Dawn of a new legislative era for housing finance

Building societies and savings associations operate under specialist legislation, which has largely confined them to raising deposits and making loans for house purchase. In all of the English-speaking countries, that legislation either has been, or is about to be, changed, so as to allow institutions to adopt wider functions, and in most cases also to convert from mutual to company status. This article, by the editor of *Housing Finance International,* Mark Boléat, describes legislative developments in the UK, USA, South Africa, Australia, the Irish Republic and New Zealand.

IN the 1960s and early 1970s, building societies and savings associations increased their share of the savings and housing finance markets. They were able to take advantage of a rapidly growing demand for housing finance loans and increasing standards of living, which in turn led to a stronger demand for savings facilities. Their success came in an era when there were government controls on the financial markets.

Partly, these controls were intended to promote monetary policy. The money supply was taken to be synonymous with bank deposits, and therefore the control of the money supply meant the control of bank deposits. There were, therefore, often special controls on the banking system which inhibited their ability to compete with more specialist deposit-taking institutions.

In many countries, housing finance was also thought to require some protection from normal market forces. Governments felt it politically wise to prevent fluctuations in market interest rates fully feeding through to the housing finance market, and in some countries the policy seemed to be little more than keeping the mortgage rate at the lowest possible level.

This led to special tax advantages for housing finance institutions, such as the ability of the South African building societies to offer tax-free deposits, to limitations on the ability of banks to offer interest on some of their accounts, as in Australia, and to a statutorily imposed interest-rate differential between savings associations and commercial banks, as in the USA.

By the 1970s, these various instruments were coming under pressure. Inflation and rapidly fluctuating interest rates had made a nonsense of some regulated interest rates, and, not unnaturally, devices were developed which enabled the statutory controls to be overcome.

By the early 1980s, the development of automated teller machines, and developments in computer technology generally, made it easier for non-traditional banking institutions to offer a full retail banking service, together with an attractive rate of interest on deposits. Specialist housing finance deposit takers found themselves left behind in this race, often because they were restricted in the extent to which they could offer money transmission services.

Simultaneously, non-traditional institutions have moved into the housing finance market, often offering a package of services, not all of which have been open to the specialist institutions. This trend became more marked when the banks were freed from the balance sheet constraints which they had operated, and also sought to attract mortgage business, partly because it was thought to be profitable in itself and partly because the banks knew it could lead to the attraction of related business.

The specialist building societies and savings associations therefore found themselves under pressure. It was no longer sufficient merely to offer a good rate of interest on savings, but money transmission had to be offered as well.

Mutuality also came under challenge as being an old-fashioned way to run a modern financial institution, and certainly inappropriate for very large institutions.

One can see all of these trends in the large English-speaking countries. Certainly the trends are not identical in each country. In the USA, an additional factor has been the earnings crisis of the savings associations, caused by them being forced to borrow short and lend long. In both Australia and New Zealand, the entire financial markets have been or are being deregulated. In the UK, the main factor has been the removal of the previous constraints on the clearing banks.

In most of these countries, there have been official enquiries of one form of another. In some cases, for example the Wilson Committee in Britain, they have been merely of academic interest, while in others, in particular the Campbell Committee in Australia and the de Kock Commission in South Africa, the reports have been a blueprint for subsequent legislative reform.

Such is the legislative process in the USA that the country's financial system is almost permanently undergoing an inquiry from Congressional Committees of one form or another. However, in the early 1970s there was also a more formal inquiry in the form of the Hunt Commission.

In Britain, the Committee to Review the Functioning of Financial Institutions (the Wilson Committee) was established in January 1977, primarily to inquire into the banking system, and in particular the provision of funds for industry and trade.

Australia produced perhaps the most impressive and influential report on its financial institutions. The Campbell Committee was set up in 1979, and it produced an interim report in May 1980, with a final report at the end of 1981 (*Australian Financial System, 1st Report of the Committee of Inquiry,* Australian Government Publishing Service, September 1981).

The report favoured the deregulation of the previously heavily regulated interest rates paid and charged by Australian building societies. It also favoured giving building societies and savings banks greater freedom to broaden their sources of funds, and generally it was against the segmentation of financial markets.

In 1983 the newly-elected Labour Government established a new committee, the Martin Committee, charged with considering the implementation of the Campbell proposals, but taking account of the Government's social and economic objectives. The report favoured the abolition of interest rate controls, and it called for a relaxation of existing restrictions on the disposition of building societies' assets. Specifically it recommended that societies should be allowed to offer consumer credit.

South African building societies had to experience not one, but rather two reports. The *du Plessis* Report, which was specific to building societies, was published in 1982, and was against the trend of other reports by arguing for a continuation of the financial sheltering of building societies, together with a restriction on the scope of their activities. In the event, the report has had little impact.

More important have been the reports of the *de Kock* Committee, which published an interim report dealing with building societies in December 1982, and its final report in 1985. The report favoured the removal of the special tax advantages which building societies enjoyed, together with a relaxation of the controls on their assets. It has strongly influenced the legislation currently before the South African parliament.

Finally, in the Republic of Ireland an inquiry into building societies was announced in September 1985, this partly stemming from controversy surrounding the effective takeover of one building society by a bank and a proposed merger between two of the largest societies.

US system deregulated

IN THE USA, savings and loan associations (as they were then known) prospered throughout the 1960s and most of the 1970s. They enjoyed a statutory interest rate advantage over the banks, and although their loans were at fixed rates, this did not present any problems, as interest rates were stable, and in any event the rate

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Ed Gray, Chairman of the Federal Home Loan Bank Board:

‘In 1982, the landmark legislation that Congress passed and the President signed into law — the Garn-St Germain Depository Institutions Act — made abundantly clear the intent of Congress. The preamble of that legislation, in a single sentence, calls it "an Act to revitalise the housing industry by strengthening the stability of home mortgage lending institutions and ensuring the availability of home mortgage loans." Indeed, it talks straightforwardly about the housing industry by name and about savings institutions by name.

This simple, clear statement of Congressional intent acknowledged the lack of stability present in the savings institutions industry at the time. With portfolios full of underwater, long-term, fixed-rate mortgages, savings institutions — which repeatedly had been denied the opportunity to make genuine adjustable-rate mortgages by the federal government throughout the decade of the seventies — desperately needed a way to restructure their portfolios.

Congress — whose purpose was to "strengthen the stability" of these "home mortgage lending institutions" — provided in the legislation new authorities by which these home mortgage lending institutions could achieve a measure of diversification. The new operating authorities that Congress granted on the asset side were characterised by far shorter maturities than the long-term fixed-rate mortgage loans maturities on the books of these institutions.

The new short-term maturity investment and lending instruments — that is to say, greater consumer lending authority, commercial lending authority, and commercial real estate lending authority — that Congress granted were not intended to change the fundamental character of savings institutions — which Congress called "home mortgage lending institutions" — but, instead, to help these institutions restructure the maturity balance of their portfolios over time.’

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of interest which they could obtain on their long-term loans was substantially above that which they had to pay on their short-term deposits. Clearly the system was vulnerable to a sharp rise in market interest rates, which would expose the associations to the consequences of borrowing short and lending long.

That sharp rise in market interest rates duly occurred at the end of the 1970s. The regulation of bank and savings and loan association interest rates was not sufficient to protect them, as money market mutual funds were rapidly established, which enabled the ordinary investor to take advantage of money market rates that were at times three times as high as those which the deposit-taking institutions were allowed to pay.

Gradually, the liabilities side of the balance sheet of the associations was freed, and they were allowed to pay market-related rates on an increasing proportion of their funds. However, there was no liberalisation of the asset side of their balance sheet. New mortgage loans were made at market-related rates, but existing loans still carried the rates of interest at which they had been made, and these were by then well below market levels. Profits dropped alarmingly in 1980, and by 1981 a huge loss for the industry as a whole was recorded.

The first legislative response was the Depository Institutions Deregulation and Monetary Control Act (DIMCA) of 1980. This had two major features. The first was a planned phase-out of the interest rate ceilings imposed for certain categories of deposit, this automatically involving the ending of the differential which the savings associations enjoyed over the commercial banks.

The second feature was a significant increase in the powers of the associations, including: (a) authorisation of interest-bearing checking accounts; (b) authorisation of investment of up to 20% of assets in consumer loans, corporate debt securities and commercial paper; (c) the easing or removing of lending restrictions; (d) expanded authority to invest in service corporations; (e) authority to invest in mutual funds, to issue credit cards, and to engage in trust operations.

In the late 1970s and early 1980s, the associations were gradually allowed to introduce some element of variability into their mortgage loans, but this was far from adequate to cope with rapidly fluctuating interest rates. In 1981, a major step forward was taken when the Federal Home Loan Bank Board, the regulatory authority for the savings associations, authorised them to issue adjustable rate loans on whatever loan terms they thought appropriate.

These measures were not sufficient to restore the industry to health, and in 1982 came the far-reaching Garn/St Germain Depository Institutions Act. This included the following provisions:

(a) authorisation of a new savings account, directly competitive with money market funds;

(b) the pre-emption, or severe limitation, of state-imposed restrictions on the ability of associations to enforce due on sale clauses in loan contracts (mortgage contracts had generally included a provision whereby the loan had to be repaid in the event of the house being sold. Where loans were at low fixed rates, obviously it was advantageous for these to be passed on to the purchaser of the new home, the benefit being capitalised in the house price. Some states had limited the ability of the associations to enforce these clauses, thereby posing financial problems for them);

(c) completion of the phasing-out of the interest rate advantage enjoyed by the associations by the beginning of 1984;

(d) capital assistance for institutions with deficient net worth;

(e) an easing of the requirements for conversions from state to federal charter and vice versa and also from savings associations to savings banks;

(f) expanded authority to invest in consumer, commercial and agricultural loans and other investments.

Many associations have taken advantage of the legislation to convert from mutual institutions into stock corporations, often with a new federal savings bank charter which gives a wider range of powers than those open to savings associations. What were the largest savings associations are now for the most part diversified retail financial institutions and, indeed, some also have a substantial commercial banking element.

UK legislation enacted

IN THE United Kingdom, the realisation that new legislation was needed came gradually during the early 1980s. In 1980, the last significant balance sheet constraint on the banks was removed, and they moved rapidly into the mortgage market, accounting for 40% of new business by the end of 1981.

Building societies found themselves, partly as a result of new technology, able to offer a wider range of services to their customers, but they were heavily restricted by legislation, which basically tied them down to taking in retail savings and making loans for house purchase.

The somewhat archaic constitutional provisions for the control of building societies were also causing some concern, and there were those who thought that building societies were not sufficiently accountable to their members.

The first steps towards new legislation were taken by The Building Societies Association, which published a discussion document, *The Future Constitution and Powers of Building Societies* in January 1983, and then detailed proposals in *New Legislation for Building Societies,* published in February 1984.

The report stressed that societies had no wish to depart from their primary functions, and that addi-

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tional powers should be incidental to these and should enhance their achievement. It argued that societies should have the power to hold land for housing development, and that they should be able to offer services related to house buying, including estate agency, structural surveys, conveyancing and insurance broking.

On financial services, the report stressed that societies had no wish to become full-scale bankers but rather wished to confine their services to retail banking. It said this could be achieved by enabling them to have a limited percentage of their assets in unsecured loans and that modest overdraft facilities should also be allowed on certain types of account.

In July 1984, the Government published a consultative document on building society legislation, *Building Societies: a New Framework* (Cmnd 9316). This commented that the law governing societies was not designed for institutions as large as societies had become, and that the limitations imposed on their business made little sense today.

It stressed that the purpose of the Government's proposals was to ensure that societies continued primarily in their traditional roles, while loosening the legal constraints under which they had operated so that they could develop in other fields. Most of the proposals in the Green Paper, some with modifications, appeared in the Building Societies Bill.

The Bill went through the upper House smoothly and became law on 25 July, 1986. Most of the provisions will be implemented on 1 January, 1987.

The new Act establishes a completely new legal framework for building societies for the first time since 1874. Societies will remain as mutual institutions specialising in the provision of housing finance and subject to special rather than general legislation. Their supervision will be placed in the hands of a new Building Societies Commission based on the present Registry of Friendly Societies.

The most important part of the legislation is the granting to societies of new powers to hold assets. Currently, societies are allowed to lend only on the security of freehold and leasehold estate. The new Act will create three categories of commercial asset (that is, total assets less fixed and liquid assets):

- Class 1 assets, which basically are loans secured on first mortgage to owner occupiers of residential property.
- Class 2 assets, which are other forms of secured lending, for example, lending on commercial property and lending on second mortgage.
- Class 3 assets, which are unsecured loans (subject to a maximum of £5,000 per person), ownership of land for residential purposes and investments in subsidiaries and associates which, broadly speaking, can do only those things within the powers of societies themselves.

Initially, at least 90% of assets must be in class 1, and within the 10% maximum for non-class 1 assets not more than 5% can be within class 3. There is provision for the non-class 1 total to be increased to 25% and for the class 3 total to be increased to 15%.

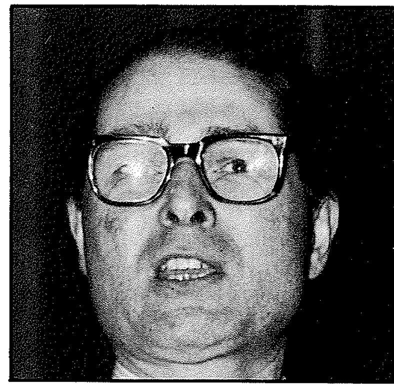
On the liabilities side, building societies will be able to raise up to 20% of their funds from wholesale sources with provision for this figure to be increased to 40%.

In addition to being able to have new asset powers, societies will also be specifically empowered to provide a range of additional services. These include money transmission services, foreign exchange services, making or receiving of payments as agents, management as agents of mortgage investments, management as agents of land, arranging for the provision of services relating to the acquisition or disposal of investments, arranging for the provision of credit, administration of pension schemes, arranging for the provision of insurance, estate agency, surveys and valuations of land.

The Act makes statutory provision for an investor protection scheme which will replace the present voluntary arrangement run by The Building Societies Association. The statutory scheme will provide for share accounts of up to £10,000 to be 90% protected. Provision is also made for a statutory Ombudsman scheme to consider complaints.

Few changes to the constitution of building societies are enacted. A common threshold of £100 is introduced for entitlement to vote and to receive documents. For the first time, borrowers are given, by statute, a right to vote on merger proposals.

A procedure is laid down by which



Ian Stewart, Economic Secretary to the Treasury, the government minister responsible for the legislation:

'This is the most fundamental legislation on building societies for over a century. It gives them new powers and will enable them to compete more effectively in a changing marketplace.

The emphasis will still be placed firmly on the provision of services for savers for house purchase, but I hope that the Bill will also enable building societies to face the future in the confidence that they will be able to continue to serve the public as they have done for many generations.'

building societies may convert to company status. However, the requirements that will have to be met are very severe and may deter societies which wish to consider converting from doing so. At least 20% of qualifying shareholders (broadly speaking those who have held an account of at least £100 for two years) must vote, and of these 75% must vote in favour.

In addition, 50% of borrowers voting must vote in favour. There is provision for limited bonuses to be paid to shareholders on the conversion. For a conversion combined to outright sale to a third party, then either 50% of qualifying shareholders must vote in favour, or the holders of 90% of share capital must vote in favour.

The consensus is that the new legal framework will give building societies adequate powers to expand in a rapidly evolving financial services market over the next 10 years. Generally, the prudential supervision of banks and building societies is being brought into line and this theme is apparent throughout the legislation. Further convergence of legislation for financial institutions is confidently expected.

Legislation for New Zealand societies to follow general financial deregulation

NEW ZEALAND has had one of the most regulated financial markets of the industrialised countries. In particular, there have been controls on interest rates, and state intervention in many other ways. In the housing finance market, the largest single lender is a government body, The Housing Corporation of New Zealand, which obtains its funds largely from the national budget and is therefore able to make loans at below market rates of interest. It is intended that from next year the Corporation will have to obtain its funds from the private market. Building societies have about a quarter of the mortgage market.

It was the election of a Labour Government in July 1984 that precipitated major deregulation of the New Zealand financial system. The Government removed controls on interest rates for deposits and mortgage loans, removed the 30 day rule on paying interest on trading deposits, and removed the limitation on the interest rate payable on passbook savings accounts.

In the unregulated financial environment, the building societies operating under the Building Societies Act 1965 were severly constrained. The New Zealand building societies have decided that an exhaustive overhaul of their legislation would be inappropriate as it would not be possible to gain the necessary place in a legislative programme, and therefore the Building Societies Association (NZ) has sought the removal of those constraints on the competitive position of societies. Also, the Government has wanted to reduce the element of discretionary power which governments and the Registrar have had over building societies.

Murray Coppen, Executive Director, Building Societies Association (NZ):

‘The changes in the financial market place have been generally welcomed by building societies, although their resources and management skills will be fully tested. In the deregulated environment the Building Societies Act often places societies in an uncompetitive position with regard to other financial intermediaries offering similar but extended services. The Association is seeking the removal of the constraints on the competitive position of societies.’

Like British building society legislation, the New Zealand Act limits societies to doing those things which are specified in the Act. This means, for example, that they cannot operate in a secondary mortgage market; they cannot offer cheques; they cannot offer ancillary customer services unless these are consequential to the main purpose of building societies; they are restricted in the type of lending which they can undertake (societies are restricted to a maximum of 5% unsecured and 10% commercial lending, the other 85% having to be secured by way of residential mortgage); and they cannot change to being anything other than a building society.

The Government has agreed to a series of changes to the Building Societies Act, principally:

- Societies will be able to operate in a secondary mortgage market.
- Societies will be able to offer customer services such as insurance, real estate agency, valuations and acting as an agent for government in matters such as selling certain savings products.
- Societies will have flexibility in the type of lending they will be able to undertake. A minimum of 50% must be in residential mortgage with the other 50% being commercial mortgages or consumer loans, whether secured or unsecured.
- Societies will be able to give security.
- Societies will be able to convert to some other form of legal entity, for example, a company.

Irish Government issues discussion document on legislative and regulatory arrangements for societies

IRISH building societies occupy a very similar market position to their British counterparts, accounting for over two thirds of new mortgage lending. The industry in Ireland is very concentrated with the five largest societies accounting for 93% of total assets. With one exception the societies are mutual. The exception is the Irish Civil Service Building Society, which has a stock ownership and which has recently been taken over by a commercial bank.

In April 1986, the Government issued a discussion document on the legislative and regulatory arrange-

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ments for building societies. This stressed the need to improve the efficiency of building societies in channelling funds from savers to borrowers, to ensure that societies are not hampered in remaining competitive in a rapidly changing environment, and that societies are not diverted from lending for housing for which they have developed a special expertise. The report suggests that five factors have called in question the regulatory and legislative environment:

- The proposed liberalisation of banking and building society operations within the EEC will alter the competitive environment for the Irish societies.
- The growth in the importance of societies in the market for deposits has led other institutions to establish a presence in the building society sector, and this points to the need for a rethinking of ownership structures.
- There has been criticism of certain restrictive practices operated by societies.
- There has been a question of how mutuality works in practice.
- Marketing expenditure by the building societies has been criticised as being wasteful.

The report concludes that there is a case for some relaxation of the restrictions on societies' activities and that this can be achieved without weakening their main function.

The report suggests that the following liberalisations would be appropriate:

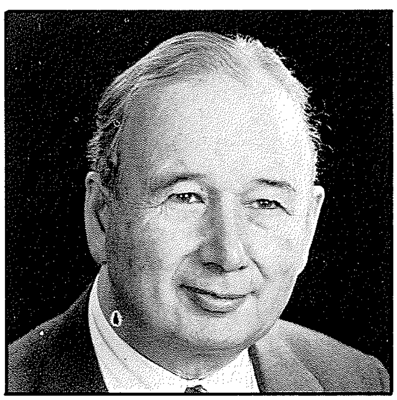
- The provision of unsecured lending, including bridging loans and lending on second mortgages, within carefully defined limits.
- Impediments to institutional borrowing should be removed.
- Societies should be able to give advice on home ownership, home improvements, general financial advice and provide agency arrangements for paying and collecting and related services.

However, the report concluded that societies should not be allowed to diversify into estate agency, conveyancing or insurance broking because it was felt that these services had considerable potential for conflicts of interest.

The report discusses the relative merits of mutuality against equity control but does not come to any firm conclusion on legislative changes.

The supervision of building societies is considered to be complex and uncertain and the report argues that rationalisation is desirable, although it does not suggest how this rationalisation should take place.

It is understood that the Government intends to introduce the relevant legislation before June 1987.



Jimmy Malone, Secretary of the Irish Building Societies Association:

'Irish building societies need new legislation for the same reason as their counterparts in other countries. The 1986 Budget extended to the banks confidentiality of investments for tax purposes, which had previously been given only to building societies. Banks can now offer all the facilities of a building society to their customers, as well as a wide range of other services. However, the government's discussion document is confused and unnecessarily restrictive and societies will be lobbying energetically for greater liberalisation so as to allow them to compete more effectively.'

Australian societies deregulated on a state-by-state basis

AUSTRALIAN building societies account for about a third of the housing finance market. With a few exceptions they are mutual. All are regulated on a state basis and generally operations take place within a state only. Each state has its own Building Societies Act and, although these are broadly similar, there are some not inconsiderable differences between the states.

The reform of the financial system in Australia has been on the basis of a report of a Committee of Enquiry under the chairmanship of J. K. Campbell and the report of the subsequent Martin Committee.

There has been a gradual relaxation of the various interest rate controls which has served to benefit the savings banks which previously were subject to the greatest controls and in April 1986 interest rates on all new housing loans by savings banks were finally deregulated. Existing savings bank loans remain regulated at 2% below the new rates. The banks have been granted a Federal Government subsidy to offset the cost of the remaining regulation.

The deregulation of societies is occurring on a state-by-state basis, although there are many common themes. In Queensland, societies have been given power to:

- Lend for household items such as furniture, white goods and other fittings.

Jim Larkey, Executive Director, Australian Association of Permanent Building Societies:

'Despite deregulatory progress by State governments, rate control and/or suasion remain in key areas. These impinge on societies' ability to respond quickly to changing market conditions and damage from time to time the flow of housing finance and capacity to compete.

The deregulatory moves by the Commonwealth will need to be matched at State levels.'

- Enter agreements with other institutions to lend for larger items, such as cars and boats, or for holidays, and to provide other financial services.
- Seek trustee status, opening up new markets for investments.
- Invest in corporations providing particular services, such as funds transfer companies.
- Participate in the newly developing secondary mortgage market.

In Western Australia, the Building Societies Amendment Act 1984 made the following main changes:

- A 2% net worth requirement, replacing the minimum 1% reserve ratio.
- Societies can offer overdraft or consumer credit facilities provided outstanding commitments do not exceed 5% of assets.
- The Registrar of Building Societies may allow societies to invest in companies which provide services to their members.
- The Registrar may allow societies to hold property for purposes other than for the conduct of their normal business.
- Additional net worth is required before activities can be undertaken. This additional net worth is determined as a proportion of the amount invested in the activity and is, for example, 7.5% for continuing credit arrangement, 10% for investment in subsidiary corporations and 20% for real estate investment other than buildings used as offices and branches.
- The minimum liquidity ratio has increased from 10% to 12.5% of withdrawable funds.

Two building society Bills in South Africa

SOCIETIES in South Africa have operated under the 1965 Building Societies Act. The South African Government has accepted the recommendations of the De Kock Commission of Enquiry that a new Building Societies Act should be implemented. The first draft of the proposed legislation would have required building societies, which operate on a mutual basis, to convert to stock-owned societies over a period.

This concept was not acceptable to all building societies in South Africa and led to a lively debate. The final outcome is that societies will be allowed to remain mutual or to convert to stock status and to cater for these two options, two separate Building Society Bills were being enacted in August 1986. They will be introduced from 1987.

Tim Hart, Secretary of Association of Building Societies of South Africa:

‘Meaningful changes to the legislation which has controlled building societies since 1965 has been achieved with the passing of two separate Bills which were approved by the South African Parliament during June 1986. The amendments are designed to give societies the options of remaining "mutual" or converting to "stock-owned" which will, with only one exception, give them parity of opportunity to conduct their business.

The amendments, although continuing to restrict building societies to the function of accepting savings for the financing of home ownership, will bring them more into line with modern business practice and also, should they adopt the equity route, a wide range of diversification of services through subsidiaries.’

The two types of society will have similar powers and these will not be vastly different from the present position. The main changes are:

- Societies are able to advance up to 90% of the purchase price or valuation of properties without additional security instead of 80%.
- Societies will be able to make unsecured advances up to 8% of their total liabilities to the public.
- Up to 5% of deposits accepted by societies may have a maturity of less than 12 months, whereas at present no such deposits may be accepted.
- Advances to purchasers of homes from societies' subsidiary development companies may not exceed 5% of the total annual amount advanced.
- Investment in fixed properties, shares and advances to subsidiaries which deal in fixed property may not exceed the issued share capital and unencumbered reserves.
- Investment in any other associates or subsidiaries, except a banking subsidiary, will be restricted to 5% of their total liabilities.
- Societies will be required to direct 80% of their operating capital into loans secured by first mortgage over urban immovable property. Of amounts secured by first mortgage, 80% will be in respect of domestic dwellings.
- Mutual societies will be required to increase their capital over an agreed period and equity-based societies will be required to comply on conversion with the new requirements (reserves and issued share capital of 4% of liabilities).

Where societies convert to stock status, this will be achieved by the creation of a building society holding company or by converting the existing mutual society into a company which, in either case, will be owned in the first instance by the members of the society before its conversion.

The holding company will have to employ 60% of its capital in its building society, but will be free to diversify into the full range of financial services subject only to obtaining the approval of the Registrar of Financial Institutions. No person, association of persons, or any group may hold more than 10% of the issued shares of a building society or building society holding company.

It is generally expected that most of the major building societies will opt for the equity route as soon as they are able to comply with the 4% reserve ratio requirement. ■

Funding options widen as finance goes international

In many countries, financial systems are in an important phase of structural change, as David Llewellyn explains

IN MANY countries financial systems are in a phase of major structural change. Although the detail varies, there are powerful parallels between countries both in terms of the form of change taking place and the underlying forces generating change. Three related pressures influencing the current evolution of financial systems are common to all: a greatly intensified competitive environment in which financial institutions and markets operate; new technology being applied to finance; and various forms of financial de-regulation. While the precise pattern of change varies between national financial systems, again three common themes seem to be emerging:

A trend away from specialised financial institutions and the erosion of traditional demarcations as financial conglomerates emerge;

An acceleration in the process of financial innovation as new markets and instruments are created which widen the range of funding, lending and investment options;

A growing internationalisation of finance as suppliers and demanders of financial intermediation and other financial services become less restricted to their domestic financial systems.

All of these elements have an important bearing on the funding operations of retail financial institutions which have changed significantly during the 1980s.

In the context of this new competitive environment funding operations

of both banks and specialist housing finance institutions have changed. Both have been influenced by the pace of financial innovation and for both the growing internationalisation of finance has had a powerful impact.

One of the features of the new competitive environment is that funding structures of different types of institution are moving closer together. Traditionally, British building societies, for example, have funded exclusively in the retail deposit market and first entered wholesale money markets only in the early 1980s. On the other hand, banks developed their liability management techniques in the 1970s predominantly in the wholesale markets rather than the personal sector savings market.

This has now changed as building societies have entered both the domestic and international wholesale money and capital markets while banks are seeking to increase the proportion of funds secured in the retail sector. This in turn has inevitably had a powerful impact on the structure of interest rates (in particular raising the relative cost of retail funds compared to wholesale funds) and must be a factor to be taken into account by building societies.

There has therefore been a significant competitive change in what has traditionally been the societies' major source of funding: the retail deposit and savings markets. There are many reasons why societies have, and should continue to, reduce their dependence upon the retail deposit market and should widen the source of funds.

Because of the competitive environment the retail sector is no longer a comparatively cheap source of funds (for either banks or building societies), the volatility of retail deposits has increased for the same reason and the average maturity of retail deposits has declined. In general it is difficult to secure long-term funds in the retail sector, and wholesale market funding also frequently offers more flexibility in terms of maturity and amount.

However, overwhelming the detailed considerations is the fundamental issue of portfolio diversification. In addition to the advantages — in terms of cost, maturity and other special characteristics — to be secured through mixing the different characteristics of alternative funding is the general presumption that the greater the variety of sources (espe-

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cially if this involves different sectors of funding, where market conditions may vary and change differently) the more stable will be the total volume of liabilities to any institution.

This is equally true for building societies which are seeking to reduce their exposure to the retail market as it is for banks, which are seeking to reduce their dependence on wholesale funding. Standard portfolio analysis recognises that just as an institution is generally more secure with a diversified asset structure, so too a diversified liability structure involving less dependence on a particular source of funds or sector enhances the stability of the balance sheet.

This is a particularly powerful consideration when market conditions in the dominant component have changed adversely, as has been the case with building societies in the retail deposit market. Prudence requires a diversified liability structure, and this advantage has increased over the past few years due to a new competitive environment influencing conditions in the societies' dominant funding market.

This represents a powerful case for building societies to continue to widen the source of funds and the methods and instruments used in their funding operations.

Financial innovation has greatly increased the range of financing facilities and instruments available to all institutions. The development of new instruments, techniques and markets has accelerated over the past few years. Developments in technology has also widened the range of services and instruments on offer.

Overall, the range of financing options and techniques now available in financial systems is infinitely wider and many of the techniques (such as interest rate and currency swaps) were not heard of only a few years ago. Financial systems have proved to be exceptionally innovative and in some cases new markets have been created.

All of these considerations have an international as well as domestic dimension. One of the central characteristics of structural change in financial systems noted earlier has been the general internationalisation of finance. As the operations of financial institutions and funding and investing options become less restricted to domestic financial systems, so national systems become sub-sets of a global financial system with a consequent increase in efficiency of financial intermediation.

In the broad sweep of the history of finance, a clear, long-run trend has been for the domain of financial intermediation to widen; *regional* displaced *local* mechanisms in the early stages of the development of financial systems and in turn *national* mechanisms became dominant.

The current phase of evolution, extending the process to its logical conclusion, is the international dimension. International options (for both funding and investment operations) are becoming increasingly viable for an ever-widening number of transactors through the effects of technology in reducing transactions costs, and offering more efficient access to information and communications systems.

Historically, the role of technology in offering cheaper and more efficient access to information, communications and trading systems, with the effect of reducing transactions costs, has been a major factor in the widening geographical domain of financial operations. What technology does in finance is to make location an increasingly irrelevant consideration in the pattern of funding and investment operations of financial institutions and their customers.

The international dimension of finance emerges at three levels: (i) neither savers or borrowers are restricted to mechanisms located within their own country; (ii) the suppliers of financial intermediation services are not restricted to business within their domestic economy, and (iii) financial institutions have the option of locating outside their own country. In all three respects finance has become increasingly internationalised.

In the process national financial intermediation and financial systems are becoming sub-lets of a global financial system. Competition in finance has become global and there is no longer a presumption that funding operations are most efficiently or cheaply conducted within the domestic financial system.

New markets, instruments and facilities have been developed in international markets, and techniques (such as swaps and options) have been refined to eliminate the extra risks incurred when institutions borrow in foreign currencies.

In effect, given the variety of techniques and instruments available in international markets, funding operations are likely to be more efficient the larger is the number of options considered.

It was indicated at the outset that financial systems in many countries are in a phase of structural change, in some cases as powerful as ever before experienced. The common theme is *integration* and an erosion of traditional demarcations.

This has been identified at three levels: retail and wholesale markets are becoming less segmented; different types of financial institutions are becoming less rigidly differentiated; and national financial systems are developing as sub-sets of a global and increasingly integrated financial system where national boundaries are becoming less constraining.

All financial institutions are affected by these trends not least with respect to the development of efficient funding operations. ■

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Money makes the world go round

The international capital market is the world's largest source of new financing. Stephen Hester, of Credit Suisse First Boston, examines how housing finance institutions can use the market

THE international capital market, or Euro-capital market, now represents the world's largest source of new financing. The market originated in the early 1960s following the imposition by the US government of controls on outflows of capital from the US. The restrictions led to a transfer of dollar financing activity and expertise offshore, principally to London. Subsequently, the activity spread across borders and across currencies worldwide.

The success of the international capital market is based on its continuing ability to meet the needs of investors, borrowers and financial intermediaries alike in more attractive and effective ways than existing domestic capital markets. The increasing level of cross-border investment and, in the 1980s, a global trend towards deregulation of financial markets have provided powerful new stimuli to growth of the international capital market.

The scale of the market can be illustrated by the annual volume of new issues of Euro-securities. This has risen from $US148 million in 1963 to $US135.7 billion last year and a much larger volume expected for 1986, demonstrating the dramatic increase in use of this market by borrowers in preference to their own domestic capital markets. The graph provides further evidence of the market's breadth, illustrating the growth in issuance of non-dollar securities through the Euro-market system and, more recently, the remarkable increase in distribution of equity through this same channel.

Investors

The international capital market has been able to offer investors a large supply of high quality investment securities — initially interest-bearing but increasingly also equity securities and a variety of more sophisticated hybrids. It also has a delivery system tailored to the characteristics and needs of individual investors through effective use of tried and tested local distribution systems such as the branch networks of major continental banks.

In addition there has developed, for the sophisticated institutional investor and financial intermediary, a global 'over-the-counter' distribution system (operating by telephone) that has emphasised low-cost, fast provision of investment opportunities.

Securities that are bearer rather than registered, and free of withholding taxes, eliminate many of the complex and costly impediments that investors worldwide have found investing directly into local capital markets abroad.

The international capital market, despite the lack of formal regulation and investor protection mechanisms, has enjoyed enviable credit characteristics. The principal reason is undoubtedly investor conservatism that has restricted the great bulk of issues to high quality corporate, bank or sovereign investments. This contrasts with the poor experience of international commercial bank lending during recent years. Investors also enjoy a full range of instruments in each major currency. Since the advent of floating exchange rates, the critical decision in international investment has been that of currency. Investors have therefore remained conservative judges of credit risk since investment performance is seldom determined by lowering investment quality in search of a small yield improvement.

Borrowers

High quality borrowers of all types and nationality have used this market which offers them: the greatest quantity of funds available on, generally, the most advantageous terms; an absence of costly and restrictive regulation enabling instant access to funds; in general, absence of the extensive financial covenants frequently demanded in domestic markets; great flexibility to tailor the structural characteristics of debt to fit particular financial needs; a highly innovative and responsive product delivery system.

The seeming complexity of new financing techniques which receive widespread publicity is largely illusory. Most 'new' structures simply represent different combinations of existing instruments and techniques previously applied in other situations and other capital markets. Clearly, at

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a price, most financial combinations are possible. Nevertheless generally the optimum securities financing offers an investor a simple, easily understood credit, currency and interest rate decision. Simultaneously, a 'private' financial structuring, frequently using currency and interest rate swaps and different forms of options, may transform the securities obligation into a form preferred by the borrower.

The international capital market has traditionally been dominated by fixed and floating rate debt securities of short to medium term maturity. Lately we have seen the successful development of markets for longer-term debt instruments of 20 years to perpetuity ($US16.1 billion in new issues in 1984 and 1985).

The full range of equity and equity-linked securities has increasingly been issued encompassing pure equity, preference shares, convertible debt and equity warrants (options). New issues in these categories have aggregated $US16.7 billion in 1986 to date up from $US5 billion in 1983. Clearly for many lesser known borrowers, these issuing opportunities are restricted. Nevertheless within the last two years the international capital markets have provided equity, convertible bonds, perpetual debt and long term debt to many financial institutions ranging from Barclays Bank, Citicorp and Nationwide Building Society to Calfed, H. F. Ahmanson and the Prudential Corporation plc.

Currencies

The key benefits which a range of currency markets present are:

The ability for many borrowers to finance on terms hitherto unavailable in their own domestic currency. An excellent illustration is the £3,285 million raised by British building societies in the last 12 months through Euro-sterling bonds and floating rate notes. Finance has been raised at rates well within the cost of retail savings deposits and yet for maturities ranging from seven to 15 years. During the same period domestic corporate bond issues totalled well under £1,000 million.

The ability to exploit comparative advantages in different currency markets arising from variations in investor credit perceptions or rarity value. By use of a currency swap funds may often be raised on superior terms through foreign currency issue which is fully hedged into the domestic liability required.

Ultimately the availability of finance in other currencies will assist international expansion by housing finance institutions by effectively counteracting the entry barriers that entrenched retail deposit gathering networks have represented hitherto.

The principal interest rate alternatives are fixed interest rates or variable rates usually linked to interbank deposit rates — the so-called floating rate note. In addition, more complex structures such as deep-discount securities and instruments where capital appreciation is linked to other indices or prices (eg, oil) have been possible for select borrowers in order to exploit particular investor preferences.

The floating rate note (FRN) market in particular has opened substantial new opportunities to financial institutions. In 1985 $US55.75 billion equivalent of FRNs were issued up from $US6.7 billion in 1981. The FRN offers financial institutions for the first time the ability to manage their balance sheet assets through the acquisition of a tradeable security. In turn the liquidity of the market has encouraged many other risk averse investors ranging from central banks to large corporations and managers of liquid assets who hitherto held this liquidity with the banking system.

Most housing finance institutions rely for the bulk of their funding on retail deposits on which interest rates will vary and maturities are generally shorter than the assets financed. For many such institutions the FRN market now offers large quantities of low cost medium to long term funds that allow much greater stability to be built into the balance sheet.

Security

In general, as previously mentioned, the international capital market has been highly credit and name sensitive and has offered only restricted opportunities to many housing finance entities. This still remains the case. Nevertheless the larger and more liquid segments of the market have developed the sophistication to accept both high quality direct credits (such as the UK building societies) and credit substitutes, most notably secured debt obligations.

The FRN market which typically comprises the most financially sophisticated investor has been the first to accept collateralised debt. Substantial new opportunities have therefore arisen for housing finance originators whose assets are generally among the most creditworthy available to the financial system, yet who are, for reasons of size or financial strength, unable to borrow unsecured funds in this market.

In 1984-86 $US6 billion equivalent has been raised in the form of international securities secured by mortgage assets. The international capital market has not yet developed much demand for the type of mortgage-backed securities issued in the US domestic markets. Nevertheless, investors in fixed rate bond markets are likely to become more receptive to this type of offering over time.

Swaps

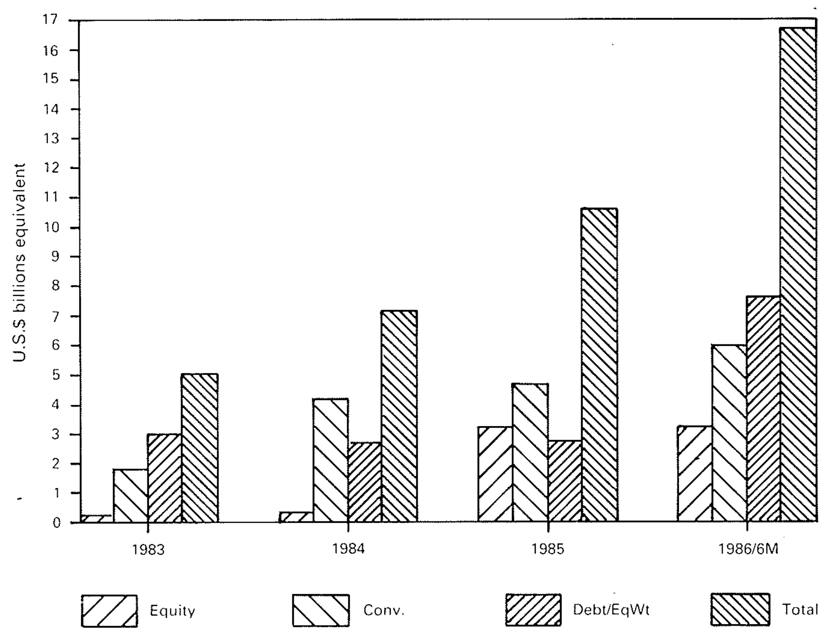
More than any other technique, the growth of the market in currency and interest rate swaps has revolutionised use of the international capital market.

A swap is simply the agreement of two counterparties to cover each other's payment obligations at agreed rates for an agreed period of time. This allows a borrower great freedom to use the type of borrowing that, relative to others, will obtain his maximum comparative cost advantage. Through the use of swaps the borrower can find a counterparty to cover his liability under the borrowing in exchange for an equivalent liability conforming to his desired borrowing structure (ie, a different currency or interest rate configuration). The comparative advantage of the first borrowing provides the margin necessary to entice a counterparty offering attractive borrowing costs in exchange for a matching liability in the desired form.

The swap market has grown from $US20 billion equivalent in 1983 to $US150 billion last year. It has been estimated that 60% of all new fixed rate bond issues are now linked to swaps. Many housing finance entities make heavy use of their own domestic bond markets and the swap allows a diversification of funds to complement these traditional sources of finance. However, it is important to recognise that most housing finance entities are not well known outside their own markets, not least because their business is seldom multinational. For such borrowers international markets may be slow to offer comparative advantage and currency swaps will offer only limited sources of new funds. In particular, the swap market outside dollars is frequently imperfect and illiquid, offering only restricted supply of funds.

Equity and equity-linked eurobond

New Issue Volume



Options

As the international capital market has developed a whole range of more sophisticated financial tools have been used, frequently adapted from the US domestic market. These tools essentially represent a range of options over currency, interest rates, maturities, equity, etc. In many cases, investors are willing to pay more for an option than a borrower perceives to be his 'risk' in writing the option. The swap markets have also been able successfully to insure issuers against the exercise of such options sometimes at a low enough price to produce an attractive funding opportunity.

The simplest forms of options are investor 'put' options and borrowers' 'call' options, both regular features of many capital markets issues. The former offer investors effectively a future interest rate option for which they are prepared to pay a premium. Such premium may be attractive to a borrower who can contemplate some uncertainty on debt maturity. Options have also been successfully securitised and sold as warrants.

Equally, the US savings and loan industry has been a heavy buyer of interest rate ceilings. The demand for these allowed $US6 billion of new floating rate note issues with interest rate ceilings last year. Issuers sold the 'ceiling' privately as the proceeds more than compensated for higher rates demanded by investors in these instruments. The borrower thereby achieved a cheaper funding cost, and the ceiling buyer acquired an important new tool for managing business risk.

The international capital market has become a vital alternative and complement to traditional domestic fund raising. The importance of this alternative lies both in the additional sources and structures of finance offered and in the market practices and techniques that are fast changing domestic capital markets. No major user of capital can ignore these markets as a source of competitive finance. ■

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A stable source of funds for UK building societies

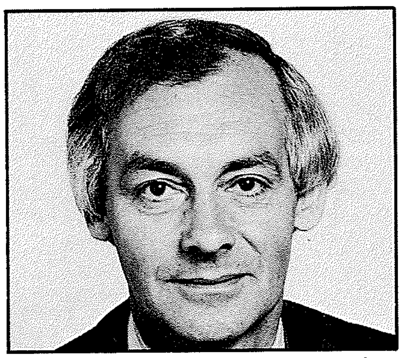
Eurobond markets are making a valuable contribution to societies' inflow, as Brian Phillips explains

BUILDING societies were originally formed in the latter part of the 18th century by individuals who joined together to subscribe to a fund in order to build or buy houses for themselves. The activities of these terminating societies were limited in that once all the members were housed, the society was disbanded.

Terminating societies were gradually replaced by permanent societies which not only raised money by issuing shares but also accepted deposits from people who were looking for a return on their investment rather than the opportunity to purchase property.

Following these early developments societies steadily increased their activities by encouraging both savings and home ownership, but it was the 1970s which saw the demand for mortgage loans increasing sharply as inflation pushed up house prices and more and more people sought to become home owners. Between 1970 and 1980 the number of borrowers increased from 3.7 million to 5.4 million, the number of societies' branches from 2,000 to 5,700 and the number of share accounts from 10 million to 30 million.

The demand for mortgage loans continued to exceed the supply despite the steps taken by societies during the 1970s to attract additional funds. First, term shares paying premium rates of interest for a fixed period were introduced to attract longer-term investments.



Subsequently, accounts paying higher rates but subject to a period of notice prior to withdrawal were launched. Although subsequent changes allowed premature withdrawals from fixed period investments and reductions in notice periods on other accounts, sufficient funds could not be attracted at reasonable interest rates. Societies therefore began to turn to the wholesale markets to increase their funding.

First, in 1980 funds were raised through syndicated bank loans, closely followed by the issue of building society bonds. In 1983 societies issued Certificates of Deposit for the first time, and started accepting Time Deposits. Following the recent issues of Eurobonds wholesale funds now represent 6.5% of total liabilities.

Regulatory reform allowing Eurobond market to be used

UK taxation laws changed in 1984 to allow companies to pay interest gross on Eurobonds and The Building Societies Association made representations for similar powers to be extended to building societies. Subsequently in the 1985 Budget, the Chancellor of the Exchequer announced that building societies would be allowed to pay interest gross on quoted Eurobonds to non-UK resident holders after 5 April 1986.

As a result, following the publication of the 1985 Finance Bill, societies were able quickly to launch their first Eurobond issues in September 1985. The only pre-requisite was that the first interest payment should be due after 5 April 1986.

The interest on quoted Eurobonds would normally be subject to UK income tax by direct assessment on the recipient non-resident holder of the bonds. However, as with other gross interest payments to non-residents, a UK Inland Revenue Extra-Statutory concession (No. B13) effectively means that no action is taken to pursue such tax liability in most circumstances, so long as the beneficial owner of the interest is not resident in the UK and has no assessable branch or agency in the UK. An example of an exception to this is where the tax can be recovered by a set-off on a claim to relief in respect of taxed income from other UK sources.

The legislation allowing building societies to utilise the Eurobond market for their funding is, therefore, a fiscal measure. In addition, however, and once again following representations by the BSA and backed by favourable legal opinion, the Registry of Friendly Societies issued a gui-

Building Society Eurosterling Issues

Date	Society	Initial Amount £m	Term Years	Lead Bank
1985				
September	Halifax	150	7	Morgan Grenfell
	Nationwide	200	10	Credit Suisse First Boston
	Abbey National	150	15	Samuel Montagu
	Bristol & West	100	7	County Bank
October	Britannia	75	8	Hambros
	Alliance & Leicester	150	8	Warburgs
November	Woolwich	200	5	Hambros
December	Anglia	100	8	Morgan Guaranty
1986				
January	Halifax	200	10	Morgan Grenfell
February	National & Provincial	200	10	Goldman Sachs
March	Leeds Permanent	50	5	Baring Bros (swap)
	Halifax	50		Morgan Grenfell (swap)
	Nationwide	75	7	Credit Suisse First Boston (swap)
	Bradford & Bingley	100	10	Credit Suisse First Boston
	Alliance & Leicester	60	5	Warburgs (swap)
	Leeds Permanent	200	10	Baring Bros
April	Halifax	200	8	Morgan Grenfell
May	Leeds Permanent	50	7	Baring Bros (swap)
June	Alliance & Leicester	50	7	Salomon Brothers
	Abbey National	200	7	Samuel Montagu
	Britannia	25	7	Hambros
	Nationwide	250	10	Baring Bros
	Alliance & Leicester	300	8	Morgan Guaranty

dance note on 5 March 1986 stating that a sterling fixed rate bond issue swapped into floating rate would be permissible. Societies have since made several issues when "windows" in the market have opened to make such issues favourable.

Why societies are using the Eurobond market

There are a number of reasons why societies have entered the Eurobond maket, the main one being to provide access to a new and very much wider source of funds than has been possible through the domestic retail and wholesale markets. This attraction will increase if societies are permitted to tap the foreign currency markets following the building societies' legislation recently enacted by Parliament.

Any funds raised in a foreign currency may readily be converted through the swap mechanism into variable sterling interest rates and the final cost could be below the London Interbank Offered Rate (LIBOR). In this way funds can be raised from a worldwide spread of investors ranging from large institutions to wealthy individuals who find the Eurobond market attractive.

Another attraction of the Eurobond market to building societies is the life of the loans — varying between five and 10 years—which is a good match for mortgages which have an average life of seven years when account is taken of early redemptions. Eurobonds have therefore led to an improvement in building society capital structures in addition to reducing the administrative costs associated with shorter-term funding.

The variable interest rates — after swaps in the case of fixed rate issues, which are usually linked to three month LIBOR — are also an attraction. These fit in well with the variable interest rate nature of societies' balance sheets and mortgage lending policies. This avoids a high level of interest rate exposure without the need to seek cover in the futures market or through other interest rate exposure management tools.

Furthermore, the ability of societies to raise large sums at short notice through the market is particularly attractive to societies seeking to respond quickly to the increased demand for mortgages that so often occurs when UK interest rates fall sharply.

Building societies entered the Euromarket for the first time in October 1985, with four societies raising £600 million between them from the issue of Floating Rate Notes. First was the Halifax on 2 September 1985, with a £150 million issue, followed by Nationwide three days later with the largest-ever issue of £200 million. Abbey National was close behind with £150 million, as was Bristol and West with £100 million.

Societies generally adopted the procedure of appointing a "lead bank" to manage the issue, organise other banks which would agree to participate with the help of one or more co-lead managers and advise generally on the issue, particularly on terms. For the first few societies this was a challenging task as British building societies needed to be "sold" to investors who were largely unaware of societies' existence and certainly unaware of their financial structure.

Undoubtedly, the London branches of the major overseas institutions helped in this task and the European and Far East Roadshows in which most of the leading building societies have participated have maintained investors' interest. So successful was the initial marketing campaign that the three largest societies paid an interest rate of only 1/16% over LIBOR. They paid 40 basis points to the lead managers to cover issue expenses and the commissions payable to other institutions for the inevitable risks between launch and issue, as no underwriting fees as such were paid.

On settlement day the societies received the cash and then were reliant on the lead managers, co-lead managers and other institutions to continue to support their issues in the secondary market — further issues on the same or similar terms would otherwise be impossible.

Following the initial issues in October most of the other leading societies entered the market by June 1986 as shown by the table. The five fixed rate issues listed in the table (Swap) have enabled societies to raised £285 million at interest rates close to or below LIBOR. This has increased the total funds raised in the Eurobond market to £3.1 billion.

With the prospect of foreign currency borrowings next year, the Eurobond markets look set to continue to provide a cost-effective means of securing stable funds for the UK housing market in the future ■.

Brian Phillips joined Nationwide Building Society from Local Government in 1967. He has served on a number of BSA committees and, in 1980, chaired a committee on marketable securities.

US housing credit agencies forge an international connection

New instruments from government-sponsored agencies have helped familiarise overseas investors with US housing finance securities, as Leland C. Brendsel reports

HOUSING credit agencies sponsored by the US government — Fannie Mae, Freddie Mac, and the Federal Home Loan Banks — have done some trailblazing abroad over the past two years. They have issued a wide variety of securities overseas, some of which were totally new instruments to the international market.

These offerings have broadened the agency financing base and helped reduce costs, but, more importantly, they have served to familiarise overseas investors with US housing finance and mortgage securities. As a result, agency efforts are clearing the way for other institutions to attract international capital to the US housing market.

Fannie Mae, the Federal Home Loan Banks and Freddie Mac — who are they?

These agencies, established by the US government to enhance mortgage credit availability and to establish the secondary mortgage market, must seem peculiar animals to most overseas investors. They are neither public nor private entities, but uniquely combine public and private features.

Each of the agencies is privately owned and financed, but has close ties to the US government. These include a direct or indirect line of credit with the US government, exemption from Securities and Exchange Commission registration requirements, and favourable treatment of their securities held by depository institutions.

'Debt issues targeted to foreign investors'

Despite the fact that agency securities are not guaranteed by the federal government, investors perceive them to be virtually as safe as US Treasuries because of federal sponsorship. This results in lower borrowing costs than would be available to similar private institutions, generally 15 to 30 basis points above yields on similar maturity US government securities.

There are, however, costs associated with agency status. These entities are subject to supervision by the US government, and must adhere to numerous constraints on business operations and financing techniques.

Fannie Mae was created in 1938 to provide a secondary market in federally underwritten mortgages. Originally part of the federal government, it was converted to private ownership in 1968. Fannie Mae is now a federally chartered private corporation whose shares are traded on the New York Stock Exchange.

Fannie Mae has developed the secondary mortgage market primarily by investing in mortgages. It purchases mortgages (today both conventional and federally underwritten) from originators, and finances these purchases by issuing debt on the private capital markets, thereby providing the mortgage market with additional funds from the capital market. Fannie Mae has become the largest single investor in home mortgages in the US. At the end of 1985, its mortgage holdings totalled $95 billion, and comprised 96% of Fannie Mae's assets.

Fannie Mae's long-term, generally fixed-rate, mortgage portfolio has typically been financed by debt of much shorter duration. When interest rates rose sharply during the early 1980s, this mismatch resulted in substantial portfolio losses, and led Fan-

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nie Mae to make significant changes in its operating strategy.

The corporation now places greater emphasis on shorter-term and interest-sensitive mortgage investments (second mortgages and adjustable-rate mortgages (ARMs)), the issuance of mortgage-backed securities, and long-term fixed-rate financing. A substantial part of its recent long-term debt issues have been targeted to foreign investors, especially to the Japanese.

The 12 regional federal home loan banks are operational arms of the Federal Home Loan Bank Board (FHLBB), an independent federal agency responsible for regulating US thrift institutions. The Banks carry out FHLBB policies and provide credit

'Freddie Mac has purchased $145 bn in mortgages'

facilities for member thrifts, by whom they are owned. US thrifts are primarily mortgage lenders. Consequently, the federal home loan banks, their source of back-up credit, are considered to be a housing credit agency.

Loans to thrifts (termed advances) form the largest category of federal home loan bank assets — $89 billion of $112 billion in total assets at year-end 1985. Since advances are available in a wide range of maturities, thrifts use them both for short-term liquidity and for long-term objectives such as business expansion and maturity matching of fixed-rate mortgage investments. Most advances are collateralised, typically with mortgage loans.

The federal home loan banks accept deposits from member institutions, but their principal source of funds is the sale of consolidated obligations, which are "the joint and several obligations of all 12 federal home loan banks." The bulk of these obligations are bonds with typical maturities of six months to 10 years. At the end of 1985, outstanding consolidated obligations totalled $76 billion.

Freddie Mac was created by the Federal Home Loan Mortgage Corporation Act of 1970 to develop a secondary mortgage market for conventional mortgage loans. The corporation is regulated by a three-member board of directors, who also serve as the FHLBB. Its stock is owned by the federal home loan banks and by member thrift institutions.

Freddie Mac has built the secondary mortgage market in a manner quite different from Fannie Mae. Rather than acting as a mortgage portfolio investor, Freddie Mac buys mortgages, pools them, and sells mortgage securities backed by these loans. Fannie Mae has served as a source of mortgage funds, while Freddie Mac has concentrated on developing tradeable mortgage securities.

Mortgage purchases are financed primarily by issuing Mortgage Participation Certificates (PCs), which represent undivided interests in a pool of mortgages, and provide for monthly pass-through of principal and interest to the investor. Freddie Mac guarantees the timely payment of interest and ultimate repayment of principal. In addition to its staple product, the standard 30-year fixed PC, Freddie Mac now issues PCs backed by 15-year mortgages, ARMS, and multi-family mortgages.

In 1983, Freddie Mac introduced a new financing vehicle — the Collateralised Mortgage Obligation (CMO) — designed to attract new investors to the mortgage market. These mortgage-backed instruments feature multiple classes, each with a different coupon and maturity. Interest on each tranche is paid semi-annually, but all principal repayments flow to the shortest outstanding tranche until it is fully repaid.

This tiered structure gives investors a choice of maturities, and a measure of call protection. The CMO has become an extremely popular instrument. In addition to the $6 billion sold by Freddie Mac, private firms have issued approximately $35 billion in CMOs.

Freddie Mac's impact on the mortgage market is inadequately measured by its asset size because the sale of PCs removes pooled mortgages from the corporation's balance sheet. Although total assets at the end of 1985 were only $16 billion, mortgage purchases during that year alone were $44 billion. Since its inception, Freddie Mac has purchased $145 billion in mortgages, and has issued $132 billion in mortgage securities.

Agency entry into foreign capital markets

The July 1984 repeal of the 30% withholding tax on interest paid to foreign investors encouraged both private firms and US housing agencies to seek foreign funds. However,

'A new class of securities was created'

unlike private companies, the agencies were prohibited from issuing bearer securities abroad.

Instead, the US Treasury Department created a new class of securities, "targeted registered", for use by the US government and federally sponsored agencies. While these issues require some certification of non-US ownership in order to hamper tax evasion efforts, the Treasury hoped that the structure would allow sufficient anonymity to appeal to foreign investors.

Since tax repeal, these three agencies have tapped overseas markets for approximately $3.5 billion through both regular registered and targeted-registered offerings (see table). Their immediate objectives have been much the same as those of private firms issuing securities abroad — cost savings and diversification of funding base. But these agencies are also keenly aware that their current efforts are serving a broader, long-run goal, that is, global access to capital for US housing finance.

Securities issued by US housing agencies

The three agencies exhibit dramatic differences, both in the type and volume of foreign security issuance. These result from the fact that each agency has unique needs and operating strategies.

Fannie Mae has utilised the international market far more extensively than have either Freddie Mac or the federal home loan banks. Its foreign issues have been an important means of lengthening debt maturities, thus reducing the duration gap between its assets and liabilities.

'Focus on the Japanese investor'

Fannie Mae entered the overseas market in 1984 with two global issues of long-term zero coupon bonds. During 1985, the corporation issued $1.2 billion in securities targeted to foreign investors, comprising a wide array of instruments — Eurodollar and Euroyen bonds, dual-currency Euroyen bonds, Samurai bonds and a yen-syndicated loan. It issued the first yen-denominated security in the US securities market in 1985, and this year was the first company to offer a dual-currency Shogun bond. All these issues have featured a fixed rate and a seven or 10 year maturity.

Fannie Mae's international focus has clearly been on the Japanese investor, who has a preference for the

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Foreign-targeted and non-dollar denominated securities issued by United States housing agencies

Date	*Instrument*	*Amount (Currency Units in millions)*	*Term in Years*	*Coupon %*
	Federal Home Loan Banks			
Dec 1984	Euro-dollar bond	$200	5	11.00
Feb 1986	ECU bonds (domestic)	100 ECU ($90 equivalent)	10	8.75
April 1986	Dual-currency yen redemption bonds	25,000 yen ($140 equivalent)	10	7.50
	Freddie Mac			
Sept 1985	Multifamily Plan B Mortgage Participation Certificates	$100	15	10.75
Nov 1985	Collateralised Mortgage Obligations,			
	Series I, Class I-5	$100	10 (1)	10.00
	Class I-6	$250	13 (1)	10.125
April 1986	Collateralised Mortgage Obligations, Series K, Class K-5	$83.925	26 (1)	7.76
April 1986	Collateralised Mortgage Obligations, Series L, Class L-5	$200	15 (1)	7.90

Date	*Instrument*	*Amount (Currency Units in millions)*	*Term in Years*	*All-in Cost (2) %*
	Fannie Mae			
June 1984	Zero-coupon bond (global issue)	$6,000 ($210 proceeds)	30	11.50
Sept 1984	Zero-coupon bond (global issue)	$6,700 ($210 proceeds)	35	10.22
Dec 1984	Euro-dollar bond	$300	7	11.57
Feb 1985	Euro-yen bond	50,000 yen ($192 equivalent)	7	10.93
Sept 1985	Dual-currency Euro-yen bond	50,000 yen ($209 equivalent)	10	10.40
Sept 1985	Samurai bond	25,000 yen ($103 equivalent)	7	10.41
Sept 1985	Euro-dollar bond	$300	7	10.35
Oct 1985	Dual-currency Euro-yen bond	40,000 yen ($182 equivalent)	10	10.54
Oct 1985	Domestic yen bond	30,000 yen ($138 equivalent)	7	10.52
Dec 1985	Syndicated yen loan	16,000 yen ($80 equivalent)	7	9.25
Mar 1986	Dual-currency yen redemption debentures	27,000 yen ($147 equivalent)	10	8.13
Mar 1986	Dual-currency Shogun bond	27,000 yen ($150 equivalent)	10	7.91

(1) Stated maturity is the date by which principal must be fully repaid. The weighted average lives of the CMOs are: Series I, Class I-5, 9.0 years; Series I-6, 11.5 years; Series K, Class K-5, 14.6 years; and Series L, Class L-5, 12.0 years.
(2) All-in cost is currency-swapped cost on non-dollar denominated issues.

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safety of US government and agency issues, for longer maturities, and who does not require bearer form. As the yen's rise has made dollar denominated securities less attractive to the Japanese, Fannie Mae has responded with yen-denominated offerings, simultaneously swapping the proceeds into dollars.

Fannie Mae is also a major player in the international interest rate swap market, which has proven a cost-effective means of extending their debt maturities. Outstanding swap agreements, most with foreign sovereigns or sovereign-related counterparties, totalled $3.4 billion at the end of 1985.

Measured by the volume of issuance abroad, the federal home loan banks have been more cautious

'Cost-effective means of extending debt maturities'

in approaching the international market. Only three issues, totalling approximately $430 million, have been specifically designed for foreign investors. However, two of these were very innovative instruments: a domestic ECU denominated bond and a dual-currency yen redemption bond.

The latter is a version of a "heaven and hell" bond, featuring a premium coupon (heaven), and a redemption price based on the yen-dollar spot rate at maturity, which at very high yen values can mean no principal is returned (hell). For both the ECU and yen issues, currency swaps with high quality counterparties were arranged in advance.

While some Freddie Mac domestic debentures were sold abroad in 1984, the corporation did not issue foreign-targeted securities until September 1985. During the past year, Freddie Mac has launched some landmark securities, including the first mortgage pass-through securities and the first CMO ever offered abroad.

The issuance of pass-through securities abroad was stalled by an

'Version of a heaven and hell bond'

uncertain tax status until August 1985, when the Treasury ruled that these instruments (if backed by mortgages originated after 18 July 1984), were not subject to the 30% withholding tax. Freddie Mac responded by issuing $100 million of an $800 million Multifamily Plan B PC in the Euromarket in targeted-registered form.

These PCs have a shorter maturity and greater call protection than standard pass-throughs, features designed to appeal to the foreign investor. The multifamily mortgages

'Freddie Mac's sights on Japanese investors'

pooled for this issue have an orignal maturity of approximately 15 years, a lockout feature prohibiting prepayments for almost five years, and a provision for penalties on principal prepayments following the lockout period.

In November 1985, Freddie Mac took its CMO product abroad. Of a $1 billion offering, two tranches totalling $350 million, and having maximum average weighted lives of nine and 11.5 years, were targeted to Europe and Japan, respectively. The CMO's tiered maturity structure allows such targeting to the maturity preference of specific international markets. This year Freddie Mac again set its sights on the Japanese investor with overseas issuance of two longer CMO tranches totalling $284 million.

Freddie Mac's issues represent an important first step in creating an international market for mortgage-backed securities, but the process will be lengthy and will require intensive educational efforts. PCs and CMOs are still a "hard sell" abroad, because of their complexity, their seemingly uncertain returns, and, above all because foreign investors remain unfamiliar with US mortgages.

But foreign acceptance will come, helped by the Euromarket's evolution

'Foreign investors unfamiliar with US mortgages'

from a retail investor market to one dominated by sophisticated institutions. It is encouraged by the international market's growing appetite for instruments containing call risk and uncertain returns, such as convertible bonds and bonds with warrants. In addition, the sheer size and growth of the US mortgage securities market creates a force that the international investor cannot long ignore. ■

Leland C. Brendsel was named acting president and chief executive officer for the Federal Home Loan Mortgage Corporation (Freddie Mac) in September 1985. He joined Freddie Mac in August 1982, serving as executive vice-president and chief financial officer.

From 1978 to 1982, Mr Brendsel was vice-president and chief economist of the Federal Home Loan Bank of Des Moines. He served as financial economist for the Farm Credit Banks in Washington, DC from 1976 to 1978. Between 1971 and 1976, he was a member of the finance department faculty at the University of Utah.

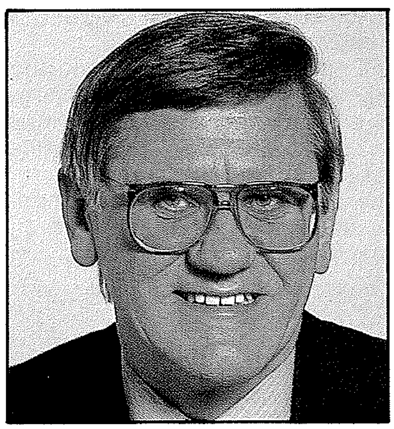
Austrian housing policy: a story of success

Dr Heinrich Ubleis, Austria's Minister for Construction and Technology, describes the housing progress that has been achieved in recent years, and recent policy changes

HOUSING is one of man's fundamental requirements. The provision of accommodation therefore forms part of the responsibilities of the public administration. The basic aim of any housing policy to ensure that everybody can obtain suitable accommodation does not, however, mean an indiscriminate provision of living quarters for everyone, but rather the direction of aid towards those who really need it. This is the guideline of any housing policy for the future.

Changes in economic and sociological circumstances have made a new direction in housing policy necessary. The quantitative deficiency in accommodation after the destruction of the Second World War was largely overcome by extensive rebuilding efforts. It has also been possible, particularly during the last decade, noticeably to reduce the number of flats requiring renovation. Both are a result of the Austrian building legislation for private accommodation, especially in the field of public advancement of private housing.

The Advancement of Private Housing Acts (Wohnbauförderungsgesetze) of 1954 and 1968 made it possible to attain a volume of new buildings which is high even compared with international standards. In the 1970s the completion of houses reached the respectable figure of an average of 50,000 premises per year. The Housing Improvement Act (Wohnungsverbesserungsgesetz) has also contributed decisively to an increase in the standard of accommodation.



'Building societies have made an enormous contribution'

The belief that all problems can be solved by a large volume of new buildings has been proved wrong. During recent years scepticism has grown towards the new buildings euphoria of previous decades. People often feel uncomfortable in their new housing environment and communication between the occupants does not function properly. New housing policy now has the duty to draw the appropriate conclusions from these developments.

A first step towards such rethinking was taken by the two new Federal Construction of Houses Acts (Bundeswohnbaugesetze), ie, the Advancement of Private Housing Act 1984 and the Improvement of Private Premises Act. With these two statutes the general policy of advancement of housing responded to the fact that it must perform not only a social but also an important economic and employment task. Public grants are to benefit those who in fact need such help. The improvement of old buildings and urban renewal are the focal points of advancement of housing development.

For the first time it becomes possible through appropriate legislative regulations to relocate financial resources in unlimited quantities from the construction of new buildings to the improvement of old ones. Urban renewal thus ceases to be a mere slogan, and the long overdue measures for the improvement of our villages and towns can come into operation.

The enormous importance of the advancement of housing within the framework of economic and employment policies is mirrored in the resources made available to this sector, which reached a new record height of 21.9 billion Austrian Schillings in 1986. On the other hand, we

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must not forget that the proportion set aside for actual building purposes is falling, and an increasing part is needed for measures supporting the individual in his capacity to afford subsidised accommodation. Expressed in sums, this means that in 1986 out of the 21.9 billion Austrian Schillings almost 25% had to be used for measures which did not benefit the building industry.

Apart from state support for the advancement of housing, the enormous contribution of the Austrian building societies to the economy of our country should not be overlooked. In the owner-occupied house-building sector, financing through building societies plays an important role, aided by public promotion of savings for building purposes, which is part of the general advancement of housing programmes. In future the emphasis will lie also in involving bausparkassen (building societies) to a greater degree in the construction of multi-storey private premises.

The importance of building societies in respect of economic and employment policy can be demonstrated mainly by the fact that about 50% of all existing loans for the construction of accommodation and the improvement of old houses stems from the four Austrian building societies. Furthermore, by guaranteeing a stable interest rate for building loans the building societies have contributed to a high degree of security for loan recipients.

The new advancement of housing policy also gives more prominence to different regional conditions. Simple legal provisions help to facilitate access to support measures.

The publicly-aided building of private housing does not, however, entirely fulfill its socio-political aim since nowadays publicly subsidised housing construction is too expensive. The distribution of subsidies, given existing social criteria, leaves much to be desired, and too little use is being made of the obvious willingness of people to make their own contributions.

Housing policy must therefore concern itself with redirecting publicly-funded housing projects to their proper task, without resulting in a reduction of the amount of accommodation provided.

Over the past decade Austria has held, even internationally speaking, one of the top places with on average a volume of 50,000 newly-erected units of accommodation. The provision of so many new homes certainly cannot be maintained over the next years, since the demand for new accommodation is falling. In future, rather, it will be necessary to improve the quality of accommodation and the housing environment.

Picture courtesy of Austrian National Tourist Office.

Great success has already been achieved in this area resulting, among other things, in a considerable reduction in the number of sub-standard homes. While in 1971 these amounted to more than 30%, in 1985 the proportion of sub-standard accommodation dropped to little more than 9%. Despite this undoubted success, too little attention has been paid in the past to the upkeep of existing accommodation in older buildings. The result has been that flats in good condition are often to be found in houses where the structure is deteriorating.

The removal of this discrepancy falls within the duties of urban and local renewal programmes and associated programmes for the improvement of older buildings.

Every necessary step must therefore be taken to grant this area the priority it deserves. Since a multitude of housing regulations, frequently at odds with each other, impede the efficient use of existing means in this area, it will be up to the Federal Minister for Construction and Technology to give the necessary stimulus through his function as appropriate co-ordinator.

This task, and the implementation of the objective of re-instating prospective tenants or owners of private accommodation in their proper central place when considering housing policy, will be the focal points of all future housing policy. ■

Dr Ubleis has been Federal Minister of Construction and Technology since March 1985. After matriculation in 1953, he joined the Austrian Post and Telegraph Administration. In 1965 he was appointed to the budget department of the general directorate of the Post and Telegraph Administration, and in 1971 moved to the Bureau of the Federal Minister for Transport as secretary to the Minister. In 1979, Dr Ubleis, then under-secretary, was appointed general director of the Post and Telegraph Communication Administration by the Minister of Transport.

Statistical Data

The Houses and Flats Census 1981 showed that in Austria there were a total of 2,763,870 households and 3,052,037 housing units; 2,691,182 of these were permanently occupied. Given a total number of places of accommodation of 366 occupied flats per 1,000 inhabitants, Austria held a position, internationally speaking, in about the middle of the field.

Legal categories of occupied premises in Austria according to the 1985 micro-census are shown in Table I.

Table IV

Average utilised area of completed units of accommodation per year

1971	66 m^2
1981	78 m^2
1984	97 m^2

Table I

Total	Owner-occupied houses or flats	Rented accommodation	Others
2,772,000	1,467,000 = 52.8%	1,108,000 = 39.88%	197,000 = 7.08%

Table II

Austrian private premises built during the following periods

	Austria	Vienna
Before 1919	29%	43%
1919-1944	11%	12%
1945-1960	16%	13%
1961 and later	41%	28%
Not known	3%	4%

Table III

Amenities categories* of continuously occupied private premises (in %)

Year	I	II	III	IV + V
1971	14.8	38.2	16.8	30.2
1981	44.3	32.9	8.7	14.1
1985	52.1	33.1	5.6	9.2

*Amenity categories	Central heating	Bath	Toilet	Water supply
I	Yes	Yes	Yes	Yes
II	No	Yes	Yes	Yes
III	No	No	Yes	Yes
IV	No	No	No	Yes
V	No	No	No	No

Austrian quartet hits a winning note

A look at the contract system operated by the four Bausparkassen in Austria

ABV

Wüstenrot

AUSTRIA'S housing finance market is dominated by four Bausparkassen, each of which is connected with one of the banking groups. The Bausparkassen operate a contract savings scheme in which a period of prior savings is required before a loan is available. Both the savings and the loan carry rates of interest below market rates and the savings benefit from a substantial government bonus. Changes in the bonus rate have led to considerable fluctuations in Bausparkassen activity over the past few years.

This brief survey of the Austrian housing finance system describes the contract system and analyses in detail the operations of the Bausparkassen.

The contract system

In industrialised countries, there are three ways in which house purchase loans can be funded:

By retail deposits attracted on the open market, the system used by building societies and savings associations.

By long-term bond issues and loans, the system used by mortgage banks.

By anticipatory savings of borrowers, the system used by the Bausparkassen in West Germany and Austria and also in the French housing savings system.

The advantages of the contract system are that the clear link between savings and borrowing is established, and the borrower is able to obtain his loan at a below market rate of interest. However, the price that he has to pay for this is that the savings also attract a below market rate of interest. In order to make the system work, a substantial government premium is generally necessary.

Although the Bausparkasse system has the advantage of being closed and therefore relatively immune from general economic fluctuations, in practice, the system must grow continually, as it is the deposits of present investors which are used to fund loans from previous savers. Also, the Bausparkasse system generally cannot provide all of the funds which the house purchaser requires and supplementary funds, generally from the banking system, are required.

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Die Bausparkasse

Raiffeisen Bausparen

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The Austrian Bausparkassen

Like their counterparts in West Germany, the Austrian Bausparkassen originated in the 1920s. There are four Bausparkassen, each of which is connected with one of the four banking groups in the country.

The largest is the **Raiffeisen Bausparkasse** (assets of AS34,750 million ($2,206 million) at end-1985) which is affiliated to the Raiffeisen banks which have an agricultural base and are therefore similar to the credit co-operatives in West Germany and the Crédit Agricole in France. There are over 800 Raiffeisen banks, most of which are very small, and they account for about 20% of the deposits of the Austrian banking system.

Of a similar size is the **Bausparkasse der osterreicheschen Sparkassen** (assets of AS33,176 million ($1,934 million) at end-1985) which is affiliated with the savings banks. There are over a hundred individual savings banks and individually they are much larger than the Raiffeisen banks. The sector as a whole is also larger, accounting for about 30% of deposits in the banking system.

The **Bausparkasse Gemeinschaft der Freunde Wustenrot** which, unlike the other Bausparkassen, is based in Salzburg rather than Vienna, is affiliated with the joint stock banks. It is about a fifth smaller than the two largest Bausparkassen. The **Allegemeine Bausparkasse der Volksbanken** is significantly smaller than the other three Bausparkasse and is linked with the Volksbanken which are smaller credit co-operatives, accounting for under 10% of the deposits in the Austrian banking system.

The Bausparkassen obtain their business partly through introductions from their related banks. They have a comparatively small branch network themselves, with a total of no more than 35 branches.

The Bausparkassen are not subject to banking law, but, rather, are supervised by the Ministry of Finance under the Insurance Supervision Law of 1931. The four Bausparkassen belong to the Arbeitsgemeinschaft osterreichischer Bausparkassen which is based in Vienna.

The Bausparkassen have achieved significant market penetration. Nearly 50% of adults have a building-savings contract and the Bausparkassen finance nearly half of all housing and renovation work.

Austrian Bausparkassen Activity, 1976-85

Year	Savings			Loans	
	New Contracts	Contracts Outstanding	Deposits AS m	New Loans AS m	Outstanding Loans AS m
1976	432,000	1,472,000	38,699	8,071	35,788
1977	417,000	1,547,000	42,645	10,604	41,606
1978	582,000	1,975,000	49,666	15,826	50,704
1979	593,000	2,393,000	62,623	18,923	61,736
1980	308,000	2,466,000	73,583	21,640	75,097
1981	424,000	2,556,000	76,606	18,352	84,924
1982	547,000	2,682,000	75,701	12,816	89,060
1983	619,000	2,913,000	79,722	11,477	90,923
1984	738,000	3,183,000	81,306	12,544	92,817
1985	779,000	3,407,000	83,360	16,393	97,242

Bausparkasse contracts

The Bausparkasse offer four separate savings contracts, details of which are shown in the accompanying table. In each case the rate of interest charged on the loan is 6%, a rate that has been unchanged for 20 years. The savings rate is 3% for the rapid and normal savings contracts, and 4.5% for the slow savings and young persons contracts. The interest in each case is tax-free.

The amount saved must be at least 3% or 4% of the contract sum each year and savings must be made over a period of between 18 months and six years. The maturity of the loan varies from 14 years for the rapid savings contract to 21 years for the slow savings contract and young persons contract. Repayments of the loan vary between 4.5% and 5.5% of the loan amount each year.

The maximum loan is AS1,500,000 ($87,500), and the maximum contract sum is AS2,150,000 ($125,000).

There have been substantial variations in the government bonus rate over the past few years. Until 1979, a bonus of 17% of the amount saved was payable. In that year it was announced that the bonus would be cut to 10% up to a maximum of AS7,000 ($408) per person. This led to a rush of new contracts towards the end of 1979, which in turn has led recently to a huge demand for loans.

The number of new contracts fell back sharply in 1980 before recovering slightly in 1981 and more substantially in 1982. This followed a government decision to increase the bonus to 13% and to raise the maximum to AS8,000 ($466). The bonus has the effect of increasing a 4.5% annual return to 9%.

The number of new contracts has grown rapidly in recent years, rising from a low point of 308,000 in 1980 to 779,000 in 1985 with the total number of contracts outstanding at the end of that year standing at 3,407,000 with total deposits of AS83 billion ($4.8 billion).

The amount lent peaked at AS21,640 million ($1,261 million) in 1980 but then nearly halved to AS11,477 ($669 million) in 1983 but recovered significantly to AS16,393 million ($956 million) in 1985. At the end of 1985 there were over 500,000 loans outstanding with a total value of AS97 billion ($5.7 billion). ■

Bankers to the world

The World Bank is becoming more involved with housing finance systems. Bertrand Renaud examines this and other aspects of the Bank's role

THE World Bank has been a leading economic development institution for 40 years. It has been active in urban development for 15 years and is now becoming increasingly concerned with the sound development of financial systems for housing in developing countries. The following profile of this large and complex organisation focuses on the World Bank as a financial institution and on its activities in housing finance.

THE WORLD BANK GROUP

THE World Bank group consists of three separate legal entities which differ by their objectives, sources of funds and types of operations. However, all three have one central purpose: to promote economic and social progress in developing nations by helping raise productivity so that their people may live a better and full life.

The World Bank or International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA), and the International Finance Corporation (IFC) have three interrelated functions: to lend funds, to provide advice, and to serve as a catalyst to stimulate investment by others. The three institutions are closely associated; both IDA and IFC are affiliates of the IBRD. The IBRD and IDA share the same staff. While IFC has its own operating and legal staff, it shares certain administrative and other services with the Bank. The same person is president of all three institutions.

Of the three institutions, the World Bank, established in 1945, is the oldest and the largest. Currently it is owned by the governments of more than 140 countries that have subscribed to its capital. Only countries that are members of the IMF can be considered for membership of the Bank. Voting rights are defined by the ownership of shares and not on a one-country one-vote basis.

The World Bank as a financial institution

The World Bank — as distinct from IDA and IFC — finances its lending operations primarily through the sale of debt obligations to private investors, financial institutions, and governments. The structure and substance of the Bank's lending operations are different from those of commercial banks. The Bank's loans are different from those of commercial banks. The Bank's loans are tied to specific projects or economic programmes that are evaluated on the basis of their financial and economic soundness. The projects must produce acceptable rates of return and must be of high priority in a country's overall economic development programmes.

The project cycle is a unique activity by which the Bank assists beneficiaries of its loans to prepare and implement projects within the context of agreed development objectives. It is an elaborate process which is fundamental to the quality of the Bank's credit. Since July 1982, World Bank loans bear variable rates adjusted every six months at 0.5% above the average cost of outstanding borrowings, with typical maturities of 17 years and a grace period of four years on principal.

The Bank's experience with respect to its loan portfolio has been excellent without a single write-off in its history. There are two major reasons behind this record. First, the project/programme concept does not leave much room for losses, write-offs, non-accruing loans or rescheduling. Second, there are substantial pragmatic reasons why borrowers do not default on World Bank loans.

In the event of a default, no further disbursement would be made on that loan or on any other loan outstanding but not yet disbursed to the country. Given the substantial amount of the Bank's undisbursed loans, borrowers would be extremely reluctant to take steps which would jeopardise access to future resources.

Further, a default to the Bank would very seriously affect the international credit standing of the country involved. It is also of vital importance to the quality of the portfolio that World Bank decisions continue to be made by professionals strictly on economic and financial grounds.

The World Bank's borrowings operations constitute the major source for financing its lending operations. The Bank borrows about 70% of what it lends. The outstanding debt of the World Bank is presently of the order of $65 billion and annual borrowings amount to about $10 billion. The diversity of its borrowings is unique. Securities are denominated in more than 15 currencies.

The Bank's liquidity policy, whereby short-term liquid assets

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represent about one third of its outstanding debt, gives it considerable flexibility to decide where to borrow, how much, at what cost, and on what terms — possibly for as long as a year. This liquidity base allows the Bank to smooth out the impact of interest rate fluctuations and to minimise the cost of funds to the Bank and to borrowers.

The capitalisation of the Bank is central to its strength as a financial institution and it has some unique features. First, the Bank's lending operations were restricted by its founders in an extraordinarily conservative way. Under the Articles of Agreement, the Bank's outstanding and disbursed loans must not exceed its subscribed capital and reserves — i.e. a ratio of "one-to-one".

This is in sharp contrast to commercial institutions where risk assets often exceed 15 to 20 times their equity base. Currently this statutory lending limit is $74.8 billion and outstanding loans amount to 77% of the limit. The second notable feature of the Bank's capital is the distinction between "paid-in capital" and "callable capital".

Paid-in capital represents only 10% of the subscribed capital, it is available for general operations and no dividends are paid to shareholders. Callable capital, which makes up the remaining 90% of subscribed capital, can be used only for the protection of bondholders.

Such a structure was considered necessary at the end of World War II for the Bank to play its role of leading international financial intermediary between capital markets and foreign borrowers of poorly known credit worthiness.

The financial strength of the Bank and the management of its operations are such that its net income for the fiscal year ending 30 June, 1986 is expected to be of the order of $1.3 billion with two-thirds coming from loans and one-third from investments. Part of this income will be allocated to reserves and the balance will be transferred to IDA in lieu of payments to shareholders.

International Development Association

There is considerable confusion in the market place and in public debates between the World Bank and IDA, in addition to very inaccurate knowledge of the operations of the Bank. The World Bank is the premier credit in the market place and has nothing to do with "the taxpayer's money" as is sometimes wrongly stated in the national press of some countries. On the other hand, IDA is a special fund whose "credits" were initiated in 1960 because, irrespective of cash flow from a project, a very poor country may not be able to generate sufficient foreign exchange resources to service conventional debt while pursuing valid developmental goals.

The World Bank and IDA are legally and financially separate entities in respect of assets, liabilities, and capitalisation. IDA is funded on a three-year cycle with grants from governments. Lending terms are highly concessional: the average loan maturity is 50 years, with a grace period of 10 years, and there is no interest.

The same standards of country and project evaluation apply to Bank loans and IDA credit. Currently 80% of IDA "credits" go to the poorest countries with annual *per capita*

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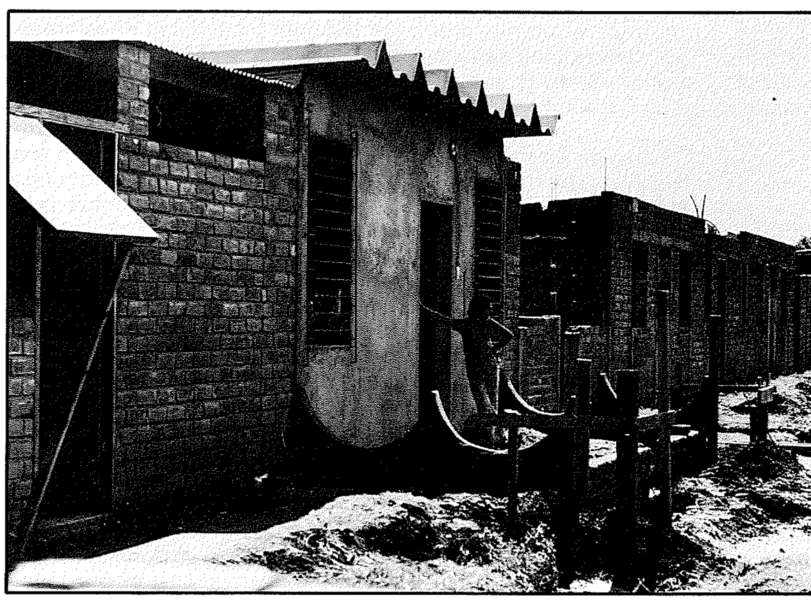

A housing project in El Salvador funded by the World Bank.

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income below $410. All borrowers have *per capita* incomes below $795. In fiscal year 1986, IDA represents 19% of the total planned loan production of the World Bank staff with World Bank loan commitments of $12.8 billion and planned IDA credit commitments of $3 billion.

International Finance Corporation

The International Finance Corporation was established in 1956 and complements the work of the World Bank in a number of ways. In addition to loans, it can offer kinds of financial services that are unavailable from the Bank such as equity participation, convertible debentures, underwritings and standby commitments.

Unlike the Bank, it makes loans without a government guarantee; in fact it may not accept a government guarantee. Following a capital increase in 1978 there has been a rapid expansion of IFC's activities. The IFC now approves about 75 investments in new projects per year. It holds equity participations in about 400 firms, its total capitalisation is about $1.5 billion and its annual net income $30 million.

URBAN DEVELOPMENT AND HOUSING FINANCE AT THE WORLD BANK

A POWERFUL tide of urbanisation is sweeping through developing countries during the last quarter of this century. More than half of the world's population will be living in urban areas by the year 2000. The urban population is expected to grow from 1.3 billion to 3.3 billion, an increase equivalent to the world's population in 1965. Africa, which is the least urbanised region of the world, will see its urban population quadruple in 20 years.

Countries that have been largely rural are being transformed within two generations, and this transformation is bringing both promises and problems. An enormous level of investment is taking place in cities, and it must be structured, organised and made more efficient through better public and private institutions. There is a great contrast now with the industrial countries where urbanisation has essentially run its course and capital infrastructure maintenance and the co-existence of urban growth and urban decline are leading issues.

The World Bank initiated an urban lending programme in 1972 in response to requests for assistance from member countries. The elaboration of operational objectives for urban projects provoked considerable debate within the Bank and among borrowing agencies over issues such as whether lending should focus on promoting urban development or alleviating urban poverty, or whether projects in shelter, infrastructure, and transport can contribute to the management of the urban sector as whole.

The debate was further complicated because the awareness for urban needs had developed at the same time as an international consensus was emerging that the rural sector should be the priority for assistance.

The Bank eventually adopted a development strategy which differed markedly from previous investment policies for urban services. It advocated new, low-cost approaches in shelter and urban infrastructure which would be consistent with the purchasing power of the majority of a rapidly growing urban population in contrast with the high standard, high cost products supplied by public agencies which required very large subsidies and reached only a tiny — mostly middle income — fraction of the total population.

Lessons of experience

Together with borrowing agencies and other lenders, the Bank has learned much since it made its first loan to Senegal in 1972. The process of learning by doing is still going on and many cities are still under great stress, but considerable progress has been made in formulating policies and action programmes. Once highly controversial principles, such as cost recovery and affordable standards of urbanisation, are widely accepted by the international community, if not yet uniformly practised. It is now finally recognised that the planning of urban and rural development is not a zero-sum game; quite to the contrary — the two sectors can, and should be, mutually supportive.

The futility of welfare approaches to urban development in developing countries has also become abundantly clear with recent economic problems, and the appropriate division of labour between the public and

Fifteen years of World Bank lending in Urban Development and Water Supply (Fiscal Years 1970 through 1985)

	Number of Projects Total	%	Size of Loans ($ Million) IBRD	IDA	Total	Total Project Costs ($ Million)
1.	43	14.1	252.2	400.8	653.0	1,172.4
2.	33	10.8	500.3	195.9	696.2	1,382.0
3.	75	24.6	2,230.0	259.6	2,489.7	5,959.0
4.	78	25.6	3,267.2	145.7	2,412.9	10,161.0
5.	45	14.7	1,864.6	104.0	1,968.6	4,863.8
6.	31	10.2	49.1	1,371.8	1,420.9	2,681.6
Total	305	100.0	8,163.4	2,477.8	10,641.2	26,219.8

1. Eastern and Southern Africa; 2. West Africa; 3. Europe, Middle East and North Africa; 4. Latin America and Carribean; 5. East Asia; 6. South Asia.

the private sector is being re-examined. In shelter, governments which had assumed — at least in theory — responsibility for all aspects of housing delivery have found that it is to their comparative advantage to improve the structure of economic incentives and to modernise policies, regulations and standards.

Governments now recognise that they should concentrate on the production of the public goods such as land tenure, urban infrastructure and sanitation which private individuals cannot provide for themselves; otherwise they should concentrate on better urban policies and regulations (particularly in the land market), and encourage the development of more efficient financial services in order to improve and increase the broad supply of private housing which is now taking place at all income levels, but very inefficiently.

Following the undertaking of a series of shelter level projects in about 40 countries, basic concepts of affordable housing, appropriate infrastructure and investment co-ordination, cost recovery, programme sustainability, operations and maintenance are considerably better understood. But problems remain in institutional development, decentralisation of decision-making, resource mobilisation and resource management, cost recovery, the transition from demonstration neighbourhood projects to sustained nationwide programmes, and, inevitably, manpower planning and development.

Loans in the urban and water supply sectors now represent 11% of the World Bank-IDA portfolio and 200 on-going projects where the Bank finances about 40% of total country investments of about $24 billion.

Objectives of the Bank in housing finance

The interest of the Bank in housing finance began with low-income shelter projects and the concern with affordability problems of the borrowers. However it soon became clear that 80 to 90% of the housing investment in many developing urban areas does not rely on institutional loans. The development of viable and efficient housing finance systems is now very important to the Bank because of the need to make the transition from a first generation of individual projects, however large, to operations which can achieve long-term sector wide impacts in housing.

In addition, some of the heavily indebted countries have experienced serious domestic credit problems which have involved housing finance institutions. The concern for better institutions in the housing sector and the broader need for sound financial development in developing economies have therefore jointly lead to the emergence of a new agenda for the Bank in housing finance.

In addition to better housing sector policies, the central aim of the World Bank in housing finance has four broad dimensions: efficient resource mobilisation and the encouragement of household saving in financial form; equitable access to financial services for all income groups; on the private finance side, the progressive elimination of the various constraints which prevents the emergence of viable systems of private housing finance and related financial infrastructure facilities; on the public finance side, government programmes must be reconsidered, subsidies granted through credit systems must often be reduced, they must become accurately measurable, and their direct and indirect impacts on the government budget made predictable.

Housing finance work in a given country must consider its size, its state of development, its economic system and degree of openness to the world economy, and the sensitive nature of financial sector issues. The nature of World Bank activities varies widely according to whether they take place in heavily-indebted countries, middle-income countries or low-income countries.

The World Bank is currently active in Chile (housing finance based on a mortgage bond market and up-front, low-income subsidies); Mexico (restructuring of commercial bank compulsory lending programmes); Ecuador (public housing bank); Tunisia (restructuring of housing public agencies); Morocco (new activities by a public housing bank); Portugal (creation of a refinancing institution for social housing); Turkey, India (private sector finance for middle- and low-income families, improved regulatory framework); Indonesia (housing sector loan); The Philippines (restructuring of the housing finance system); Korea (modernisation of the financial sector); the Ivory Coast (restructuring of public sector agencies); Zimbabwe (new lending activities by building societies); and Malawi (development of housing finance).

The IFC, which was involved in housing finance much earlier than the Bank with the creation of six housing banks, is also involved in the creation of new secondary mortgage facilities. ■

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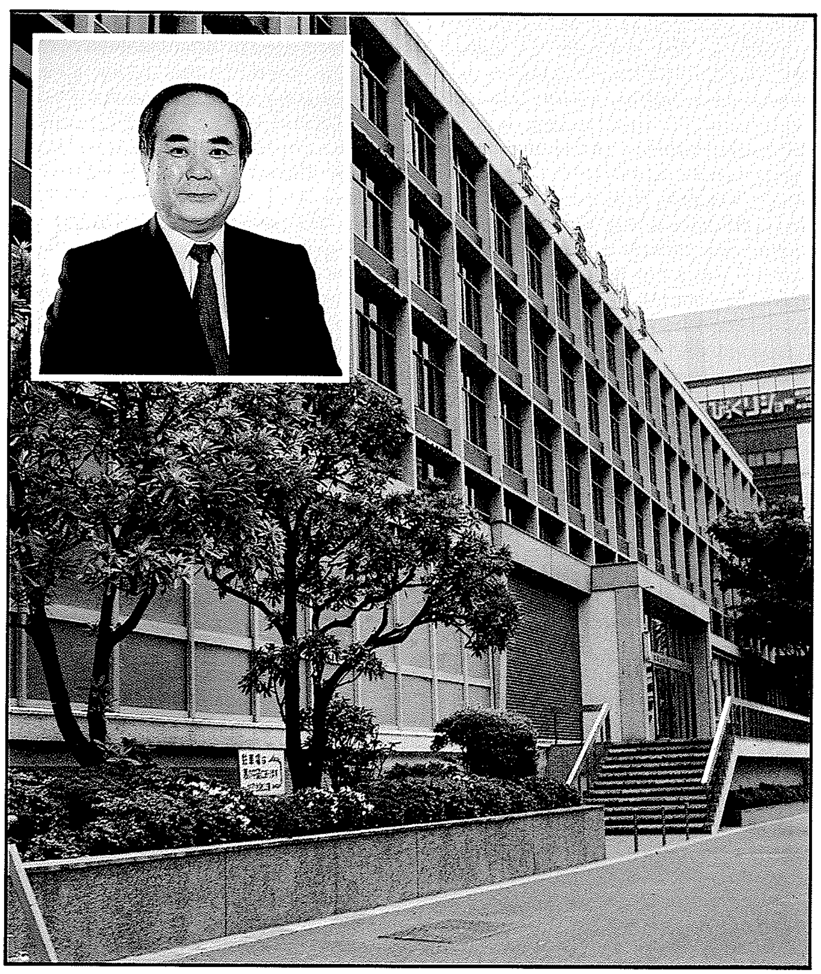
Bright future for world's largest holder of home loans

Japan's Government Housing Loan Corporation, which has over five million outstanding loans, seems set for further growth, given the high level of demand for house purchase



The Housing Loan Corporation's head office, and its president, Shozo Kohno.

THE Government Housing Loan Corporation (GHLC) of Japan is the largest holder of housing loans in the world. It has over five million outstanding loans with a total value, at the end of 1985, in excess of $100 billion and it has originated these loans itself. Its nearest competitor in terms of holding loans is the Federal National Mortgage Association, an American institution which purchases loans on the secondary market and which had a mortgage portfolio, at the end of 1985, of $95 billion.

GHLC holds more than four times the amount of housing loans as the largest deposit taking lenders, the Halifax and Abbey National Building Societies in the United Kingdom and the largest Californian savings associations. The Corporation operates on a non-market basis and has little direct contact with its customers, raising its funds from a government agency (and indirectly, from the postal savings system) and lending by using banks as agents.

Housing background

The role of GHLC needs to be seen in the context of the particular housing circumstances of Japan. The economic record of Japan in the post-war years is well known. It has grown rapidly and has achieved a dominant position in many industrial markets. However, living standards have not matched the macro-economic performance; arguably, economic growth has been at the expense of domestic welfare.

Japan has a very high savings rate which has enabled an equally high level of investment to be financed. Various explanations for the high savings rate have been put forward, including the relatively underdeveloped social welfare system compared with other countries. The result is that many Japanese families have a significant proportion of their wealth in savings rather than in housing and consumer durables.

For an industrialised country Japan has a very high proportion of people living in dwellings not connected to proper sewerage facilities (68% as against only 3% in the UK and 28% in the USA). Many houses are built of wood and have a fairly short life of perhaps 40 or 50 years. A particular problem which the country faces is that it is densely populated.

Only 21% of its total land area is classified as habitable, compared with over 60% in France and West Germany and about 50% in the USA. The density of population is 1,450 persons to the square kilometre, compared with 386 in West Germany, 357 in the United Kingdom and only 22 in the USA. The problem is tending to get worse rather than better as the population of Japan is continuing to rise rapidly and the number of households is rising even more rapidly.

Housing Loans Outstanding, Japan, End-1985

Institution	Number of Loans	Amount of Loans		
		Yen bn	$ bn	%
Housing Loan Corporation	5,569,000	21,216	104.6	35
City banks	1,390,000	8,246	40.7	13
Regional banks	1,401,000	6,221	30.7	10
Housing loan companies	431,000	5,053	24.9	8
Shinkin banks	428,000	4,699	23.2	8
Life insurance companies	532,000	3,763	18.6	6
Sogo banks	670,000	3,405	16.8	6
Trust accounts of all banks	593,000	2,463	12.1	4
Agricultural co-operatives	—	1,978	9.8	3
Labour credit associations	380,000	1,394	6.9	2
Other	315,000	2,661	13.1	4
Total	11,709,000	61,099	301.3	100

Source: *Economic Statistics Monthly,* April 1986, Bank of Japan, Table 51.

Notes: 1. Figures include loans for construction, re-building and purchasing of houses and purchasing of residential land.

2. Figure for total number of loans excludes agricultural co-operatives.

Regular surveys of housing demand show the dissatisfaction with the present standards of housing. In 1983 7.1% of households said they were very dissatisfied with housing and 31.3% were a little dissatisfied. This total figure of 38% compares, for example, with a figure of 5% revealed in a recent British survey.

The Japanese Government has responded to this situation by actively encouraging a high level of investment in housing. The number of houses completed has been running at well in excess of one million a year and, by international standards, Japan devotes a high proportion of its GDP to investment in housing — 6.5% between 1960 and 1983 compared with the OECD average of 5.3%. One government agency, the Housing and Urban Development Corporation, has played a major role in constructing new houses.

It is government policy, implemented by GHLC, to provide low-interest loans for house purchase and

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Condominiums financed by Japan's Housing Loan Corporation.

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improvement. It may be questioned whether subsidised loans are necessary in a country as wealthy as Japan, but, again, the special housing circumstances need to be noted. The rapidly growing population, combined with a relatively small habitable area, means that house prices are extremely high and even a basic unit, perhaps one hour's commuting time from Tokyo, could cost upwards of $100,000.

Constitution

The Government Housing Loan Corporation was established under the Government Housing Loan Corporation Law in June 1950 with the status of a special public corporation. Its senior executives comprise a president, a vice-president and six directors. The president is appointed by the Minister for Housing with the approval of the Cabinet, and the vice-presidents and the directors are appointed by the president with the approval of the competent Minister.

The Corporation has a relatively small staff — 1,146 in 1985 — and operates from a headquarters in Tokyo, together with 12 branch offices throughout the country and one housing centre located in Tokyo.

Lending

The Corporation accounts for over one-third of housing loans outstanding by value. After the Corporation, the other main lenders are the city banks, which, as their name suggests, have branches only in the cities, and the regional banks which operate in one or more of the prefectures into which the country is divided. Other lenders include housing loan companies (most of which are owned by other financial institutions), the shinkin banks (similar to credit unions), life insurance companies and sogo banks (mutual loan and savings banks).

Although the Corporation formally originates the loans which it holds, the actual work in making the loans is delegated to financial institutions. As at October 1985, 900 financial institutions with 11,840 outlets were commissioned to handle housing loan business on behalf of the Corporation. Loans are promoted both by the Corporation and by its agents, and also by housing developers, but as they carry a below market rate of interest, extensive promotion is unnecessary.

The financial institutions handle all of the administrative work in making a loan and they also collect the repayments and handle repayment difficulties. Effectively, the agents can take the decision as to whether to grant a loan but this has to be within the guidelines laid down by the Corporation. Individuals pay a commission for obtaining a loan of 40,000 yen (about $200) which is usually deducted from the loan. A fee is paid to agents for introducing business.

The major part of the Corporation's lending programme is loans to private individuals who are financing the construction of their own homes. Applications under 40 cannot qualify for loans unless another person is living in the household. The housing must conform to construction standards laid down by the Corporation and must have a floor area of between 50 square metres and 165 square metres.

The maximum loan depends on the

Number of Houses Financed by Government Housing Loan Corporation, Japan, 1980-85

Year	Owner-Occupied		For Sale		Rented		Total	
	000	% of Total	000	% of Total	000	% of Total	000	% of Total
1980	421	51	95	30	32	11	1,214	35
1981	417	52	90	35	34	11	1,143	37
1982	480	59	91	40	47	14	1,157	42
1983	373	52	87	36	43	11	1,135	33
1984	369	51	87	38	41	8	1,207	31
1985	356	48	93	41	42	8	1,251	29

Source: GHLC.
Note: The Corporation also funds a limited number of tied houses, 1,181 in 1980 falling to 310 in 1985.

Government Housing Loan Corporation, Japan, Assets and Liabilities, End-1985

Liabilities	Yen bn	$ bn	%	Assets	Yen bn	$ bn	%
Trust Fund Bureau	23,835	117.5	98.0	Private housing loans	20,631	101.7	84.9
Life Insurance and Postal Annuity	475	2.3	1.9	Rental housing loans	1,845	9.1	7.6
Debentures	149	0.7	0.1	Rehabilitations and improvement loans	782	3.9	3.2
Reserves for loan losses	17	0.1	—	Curtilage development loans	648	3.2	2.7
Capital	97	0.5	—	Redevelopment housing loans	524	2.6	2.2
				Other loans	143	0.7	0.6
				Other assets	44	0.2	0.2
Total	24,313	119.9	100.0	**Total**	24,313	119.9	100.0

Source: *Economic Statistics Monthly*, April 1986, Bank of Japan, Table 37.

region of the country and the structure and floor space of the house. The maximum loan to value ratio is 80% and the repayment term varies from 25 years for wooden structures to 35 years for fireproof structures. The rate of interest is 6.85% for dwellings between 135 square metres and 165 square metres. For dwellings between 110 square metres and 135 square metres, the rate is 6.4% for the first 10 years and 6.85% thereafter, and for dwellings between 50 square metres and 110 square metres, the rate is 5.5% for the first 10 years and then 6.8%. GHLC requires a first mortgage and a guarantee.

The Corporation also makes a smaller number of loans to those purchasing existing owner-occupied property. Here, the maximum loan is 60-70% of that which would apply for new housing, which means in practice a maximum loan to value ratio of about 50%, the rate of interest is 6.4% for the first 10 years and then 6.85%, and the repayment term is a maximum of 20 years.

In addition, the corporation makes loans to individuals for improvements, it operates a relatively small contractual savings scheme for house purchase, and it makes loans to developers, for owner-occupied and rental housing and for urban renewal works.

The Corporation has been financing over one million housing units a year. Although it appears to have been accounting for a declining proportion of the total number of loans made, this reflects a reduction in activity in the owner-occupied sector, in which the Corporation has a 50% market share, and an increase in the rented sector, in which it has a much smaller market share.

Funding

The Corporation is a government agency which raises virtually no money itself on the open market. Rather, its source of funds is the Trust Fund Bureau which in turn raises its funds from the postal savings system. The system is itself the largest single holder of deposits in the world, holding personal deposits in excess of 100 trillion yen ($495 billion) at the end of 1985.

The postal savings system hands over all the funds it collects to another government agency, the Trust Fund Bureau. This agency in turn lends to the Housing Loan Corporation and various other government bodies. At the end of 1985, deposits in the postal savings system of 100 trillion yen ($495 billion) accounted for 61% of the total funds in the Trust Fund Bureau of 163 trillion yen ($804 billion). Loans by the Trust Fund Bureau to the Corporation of 24 trillion yen ($118 billion) accounted for 15% of its total funds.

The Corporation borrows money from the Trust Fund Bureau at a rate of interest of 6.8%. The maximum rate of interest which it charges on its loans is 6.85%, and this applies only from the 11th year of the loans except for loans on the largest dwellings. The Corporation receives from the government a subsidy to cover the difference between the interest rate on its borrowings and that on its lending and also its administrative expenses. In the 1985 fiscal year this subsidy amounted to 330.9 billion yen ($1,632 million).

It might be expected that the Corporation would have a permanent problem of meeting demand given its subsidised loans. In practice, demand is forecast using sophisticated techniques and adequate funds have been forthcoming from the Trust Fund Bureau to meet demand.

The balance sheet for the Corporation is in some respects a typical mortgage bank's balance sheet. However, it will be noted that a single source of funds, the Trust Fund Bureau, accounts for 98% of liabilities, and that reserves and capital are exceptionally low compared with those which a commercial institution would need to hold. Loans account for no less than 99.8% of total assets.

The future

Japan has a highly regulated financial system and much consideration is now being given to financial deregulation. In any such discussion, the non-market role of the Housing Loan Corporation will need to be considered. The work of the Corporation is highly regarded within Japan and no major changes are anticipated.

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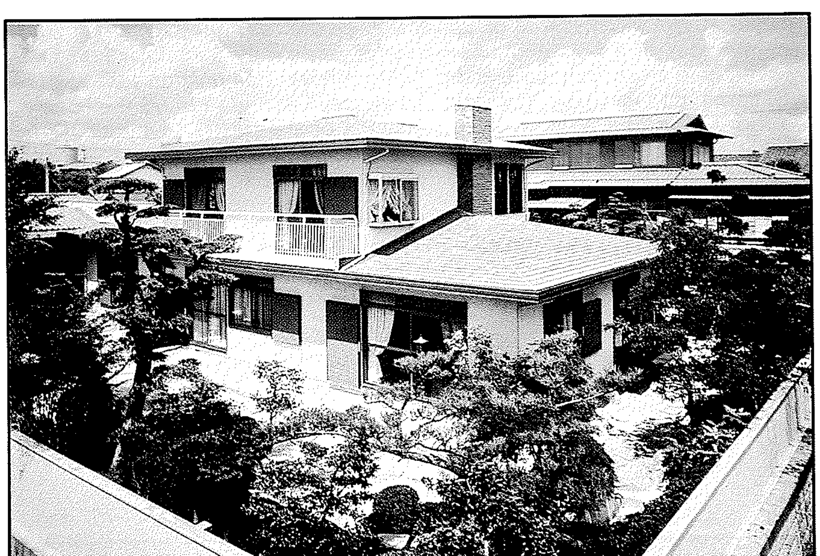

Single-family homes financed by the Housing Loan Corporation.

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However, it has taken steps to supplement its funds, for example by increasing the interest rate from the 11th year on loans.

Certainly the need for a large volume of lending will continue. It is expected that new house construction will run at about 1.3 million dwellings a year with there being a major need to replace wooden structures, perhaps at the rate of 600,000 units a year. Demand for house purchase continues to run at a high level, despite high house prices.

The Corporation seems not to have any significant potential competitors. However, the city banks and regional banks may wish to expand their personal business. The postal savings system is recognising the need to expand its operations and perhaps, in the longer term, it might prove to be a competitor to the Housing Loan Corporation for housing loans, even while remaining, indirectly, its principal funder.

It is the general financial deregulation in Japan which is likely to affect the position of the Corporation, by removing the constraints on the bank and perhaps the postal savings system, rather than any specific action in relation to the Corporation itself. ■

The end-1985 exchange rate of 202.8 yen to the dollar has been used throughout this article.

Japan's postal savings system

THE postal savings system can be seen as an important part of the housing finance system of Japan. Although it does not make loans directly itself, it effectively funds the loans made by the Housing Loan Corporation through the intermediary of the Trust Fund Bureau.

In terms of deposits, the Postal Savings System is by far the largest financial institution in the world. At the end of 1985, deposits in the system exceeded 100 trillion yen ($495 billion). The system therefore holds deposits more than three times those of all British building societies, more than four times those of all German savings banks, and nearly half those of all American thrift institutions.

However, the system is not really a financial institution at all: it is a state function managed and administered by the Postal Savings Bureau of the Ministry of Posts and Telecommunications. The system operates through over 19,000 post offices and 4,300 postal agencies throughout the country. In addition to providing a savings service, the system also offers a postal money order service and postal giro service.

The system offers several types of deposit. The most important is the Teigaku Deposit Certificate which accounts for nearly 90% of outstanding deposits. This scheme provides for a fixed sum to be invested on condition that it will not be withdrawn in the first six months. After this period, withdrawals can take place at any post office. The longer the sum is deposited (up to 10 years), the higher the rate of interest payable. Currently, the rate of interest varies from 4% for deposits of one year or less, to 5.75% for deposits in excess of three years.

The other main savings product offered is the ordinary deposit which accounts for nearly 9% of total deposits. Money can be paid into or withdrawn from ordinary deposit accounts at any post office. Transactions are recorded in a pass book. The current interest rate is 2.88% a year.

Total deposits of up to 3 million yen ($14,800) attract interest free of tax. Every member of a household can, however, hold an account and, in the past, some people have probably held more than one account but in different names. Steps have recently been taken to prevent this.

The postal savings system offers only very limited loan facilities. Rather, 99% of its funds are transferred to the Trust Fund Bureau. The system holds no reserves and in fact carries an accumulated loss on its balance sheet.

Japan has had a highly-regulated financial system and there are controls on interest rates payable to depositors. There is now a general belief that these should be removed and this is likely to expose the postal savings system to greater competition, especially as depositors can also hold 3 million yen in banks and obtain the interest free of tax.

Consideration is therefore being given as to what additional services the postal savings system might offer, especially loan facilities. This might raise the question of fair competition, bearing in mind the special status of the postal savings system and the fact that it does not seem to hold any reserves.

Personal Savings, Japan, End-1985

Institutions	Yen bn	$ bn	%
Postal savings system	100,086	495	32
City and regional banks	99,696	493	32
Agricultural and fishery co-operatives	40,474	200	13
Shinkin banks	36,717	182	12
Sogo banks	22,789	113	7
Credit co-operatives	9,561	47	3
Labour credit associations	4,783	24	2
Total	314,106	1,554	100

Source: *Economic Statistics Monthly,* Bank of Japan, April 1986, Table 4.6.

US savings associations stage a recovery

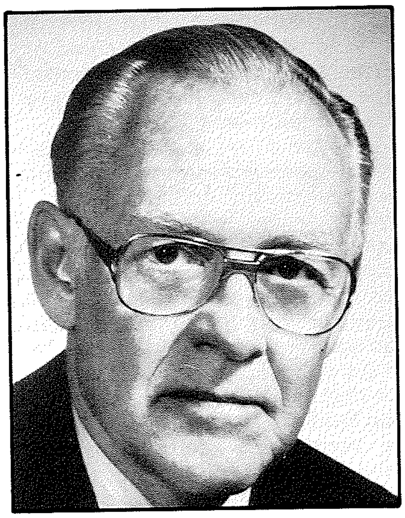
Although failures continue among savings institutions in the United States, many are notching up record earnings, as Norman Strunk explains.

IN recent years the savings and loan story in the United States has been a "good news — bad news" story. It continues to be so. 1985 was a year of substantial recovery in the earnings of America's savings and loan associations, with a record net income of $3,970 million, 0.39% of total assets. Earnings this year are expected to be well above the 1985 record, with many associations doubling last year's figures.

The bad news is that the business is currently looking at losses that will result from the failures of institutions — estimated to be in the range $12,000-18,000 million — which will have to be borne by the savings and loan system itself by way of extra, or special, annual contribution to the Federal Savings and Loan Insurance Corporation (FSLIC) and the virtual depleting of the "free" reserves of the Federal Home Loan Banks which, in turn, are owned by the savings and loan institutions.

The savings and loan industry

The savings and loan system in the United States currently comprises some 3,250 institutions with resources of $1,000 billion. Approximately one-third of the institutions are in capital stock form, and the other two-thirds mutual. Half of the 300 largest are of the stock type. A high percentage of the large institutions have converted to stock form since 1981, and practically all of the new institutions chartered in the past decade have been of the stock form.



The institutions are chartered and operate under an authorising law, either of the state in which their offices are domiciled, or of the federal government. Except for a small number of multi-state organisations, which have resulted from the merger of failed institutions, associations still operate from main and branch offices within their own state, although they may make and purchase loans beyond their own state borders.

The smaller institutions, of which there are many, essentially confine their savings and lending services to their own metropolitan areas. All the active savings and loan associations are members of the General Home Loan Bank System, which provides emergency and seasonal credit and long-term loans for on-lending. Virtually all institutions have their deposits insured by the FSLIC, a federal government instrumentality parallel to the Federal Deposit Insurance Corporation (FDIC), which insures deposits in commercial banks and the traditional savings banks. Some 70% of the assets of the savings and loans are invested in mortgages on residential property.

The earnings crisis and regulatory response

With the escalation of interest rates, which began in the late 1970s and became full-blown in 1981, these institutions suffered a severe earnings squeeze because of rising deposit interest costs, and the fact that practically all of their mortgages were written at fixed interest rates in earlier years.

In the mid-1970s, competition for deposit funds began to develop from a new group of unregulated financial intermediaries, known as money market funds, generally sponsored by security brokerage firms and by the large insurance companies. They offered the public the equivalent of a demand deposit with chequeing account privileges, at rates that were obtainable by the investment of funds in short-term money market instruments, primarily US Treasury and federal agency obligations.

The initial response to the problems these funds posed to the depository institutions was to permit thrift institutions and banks to offer so-

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called "money market certificates" of six-month maturity, with the rate being tied to the rate at the time on six-month obligations of the Treasury. This resulted in a massive flow of deposits from passbook accounts to the higher rate certificates.

Many institutions then found themselves in a position of paying out more for deposits than they earned on their assets. This disastrous earnings squeeze resulted in the depletion of the net worth of the business generally, and a virtual loss of the net worth and resulting insolvency of about a quarter of the institutions, including some which were large and highly regarded.

Once the minimum statutory reserve of 3% is penetrated, institutions in the US become subject to close federal supervisory scrutiny, and in many instances mergers are arranged. The number of associations fell rapidly from 4,613 at the end of 1980 to 3,244 at the end of 1985 as a result of failures and merging of institutions with weak net worth positions into stronger ones. It is interesting that during this same period of disappearance of institutions through failures or mergers there were some 300 new institutions chartered. These new institutions have not, of course, suffered the handicap of portfolios of low-rate, fixed-rate mortgages.

An Act of Congress, passed in 1980, granted permission to savings and loan institutions to issue interest-bearing chequeing accounts to individuals, and provided for the phasing out of the system controlling deposit interest rates known as Regulation Q. As of 31 March this year, the last vestiges of ceilings on deposit rates paid by banks and savings and loan associations have disappeared.

In 1982, Congress passed landmark legislation dealing with the savings and loan system — the Garn-St Germain Act — which provided for substantial deregulation. This permitted banks and savings and loan associations to compete on an even basis with the money market mutual funds, and to offer a wide variety of deposit and investment accounts in the acquisition of funds.

The Garn-St Germain Act also substantially broadened the range of assets in which federally chartered thrift institutions could invest. It permitted, for example, up to 40% of assets to be invested in mortgages on non-residential property, up to 30% of assets in consumer loans (which may be unsecured), commercial paper and commercial-type securities. It permitted another 10% of assets to be invested in secured or unsecured loans for commercial business purposes, ie loans typically made by commercial banks.

At the same time, state legislatures took parallel action, and in some important savings and loan states in growth areas, notably California, Texas, Florida and Arizona, the legal restrictions with respect to investment activities of thrift institutions were liberalised to a greater degree than were the federal associations by the Garn-St Germain Act.

In 1981 and 1982, the Federal Home Loan Bank Board eliminated many of the restrictions on loan-to-value ratios, limits on owner-occupied versus rental property loans, and repayment terms that had been carefully written into the regulatory rules in earlier years to prevent dangerous lending practices.

It should be noted that with the passage of the Garn-St Germain Act there is today no real legal distinction between savings banks and savings and loan associations in the United States. There are about 325 traditional savings banks, most of them located in the north-east section of the country.

In recent years, many savings and loan associations have changed their names to include the word "bank," but continue to be supervised by the Federal Home Loan Bank Board and their deposits insured by the FSLIC. They are generally still considered to be part of the savings and loan system. The data accompanying this article include all such institutions, but not those of the "traditional" savings banks.

One of the more constructive regulatory changes was the action of the Federal Home Loan Bank Board in 1981 to permit the widespread use of the adjustable, or variable, rate mortgages with only the restriction that the interest rate had to be tied to some published index.

After an initial period of uncertainty, the savings and loan associations began to make widespread use of this authority, and by 1984-85

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Earnings of Savings Institutions

Year	Portfolio Yield	Cost of Funds	Net Income (Millions) $	Return on Assets	Net Worth at End-Year $m
1975	7.71%	6.32%	1,448	0.47%	19,779
1976	8.00%	6.38%	2,250	0.63%	21,998
1977	8.26%	6.44%	3,198	0,77%	25,184
1978	8.50%	6.67%	3,918	0.82%	29,057
1979	8.86%	7.47%	3,620	0.67%	32,638
1980	9.34%	8.94%	784	0.13%	33,391
1981	9.91%	10.92%	−4,632	−0.73%	28,395
1982	10.68%	11.38%	−4,271	−0.65%	26,233
1983	11.17%	9.83%	1,968	0.27%	30,867
1984	11.66%	10.03%	1,101	0.12%	34,764
1985	11.53%	9.20%	3,970	0.39%	41,293

Source: Federal Home Loan Bank Board.

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some two-thirds of all mortgage originations were of the adjustable rate type. At the close of 1985, it was estimated that 46% of the residential mortgage portfolios of savings and loan associations comprised adjustable rate mortgages.

Recent years have been characterised by a strong real estate market, and until mid-1985 relatively high interest rates in the mortgage market. The result was a substantial improvement in the earnings of most institutions as they enjoyed high yields and origination fees on new loans made, plus a roll-off of the balances on the older, lower-rate mortgages.

New business and new problems

Most institutions moved carefully into broader investment and lending fields and, with some notable exceptions, have not only improved their income position but also the match of maturities between their assets and liabilities.

By early 1985, however, some problems came to the surface. Weaknesses began to appear in the federal supervisory system, particularly for savings and loan associations. With deregulation, both in deposit promotion and pricing and in asset management, there were simply not enough examiners, particularly examiners with experience, to monitor adequately the activities of the thousands of institutions.

There was high turnover among the top supervisory and legal people at the Federal Home Loan Bank Board. Further, the supervisory forces in a number of state governments, particularly those that substantially liberalised the powers of the institutions chartered under their laws, turned out to be completely inadequate.

Also in the period from 1981 through 1984, there had been a substantial turnover in the management of many savings and loan associations, and quite a few people came into ownership and management whose objectives were not consistent with the traditional objectives of the business, but who were primarily interested in short-term profits from the capital stock of the institutions, even if it meant taking enormous risks.

Further, many of the more traditional managers began to engage in more speculative lending as a way to improve earnings and to restore the net worth ratio of their institutions. In too many instances the results have been disastrous.

From 1980 through 1984, it is estimated that 270 institutions failed essentially as a result of a maturity mismatch, i.e. "earnings squeeze." Since 1980 there have been approximately 90 failures because of bad investments and operating practices, and another 200 to 300 institutions are in such a poor asset and net worth position as to suggest that they will not recover.

In the United States, institutions whose accounts are protected by deposit insurance do not fail in the classic sense, i.e. they are not closed or put into receivership and liquidated. Rather, to protect the deposits of savers and preserve their confidence, failed institutions have, with few exceptions, been merged with other institutions with capital assistance from the FSLIC (or FDIC in the case of a bank). In some instances, a failed savings and loan association has been sold to a commercial bank.

More recently, with fewer potential acquiring institutions and the danger of the depletion of the resources of the FSLIC facing the federal authorities, the FSLIC has followed the practice of dismissing the officers and directors of the failed institutions and placing management in the hands of a new board of directors, with executives borrowed from large, strong institutions. The FSLIC currently has some 40 of these "consignment cases" and more are expected.

Losses from failures due to poor investment practices and from institutions not expected to recover from the earnings squeeze are expected to be in the $12-$18 billion range. There are some estimates that these losses may be as high as $25 billion.

These potential losses should be compared with the total net worth of the savings and loan institutions of $41 billion at the end of 1985. However, 209 institutions with total assets of $260 billion had a net worth ratio of under 3%. Published net worth is the so-called regulatory net worth and includes intangibles and certain accounts not recognised under "generally accepted accounting principles" by the chartered, or "public," accountants.

New Deposit Flows and Loan Originations

Year	Net Deposit Flows $m	Loan Originations $m
1975	42,806	55,040
1976	50,585	78,776
1977	51,016	107,368
1978	44,864	110,294
1979	39,304	100,546
1980	42,094	72,537
1981	14,339	53,283
1982	39,774	54,298
1983	110,446	135,290
1984	106,828	172,234*
1985	47,627	180,017

**New series. All activity reported on a gross basis including refinancings and construction-Purchase loans.*
Source: Federal Home Loan Bank Board.

UNITED STATES

Share of the Market for Savings and Home Loans
Year-End 1985

	Total Savings Deposits Amount ($ Billions)	% of Total	Total Home Mortgage Loans Amount ($ Billions)	% of Total
Savings Associations	752.3	30.6	430.9	33.8
Savings Banks	271.7	11.1	122.1	9.6
Commercial Banks	1,227.1	49.9	214.3	16.8
Life Insurance Cos.			13.5	1.1
Pension Funds			5.1	0.4
Money Market Funds	207.5	8.4		
Federal Agencies			490.6	38.4

The assets of the FSLIC currently total $11 billion, of which about 60% represents real estate or defaulted loans acquired from failed institutions (which had been merged with other institutions), or investment in the net worth of institutions whose capital had been impaired but kept in operation.

Few people have been willing to go to Congress and the Treasury to ask for a contribution of federal, i.e. "taxpayer", funds to recapitalise the FSLIC and give it sufficient funds to meet its obligations to depositors. The result has been the development of legislation which is being considered by Congress that will provide for funds to be contributed by the insured institutions under a special assessment of ⅛ of 1% per year. This was initiated with effect from 1 January, 1985 and is in addition to the regular 1⁄12 of 1% regular annual insurance premium, that institutions pay to the FSLIC.

In addition, the reserves of the Federal Home Loan Banks, totalling $1.6 billion, are to be set aside into a new financing corporation which will leverage these funds by borrowings in the US capital markets to add to the resources of the FSLIC.

Reregulation

There is also a definite move to make sure that the mistakes of the past are not repeated. The federal examination staff has been substantially increased and higher salaries approved to permit the retention of competent people and the hiring of qualified accountants. The Federal Home Loan Bank Board has moved in the direction of reregulation — imposing limits on the extent to which FSLIC-insured institutions can engage in "direct investment" activities — investment in land, home building operations, etc., and in assets other than real estate mortgages, as permitted by the law for many of the state-chartered institutions. The Board, by regulation, had acted to slow down irresponsible growth and impose a higher standard of investment practices on the business. This contributed to a decline in net deposit from $107 billion in 1984 to $48 billion in 1985.

In addition, the Board is asking Congress to make certain amendments to the regulatory statutes so as to permit it to move more promptly in cases where bad management is apparent.

The industry in context

The failing institutions syndrome is not confined to thrift institutions. There have been hundreds of failures in the commercial banking system, the most notable being that of the Continental Illinois National Bank and Trust Company in Chicago.

The dire conditions in the farm and energy economies have produced problems for commercial banks throughout the Midwest, particularly in Texas and Oklahoma. There is also concern about the loans of the large banks to third world nations which are recognised as "problem" loans, but which the banks have been able to avoid declaring in default and writing off.

The extra assessment that the insured savings and loan institutions are paying to the FSLIC has, to some extent, hindered the rebuilding of the tangible net worth of the business, but there is general optimism that most of the problems are behind it.

Through writing adjustable rate mortgages, the business has achieved a closer match in the maturities of its assets and liabilities. This programme has been retarded in recent months with many of the high interest and adjustable rate mortgages being refinanced by borrowers at today's lower interest rates, and usually on a fixed-rate basis. House buyers clearly prefer the fixed-rate mortgage, particularly at today's rates, and probably not more than a third of all savings and loan mortgage loan originations today are on a variable rate basis.

As one looks ahead, it is easy to see that the barriers to interstate branching are breaking down. the large and strong institutions are becoming, in effect, financial conglomerates with emphasis on residential real estate finance, which in the US remains a huge market. One can see a further decrease in the number of thrift institutions in the next five to 10 years, but most of the surviving institutions will still bear considerable resemblance to the savings and loan associations that were so successful until 1980. ■

Norman Strunk is secretary-general of the International Union of Building Societies and Savings Associations, a position he has held since 1980. From 1952 until 1980 he was the executive vice-president of the United States League of Savings Institutions. He remains affiliated to the United States League as senior counsellor. He currently serves on the boards of Great Western Financial Corporation, Talman-Home Federal Savings Association, Mortgage Guarantee Insurance Corporation, Federal Home Loan Bank of Chicago and the Liquidity Fund for Thrifts.

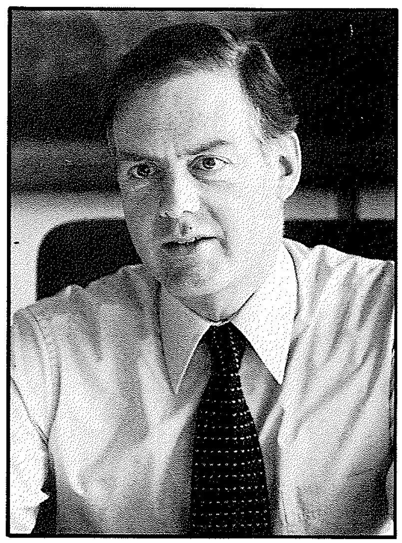
Denmark's credit institutions spread their wings

Since last year, Danish mortgage credit institutions have been allowed to lend in other OECD countries, as Erling Olsen explains

TRADITIONALLY, building and construction have been domestic industries, but now they have gone international. Danish contractors in the building trades and Danish exporters of building components are exporting goods and services abroad totalling some 2% of the Danish gross national product. The Danish import of construction and building components is of a similar magnitude. Even in building and construction we are moving towards a world market.

When Danish architects, engineers and building contractors decided to go abroad, they were helped by Danish commercial banks and savings banks, partly because they wanted to serve their clients abroad to keep them as clients at home, and partly because they wanted new business. In most cases, the Danish commercial banks or savings banks financed the Danish exports during the construction period, ie the time which elapsed before long-term mortgage credit could be arranged through a local mortgage credit institution.

The services provided by Danish banks and savings banks to the exporters of construction and building components were not very different from those rendered to other Danish exporters during the years when Danish banks had been allowed to go international. At the outset the foreign lending was carried out as "cross-frontier lending" from Copenhagen, but after a while the banks were allowed to establish themselves abroad. They often started by setting up representative offices.



Subsequently, the representative office might be followed by a foreign branch or subsidiary or the Danish bank or savings bank. In some cases it might buy a foreign bank or move into some joint venture with foreign banks or other foreign credit institutions.

During the early 1980s, the Danish mortgage credit institutions asked themselves and the Danish authorities why they should not be allowed to follow their clients abroad, given that the Danish commercial banks and savings banks had been allowed to do so.

Financing of construction in Denmark is segmented. The commercial banks and the savings banks account for most of the financing of buildings during the construction phase. At the end of this phase the mortgage credit institutions take over. The Danish mortgage credit institutions are not profit-seeking institutions, but they do make profits, although the spread between their lending and funding rates of interest is only some 0.5%. This is due to their low costs of administration, which can be explained partly by their very simple lending practice.

Mortgages are granted on the security of the property only, and they cannot exceed 80% of the value of the property. No regard is paid to the borrower's financial circumstances. This makes possible a high degree of automation in lending processing. The Danish mortgage credit institutions fund themselves by issuing bonds on the market.

They may issue as many bonds as they need to supply borrowers with the mortgage loans required. Consequently, mortgage loans are always available at a market-related rate. The institutions have no problem in matching assets and liabilities because their loans are matched by bond issues with similar terms.

The Danish mortgage credit institutions were, however, not allowed to operate outside Denmark, although they would no doubt be competitive abroad. If Danish exporters of construction could not only market their own skills but also those of the Danish mortgage credit institutions, ie not only construct the buildings abroad but also have them mortgaged in the Danish fashion, they could probably increase their exports. Hence they supported the mortgage credit institutions' demand

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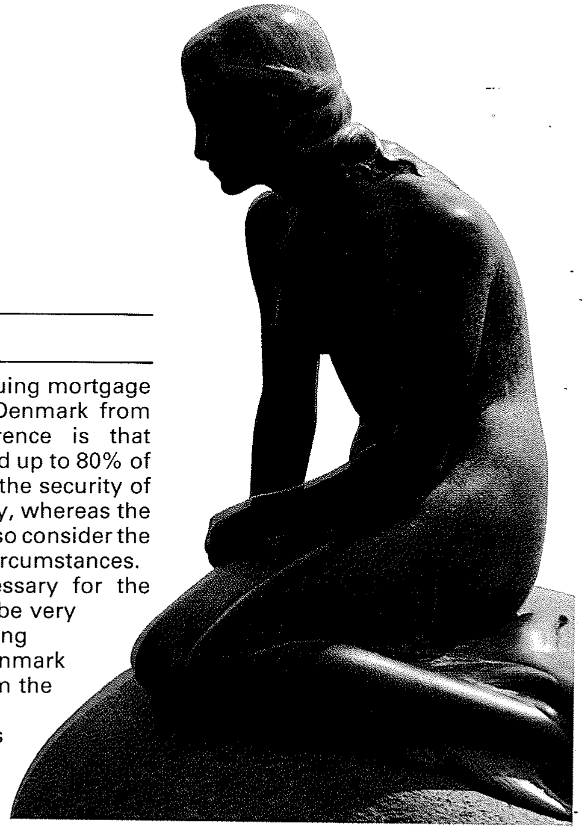

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for permission to operate abroad like the Danish commercial banks and savings banks.

Initially, the Danish authorities were rather reluctant to permit their mortgage credit institutions to go international, but in June 1985 the Danish Parliament unanimously passed a new Act which allowed Danish mortgage credit institutions to lend in other OECD countries on an experimental basis. However, the annual lending activities must not exceed 3% of their equity capital, and the mortgage credit institutions were to cover their interest and foreign-exchange risks. They were also required to fund their foreign lending activities on foreign capital markets.

The table shows certain key figures for the three Danish mortgage credit institutions issuing bonds to finance housing. Following these figures are their annual quotas for lending in other OECD countries. The export demand for mortgages is growing so fast, however, that the 3% foreign lending quota is becoming insufficient.

It is expected that the Danish authorities may allow Danish mortgage credit institutions to establish themselves abroad even before 1989 when the European market for mortgage loans is scheduled to be liberalised under a European Community directive. A Royal Commission is considering how this could be done — if it should be done. Throughout 1986, however, foreign lending will take place as cross-frontier lending from Denmark.

Kreditforeningen Danmark (KD) was the first Danish mortgage credit institution to involve itself in the foreign lending business, but the other two institutions soon followed suit. They are all active in the German market. KD is implementing plans to lend in Great Britain, France, Portugal and the United States.

The German market is the closest one to the Danish mortgage credit institutions, not only from a geographical point of view but also from an institutional one. The whole idea of setting up bond-issuing mortgage institutions came to Denmark from Germany. The difference is that Danish institutions lend up to 80% of the property value on the security of the property value only, whereas the German institutions also consider the borrower's financial circumstances.

This makes it necessary for the Danish institutions to be very cautious when assessing property values. In Denmark this is never done from the central offices, but by professional surveyors operating in the local areas. Lending abroad makes it even more important to use local professional surveyors.

Key Figures for Mortgage Credit Institutions in Denmark. 30 November 1985 and Year Ending 30 November 1985.

	Total Assets DKrm	**Equity Capital** DKrm	**Profit** DKrm	**Foreign Lending Quota** DKrm
Kreditforeningen Danmark (KD)	229,651	13,985	1,000	425
Nykredit	224,340	14,053	1,117	425
Byggeriets Realkreditfond (BRF)	87,399	6,209	403	183
Total	541,390	34,247	2,520	1,033

Source: Realkreditraadet, *Beretning og regnskab,* 1985, Copenhagen 1986, pp. 86-91. (DKr1 = $0.11).

The British market is a little more difficult for the Danish mortgage credit institutions because mortgage lending often goes up to 90% or 95% of the property values, and this requires an evaluation of the borrower's financial status. But at the upper end of the market 80% is enough, and Danish builders usually supply this end of the market.

France is even more difficult to work in for a Danish mortgage credit institution, but Danish contractors are active in France and they want assistance from their domestic mortgage lenders. The keyword here is joint ventures between Danish and French mortgage lenders.

In Portugal, Danish mortgage credit institutions may lend in sterling or German marks, mostly against security on holiday homes on the Algarve coast.

The American market offers exciting potential for Danish mortgage lenders because it is so innovative. It leaves an impression of a future global mortgage credit market. ■

Dr. Erling Olsen, MP, was born in 1927. He has been a Professor of Economics at the University of Copenhagen and Vice-Chancellor of Roskilde University, Denmark. He has been a member of the Danish Parliament since 1964. From 1978 to 1982 he was Minister of Housing. He is now with Kreditforeningen Danmark.

Index linking helps Colombians live with inflation

Lauchlin Currie explains how a system of index linking has eased Colombia's housing finance problem, despite a high inflation rate

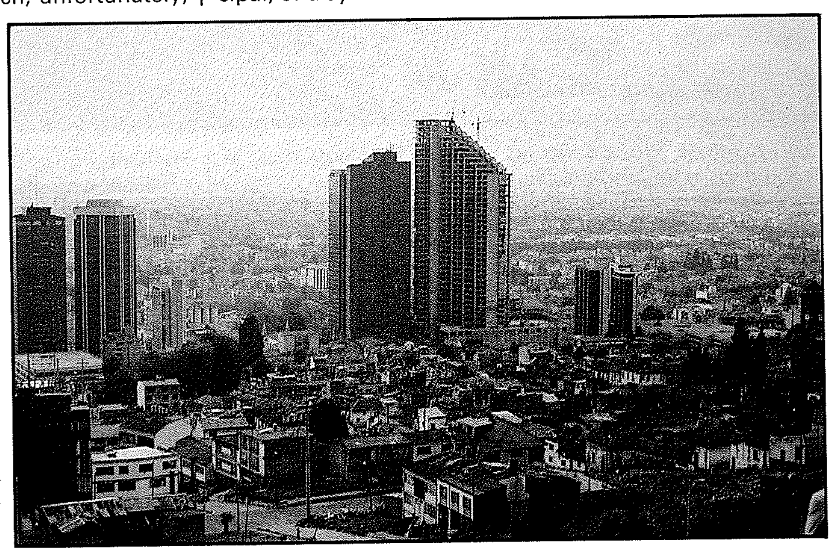
WHEN inflation is high, varying and chronic and is accompanied by high and varying interest rates of 20-40%, how is it possible to provide for continued, long-term housing finance? This was the problem confronting Colombia in 1972 — a state of affairs which, unfortunately, continues until the present.

Savers, quite properly, require security, liquidity, a return on their savings and protection against the loss of purchasing power. Borrowers require long-term loans and a debt service that at no time exceeds a certain percentage of their incomes (say a maximum of 25%).

So the problem is, how to meet these varying requirements? In the early '70s, Colombia's rate of growth was high, at over 7% per annum, but with heavy migration from the countryside to the cities, there was still unemployment, especially of relatively unskilled workers.

In short, there was urgent need for a financial system that would attract savings, finance building and create more growth and employment under rather difficult conditions.

The answer was found in linking savings and mortgages to the index of the cost of living. It should be noted that the link was made to the *principal* of savings and mortgages, not to the varying rates of interest on that principal, or a system that the Americans now call variable rate mortgages. The latter was considered as a possibility but was rejected.



There was, in Colombia, no prime rate, and rates in general were subject to wide fluctuations. By making the link to the real value of money, the real rate of interest on deposits and loans could become stable and low. Writing up the principal as inflation proceeded meant only a small addition to the monthly debt service, matched by the rise in incomes and property values.

It is true that the basic simplicity of the idea was complicated by the necessity of keeping accounts in terms of two units — one in current pesos, the other in pesos of constant purchasing power (Unidad de Poder Adquisitivo Constante, hence "the UPAC system") — and this caused some confusion at first. But it was amazing how quickly thousands of savers (now 3½ million) grasped the basic idea and the infant system grow so lustily during the first year and a half that a succeeding, hostile, Government did not dare to dismantle it.

It is now an essential part of Colombian life and "UPAC" has become a good Spanish word, serving as a verb as well as a noun. A branch of one of the 11 nationwide associations can be found in nearly every street.

It often appears that savers and

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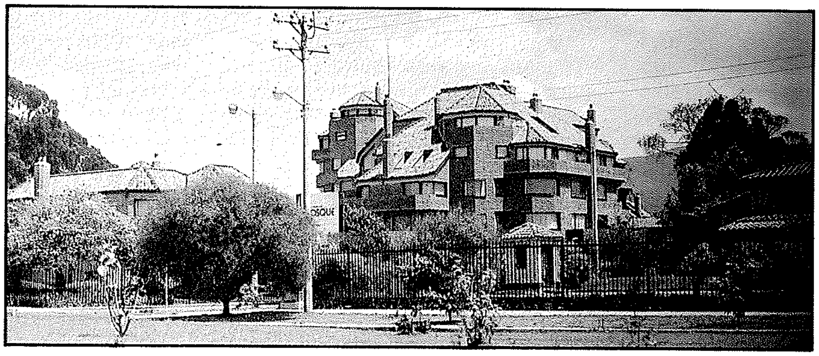
borrowers understand the basic principle of the system better than government officials, who cannot resist the endemic disease of "tinkering" by way of trying to use a privately owned system as a philanthropic agency of the State, putting limits on the monetary correction in the interest of the borrowers or of competing commercial banks, reducing interest rates by decree, and so on. It seems impossible for them to leave well alone.

Given the choice of living by principles or yielding to pressures, governments, at least in developing countries, will invariably choose the latter. Hence it is a constant struggle to maintain the basic principle of indexing and to keep indexing as automatic and non-discretionary as possible.

The only other country that has succeeded in doing this to an acceptable degree is Brazil, and it is significant that in the current heroic attempt of that country to return to stability, the only form of indexing that was retained at the beginning of the attempt was the indexing of savings and mortgages.



The Brazilian experience points to an important distinction that should be kept in mind. The reason why the term "indexation" has acquired a bad connotation among many economists is that it has been mistakenly applied. Instead of it being applied strictly to the correction of distortions and inequities caused by inflation *in the past,* as for example in old age pensions, it has been applied to wage agreements that try to *anticipate* inflation in the future and so raise unit costs immediately.

To return to the Colombian system, in the attempt to make it into a popular housing agency, the Government succeeded in making it practically profitless. This in turn has meant that it is very difficult to maintain a proper ratio between capital funds and total deposit liabilities. Since there is no deposit insurance in Colombia, the margin of safety supplied by the shareholders' equity is highly important.

So far the ratio of doubtful loans to the total has remained below that of other financial organisations. When failures do occur, the usual pattern is for the Government to take over the institution. The link between a long and severe recession and the growth of nationalisation is, in Colombia, to be found not in ideology but in expediency.

In the maintenance of such a rate, building has a most important rôle to play. Because of the peculiar nature of the demand, it is one of the few sectors that are responsive to exogenous stimuli and can be induced, if necessary and desirable, to move against the trend of activity. The key relationship is that of the monthly debt servicing charges and the rents on comparable existing houses. If monthly debt servicing charges can be reduced, new building will respond. This is the fundamental reason why building can be used as a leading sector, or arm of macroeconomic policy.

Index linking has permitted a steady flow of savings to the long-term financing of housing, even in a period of high inflation and deep depression. The amortisation of mortgages has created a new and important flow of savings to building. Colombia was so starved for proper housing and the demand for loans was so strong that an initial limit of 15-year maturities for loans was adopted, and this limit still remains.

The ability to start servicing mortgages with low real interest rates has broadened the market. Otherwise, paying nominal rates of, say, 30% would have meant, in effect, payments in the first year amounting to nearly a third of the original loan. Options are now available to make monthly payments a constant proportion of income throughout the life of the loan.

Very well, but what would happen if, as we all hope, inflation disappears? Nothing. Monetary correction would disappear and the two units of accounting would be the same. If inflation reappears, as is most likely, correction could occur automatically.

This appears to be an innovation in housing finance that merits close study and justifies the favourable judgment of Mark Boléat: "The experience of Colombia confirms that of Brazil in showing that housing finance systems can work even when inflation is running at a high level, given an appropriate method of indexation."[1] ■

[1] *Mark Boléat, "National Housing Finance Systems," Croom Helm Ltd, Kent, UK, 1985, pp. 363.*

Professor Lauchlin Currie is Professor of Macroeconomic Theory at the University of Los Andes. A more detailed study of the Colombian system is made by Luis Eduardo Rosas and the author in the pamphlet "UPAC: A Theory Converted into a Successful Reality," 1986, and is available on request to the Instituto Colombiano de Ahorro y Vivienda, PO Box 34281, Bogotá, Colombia.