslavia. There can be no doubt that diverse forms of partnership can benefit savings banks: exchanges, twinning, agreements, conventions, investment funds, subsidiaries, representative offices, consortia or joint ventures, to mention but a few. Each savings bank can continue to extend the list.

Whereas up to now co-operation had tended to develop mainly within each zone — West and East — the potential for intra-European co-operation between savings banks is vast. Exchanges have taken place regularly between savings banks in Western Europe and their counterparts in the East for more than 20 years. It is clear that, as the overall liberalisation of the political and economic context progresses, so will the scope for co-operation expand more easily and quickly.

On the other hand, in response to our day-to-day needs, regular annual meetings of foreign exchange dealers and foreign department managers have proved to be highly popular and we believe they served their purpose of increasing contacts among practitioners which result in tangible forms of business co-operation. Judging by the continued success of these events, it can be said that they promote international co-operation in concrete terms and that the nature of subjects and discussions have widened in scope and quality.

This is, indeed, a reflection of the individual and collective importance of the savings banks sector which is an important force in the financial community in different countries. We have a tremendous challenge ahead of us, and one which heralds a very promising future. ■

JEAN-MARIE PESANT is general manager of the International Savings Bank Institute based in Geneva, Switzerland.

France introduces securitisation

By François Henrot

SECURITISATION consists of transforming bank loans into negotiable securities. This technique, which appeared in the United States and then in Great Britain and Canada two years ago, has now been introduced in France. It marks a new stage in the transformation of the financing structures of the French economy. That is why the authorities have provided it with a legal framework by creating the concept of a common claims fund (fond commun de créances). The impulse given by the authorities will not, however, be sufficient to ensure its success. The market in securitised loans will not develop unless banks and investors find it to their advantage to meet in it.

Securitisation and financing of the economy

The financing circuits of the French economy have been characterised by three periods over the past 40 years. During the post-war period liquidity for credit-granting was provided by the machinery of rediscounting at the Banque de France.

The reform of the banking system in 1966-67 opened a second phase, that of the transformation of liquid savings into medium- and long-term lending by the branch banks.

The third phase began with the reform of the financial markets started in 1984, which is continuing today with securitisation; it consists of resorting to the money markets in order to provide liquidity for credit and for financing the economy.

Securitisation will make it possible to strengthen the financial markets. The securities issued to represent claims will constitute a new financial product adding to the existing range, already enriched by the negotiable instruments of claim created since 1985.

This product may involve very large amounts of money; the outstanding amount of lending to households was nearly 2,000 billion francs at the end of 1988. Securitisation of part of this outstanding amount will help to stimulate the French financial market by giving it greater weight at European and world level.

Monetary policy will also benefit by the growth in securitisation. This technique will in fact facilitate control of the creation of money, because the transfer of a claim to a non-bank investor destroys the money of which this claim is the counterpart.

The effectiveness of monetary policy operating through the controlling of interest rates will be enhanced: by linking the credit market to the capital market, securitisation reinforces the action of interest rates in the regulation of lending activity.

The monetary authorities appear, however, to fear that the use of securitisation may create, in the banks, a rapidly renewed capacity for short-term lending which is liable to increase the indebtedness of households. That is the explanation of the prohibition, for the time being, against securitising claims whose initial term is less than two years.

The framework of securitisation

The advantages expected from securitisation will materialise only if it develops under conditions of security and economic stability conducive to its permanence. That is the purpose of the legal framework established by the law of 23 December, 1988, creating common claims funds (CCF) and of the implementing decrees.

Securitisation is based on the transfer of ownership to the CCF of the claims held by the transferring institution; these are, therefore, removed from the institution's balance sheet. The CCF itself is defined as a co-ownership, without corporate personality, which issues, in a single operation, units representing the claims acquired.

The CCF units are securities of a new type, similar in some ways to bonds and in other ways to shares. The CCF may, for instance, issue several categories of securities comprising different proportions of principal and interest; such securities are similar to bonds offering several types of coupons.

Investment in CCF units is, however, risky in the same way as investment in shares, because the guarantee still leaves a risk of non-payment and a risk of anticipated redemption. Lastly, certain prerogatives of the shareholders of joint-stock companies are granted to the bearers of CCF units: for instance, the possibility of challenging the auditors.

The minimum amount of the Common Claims Fund unit has been fixed at F10,000. The units cannot be repurchased by the Fund. The claims acquired by the Fund must represent credits of the same nature. A Fund, therefore, chooses either real estate claims or consumer credit claims. The units may not represent either frozen claims or doubtful or disputed claims.

The law also regulates the relations and duties of the "ménage à trois" represented by the transferring institution, the initial debtor and the bearer of units, represented by the Fund's management company.

The transfer of the claims takes place by the mere issuing of a receipt note to the transferor. This contains the name of the Common Claims Fund and the details of the claims transferred.

The transferor remains responsible for the guarantees attaching to the claim. The law expresses concern for protecting the borrower because, while the lender can transfer its claims to a CCF, merely notifying the debtors by an ordinary letter, on the other hand it cannot transfer the collection of the claims to another institution without the express consent of the borrowers to this transfer. The borrowers should, therefore, usually keep the same partner throughout the period of their credit.

Conflicts of interest may arise between the transferor and the Fund's management company; the management company will endeavour to avoid delays in payments, while the transferring institution, being concerned with its corporate image in its customers' eyes, may be tempted to accept rescheduling of the claims all the more readily because it does not bear the cost of this.

Demarcation of the powers of each party is therefore essential and will be provided for by the CCF rules. A real separation between the producer of loans and the investor is considered to be necessary in order to ensure that securitisation shall develop in a proper market and not be confined to a mere merry-go-round operation in which banks remove the claims from their balance sheets in order to place them in the UCITS which they control. That is why the permissions given to buy CCF units are confined by decree to 5% of the UCITS of the issuing institution.

The Commission des Opérations de Bourse (Stock Exchange Operations Commission) (COB), after consulting the Banque de France, gives its prior consent to the establishment or winding-up of a CCF. With regard to the quality of the CCF, COB gives its consent after examining a document drawn up by an authorised body.

These bodies, credit rating agencies, are entrusted with the assessment of the Funds and, together with the auditors, have the duty of watching the operation of the CCFs. Their role is crucial, both in order to ensure the quality of the proposed transactions and to set the valuation standards.

They check, in particular, that the guarantee offered is sufficient to cover the risk of default. Three types of guarantees are accepted: the guaranteeing of the fund by an external body, an insurance company or credit institution, overdimensioning and subordination, consisting of creating specific units which bear the greater part of the risk.

A new tool in the service of the banks

Securitisation ought, first of all, to make it possible to diversify the means of financing of the credit institutions and thus to remedy the lack of liquidity observable on the mortgage market. Securitisation of mortgage loans appears, however, to be difficult at the moment.

In the present state of the money markets a portfolio of mortgage loans to individuals, at a fixed-interest rate and for a long term, would have to produce, in order to be able to be securitised, a yield equal to or greater than 11%. However, the rates applied for the financing of housing are at present between 9 and 10%.

But what seems difficult today may be easier tomorrow, because market conditions evolve. New participants with lower infrastructure costs may also present themselves; in particular, the introduction of freedom of rendering of services on a European scale will enable financial institutions to operate directly from abroad without the expense of setting up local establishments.

Securitisation will allow these participants to concentrate on the selling of credit and to benefit, for securitised lendings, from a good signature quality which will depend only on the quality of their claims and not on their own financial structure. For traditional institutions, securitisation nevertheless already offers opportunities now.

As regards the longest maturities, applying to loans to local authorities, and also medium-term maturities (one to seven years), the refinancing market is too narrow at present. The rates applied to these two types of maturities are high enough to make securitisation attractive.

Securitisation can also be seen to be a very useful balance sheet management tool, first because it makes it possible to obtain a gain in own funds. This is because the removal of claims from the balance sheet is a way of meeting the requirements of the prudential regulations concerning the ratio of own funds.

Here again it would seem that mortgage loans will not be the most attractive candidates for securitisation because the Cooke ratio and the planned European solvency ratio take them into account only to the extent of 50%, unlike short- and medium-term credits, the weighting of which is 100%. But the gain in own funds is not the only benefit to be expected for balance sheet management.

Securitisation will make it possible, when the market has reached a certain size, permanently to adjust interest rate and liquidity matchings by operating on both sides of the balance sheet and not only the liabilities side.

This being so, the question of the cost-benefit balance no longer arises in the same terms: an institution will accept an immediate loss on the transfer of a portfolio of claims if this transfer enables it either to eliminate an interest rate risk or a liquidity risk, whether this risk be latent or actually materialising, or to replenish its capital and speed up the expansion of its activities in a market sector

34 →

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which it considers to be more promising or more profitable than the average of its present activities.

Substantial short-term costs coupled with medium-term benefits

A securitisation operation first of all entails entry costs: costs in human resources, acquisition of know-how, costs of adaptation of data processing systems in order to produce the data necessary for the valuation of claims and their automated processing, administrative and accounting costs for the establishment of the information circuits and for meeting the requirements of the checks imposed by law, legal costs, and lastly the costs of working out the various contracts between the parties. Altogether, the costs which will have to be met by each institution in order to enter the securitisation market may be estimated at about ten million francs.

On top of these entry costs there are recurrent costs of five types: the cost of guaranteeing and placing the securities, plus the remuneration of the classification agencies; a possible additional cost of risk cover compared with the cost as recorded or valued in the balance sheet of the credit institution; the additional cost of management of the claims made up into portfolios, which corresponds to the managing body's margin; the extra administrative cost entailed by the operation of the Common Claims Fund (CCF); and, lastly, a novelty premium for the purpose of interesting investors in the product.

In the short term there is every possibility of, at best, the balance of costs and gains breaking even, except for institutions which are in a special situation as regards interest rate risks or which have difficulty in gaining access to the capital market. In the medium term, however, securitisation will lead to rationalisation of the operation of banking activities, because it necessarily involves a precise analysis of the costs of and profits on each operation carried out by the banks.

Risks of default will have to be the subject of a more detailed analysis in order to meet the information requirements of the classification agencies and of investors. It will also be necessary to identify all the interest rate risks. This step is necessary for each institution in order to enable it to determine whether securitisation presents any advantage for it and, if so, in order to ensure that it possesses everything necessary for the utilisation of this technique.

The improvement of its knowledge of costs should reveal the productivity gains to be obtained; it will show, for each institution, the advantage of specialising in the functions in which it has the best capability and of subcontracting the other functions; it will thus lead to an improvement in profitability.

The investors' expectations

The securitisation market will offer a supply (that from the credit institutions) to meet a demand (that from investors). It can operate effectively only if it is to the advantage of the latter to acquire what it is to the advantage of the others to transfer.

Like any new product, the securities issued by the CCFs must assume a position in relation to existing products and offer a comparative advantage which will attract the purchase-investor. The profitability offered by the securities issued by the CCFs must be established not only in relation to production costs but also in relation to market expectations in order to ensure a rapid take-off of securitisation. It has been seen, for instance, how the weakness of the interest rates applied in lending for housing makes a price calculated on the basis of a production cost incompatible with the hierarchy of market rates.

The offerers will furthermore have the advantage of offering products which are sufficiently original to attract investors. The CCFs will be able to offer securities with very long or medium terms, of which there are still only a few on the market. Pension funds, for instance, are interested in long-term products. The flexibility allowed by the legal framework and the various forms of guarantees which can be used give scope for the expression of financial creativity. It does, however, seem necessary that the products offered should be sufficiently simple and easy to analyse, during an initial period, so as to attract the largest possible number of investors.

The market could start its operations by private placement, but there must subsequently be real prospects of subsequent development of a secondary market. That calls for organisation efforts: the creation of stocks of securities ought to increase market liquidity; the appearance of market-makers will also be welcome, especially as securitisation is a new technique; lastly stock exchange listing of certain products might be envisaged.

During an initial period the CCFs' market will probably in fact be confined to institutional investors. This is because the complexity of the product makes access to it by the public difficult. Even if French institutional investors continue to take a wait-and-see attitude, one should not overlook the advantage which securitisation may offer for new categories of investors: foreign banks which wish to include securities representing French claims in their portfolios, firms with structural liquidity surpluses and desirous of benefiting by the yield on these securities.

The investments involved in order to gain entry to the securitisation process are expensive. They are nevertheless essential, because European financial integration demands improvement of the competitiveness of the French financial system. ■

FRANÇOIS HENROT is executive vice-president of Compagnie Bancaire.

Role of the insurance market in development of mortgage securitisation

By Dane Douetil

Securitisation, which has become one of the financial "buzz words" of the late 1980s, is used to describe a range of different financings. People talk about securitising most forms of assets, such as automobile receivables, credit/charge/store card receivables, lease receivables, trade receivables and even debt secured on camping sites! Securitisation of most of these assets has occurred, but rarely outside the United States. However, the securitisation of residential and commercial mortgage assets in the UK has been a major success.

What exactly is securitisation? Briefly, it describes the sale of bonds (the securities) which are collateralised by a pool of financial assets and which are not supported, from a credit point of view, by the originator. It is a technique which enables assets to be taken off the originator's balance sheet and transferred to the investor. By taking them off the balance sheet, the capital which is used to support them is released and can be used for further lending.

'Steady increase in volume'

Residential mortgage securitisation first occurred in the United States in the 1970s but did not take off until some 10 years later. Since then there has been a steady increase in volume, with over US$100 billion issued in 1986 alone.

The successful growth of the US market can be directly attributed to the federal guarantees that are provided by such institutions as Freddie Mac, Ginnie Mae and Fannie Mae. With a third-party guarantor it is easier to bundle up residential mortgages into pools and use them as the security to issue various forms of bonds.

In spite of the lack of such government support in other countries, securitisation is spreading, especially in the United Kingdom and to a lesser extent in Australia, New Zealand and, shortly, France. Of particular interest are the very different reasons as to why there has been a success in the securitisation of residential mortgages in different countries, and the factors that allowed it to occur.

In the United States the basic rationale behind securitisation was to assist the movement of the surplus of deposits in one state across the continent, and make the monies available for the funding of shortfalls of residential finance in another state. Borrowers in one state would sell bonds to geographically dispersed investors. This helped avoid local regulation which forbade the transfer of funds through the banking system across state boundaries.

In the United Kingdom mortgage backed securities developed for quite different reasons. In this case, a new type of mortgage lender emerged, the "specialist lender", who was unable to raise funds through deposits and had to rely purely on the wholesale funding market.

By contrast, the forthcoming securitisation of assets in France (titrisation) is predominantly being pushed forward by the French Government to allow the larger French banks to conform with the new capital adequacy regulations (following the Cooke Committee Report). Selling off pools of assets is one way of improving their capital adequacy ratios. It is not yet known exactly what form these securities will take in France; whether they will be traded domestically or internationally, whether they will be secured by way of over-collateralisation, subordinated debt or by insurance, and even what assets will be used. It may not be mortgages at all. The margins available in mortgage financing are so small that they may not cover the costs of securitisation. Instead pools of, for example, auto loans may be the favoured assets.

'Protecting the bond holders'

In each of these markets insurance either has had, or will have, a role to play in protecting the bond holders against the default risk associated with the assets and thereby enabling them to be transferred off balance sheet. In the US, as mentioned

36 →

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above, this protection is by way of government schemes, but in the UK it has been the private insurance market that has undertaken this role. We believe that this will also occur in the French market.

It may be asked why insurers are expected to get involved at all. This question is particularly apposite in the UK, given the outstanding credit performance of UK mortgages. Are not investors in the mortgage-backed securities happy to take the almost non-existent credit risk? It seems not. The security houses involved in the formation of the mortgage backed notes believe it is essential that if investors are to buy these securities then the rating agency's approval, as credible referees to the credit worthiness of a securitised issue, is necessary. They, in turn, will not provide such approval unless the catastrophe credit risk is absorbed by someone other than the investor.

Insurers are particularly suited to taking this risk. Banks can guarantee the issues but there is not a prevalence of AAA rated banks in the world let alone in the UK (in fact there are only two). However, UK insurers have been guaranteeing the top slice risk for mortgage lending for years (*see article on "Mortgage Guarantee Insurance in the UK" in the November 1988 issue*). They were therefore experienced enough in this market to extend their guarantee to protect a pool of mortgages, as opposed to individual mortgages. Also, and very importantly, insurers can write the risk cheaper than can the banks, due to their different capital requirements.

It has, however, not been an easy task to persuade insurers to undertake this business because of the very large numbers involved, their lack of knowledge of the complex financial structures and the past track record of guaranteeing mortgages, for example the EPIC/MGIC programmes in the United States, which cost European reinsurers dearly. On MGIC the European insurers have so far paid out nearly US$600 million above the premium received, and the claims are not yet exhausted.

These problems have been overcome by explaining the complex financial structures in insurance terms, demonstrating, by risk stress models, the pure catastrophe nature of the insurance covers being purchased and the development of reinsurance techniques, which spread the risk throughout the world. In 1987 it was difficult to find insurance support for £1 billion of mortgage lending. Due to the constant marketing efforts of Special Risk Services in 1988, over £5 billion of capacity was created. In 1989 we have been able to widen this to well in excess of £12 billion of capacity already pledged to under UK deals alone. The number of insurers entering into the market has increased from six-seven in 1987 to 15-20 in 1988, to well over 30 in 1989.

We believe that this capacity will

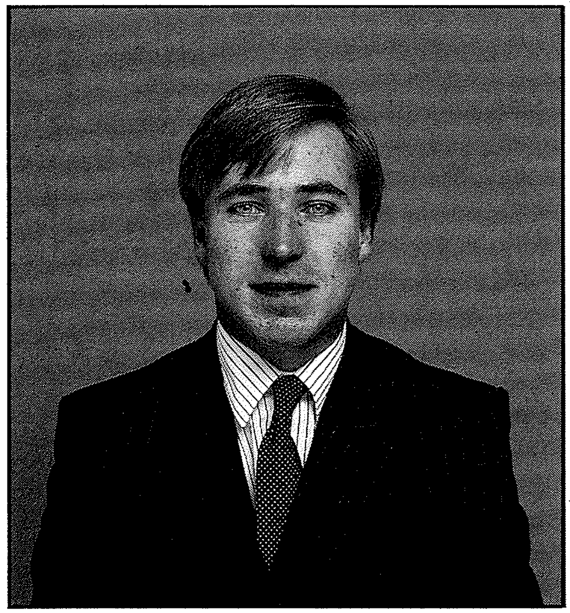
UK MORTGAGE-BACKED SECURITIES

Issue	*Issue Date*	*A-Notes £m*	*S&P Rating*	*Credit Enhancement*	*Broker*
1988					
Household Mortgage Corp. No. 2	14 Jan 88	175	AAA	Junior/Senior	
Mortgage Funding Corp. No. 1	23 Feb 88	175	AA	Eagle Star	Special Risk Services
The Mortgage Corp. No. 5 (Salomon Bros.)	1 Mar 88	125	AAA	Pohjola/Eagle Star	Special Risk Services
The Mortgage Corp. No. 6 (Salomon Bros.)	11 Mar 88	100	AAA	Pohjola/Eagle Star	Special Risk Services
Residential Prop. Sec. No. 1 (Bank of Ireland)	11 Apr 88	200	AAA	Skandia/Pohjola/ES	Special Risk Services
The Mortgage Corp. No. 7 (Salomon Bros.)	25 Apr 88	100	AAA	Pohjola/Eagle Star	Special Risk Services
Household Mortgage Corp. No. 3	16 May 88	150	AAA	Junior/Senior	
The Mortgage Corp. No. 8 (Salomon Bros.)	27 May 88	100	AAA	Pohjola/Eagle Star	Special Risk Services
MAES Funding (Canadian Imperial Bank of Commerce)	6 Jun 88	200	AAA	Hansa/Eagle Star	Special Risk Services
Residential Prop. Sec. No. 2 (Bank of Ireland)	30 Jun 88	200	AAA	Hansa/Eagle Star	Special Risk Services
Exclusive Finance No. 1 (TSB)	27 Jul 88	135	AAA	Hansa/Eagle Star	Special Risk Services
The Mortgage Corp. No. 9 (Salomon Bros.)	1 Aug 88	200	AAA	Pohjola/Eagle Star	Special Risk Services
Mortgage Funding Corp. No. 2	4 Aug 88	115	AAA/AA	Junior/Senior + ES	Special Risk Services
The Mortgage Corp. No. 10 (Salomon Bros.)	1 Sep 88	200	AAA	Pohjola/Eagle Star	Special Risk Services
National Home Loans No. 4	20 Sep 88	100	AAA	Junior/Senior	
First Mortgage Sec. No. 1	1 Oct 88	220	AAA/AA	Junior/Senior + ES	Special Risk Services
Mortgage Funding Corp. No. 3	8 Oct 88	120	AAA/AA	Junior/Senior + ES	Special Risk Services
The Mortgage Corp. No. 11 (Salomon Bros.)	22 Oct 88	500	AAA	Pohjola/Hansa/ES	Special Risk Services
Household Mortgage Corp. 101	24 Oct 88	100	AAA	Junior/Senior/AIG	
		3,215			

grow with the emergence of other markets for mortgage-backed securities. The reason for this is that insurers will be able to spread their risk further by taking on similar credit risks from other countries, thus spreading themselves geographically. The French insurers will be able to retrocede their accumulative economic risk to the UK insurers and vice versa.

What exactly does the insurance cover? There are essentially two different sorts of product. The first guarantees the ultimate bad debt associated with a pool of, for example, mortgages, after the disposal of the properties, the realisation of other securities such as life policies, creditor protection plans, and endowment/pension plans, less the principal and interest, including interest on interest, outstanding at the date of disposal of the property. There is normally some form of first loss fund that is deposited by the originator (the mortgagee), thus allowing the premium to be reduced by the insurer and the "moral risk" of the mortgagee underwriting reduced. In the United Kingdom this is set at around ½% of the issue size. The sum insured (limit of indemnity) is established by the rating agencies, using complex calculations to estimate the worst probable loss to a pool of mortgages undergoing severe economic stress. This has been between 6½% and 10½% on the UK mortgage pools.

The second product is concerned with pure "enhancement" of a credit rather than the remote catastrophe risk associated with the mortgage pool. The need for it arises as follows. The insurance policy described above pays only once a net loss has been established. By definition this can only happen once the asset has been repossessed and sold. This may be several months, or even years, after the original default. In the meantime, interest payments need to continue to be made to the bond holders. Frequently, this shortfall is offset by a bank line of credit. Unless the bank providing this



Dane Douetil: Considerable opportunities for high quality premium.

possesses the same rating as that of the issue, the bank's credit must be enhanced up to that standard. An insurance product known as "the servicer performance bond" does just this.

The principles on which these two insurance products are founded are capable of being adapted to a wide range of assets. In France, it is likely that the insurance policy will be required to underpin the default rate on automobile loans, rather than mortgages. In Australia, one requirement is to enhance the credit of an institution which will commit to buy back a pool of mortgages after several years. Here, the security is being structured with a life shorter than that of the underlying assets to increase its appeal to investors. Without somebody to buy back the unamortised assets at maturity of the bond, such a structure would be impossible. Without insurance to enhance the commitment of the "buy back" provider the issue would never achieve the required rating.

To summarise, insurers basically have two roles to play in securitisation. They can accept the catastrophe default risk on portfolios of assets and they can "rent" their high quality balance sheets to enhance this credit of various parties to the securitised transaction. This private insurance technology has developed principally in the UK, in the absence of government schemes such as exist in the USA.

Now these insurance techniques are being exported, just as those for privatisation were several years earlier. France will be the next large market in Europe, but in five years' time we believe securitisation will have spread much wider than this. The opportunities for high quality premium this represents are considerable. It is difficult to think of another new product in the last decade that has offered such excellent opportunities to insurers who are prepared to invest the necessary time and effort to learn the business, whilst fulfilling the developing financial requirements of the housing market. ■

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Mortgage insurance in Europe

The European Federation of Building Societies and the European Community Mortgage Federation will shortly jointly publish a study, *Mortgage Related Insurance in Europe.*

This article briefly sets out the nature of the study, and then draws on the individual country chapters to describe the insurance of mortgage loans in each of the countries studied. The article concludes by reproducing the conclusions of the study.

EARLY in 1987, the two European federations decided to initiate and arrange a study into mortgage insurance, and other insurance-related aspects of mortgage lending. The study was felt to be necessary because:

(a) There are widely differing systems of mortgage insurance and each country can learn from the experience of others.

(b) As lenders increasingly operate across national frontiers, they need to be familiar with the different techniques of mortgage insurance.

(c) The question of mortgage insurance is relevant to the operation of secondary mortgage markets which, by definition, are more international than primary markets.

The terms of reference for the study covered:

(a) The insurance of mortgage loans.

(b) Policy and practice with respect to state assistance to borrowers who have difficulty in repaying their mortgage loans.

(c) The experience of countries with respect to mortgage arrears and default.

(d) Policy and practice with respect to mortgage loans linked to endowment insurance policies.

(e) Policy and practice with respect to the insurance of properties mortgaged to housing finance institutions.

The study was carried out by a group comprising executives from institutions belonging to the two federations. The convenor of the group, who acted as both chairman and secretary, was Ian Lumsden of the Halifax Building Society in the United Kingdom.

Insurance of mortgage loans — general considerations

By insurance of mortgage loans is meant systems which protect the lender rather than the borrower from the consequences of the borrower defaulting on his loan. Some of the countries in Europe have no system for insuring mortgage loans. Among the others, there are several systems by which lenders can protect themselves against default by borrowers:

(a) By the whole loan being insured.

(b) By the amount of a loan exceeding a set percentage of the valuation of the property being insured (the system used in Britain).

(c) By borrowers being required to contribute separately to a reserve fund to cover losses (the system used by Danish mortgage credit institutes).

(d) By borrowers being required to provide guarantors (as in West Germany and France).

The manner in which any insurance is effected can also differ between countries. The Danish mortgage credit institutions effectively use the self-insurance system. In Britain, top slice mortgage insurance is undertaken by the large insurance companies as part of their normal business. In many non-European countries (the USA, Australia and Canada, for example), there are specialist mortgage insurance companies or government agencies.

There is a close relationship between mortgage insurance and lending terms:

(a) The mortgage insurers may effectively determine lending criteria, for example, loan to income and value limits.

(b) Mortgage insurance may be needed for all loans or simply for loans which fail to meet certain criteria.

West Germany

There are no mortgage insurance schemes in West Germany. This is because lenders and insurance companies fear that mortgage insurance covers unspecified risks; that means collective risks, and, therefore, the probability of loss is impossible to calculate. They may also be reluctant to introduce mortgage insurance, because this would shift the risk of loss from lender to insurance company, and this might encourage the lender to engage in riskier lending.

The Bausparkassen cannot lend more than 80% of the value of the property unless adequate additional collateral is pledged. Bank guarantees provide the additional collateral. Some Bausparkassen co-operate with institutions specialised in guarantee undertaking, and act as an intermediary for guarantees.

A guarantee fee is usually around 1% of the guaranteed top slice of the loan. After a mortgage claim has been made against the guarantor, the guarantor may have recourse to the borrower.

Belgium

Belgium also has no mortgage insurance system providing for specific and systematic insurance cover for mortgage loans. However, certain companies do have recourse to credit insurance. Mortgage credit is just one of many transactions covered by credit insurers, and it is impossible to give precise information on the amount of mortgage business which is covered. The system is not widely successful for a variety of reasons.

Credit insurance normally covers all the business handled by the lender so as to spread the risk and to reduce premium amounts. The agreement between the insurer and insured lender usually stipulates a threshold, for example 50% or 80% of the public site value, at which the lender is required to submit the case to the credit insurer. The insurer will conduct his own investigations. Although cover extends throughout the loan period, mortgagees often require cover for only the initial years of repayment.

In the absence of credit insurance, lending companies generally make the granting of loans with high lending ceilings conditional on the provision of certain additional guarantees or risk premiums, such as an increase in the interest rate, the pledging of securities or the personal guarantee of a third party.

Denmark

Mortgage lending in Denmark is highly regulated and mortgage insurance is unknown. The rules under which the institutions operate are designed to safeguard the safety and solvency of each institution.

The law lays down maximum lending limits and loan terms. There must also be equivalence between the borrowers' mortgage debts and the nominal value of mortgage bonds in circulation. There are special requirements in respect of the minimum amount of reserves.

Reserves for residential mortgage loans have to be at least 5% of the value of bonds in circulation. This is met by way of an up-front payment of 1% of the principal, and a contribution of 2% of the quarterly or semi-annual instalment. It should also be noted that borrowers have joint and several liability for the obligations of the institution.

Spain

Until recently, there was no credit insurance for mortgage loans. Institutions protected themselves by carefully assessing the property that would serve as security, and by not lending more than 70% or 80% of the assessed value of the property. However, the situation is now changing.

Strong competition in the mortgage market is causing the amounts loaned to tend to approach the real value of the property. Fluctuations in the real estate market or poor upkeep of the property may also cause problems to lenders. Credit insurance companies offer various services to the financial institutions including foreclosure of the mortgage, and they will advance the amount of the debt outstanding to the lending institution.

France

There is no mortgage insurance in France nor is credit insurance practiced in the field of mortgage credit. To cover himself, the lender may require:

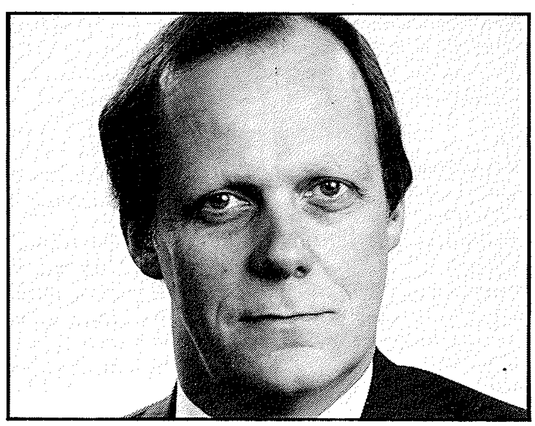
(a) A mortgage security on the property which is the subject of the loan.
(b) A mortgage security on another property belonging to the borrower.
(c) The joint guarantee of one or more persons.
(d) The mortgage guarantee of one or more persons.

United Kingdom

Where building societies lend more than 80% of the value of the property, a system of mortgage insurance is used. Building societies have operated this system for many years. The main features are:

(a) Insurance cover is given by composite insurance companies rather than by specialist mortgage insurers.
(b) The top slice of the loan, that is, that part of the loan above 80% of the purchase price, is insured.
(c) A single premium is paid by the borrower at the time the loan is taken out. Currently, premium rates vary from 3.5% of the amount insured, for loans between 80% and 90% of purchase price, up to 7% for amounts over 95%.

40 ⟶



Ian Lumsden, convenor of the Research Group on Mortgage Insurance.

← 39

(d) Building societies undertake all the additional administration and tell the insurance companies what loans have been insured.

(e) When a building society makes a claim, it notifies the insurance company of the amount which is then paid. A claim exists only where the sale proceeds of a property taken into possession are lower than the outstanding loan, plus the costs of possession.

Greece

There is no mortgage insurance system in Greece. The maximum amount of a loan is about 50% of the market value of the property and market prices have never fallen in the last 20 years. However, a large number of loans have a state guarantee. This guarantee is given to earthquake victims and can also be given to some large organisations if they build houses for their employees or for students.

Italy

Regulations governing loans secured on existing buildings require as collateral against the obligations assumed by the borrower, only the granting of a mortgage on the property to the lending institution. Regulations governing lending for housing under construction give the lender the right to request at the borrower's expense additional mortgage guarantees for that part of the loan that exceeds 50% of the cost of construction, including land purchase. There are three principle forms of supplementary guarantee used to back loans:

(a) Guarantee from a third party (normally a bank), which guarantees the payment of the loan instalments or repayment of the entire principal.

(b) A guarantee policy issued by an insurance company (in exchange for a single payment premium paid by the borrower, prior to the disbursement of the loan) for the amount in excess of 50% of the building cost.

(c) Supplementary or auxiliary state guarantee of the full repayment of principal, interest and related charges.

Portugal

In Portugal, there is no mortgage guarantee insurance system as such. However, such insurances are provided by insurance companies accepted by the mortgage lender, and with the consent of the insurance companies. In the case of loss, the mortgage lender has the contractual right to receive directly from the insurer the indemnity.

Norway

In Norway, lenders do not normally lend more than 80% of the valuation, which is generally lower than the purchase price. If the borrower wants a higher loan, then he will be required to give a bank or personal guarantee. Some credit institutions would extend the 80% limit with a customer credit insurance to cover losses caused by the borrower's insolvency.

The Netherlands

In the Netherlands, there are no legal requirements relating to mortgage related insurance. There are two types of insurance relevant to mortgage interest:

(a) Mortgage interest insurance through a mutual guarantee pledge.

(b) Top slice insurance. The lender can insure his total portfolio against all risks of not getting repayment of the mortgage for what ever reason only for the top slice of the mortgage loan, that is, above 100% of the foreclosure value.

Conclusions

The conclusions of the report are set out in full below:

"The country chapters in this study illustrate major differences between the European Community countries as to the security which mortgage lenders take, in addition to the property itself. It is clear that there is no single best practice in this respect. Each country has a unique housing finance system which has been shaped by housing policy, the structure of the financial system and the taxation system. The security which a lender looks for will vary according to a number of factors which differ between countries.

"In countries where high percentage loans are not required then, clearly, lenders can rely to a large extent on the property alone as security. In countries where the housing finance market requires high percentage loans, then lenders do need security in addition to the property itself. There are a number of types of additional security of which bank guarantees and insurance policies are the most common.

"The extent of state support for borrowers who have difficulty in meeting their repayments also differs markedly. This in itself can be seen as a form of mortgage insurance, and the more there is state support, the less the lenders themselves need to seek additional security.

"Perhaps the one conclusion that can be made is that mortgage insurance does enable higher percentage loans to be made than would otherwise be the case, and also significantly reduces the risks faced by lending institutions. In turn, high percentage loans can, depending on the relationship between property prices and incomes, allow people to become owner occupiers, either who could not do so at all, or at an earlier age than would otherwise be the case.

"The study explains the insurance aspects of mortgage lending, and enables the reasons for the differences between the countries to be clearly seen. Each country can learn from the system of others, and it is hoped that the study will enable relevant institutions to assess whether they have the most effective system of protecting lenders and borrowers in the light of their own special market conditions." ■

Real estate and fiscal legislation

THE International Real Estate Federation (FIABCI) published a special report in December 1988 on real estate and fiscal legislation and practice. This article briefly summarises those parts of the report of particular relevance to housing finance.

IN most countries there is a promissory contract involved in the purchase of a property. It is required by law in Belgium, France, India, Ireland and Switzerland, and is optional in most countries. Germany and Norway do not use promissory contracts.

In all of the countries surveyed, except Norway, the borrower usually pays a deposit on signing the promissory contract, although it is optional. The amount of this deposit varies. In Luxembourg it is as low as 2%, in a number of countries including The Netherlands, Switzerland and Italy, it is 10%, while in other countries it varies quite considerably, for example, from 10% to 25% in Ireland. The deposit can be highest in Israel where it can be for up to 50%.

Generally, the promissory contract must be signed by a notary, though there are exceptions (Australia, Norway and the USA).

Many countries have restrictions on the purchase of real estate by foreigners. Purchase is forbidden in Norway, except for residence purposes. There are restrictions to purchase in Belgium, France, Germany, Ireland, Luxembourg, The Netherlands, Singapore and the USA.

A number of countries also place restrictions on citizens wishing to purchase abroad. Greece, for example, does not allow any currency transfer for this type of transaction. Authorisation to purchase properties abroad is required in a number of countries including Finland, France, Ireland, Israel and Norway.

Fees and taxes paid in owner-occupied markets

The transfer of houses is normally expensive for both buyer and seller, but there are huge variations between countries. Table 1 shows expenses and taxes paid by the vendor for a $100,000 house as a percentage of the total purchase price.

It should be noted that the figures are as reported by real estate practitioners, and there is no guarantee that similar definitions have been used. Nevertheless, the figures are probably indicative of the differences between countries.

Agents' fees are, in most countries, the most important expense which has to be borne by the vendor. They vary from 1.1% in Greece, to 2% in the UK and Australia and to over 4% in a number of countries including Belgium, Canada, Finland, France, Italy and Mexico. High legal or notary fees have to be paid in Indonesia and Ireland.

Table 2 shows fees and taxes payable by the buyer for a $100,000 house. The variations here are even more marked than in the case of vendors, largely because of government taxes or registration fees. Costs are particularly low in the United Kingdom, the USA, India and Australia.

They are exceptionally high in Belgium at 20% of the purchase price, largely because of 12.5% registrar's fees and 4% notary/legal fees. Other countries with high purchase costs include Italy, France, Greece and Mexico.

42 →

Table 1 Expenses and Taxes Paid by the Vendor, $100,000 House %

Country	*Agent's Fees*	*Legal/Notary Fees*	*Other*	*Total*
Australia	2.0	0.4	0.2	2.6
Belgium	4.0			4.0
Canada	5.5			5.5
West Germany	3.0			3.0
Finland	4.0			4.0
France	5.0			5.0
Greece	1.1			1.1
Indonesia	2.5	2.5		5.0
Ireland	3.8	2.5		6.3
Italy	5.0			5.0
Luxembourg	3.0			3.0
Mexico	5.0			5.0
Netherlands	2.2			2.2
Pakistan	2.0			2.0
Switzerland	2.0	0.1	1.9	4.0
USA	3.8	0.2	0.1	4.1
UK	2.0			2.0

Note: UK figures added by International Union.

← 41

Rental transactions

There are huge variations in the lengths of residential leases. In some countries the period of a lease is entirely negotiable, for example, Denmark and Australia. One-year renewable leases are common in the USA and Spain. A typical lease period in Germany is between five and 10 years, while Belgium has periods of three, six and nine years.

The length of the lease is regulated by law in Belgium, France, Greece, Italy, Mexico and The Netherlands. Rents are regulated by law in Austria, Finland, Greece, Italy, Luxembourg, Mexico and The Netherlands.

In most countries deposits are paid by the tenant when signing the lease. This is required by law in Belgium, Canada, France and Spain. The amount of the deposit typically varies from one to six months' rent. Spain and Canada are among countries where one month's rent is typical. In Norway the deposit is particularly high, between three and six months' rent.

In a number of countries a tenant has to pay a registration duty on the rent. In Austria this is 3% of the annual rent, and in France 2·5% of the monthly rent.

Real estate agent's frees for rentals are typically in the 5%-10% range. In Switzerland, for example, 5% of the annual rent is typical, and in Spain and the USA 6% is common. The figure is high in Belgium at 10%, and even higher in Italy at 15%.

Table 3 Urban Homes, Sales Prices and Rents

Country/Town	*Sales price square metre $*	*Rent per year square metre $*	*Sales price/ rent*
Andorra/Andorra	975		
Australia/Sydney	1,606	70	23
Belgium/Brussels	1,406	90	16
Brazil/San Paulo	255	35	7
Colombia/Bogota	270		
Denmark/Copenhagen			
Germany/Hamburg	2,681		
Spain/Madrid	2,438	102	24
Finland/Helsinki			
France/Paris	5,115	170	30
Greece/Athens	431	29	15
Indonesia/Jakarta	162	35	5
Ireland/Dublin	791	58	14
Israel/Tel Aviv	2,000		
Italy/Milan		58	
Luxembourg/Luxembourg	1,918		
Netherlands/Amsterdam	475		
Norway/Oslo	1,145	87	13
Austria/Vienna	1,261	107	12
Pakistan/Karachi	300	28	11
Switzerland/Basle	3,791	126	30
Sweden/Stockholm	2,348	78	30
USA/New York	3,000		

Table 2 Fees and Taxes Payable by the Buyer, $100,000 House %

Country	*Agent's Fees*	*Notary/ Legal Fees*	*Stamp Duty/ Transfer Tax*	*Registrar's Fees*	*Other*	*Total*
Australia		0.7	1.9		0.3	2.9
Belgium	4.0	4.0		12.5		20.5
West Germany	3.0	1.0	2.0			6.0
Spain	5.0	0.6		0.3		5.9
Finland	5.0				1.6	6.6
France	5.0	2.2		5.4	0.6	13.2
Greece	1.1	1.0			13.3	15.4
India	2.0					2.0
Indonesia	2.5	2.5				5.0
Ireland	1.9	1.0				2.9
Italy	2.0	3.0		8.0	2.0	15.0
Luxembourg		0.9		6.0	1.9	7.9
Mexico		2.7		0.1	10.2	13.0
Netherlands	2.3	1.1		6.0		9.4
Norway		1.8		2.5		4.3
Austria	3.0	1.0	3.5	1.0		8.5
Pakistan	2.0		8.0	0.1		10.1
Switzerland	1.9	0.3	2.7			4.9
USA					3.0	3.0
UK		0.7	1.0			1.7

Note: UK figures added by International Union.

Residential property market

The survey includes basic data on the real estate market in 1988. Table 3 shows the sales price per square metre and rents per square metre for urban homes, and also the relationship between sales prices and rents.

The most expensive city in the survey, by quite a long way, is Paris with a price of $5,115 per square metre. This is followed by Basle, Switzerland ($3,791), New York, USA ($3,000), Hamburg, Germany ($2,681), Madrid, Spain ($2,438) and Stockholm, Sweden ($2,348).

It is, perhaps, significant that the variations in sales prices were much greater than the variations in rents. In countries with high sales prices the ratio of sales price to rent was also high — averaging 30 in the European cities where prices were highest. In other European cities a ratio of 12-15 was more common. ■

Housing finance in the Caribbean

TWO recent publications usefully give up-to-date information on the housing and housing finance situation in the Caribbean.

On September 27 and 28, 1988, the Caribbean Ministers of Settlement and Shelter held their first joint meeting. The meeting was hosted by the Government of the Republic of Trinidad and Tobago, and was co-sponsored by the United Nations Centre for Human Settlements (Habitat) and the United States Agency for International Development. The conference was on the theme "Shelter for the People: A Catalyst for Economic Reconstruction". The proceedings of the conference have now been published (*Report on the First Meeting of Caribbean Ministers of Settlements/Shelter),* Ministry of Settlements and Public Utilities, Trinidad and Tobago, 1988).

Five papers were given —

Shelter and Urbanisation Overview, by Dr George Peterson, The Urban Institute, Washington.

Efforts to Address the Problem, by Jeremiah Scott, Minister of Housing and Community Development, St Vincent and the Grenadines.

'Need for creative strategies'

Sou Sou Land Concept — Lessons Learnt: The Way Forward, by Pamela Nicholson, Minister of Settlements and Public Utilities, Trinidad and Tobago.

Formulating and Implementing a Shelter Strategy, by Bruce Golding, Minister of Construction (Housing), Jamaica.

Donor role and Co-ordination in Financing, Role of International and Regional Agencies.

Dr Peterson noted that the productive use to which the home could be put was an important source of income for the householder, and he cited the following implications for shelter policy —

(a) A review of laws which prohibit the commercial use of properties in residential neighbourhoods.

(b) The issue of house design and lot sizes.

(c) The provision of credit assistance to small home-based entrepreneurs facilitating the upgrading of the home.

With respect of the method of payment, Dr Peterson proposed that creative strategies be applied to the collection of rents from the housing beneficiaries, and that the increment in value of serviced land be taxed.

In discussion it was noted that tax incentives were being provided in Trinidad and Tobago to enable private financial institutions to grant loans at low rates of interest to low income groups. In addition, housing bonds were also being floated.

Pamela Nicholson described the Sou Sou Land concept under which —

(a) Deposits were made by subscribers and, together with the interest, are utilised by the National Housing Authority to meet the costs of providing fully serviced lots.

(b) Subscribers are allowed to drop out of the programme and have their deposits refunded.

(c) Subscribers can choose from a number of design/shelter options based on affordability, and be provided with professional guidance for construction.

(d) The land is developed to acceptable standards.

(e) Because development is carried out on an incremental basis the cost of land is considerably lower than the open market value.

(f) Self financing is encouraged, but tax incentives are available to approved mortgage companies to make adequate financing available to the low income group below the normal rates of interest.

The paper by Jeremiah Scott, Minister of Housing, Labour and Community Development in St Vincent and the Grenadines, described recent initiatives in housing finance. In 1987 the Caribbean Development Bank approved a loan of EC$4.95 million for the mortgage finance programme administered by the state-owned National Commercial Bank. The national insurance scheme of St Vincent and the Grenadines agreed to fund a similar amount, and including recycled funds the total amount of the programme to be disbursed over a four-year period would be $10.7 million. The programme is intended to assist in meeting some of the credit needs of lower middle income households for home improvements and new housing. Loans will be for up to 90% of the estimated market value of the land and the cost of new construction, and will be for up to 20 years. Minor home improvement loans will be made for up to 10 years. There are income limits for the loans.

'Housing bonds floated'

The National Commercial Bank established a mortgage finance department in June 1988. It will also

44 →

← 43
operate a scheme of its own. All mortgage loans will be at 10%.

On November 7 and 8, 1988, the Caribbean Association of Building Societies and Housing Finance Institutions (CABSHFI) held a housing finance seminar on the theme "Financing Low Income Housing in Small Economies" in Port of Spain, Trinidad and Tobago.

Ten papers were given with speakers coming from both the Caribbean and the wider international community. A summary of some of the major papers was published in the last issue of *Housing Finance International.* The full proceedings of the conference have now been published by CABSHFI (*Financing Low Income Housing in Small Economies,* CABSHFI, 1988).

A paper by Dr John Cole, on Trinidad and Tobago, deals specifically with housing finance. The paper notes that interest rates are critically important, but that riskiness in the mortgage sector can be relatively low. In Trinidad and Tobago the default and liquidity risks in an institution of the mortgage portfolio can be reduced through use of the secondary market institution, the Home Mortgage Bank. Because there is a danger of a shortage of new deposits to fund mortgage lending the emphasis must be on keeping house prices down, and housing finance institutions must expect to be able to influence the construction industry.

'Mortgage risk can be low'

Elaine Weis, Executive Director of the Garn Institute of Finance at the University of Utah, Salt Lake City, Utah, contributes a paper on impediments to efficient low income housing finance delivery systems in the Caribbean. The paper suggests that the current framework for housing finance systems in the Caribbean regards residential housing as a consumption expenditure rather than a capital investment. Government-subsidised housing finance programmes have discouraged greater private sector involvement in low income housing solutions. A high proportion of housing investment is provided through private initiative without the support of financial institutions. The legal and regulatory structure and current credit underwriting standards effectively limit access to housing credit for low and moderate income households.

In the Caribbean countries there has been a lack of focus on formulating housing finance policies, and there is not even any central information or co-ordinating bodies dealing with all the agencies involved in housing finance. There are numerous institutions involved in housing finance in the Caribbean, most of which are specialised institutions. One of the impediments to a more effective housing finance system is that the specialised lenders account for a relatively small share of total financial resources in Caribbean countries. For example, in Jamaica the ten commercial banks hold 70% of deposits and 66% of loans outstanding, and in Barbados the banks have an estimated 80% of deposits. The participation of commercial banks in mortgage financing is limited, for example in Barbados mortgage loans on private homes make up less than 4% of total commercial bank loans and advances outstanding.

'Lack of focus on policies'

Financial and regulatory incentives could be structured to make mortgage lending more attractive to the commercial banking sector. Financial incentives could include tax credits, the creation of a government secondary mortgage market, mortgage indemnity insurance, linked deposit programmes, and loans to lenders programmes. Regulatory incentives could include lower capital requirements for low and moderate income mortgage portfolios, removal of mortgage interest rate ceilings, and exemption from restrictions on bank lending for personal and consumer purposes. However, in addition to incentives education is needed, both for borrowers and for bank officers.

'Need for education'

Generally, laws and regulations governing financial institutions and residential mortgage finance tend to discourage a higher level of housing finance. Many governments have controls on interest rates, and even where there are not controls the institutions often have to compete against fierce government competition in the markets. Another impediment to the more widespread use of mortgage credit is the legal nature of the mortgage itself. The borrowers must have a legal interest in the property being financed, and be able to provide the necessary documentation in order to obtain a mortgage loan. Most low-income borrowers occupy land to which they have no title. Mortgage lenders should consider alternatives to registered title as security for housing loans to credit worthy borrowers. ■

Urban Housing Finance

THIS OECD publication (*Urban Housing Finance,* OECD, 1988) is the result of a three-year study undertaken within the framework of the OECD Urban Affairs programme. It is based on reports provided by OECD governments considering the overall direction of their housing policies and main concerns, and in-depth studies on tax policies, and maintenance and modernisation of urban housing, and on the results of a seminar on housing investment and urban change. The report was written by Ray Robinson, Reader in Economics at the University of Sussex, in co-operation with the OECD Secretariat.

The report comprises five chapters: (a) The context of housing policy, recent trends and prospects for the future; (b) An overview of housing markets and housing policies; (c) Policies towards owner-occupiers; (d) Housing loan finance; (e) Policies towards the rental sector; (f) Housing re-investment strategies.

The chapter giving an overview of housing markets and housing policies contains much useful statistical material. It is noted that most countries now have a balance, or an aggregate net surplus, of dwellings over households, and have increasingly turned their attention to the issue of housing quality. No internationally comparable figures are available on this, but it is possible to analyse figures on space. As far as dwelling size is concerned Canada and New Zealand are at the top of the range with an average of five to six rooms per dwelling. Luxembourg, The Netherlands and the United Kingdom also have a large average dwelling size. In all countries 90% or more of dwellings have inside running water, and the level of provision of inside flushed toilets is high in most countries, although Japan is a notable exception with less than 50% of its dwellings possessing this facility.

In many cases the quality of a dwelling is closely related to its age. The United Kingdom and France have a particularly high proportion of old housing, and these are a source of concern.

Attitudes towards the different forms of housing tenure vary between countries, although in most owner-occupation is viewed favourably, both by individual households and by governments. The proportion of households within the owner-occupied sector rose steadily throughout the 1970s in most countries.

The chapter on housing loan finance is of particular interest to housing finance institutions. During the 1970s housing finance markets were subject to pressures resulting from inflation, interest rate volatility, and fluctuations in the supply of funds.

Among the responses to inflation have been deferred interest mortgages, index-linked mortgages, and equity or shared appreciation mortgages.

Greater interest rate volatility has posed serious problems for those countries such as Canada, the United States and the Netherlands, where loans have been at fixed rates of interest. Such countries have tended to move to the variable rate system.

The problem of the supply of funds has been dealt with by interest rate deregulation and also by institutional finance being invested in the housing market by a variety of means.

The group recommendations in the report are reproduced in full below.

This publication is a very welcome addition to the modest range of publications dealing with housing and housing finance problems at the international level.

Introduction

There are wide variations in the housing systems and policies in OECD Member countries. But most of them have experienced difficulties in achieving the basic housing objectives of efficiency and equity. In particular historical development of housing finance and tax systems has led to a pattern of subsidies which obscures the real cost of housing.

At the moment many countries are in the process of reassessing their housing policies. The first task is to determine the appropriate role of central and local government in housing. Within their fiscal restrictions governments may wish to produce a more cohesive and consistent housing strategy to cover all tenures. This might be primarily designed to meet housing objectives rather than a subsidiary component of other policies, eg employment or regional policies.

New priorities

Rising incomes and changes in demographic composition have led to increased aspirations for smaller but higher quality dwellings in many OECD countries. There is an increasing trend for this to be met by the private market through new construction and adjustments to the existing stock.

Concern is shifting in many countries from the provision of new dwellings to maintenance, repair and improvement of existing dwellings. Governments may wish to consider whether their housing policies emphasise sufficiently both this need and the necessary stock adjustments.

In those countries still experiencing migration into urban areas and higher population growth, however, policies are likely to continue to focus on new construction.

46 →

← 45

Most housing policies are nationally-based, yet housing conditions and problems can differ significantly between regions within a country. Governments may wish to consider whether their systems offer sufficient flexibility to deal with the variety of regional problems encountered.

Urban regeneration

Revitalisation of urban areas is an increasing concern in many countries. Governments may wish to consider the extent to which the required reinvestment can be initiated by housing activities. Also attention needs to be devoted to the relative roles to be played by the public and private sectors, in partnership, in reviving confidence in an urban area.

Successful urban regeneration encompasses non-housing as well as housing reinvestment; this needs to be spatially concentrated in well-defined neighbourhoods. It is also desirable to decentralise public services. It is important that housing policies are consistent with this, and that they are supported by other activities, such as social and environmental improvement programmes, which allow for comprehensive area improvement.

Pricing

In order to develop efficient housing policies governments have to be aware of the real cost of housing and aim towards a pricing structure which in general reflects these costs.

In the social housing sector, too, rent structures need to correspond more closely to the value of housing services provided by dwellings.

Subsidies to Consumers

Housing, however, is an expensive commodity and most countries will wish to continue to limit the level of cost borne by consumers. Some countries will wish to maintain a broad-based support system.

Others may prefer a greater degree of targeting and selectivity. They may consider adapting their policies to achieve greater targeting in terms of some of the following criteria:

- Households on low incomes;
- Households wishing to enter or having recently entered the housing market such as first-time buyers, new entrants to the rental sector, etc;
- Households with special needs, eg people with handicaps, mental disabilities, etc;
- Household expenditure on specific aspects of housing for which the social benefit is greater than the private benefit, eg, energy saving features;
- Households moving into or improving dwellings in areas undergoing revitalisation where the social benefit is greater than the private benefit.

Tenure choice

It may be the case that the expansion of a particular tenure is the most efficient way of achieving a general housing or social objective. But countries may wish to consider whether there is a case for greater emphasis on tenure neutral approaches.

Owner Occupation

In those countries seeking to achieve growth of owner occupation special mortgage instruments such as deferred payment, index-linked and equity sharing mortgages can help to reduce the outlay of home owners in the first years and may have a greater role to play than they have to date. They will be of special help to families with modest incomes and help to defray the transaction costs associated with movement.

Some governments may wish to consider methods to improve the targeting of subsidies to home owners in order to contain their costs and reduce their other negative aspects. These could include restricting them to first-time buyers; introducing a ceiling on tax relief; restricting the period of time over which it is available; introducing tax credits; or directing aid to home owners on low incomes.

The Rental Sector

Some countries are concerned to encourage the growth, or maintain the size, of their rental sectors because of the advantages they offer by providing a tenure suitable for some households' circumstances and facilitating mobility.

The Private Rental Sector

In the private rental sector this may best be achieved by the gradual decontrol of rents, for example decontrollings new lettings at a pace which allows the supply of housing to adjust and thereby avoids the incidence of windfall capital gains. This must not jeopardise security of tenure and may need to be supported by housing allowances. This strategy is most likely to achieve the necessary broad political consensus. Rent decontrol may also lessen the problems of disrepair and maintenance.

Within the private rental sector, arrangements which enable tenants to be consulted about the ways in which their housing is managed can also contribute to maintaining the quality of this housing.

Public Rental Sector

In seeking to encourage the public rental sector, some countries may wish to adopt initiatives that are already underway elsewhere; these aim to improve management and to introduce more flexibility in setting rents and improving housing conditions, especially on large estates.

In response to criticisms of overcentralised and bureaucratic management practices which do not respond sufficiently to tenants preferences, a number of countries are developing new management systems. These involve the decentralisation of functions, responsibilities and budgeting, and may incorporate a

48 →

← 47
operated very closely with the African Union and the training courses which that Union provides. The group has, however, felt the need for a high level executive development facility. To this end, a Leadership School was launched in Johannesburg in 1988 at the University of the Witwatersrand and underwritten by the Association of Building Societies of South Africa.

Delegates attended from 10 countries in Southern Africa. The first School ran for two weeks and covered a wide range of subjects. To a large extent, building society officials were used to lecture. Although the School was successful in building bridges and bringing the practitioners from the other countries closer together, it was not an academic success. The venue was also not good and two weeks away from their offices was too long a period for persons running small organisations.

Notwithstanding the adverse aspects of running the School, the Group of Ten decided that a second attempt should be made. The Building Societies Institute of Southern Africa undertook to organise a second School on the basis of uplifting the subject matter to chief executive status (no compromise being made whatsoever to any delegate who may not be at the required level). Lecturers were to be the best professionals available, the venue to be first class and the duration of the course to be restricted to one week or five working days.

The subjects covered during the course were all those items which a chief executive of a building society anywhere in Africa would be expected to deal with. The subjects covered by the experts acknowledged as the best in their respective fields were:

1. *Marketing*
   Advertising
   Creativity
   Research
   Sales
   Public relations
   Attainment of targets.
2. *Personnel Management and Development*
   Dealing with unions
   Organisational diversification
   Manpower diversification
   Executive development
   Future trends in manpower development.
3. A special report on the effect of AIDS on the world economic trends was presented by the author of a most thought provoking book.
4. *Financial Risk Management*
   Financial markets and instruments
   Financial derivative instruments
   Instruments of monetary policy.
5. *Building Society Management*
   Negotiating skills
   Electronic banking
   Building societies as envisaged for the year 2000.
6. A final presentation was organised by the delegates based on their proposals to be made to their respective societies to solve actual problems which existed in their own environments. (This section was incredibly well presented and most stimulating.) Although very little free time was allocated to the delegates and only one social function arranged, I was impressed by the apparent amount of time that had gone into the preparation of the presentations and also by the amount of reference that was made to the study material and the content of the various lectures. I can only deduce from this that the subjects covered must have been well chosen for their relevance.

The second School was an undoubted success and has now generated its own momentum and will, I am sure, become a permanent feature of the activities of the Group of Ten. ■

← 46
greater degree of tenant participation in decision making.

In some countries poor housing conditions and social problems are particularly acute in the large tracts of post-war social housing. These may require a greater level of maintenance and reinvestment than is presently taking place. Countries may consider how best to achieve a more balanced mix of tenants on these estates. One means of integrating public housing tenants into the life of the city in a way that spatial segregation does not permit, is to build housing in small scale developments at locations throughout the urban area. Another could be building or converting dwellings for private ownership on existing estates.

Non-Profit Rental Sector

In countries where non-profit organisations have developed into large scale operations, their division into smaller units is favoured as a means of improving efficiency and accountability. Elsewhere small scale non-profit organisations may offer an attractive alternative tenure in the rental sector. They possess a number of features such as relative autonomy, using a combination of public and private finance, often decentralised management structures, and frequently incorporating tenant participation, which make them particularly suited to the changing housing situation.

Concluding remarks

Many aspects of housing finance and tax systems have direct implications for urban development. Although there is a tendency for governments to decentralise responsibilities, there is nonetheless a continuing need for national governments to ensure consistency between housing policy and their objectives for cities. Due attention to these linkages is a necessary prerequisite of successful urban regeneration strategies and for ensuring an acceptable quality of life for people in urban areas. ■