

The Revolution in Mortgage Finance

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INTRODUCTION

Mortgages developed as a form of long-term finance for individual home-ownership with the emergence of mass markets for owner-occupied house building. As was shown in the previous chapter, the timing of the growth of urban home-ownership differs substantially between countries. In the USA and Britain, the inter-war period marked the advent of mass home-ownership, whereas in most European countries it developed during the post-war era. Owner occupation did exist before then, but mainly in the form of scattered, self-built housing developments in rural areas.

Similarly, the growth of specialised mortgage finance institutions is linked to the expansion of a mass market of standardised housing for sale. That market could only develop with the existence of specialised mortgage lenders, facilitating house purchases by individual home-owners. Although some mortgage finance institutions, as we know them now, were created as late as the 1930s, most derive from institutions that were set up in earlier centuries. For instance, the building society movement in Britain and the savings and loans associations (s&ls) in the USA developed during the eighteenth and nineteenth centuries respectively. Yet in both cases their current institutional structure and market significance were established during the inter-war period, as home-ownership became a mass phenomenon.

The history of the mortgage banks, which are major providers of housing loans in most European countries, is somewhat different. Their contemporary structure had already

developed during the second half of the nineteenth century, when mortgage banks played a major role in financing rapid urbanisation. Mortgage banks traditionally funded rented house building and urban infrastructural developments. The switch to owner occupation only occurred in the post-war period.

Recent changes in the traditional institutional structure of mortgage finance in many advanced capitalist countries have been amongst the most dramatic transformations in housing provision. Protected specialised financial circuits that dominated housing finance for long periods are disappearing in many countries. The changes are taking place in an era of increased competition between financial institutions, deregulation of financial markets and increasingly unstable housing markets. This chapter summarises and discusses the main developments leading to this 'mortgage finance revolution' and evaluates its likely consequences for housing markets and consumers.

Before dealing with recent developments, a description is given of the major types of specialised mortgage lenders in each of the countries we are dealing with.¹ A historical perspective shows that the implementation of protected and regulated housing finance systems in many cases resulted from earlier failures in financial and housing markets. Post-war inflation created optimism amongst policy-makers, investors and consumers alike, that house price rises are eternal and mortgage defaults a risk for consumers only. Such optimism is unfounded as past and current examples from a number of countries show.

MORTGAGE FINANCE INSTITUTIONS: TYPES AND SIGNIFICANCE

Two basic types of institution specialise in long-term housing loans in the countries included in our survey. The difference between them focuses fundamentally on the characteristics of their financial circuits. The first type of specialised mortgage lender uses personal sector liquid assets, further referred to as retail or personal savings, to fund housing loans and dominates mortgage finance in the USA and Britain (as well as in most other English-speaking countries). It can be referred to as savings banking, which may be limited to lending for housing only or include wider activities. The second type of institution is

found in most European countries (but not Britain) and taps funds from the wholesale money market via the issuing of mortgage bonds. These are called mortgage banks.

The distinct income sources of these institutions influence the type of financial market in which they operate and the terms and conditions of the mortgage loans they offer. The savings banking type operates in the personal sector and traditionally has been comparatively sheltered from fluctuations in capital markets. Savings banks work on the principle of borrowing short-term 'liquid' retail savings and lending longer-term loans. To respond to short-term fluctuations in interest rates, savings banks tend traditionally to offer variable interest rate loans. This has always been the case with the British building societies (as with savings banks in most countries), but the exception to interest rate variability are the savings and loan associations (s&ls) or other Thrift institutions in the USA, for reasons that shall be explained below.

The situation is very different for mortgage banks, which buy their funds wholesale on capital markets, or more specifically, the bond market. The long-term fixed interest rate debt papers (mortgage bonds) they issue, in principle reflect the time profiles and the interest rate structure of the mortgages they lend.

Further differences exist between the two types of mortgage finance institutions, for instance regarding the housing market sectors in which they traditionally specialise. Other variations occur between countries with similar types of housing finance institutions. The following section first describes the savings banking scheme in more detail for Britain and the USA, followed by a description of the specialised types of institutions that dominate mortgage lending in West Germany, the Netherlands and Denmark.

The Savings Banking System

The origin of the savings banking scheme for funding housing loans goes back to the start of the building society movement in eighteenth-century Britain. The first were terminating societies, regularly subscribed to by a small number of members, until enough money was accumulated to build houses for each of them. Such initiatives for providing housing, based on thrift and co-operation, expanded amongst the middle class and the

regularly employed working class. Even though their overall significance in house building remained limited at the time, the growth of the building society movement was linked to processes of industrialisation and the growth of wage-earning classes and signified the need for personal savings and loans for obtaining home-ownership. British immigrants introduced the building society concept to the USA, where they are referred to as the Thrift industry, which comprises savings and loan associations and mutual savings banks (Ornstein, 1985).

As the building societies and the Thrift industry expanded, many were converted from a terminating to a permanent basis. In both countries, this transformation occurred around the mid-nineteenth century and signified a major change as the link between investors and borrowers was broken. Individuals could deposit their savings without necessarily wanting to buy a house and the savings associations and societies could diversify their investments by lending to house-builders and private landlords. But, in the main, the associations continued to raise retail funds from moderate-income households and to lend to individual house-buyers.

Although the origins of the British building societies and the Thrift industry in the USA are quite similar, their current structures are very different. The legal framework for building societies was first established in its modern form by the Building Societies Act of 1874. Adjustments, however, were made in subsequent decades, following society failures through reckless speculation, which reduced public confidence in the sector as a whole. An act of 1894 tightened supervision by the Registrar of Friendly Societies and lending was restricted to first mortgages only (Cleary, 1965). Further adjustments were made at the end of the 1930s, after building societies had experienced 20 years of rapid expansion with the emergence of mass home-ownership in Britain and low returns on competing investments. Building societies complemented the activities of speculative house-builders through facilitating large-scale house purchase amongst the skilled working and middle classes. Building societies and builders developed practices which required only small down payments by house-buyers. These so-called builder's pools led to malpractices in mortgage lending and eventually to a new act in 1939 (see Craig, 1986 for a detailed account). Rather than just outlining the structure of building societies, the act defined, for the first time in some detail, practices relating to lending

security and property valuation and also aimed to distinguish between the interests of builders and lenders (Cleary, 1965).

Another major development during the 1930s concerned the formation of a building societies' interest-rate-fixing cartel following intense competition between them. The cartel only became effective at the end of the decade, when demand for mortgages was faltering, but it was subsequently maintained until the early 1980s. Interest rate levels in the cartel generally allowed for a sufficient inflow of funds to building societies, plus an adequate interest rate margin between borrowing and lending for most of them. A strong inflow of funds was further secured by tax advantages given to the societies and their investors, which helped the societies to expand their share of the retail savings market. The ascendancy of building societies in mortgage lending was established during the inter-war period, a position that was to improve after the war in an era of non-price competition between them.

Compared to the building societies, the American Thrift industry relied far less on self regulation. As in Britain, the modern structure of the Thrift industry was established in the 1930s, but the circumstances differ substantially. Savings and loans associations grew rapidly during the 1920s, but the Wall Street crash of 1929, and the subsequent run on savings deposits, caused massive failures amongst Thrifts, which in addition had to cope with large-scale defaults on housing loans during the Depression. In response to these problems, measures were taken in a number of acts under the New Deal, making the housing finance industry in the USA possibly the most regulated in the world. The new regulations, meant to prevent similar banking failures in the future, can be summarised as follows:

- i) A segregation was created between the various sectors of the financial industry. Commercial banking became separated from investment banking, and investment banks were not allowed to accept deposits or to make loans. To insulate housing finance from capital markets, Thrifts became legally required to invest in housing loans and received tax exemptions for doing so. Both commercial banks and Thrifts were barred from having branches in more than one state (Florida, 1986).
- ii) The Thrift industry was subordinated to a special charter-

ing and regulatory body, the Federal Home Loan Bank Board (FHLBB), which also has supervisory authority over the Federal Home Loan Bank (FHLB). The FHLB was established as a central bank for the savings and loan industry (equivalent to the Federal Reserve System for commercial banks) to advance extra funds to its member organisations when these were needed (Ornstein, 1985).

iii) All federally regulated financial institutions were required to insure their deposits. For the s&ls, the Federal Savings and Loan Insurance Corporation (FSLIC), also supervised by the FHLBB, fulfilled this function and to a lesser extent also the Federal Deposit Insurance (FDIC), which was mainly set up to insure deposits with commercial banks.

iv) Interest rate ceilings on savings deposits were imposed. The measure aimed to reduce competition for such funds and thus encourage more prudent lending practices. Regulation Q, which set interest rate ceilings on deposit accounts, gave Thrifts a quarter percentage differential above commercial banks' lending rates.

v) A secondary market for mortgages was established via the creation of the Federal National Mortgage Association (FNMA, usually referred to as Fannie Mae), which could buy mortgages from the portfolios of s&ls which were in need of extra funds.

vi) Finally, a mortgage insurance scheme was introduced through the Federal Housing Administration (FHA). After the war the scheme was joined by a guarantee scheme under the Veterans Administration (VA). The main advantage of the FHA and VA loans is that they require only small deposits from house-buyers and the scheme was aimed at encouraging house building. Another aspect of these loans is that they introduced a new type of mortgage, the fixed interest rate, self-amortising annuity loan. The fixed interest rate loan also developed as the standard instrument for what is called conventional, i.e. non FHA & VA, loans.

Thus the fixed rate loan, refinanced by relatively cheap funds resulting from interest rate ceilings on retail deposits, made individual home-ownership an increasingly attractive proposition. FHA and VA loans, in particular, helped to fuel the post-war house-building boom in standardised housing in large-scale suburban developments (Checkoway, 1980). Although Thrifts

were not the only participants on the housing market, they remained the main mortgage lending institutions after the war and expanded their asset volume considerably. Although the largest American Thrifts have more assets than the largest British building societies, the Thrift industry is much more dispersed, because of the inter-state banking laws: with 3,350 Thrift institutions, in 1984 and the largest five taking up nine per cent of the total asset volume, whereas building societies numbered 206 institutions, with the largest five taking a 55 per cent market share (see HM Treasury, 1984 and National Council of Savings Institutions, 1985).

Finally, the West German *Bausparkassen* should be mentioned as another specialised mortgage lender within the savings banking scheme. Unlike British building societies and American Thrifts, *Bausparkassen* have always maintained the link between investors and borrowers, but in a way which differs from the terminating societies mentioned earlier. Loans are only allocated to contract savers and the size of a loan depends on the amount saved and the duration of the savings contract (usually about seven to ten years), *Bausparkassen* operate fixed low-interest savings and loan schemes. Contract savings are subsidised by the state and have therefore been competitive. The low interest loan costs, however, are offset by their high amortisation rate (seven per cent). Loans are repaid rapidly relative to other mortgages, which in terms of annual outgoings makes them at least as expensive as other forms of finance. The high amortisation rate thus limits the *Bausparkassen* to funding second mortgages as their loans are too expensive to repay full housing loans.

Bausparkassen were founded from the mid-1920s onwards to encourage collective savings schemes for house building. Their foundation was a response to a period of hyper-inflation, which was followed by a currency revaluation in 1923, and had led to a massive destruction of savings. Their role in funding second mortgages grew in the 1930s when deflation led mortgage banks to restrict lending limits to 40 per cent of house prices. *Bausparkassen* expanded substantially after the Second World War, with a 20 per cent market share of all outstanding housing loans by 1970. Their expansion was strongly linked to owner-occupied one-family house building.

The Mortgage Banking Scheme

The origins of mortgage bonds go back to eighteenth-century Prussia, when agriculture was destroyed after a war with Austria (1756–63) and large landowners were unable to finance recovery (Pleyer and Bellinger, 1981). To overcome the problem, landowners formed associations, which issued collectively guaranteed debt papers (bonds) to their individual members. These bonds were secured by landed property and enabled landowners to raise long-term funds on capital markets. The mortgage bond scheme subsequently expanded rapidly to other European countries.

With the creation of the *Crédit Foncier de France* (CFF) in 1852, the mortgage bond issuing system was transformed into what are now known as mortgage banks. Rather than just facilitating borrowing for their members, mortgage banks act as financial intermediaries between borrowers and investors. But, like their predecessors, they specialise in raising long-term funds with debt papers secured by real estate. Such mortgage banking institutions were founded in West Germany and the Netherlands (as well as in many other European countries) from the 1860s onwards.²

The Danish mortgage credit institutions (MCIs) differ somewhat from the mortgage banks. Most contemporary MCIs developed out of the agricultural co-operative movement during the second half of the nineteenth century. They did not function as banking intermediaries, but were based on similar principles to the original Prussian scheme, with mutual associations of borrowers who provided mortgage bonds for their members, farmers or house-buyers. Only as late as 1980 were MCIs fully transformed into a 'cash loan' system, whereby borrowers were given loans directly, rather than in the form of bonds, which they could sell individually to raise finance. But MCIs remain mutual organisations (except for one founded after the war), with members collectively guaranteeing all the bonds issued.

Mortgage banks in West Germany and the Netherlands were originally privately owned stockholding companies. Most Dutch mortgage banks used to be independent, although the first one to be founded was owned by the co-operative banks and a couple were taken over by insurance companies in the late 1930s. (More recent developments are discussed later.) In

West Germany, mortgage banks were also founded in the public banking sector during the inter-war years. German public mortgage banks have been instrumental in funding public infrastructural works and social house-building projects, particularly during the Weimar republic and the period following the Second World War.

The specialisation of mortgage banks derives from their ability to issue long-term bonds on capital markets: a privilege restricted to a small number of institutions. The Danish mortgage credit institutions and Dutch mortgage banks monopolise the long-term bond market, whereas in West Germany the specialisation of mortgage banks compares with the far greater restrictions imposed on the volume of bonds other types of banks are allowed to issue. Apart from bonds, Dutch mortgage banks can also raise funds via *onderhandse leningen* (private loans), which are loans directly provided by large investors, such as pension funds and insurance companies, without intermediation by a financial institution. This type of funding has become more important over the last two decades.

The history of mortgage banks has not been without turbulence. Failures have followed real estate booms (as in West Germany in the 1870s) or agricultural crises (like in Denmark in the 1930s). Periods of falling house prices have threatened the security of mortgage bonds for investors and led to the introduction of limits on mortgage/house price ratios. In West Germany, mortgage banks are legally confined to lending on first mortgages only, defined as the first 60 per cent of house price valuations. In Denmark, until the 1970 reform of mortgage credit institutions, lending policies of MCIs were not legally stipulated. Instead, lending limits were related to practices developed by the MCIs themselves, who offered only a particular tranche of a loan. Thus, until 1970, house-buyers had to obtain first, second and third mortgage loans from different institutions, covering respectively, up to 40/50 per cent, 40/50 - 65/70 per cent and 65/70 - 75/80 per cent of house prices. Credit institutions specialised in one of the tranches. With the 1970s' reform, MCIs were merged into four institutions, the tranche system disappeared and new, strict lending criteria were enacted. MCIs, for example, were restricted to lending up to 80 per cent of valuation prices for new houses and 40 per cent for existing ones.

Dutch mortgage banks have lacked regulation and govern-

ment supervision for most of their history. While in Germany the first act to regulate mortgage banks dates from 1899, the first legislative controls were as recent as 1979 in the Netherlands. Prior to 1979, government supervision was limited and indirect via the central organisation of Dutch mortgage banks. The state savings bank also had some supervision rights, but on behalf of investors in mortgage bonds (Klein & Vleesenbeek, 1981). Regulations were only concerned with protecting bond investors: most significantly, lending was generally restricted to first mortgages, which could cover up to 75 per cent of house price valuations. The losses Dutch mortgage banks had made during the economic depression of the 1930s, unlike experiences elsewhere, had not led to more government regulation and supervision. Instead, the 'self-regulating' response was a wave of mergers within the sector and of take-overs of some mortgage banks by insurance companies at the end of the decade.

Until taken over by the Ministry of Housing in 1981, supervision over the Danish MCIs was in the main left to their central organisation. So the predominance of self-regulation for most of their existence is similar to the Dutch case, but as explained before, MCIs are not financial institutions. They only facilitate borrowing from the capital market for their individual members, without being financial intermediaries. In reality, however, the new supervision power of the Ministry of Housing is still limited, as hardly any sanctions are linked to it. Supervision by the Ministry was negotiated when mortgage lending possibilities for MCIs were liberated by parliament. Liberation particularly concerned an increase of mortgage/house price ratios for existing housing. MCIs are generally not regarded as being exposed to major lending risks, because of the regulated loan to house price ratios. Loans are tied to the house, rather than the borrower, whose financial situation is not really assessed by the MCI. In case of default, the loan is sold with the property to the next owner, or, if the selling price is insufficient to cover the debt, temporarily acquired by the MCI. House prices, so far, have not fallen enough to threaten the system. A more important aspect of adjusting lending limits of MCIs is that it is used as a policy instrument to control the volume of consumer credit that can be financed by mortgages. As MCIs not only monopolise the mortgage bond market, but also came to be the sole providers of housing loans in Denmark for both rented and owner-occupied housing, it is not surprising

that they are a main target of monetary control policies.

The business of German mortgage banks was stagnant for most of the inter-war period, but it has expanded substantially since 1945. Up to the 1960s growth was linked to state-subsidised house building, for which long-term fixed interest rate loans were required. By financing West Germany's large post-war house-building programme, mortgage banks, public and private, became the largest housing finance institutions, with a 36 per cent share of outstanding mortgage loans in 1970 (Ball et al., 1986). Only in the 1970s did West German mortgage banks start to lend to individual house-buyers on a significant scale.

The Dutch situation is different again. Mortgage banks expanded substantially during the inter-war house-building boom by financing large-scale housing developments in the private rental sector. Private rental house building virtually disappeared after the war and what remained was financed and managed by pension funds and insurance companies. Most social rented house building was realised with state subsidies and state loans. Owner occupation did not develop until the late 1950s, when direct subsidies were given to house building for own use and when a government mortgage loan guarantee scheme was introduced to reduce down payments for prospective house-buyers. The guarantee scheme for owner-occupiers enabled mortgage banks, previously restricted to ratios of 65–70 per cent, to lend up to 90 per cent of house price valuations. The business of mortgage banks increased as a result, but did not really take off until the owner-occupied housing boom of the 1970s. Meanwhile, mortgage banks had incorporated other activities in their investments, such as financing commercial property developments. So it is mainly due to the peculiar post-war provision structure of rental housing that Dutch mortgage banks were confined to lending to owner-occupiers. The market share of mortgage banks was estimated at 28 per cent in 1935, with private individuals as market leaders in housing loans. Mortgage banks only regained this market share again 40 years later (Rijnvos, 1981).

Finally, the USA mortgage companies should be mentioned, as they have played a major role in post-war housing finance. American mortgage companies differ from the European mortgage banks as they do not hold mortgages in their portfolios, but only originate mortgages for sale on to other

investors. Profits are made from the fees charged for mortgage origination, and through servicing mortgages for the ultimate investors. The major source of income is through servicing loans. Also, those firms which specialise in mortgage origination make a profit from selling the right to service the loans.

Mortgage companies, typically, specialise in funding single-family owner-occupied housing. They gained significance during the 1920s, when long-term loans were hard to find. The industry declined with the rise of the Thrift institutions in the 1930s and after the war, but revived again in the 1970s with the rise of the secondary mortgage market. The role of mortgage banking in mortgage originations has tended to be cyclical, rising in significance when market rates of interest increase; when Thrifts were less competitive in raising sufficient funds to meet demand, because of ceilings on their deposit rates.

Mortgage banking in the USA is not regulated and as there are no restrictions on inter-state mortgage banking, a national presence can be developed. Mortgage companies have been important in selling FHA and VA loans, and in shifting funds between states and channelling them into housing. Non-regulation includes the absence of restrictions on loan to own-capital ratios for the mortgage companies. Mortgage/house price ratios are regulated indirectly, via requirements linked to the mortgage pools held by the federally supported, secondary mortgage market institutions (see below). Most housing loans that are originated by mortgage companies are sold via such mortgage pools. These loans mainly include FHA and VA loans, but increasingly also privately insured, conventional loans.

COMPETITORS FOR MORTGAGE LENDING

Specialised housing finance institutions have never been the sole lenders of mortgages in the countries studied here, with the exception of Denmark. But until the mid-1960s, competition for mortgage lending was fairly limited as the market was divided by region or housing sector, between the active financial institutions. Table 4.1 gives an overview of the financial institutions with significant shares in housing loans in the respective countries. A brief mention will now be made of the non-specialist mortgage lending institutions, as the specialised institutions have already been discussed.

Table 4.1: Housing Finance Institutions and their Changing Significance: market shares in the volume of outstanding mortgage credit

Country	Specialised Institutions Source of Funds		Other
	Retail	Wholesale	
WEST GERMANY	<i>Bausparkassen</i> (18% – 19%)	Mortgage Banks (36% – 25%)	Savings Banks (34% – 32%) Commercial Banks (5% – 11%) Co-operative Banks (5% – 11%)
1970–84			
NETHERLANDS		Mortgage Banks, <i>Bouwfondsen</i> (31% – 8.2%)	Co-operative Banks (29% – 37%) Universal Banks (18% – 22%) Savings Banks (8% – 16%)
1975–84			
DENMARK		Mortgage Credit Institutions (100%)	
BRITAIN	Building Societies (63% – 76.5%)		Clearing Banks (8% – 16.5%) Local Authorities (11% – 3%) Insurance Companies (18% – 2%)
1960–85			
USA	Savings & Loan Ass. (39%–)	Mortgage Companies (originations only)	Commercial Banks (13% – 15%) Life Insurance Companies (12% – about 3%) Federally Related Agencies (7% – 9%)
1970–84	Mutual Savings (14%–)	Mortgage Pools (0.7% – 21%)	
	(both 41% in '84)		

Note: Data for the Netherlands, the USA and Britain only concern lending to individual home-owners, whereas in Denmark and West Germany other tenures are also included.

Sources: West Germany: Deutsche Bundesbank, *Statistische Beihefte*; The Netherlands: Nederlands Bank nv, *Annual Report 1984* & Burgert et al., 1981; Britain: Ball et al., 1986 & *BSA Bulletin*, no. 47, 1986; USA: *The Report of the President's Commission on Housing* (1982) & Meyerson 1986.

Savings banks are West Germany's largest banking sector and were the second largest mortgage lenders in the early 1970s. They are owned by the local authorities or regional councils (*Kreise*) and their activities are limited to the jurisdiction of their parent authority. The ownership structure influences the role savings banks play, which is to invest in municipal projects, small companies and housing loans and to encourage moderate-income households to save. Thus savings banks mainly borrow retail funds and have most of their assets in long-term loans, about half of which are mortgages. Savings banks' substantial market share in housing finance is mainly achieved via funding variable rate, first mortgage loans to individual home-owners. Traditionally, their business was complementary to mortgage banks' lending to rented house building and to *Bausparkassen*, which only issued second mortgage loans.

In the Netherlands, competition for mortgage lending focused on the owner-occupied housing sector, as rented housing was generally financed without the intermediation of financial institutions, referred to in financial statistics as business loans. The latter are not included in Table 4.1. Rented housing loans are mainly provided by the state, insurance companies or pension funds and only occasionally by mortgage banks, when the former sources could not meet the demand.

Apart from the mortgage banks and *Bouwfondsen*,³ Dutch housing loans are also provided by co-operative and savings banks, but in relative isolation from each other and with little competition between them (Rijnvos, 1981). The co-operative banks, with a market share of about 50 per cent in financing individual home-owners during the 1960s, are mainly agrarian based and focused on rural areas. Savings banks, on the other hand, are more orientated on the urban population. Traditionally, their main function was to secure deposits small savers made with them and savings banks were in effect rather like a social security scheme rather than a banking institution. Savings banks are legally confined to dealings in the retail sector in contrast to the co-operative banks, which are included in the commercial banking sector and allowed to issue business loans. Within the co-operative and savings banking sectors competition used to be limited, because of the regional or local specialisation of their member banks. The Dutch mortgage market was dominated by the co-operative and savings banks until the late

1960s. As mentioned earlier, Dutch mortgage banks did not substantially expand their mortgage business until the 1970s. The high costs of their funds compared to their main competitors led to their status as lenders of last resort.

The Danish mortgage credit institutions faced very little competition. Savings banks, for instance, were active in providing second mortgages in the period up to the late 1960s, following policies of MCIs of lending only 50 to 60 per cent of house prices. Housing loans offered by savings banks were more expensive than those refinanced by mortgage bonds and therefore unattractive as first mortgages; a situation which is different from many other countries. Danish banking institutions were only active in areas where MCIs' activities were restricted, such as in the second-hand housing market. Competition was also limited between MCIs, because of their specialisation by region or particular loan tranches.

Apart from the British building societies, with by far the largest market share in post-war mortgage lending, housing loans were also provided by insurance companies, local authorities and clearing banks. Again, each of them specialised in particular segments of the market. Local authority lending concentrated mainly on smaller, cheaper dwellings and was aimed at encouraging lower-income home-ownership, because, at the time, these were household and housing categories which building societies were reluctant to invest in. Insurance companies, on the other hand, primarily lent to upper-income groups. Generally, mortgages have only been a minor part of their assets (Ball et al., 1986). (The Dutch insurance companies, in contrast, are major mortgage originators, but sell them on to pension funds to maintain liquidity.) As elsewhere, insurance companies' main reason for investing in mortgages is to sell insurance policies, which accounts for their role in the growth of endowment mortgages during the 1970s.

The British clearing banks, finally, do lend mortgages, but did not have a significant presence until the 1980s. Clearing banks owe their name to their collective monopoly over the British cheque-clearing system. The sector is dominated by a handful of large private banking concerns, which had traditionally concentrated on lending to industry, trade and the public sector and only diversified into large-scale consumer lending during the 1960s. They tended to concentrate mortgage lending on the higher-priced sectors of the market.

The main competitors to the Thrift industry in the USA are the commercial banks and insurance companies. But both latter types of investor lost major market shares in mortgage lending to individual house-buyers during the 1960s (Tucillo and Goodman, 1981). Their loss of market share enhanced the role of the Thrifts in mortgage lending. But the reason for the reduced role of commercial banks and insurance companies was related to the reduction in the net return on mortgage investment relative to corporate securities (*ibid.*). The role of insurance companies in mortgage origination reduced to virtually nothing and the mortgage lending business of commercial banks became increasingly cyclical.

PRESSURES FOR CHANGE

Having examined the different types of financial institutions involved in housing finance in each of the countries, the remaining part of this chapter will discuss the transformations they have undergone over the past decade and the reasons for the changes. Specialisation and semi-protected financial circuits provided the key to the expansion of the mortgage finance institutions during the post-war house-building boom. But their competitive environment has changed substantially over the past two decades, and so has the political support given to them.

Pressures for change differed in their effects and in their specific outcomes. But, at a general level, the following developments contributed to the transformation of specialised mortgage lending. Each will be discussed in more detail in subsequent sections.

- i) There has been a general increase in competition in financial markets, both in the business of mortgage lending and in attracting funds, particularly retail savings. Changes in the financial environment in which housing finance institutions operate include general trends towards deregulation and financial supermarkets and the impact of technological innovation on competition.
- ii) Specialised mortgage lenders had to adjust to a new era of rising and volatile levels of interest rates, particularly during the 1970s and early 1980s. Particularly affected were institu-

tions which traditionally offered long-term fixed interest rate loans.

iii) Developments in housing markets altered the economic environment of mortgage lending institutions' investment activities.

iv) Managers of housing finance institutions, in addition, opted for continuation of the rapid expansion they had experienced throughout the post-war years.

v) Finally, commitment of central governments to maintain the semi-protected financial circuits for housing loans disappeared in many countries, or has been greatly eroded, together with the political priority given to house building.

COMPETITION IN FINANCIAL MARKETS

The 1960s brought about major changes in the competitive environment of specialised housing finance institutions. Their institutional structures did, however, not undergo major alterations until the 1980s, with the exception of West Germany's mortgage banks.

Competition grew for mortgage institutions' sources of funds in a number of countries, particularly in Europe, as a result of new attempts by commercial banks to increase their share in personal borrowing and lending. The growth in personal wealth during the post-war years made retail savings an increasingly attractive source of funding for commercial banks. Extra competition for retail funds coincided with trends to deregulate interest rate fixing. Similarly, reductions were made in tax advantages related to credit institutions traditionally operating in the retail market, and they affected the competitive position of savings banks, credit co-operatives and, in some cases, specialised mortgage lenders. As a result of these changes during the late 1960s differences between the types of banking institution reduced substantially, leading to the gradual evolution of universal banking. Again, the timing of these developments differs between countries. In Britain, for instance, specialisation within the banking sector still prevails, although it is less rigid than before, whereas the universal banking system has dominated in West Germany for over 15 years. Mortgage lending has been a major influence on the growth of universal banking.

West Germany's commercial banks saw their market share of banking business fall substantially during the 1960s (from 37.6 per cent in 1950 to 22.1 per cent in 1967) (EAG, 1981). The loss was particularly marked for the big three commercial banks following a decline in the demand for industrial credit. The 'big three' along with the credit co-operatives and their central organisation, became the most aggressive competitors for mortgage finance in the 1970s. All these institutions developed a market position in mortgage lending by acquiring majority shares in private mortgage banks during the early 1970s (see Ball et al., 1986 for a more detailed account). By integrating private mortgage banks into their banking consortia, commercial and co-operative banks were following what were already existing practices within the public banking sector. There, the savings banks offered full mortgage packages in co-operation with public mortgage banks and public *Bausparkassen*. So, within a very short period of time, the competitive environment for mortgage lending institutions changed dramatically: from a situation where mortgages were offered by institutions who specialised in particular segments of the market, to competition between the three major pillars of the universal banking sector. Commercial banks, savings banks and co-operative banks each offered similar mortgage packages (usually referred to as 'finance under one roof'), which were refinanced by a mixture of wholesale and retail funds.

The main losers from the new intense competition have been the mortgage banks, whose share of outstanding loans declined from 36 per cent in 1970 to 25 per cent in 1983 (Ball et al., 1986). Losses for the mortgage banks became gains for commercial and co-operative banks, partly because of their new ownership of mortgage banks and partly as growth in mortgage lending during the 1970s was concentrated in the area of second mortgages, which mortgage banks could not fund.

West German universal banks' policy of expanding their market share in mortgage lending was not followed by banks in other countries during the 1970s. Other diversification strategies were used instead by most commercial and savings banks. The central organisation of the Dutch co-operative banks (the Rabobank) does own the country's largest mortgage bank, but the ownership relation dates from the last century and so was not part of any new investment strategy. The Rabobank, however, has been and still is the largest single mortgage

lending institution in the Netherlands, which may indicate the advantages of combining commercial and mortgage banking. The Danish MCIs, in contrast, outrank the largest banks in asset volume, which makes it more feasible for them to acquire commercial banks, rather than the other way around. But with the exception of West Germany, government policies have, so far, prevented mergers or take-overs between institutions operating in different financial sectors. Such sector policies have aimed to prevent national economies becoming dominated by just a very few financial supermarkets. But the trend towards deregulation and the development of large financial conglomerates, offering all kinds of financial services has persisted in all countries. In some cases, as will be shown below, crises within the mortgage finance sectors accelerated the deregulation process of financial markets.

For West German universal banks, mortgage lending was primarily seen as a profitable and secure form of new investment. Dutch commercial banks, conversely, developed their involvement in housing loans during the 1970s as a way of expanding their business in the personal sector and particularly in the retail savings market. Their strategy was to offer mortgages on very competitive terms if customers would accept other financial services from them. Such strategies were particularly targeted at newly built housing areas. Another new competitor in Dutch mortgage lending, the Post Office Savings Bank (RPS), now the second largest mortgage lender, entered the business for similar reasons. As with other savings banks, it has developed from an institution obliged to find secure long-term investment for small savers' deposits, to an institution providing full banking services to, in the main, personal customers.

Developments in the competitive environment of specialised mortgage lenders seem to have occurred differently in countries where savings banking forms were dominant. In both Britain and the USA, specialised housing finance institutions dominated mortgage lending well into the 1980s. The market share in housing loans of the British building societies (around 80 per cent) was, however, much larger than that of the American Thrift industry (nearer to 50 per cent). Competition was limited in Britain, at least until recently. Only during the 1970s was local authority lending to home-owners of any significance. Clearing banks started to expand in housing loans during the

same period, but without acquiring a significant market share until the early 1980s. Before then, competition between banks and societies focused on retail savings and the latter were most successful, overtaking the banks as market leaders by the mid-1970s (Ball et al., 1986).

In the USA, the situation was similar in the sense that competition was fiercest in the retail savings market, i.e. for funds rather than over investments. But competition for the Thrifts was with institutions operating outside the regulated banking system, as both banks and Thrift institutions had imposed interest rate ceilings on the savings deposits they could offer. At the same time, Thrifts' market share in mortgage lending increased during the 1960s and 1970s. Rising inflation and interest rates encouraged insurance companies to leave the market, shifting to higher-yielding securities and real estate, while the banks' mortgage lending activities became more cyclical, depending on the rate of profitability of mortgage lending in comparison with other types of investment (Tucillo and Goodman, 1983).

INFLATION AND INTEREST RATE VOLATILITY

Of all the countries included in this survey, the effects of inflation and unstable levels of interest rates have been most dramatic for housing lenders in the USA. Although Thrift institutions managed to expand their market share in housing loans due to the withdrawal by insurance companies from mortgage lending, interest rate volatility periodically caused what are called 'disintermediation' problems. During periods of rising interest rates, returns on deposits with Thrift institutions increase more slowly than general interest rates, encouraging many savers to deposit their funds in higher-yielding investments elsewhere (Miles, 1983). A disintermediation crisis in the mid-1960s caused a net outflow of funds with Thrifts and commercial banks, leading to the first major pressures towards deregulation. But, rather than resulting in deregulation, Thrifts were instead put under the same regulatory powers as the banks. Before 1966, Thrifts were able to adjust deposit rates subject to supervision by the FHLBB, but deposit interest rate ceilings have been imposed on them since that year, Regulation Q, however, permitted Thrifts to offer one-quarter per cent

above commercial banks' deposit rates, enabling Thrifts to continue to expand their share of the personal savings market.

Interest rate ceilings on deposits seemed only to exacerbate problems of the Thrift industry during the 1970s as outflows of funds continued to occur during high interest rate periods, and at times inflation reduced the real value of the interest rates of their savings deposits to zero or even less. Pressure for deregulation continued, particularly from the large commercial banks (Florida, 1986). Since the late 1950s there has been a succession of committees to review the legislative framework of the New Deal banking system. Large banks initially responded to the success of the Thrift industry under the regulatory system. Mortgage lending proved very profitable in the years following the war, enabling Thrifts to develop to sizeable financial institutions and Thrifts' market share in the retail savings market increased substantially. Deposit rate ceilings and Regulation Q inhibited banks from improving their competitiveness in this market. Pressure from the large banks for deregulation stepped up during the second half of the 1970s, when they faced more competition from non-banking institutions entering the business of consumer lending and from foreign banks in both international and domestic financial markets (*ibid.*). It was finally introduced with the Depository Institutions Deregulation and Monetary Control Act (DIDMC) of 1980.

The act responded to the policies of non-regulated institutions, like insurance companies and brokerage houses, which had introduced highly competitive money market funds for personal savers. Such money market funds again led to a net outflow of funds from the regulated institutions during the late 1970s. The DIDMC act allowed Thrifts some diversification of asset powers and — more importantly — imposed a gradual phasing out of deposit rate ceilings. But because it was introduced at a time when market interest rates were at very high levels, it resulted in a substantial increase in the costs of borrowing for Thrift institutions. The Thrifts' problems were compounded by the fact that most of their assets were in long-term, fixed interest rate loans issued during periods of lower interest rates. The consequences for the industry were dramatic. Three-quarters of Thrift institutions made losses during the early 1980s. Between 1980 and 1984, 1,200 institutions disappeared following failures and mergers. Of the 3,000 or so

Thrifts left, another 1,200 were still in 1985 technically bankrupt. Another indication of the extent of the crisis of the industry is that FSLIC, the institution which insures Thrifts' deposits, will need at least \$20 billion to help the failing Thrifts, \$15 billion of which is expected to be paid by the US government (*New York Times*, 30.4.87).

In effect, deregulation exacerbated the crisis within the Thrift industry. To allow Thrifts to compete more directly with their already highly diversified competitors, the 1980 act was followed by another two years later (Garn-St. Germain Act), which aimed at accelerating the deregulation process. The act accelerated the phase-out of deposit rate ceilings and allowed Thrifts and banks to offer accounts comparable to the money market funds. Deregulation was particularly stepped up on the asset side, as Thrifts were allowed to divert a much higher percentage of investments into areas like commercial and consumer lending and business loans. The massive crisis within the Thrift industry and its subsequent restructuring, however, has reduced its significance as originator and — more importantly — holder of mortgage loans. Its market share in the volume of outstanding housing loans fell from 56 per cent in 1977 to 41 per cent in 1984 (Meyerson, 1986).

The crisis of the Thrifts enhanced the role of the secondary mortgage market. Already during the late 1960s and early 1970s a new impetus was given to this market with the restructuring of the FNMA and the foundation of two new federally supported secondary mortgage market institutions, the Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). Initiatives to expand the role of the secondary mortgage market aimed at the supply of additional funds to Thrift institutions when their traditional resources failed them. FNMA was privatised in 1968 and retained its secondary mortgage market function as a major buyer of mortgages from originating institutions like Thrifts, commercial banks and, most significantly, mortgage companies. GNMA is, however, fully owned by the US government and took over FNMA's function to support special federally assisted housing programmes. But more important has become GNMA's scheme to guarantee instruments which are sold to private lenders to attract additional funds into housing (HUD, 1973). The introduction of pass-through, mortgage-backed securities and mortgage-backed bonds, as these instruments are called,

particularly enhanced the role of the secondary market during the 1970s. Mortgage-backed securities are made from pools of mortgage loans, which are guaranteed by GNMA in the case of FHA/VA loans. Similarly, FHLMC, a private corporation and member of the FHLB system, guarantees mainly conventional loans. The combination of risk pooling and guarantee by federally supported institutions made these securities into attractive investments.

Virtually all new loans originated by Thrifts are today passed on through the secondary market. Originating and servicing loans for the ultimate investors is now seen by many Thrifts as a securer way to earn a steady income. The secondary mortgage market has also come to the rescue of Thrifts, by allowing them to sell their non-performing, low interest mortgage portfolios. Special mortgage-backed security programmes were devised to assist Thrift institutions in selling off the old low-rate mortgage debt. In the scheme, old loans are transformed into tradeable securities and repurchased by the Thrift institutions. 'Swap deals', as these are called, are in fact no more than a creative accounting device (with a federal stamp) to improve liquidity within the Thrift sector (and apparently also a very profitable exercise for FNMA). Thus the market share of the volume of outstanding mortgage loans which the Thrifts lost was mainly a gain for the mortgage pools held by the federally sponsored secondary market institutions (see Table 4.2).

The effects of interest rate volatility and inflation in an era of increased competition in financial markets has been less devastating for the operating structure of specialised mortgage lenders in the other countries in our survey, but there have still been dramatic effects in some cases. Volatility of market interest rates has forced mortgage banking institutions to juggle between the interests of borrowers and investors. When interest rates rise, borrowers are unwilling to take on expensive, long-term fixed interest rate loans, while, at such times, investors try to sell their existing bond portfolios. Conversely, when rates are low, investors are less inclined to buy long-term bonds, expecting a future rise in interest rates, whilst borrowers try to refinance their loans.

For West German mortgage banks, the dilemma resulted in a substantial reduction in the repayment period of mortgage bonds and consequently, in the length of the fixed interest rate loan period of the loans they could offer. In the late 1960s most

Table 4.2: Home Mortgage Debt by Lenders 1975-84

Year	Savings Institu- tions ¹ %	Com- mercial banks %	Federal and related agencies %	Mort- gage pools ² %	House- holds %	Pension funds ³ %	Other ⁴ %
1975	55.3	15.7	8.3	5.2	8.9	0.7	5.9
1976	55.9	15.6	7.3	6.7	8.8	0.6	5.1
1977	55.8	16.2	6.7	8.2	8.3	0.5	4.2
1978	54.2	17.0	7.1	8.6	8.6	0.5	3.9
1979	51.6	17.0	7.5	10.0	9.2	0.5	4.2
1980	49.4	16.4	7.7	10.9	10.4	0.5	4.5
1981	47.2	16.1	8.0	11.8	11.6	0.5	4.9
1982	41.7	15.7	8.7	15.7	12.7	0.5	4.9
1983	40.5	15.0	8.8	19.7	10.7	0.5	4.8
1984	40.8	14.7	8.8	21.0	9.3	0.4	5.0

Notes: ¹ Savings institutions include savings and loans, mutual savings banks and credit unions.

² Mortgages in pools backing pass-through securities issued and/or guaranteed by the Government National Mortgage Association, Federal Home Loan Mortgage Corporation, or Federal National Mortgage Association.

³ Includes private and public.

⁴ Includes state and local governments, real estate investment trusts, finance companies and life insurance companies.

Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, Assets and Liabilities Outstanding (from Meyerson, 1986).

housing loans issued by mortgage banks had interest rates fixed for 15 years or more, but by the mid-1980s it had fallen to eight years or less. The effect was to make the type of mortgages offered by mortgage banks much more like those refinanced via retail resources, which usually carry variable interest rates or rates fixed for a maximum of three to five years.

In Denmark, on the other hand, bonds issued by MCIs still carry long-term, fixed interest rates. This is explained by the monopoly MCIs have over the bond market, the fact that the government does not allow price competition between them, and the nature of the institutional investors in bonds. Pension funds, for example, are required to hold up to 80 per cent of their assets in bonds and have, therefore, a limited scope to divert to other, shorter-term investments, when interest rates are falling. There is, in addition, little incentive for borrowers to redeem loans early when interest rates fall, because the price

of the bonds linked to the loan will have risen commensurately, and so repurchase involves higher costs.

Again, the picture is different in the Netherlands. Unlike those in Denmark and West Germany, Dutch mortgage banks have abandoned the principle of matching the volumes, interest rates and repayment structures of borrowing and lending. This happened in the post-war years, when mortgage banks gained access to short-term funds via *onderhandse leningen*. Unlike bonds, such funds include short-term borrowing, even though they are used to finance longer-term fixed rate loans. At times when the term structure of interest rates becomes inverse, so that the costs of short-term funds rise above those from capital markets, as occurred during the early 1980s, mortgage banks lose millions (Bakker, 1986). But, as will be shown below, it was not the interest rate matching problem, but developments in the housing market, that brought the final blow to the independent Dutch mortgage banks.

UNSTABLE HOUSING MARKETS

The 1970s marked the end of the post-war housing market expansion and the start of a secular decline in virtually all advanced capitalist countries. The turning point in most countries is around the mid-1970s, when an initial housing market boom turned into the most severe down-turn since the war. Subsequent housing market cycles indicate a significant qualitative change in market behaviour. Although house building rose again during the second half of the 1970s, overall production remained below the levels of earlier periods, partially because of a substantial fall in rented house building. The volume of mortgage lending, however, increased substantially due to rapidly rising house prices and a large increase in the sales of second-hand housing (see also the previous chapter). Thus, lending to individual home-owners proved very profitable during the period and, as the market was expanding, new financial institutions were induced to enter and establish niches in the owner-occupied market. Optimism over ever-rising house prices and increased competition between financial institutions encouraged more generous lending policies, such as larger mortgage to house price ratios. The new lending policies further encouraged the housing market to expand as shorter

periods to save for down payments were required and younger households were drawn into home-ownership.

By the late 1970s and early 1980s, the housing market boom collapsed into another major slump, triggered off by stagnating income developments, especially in relation to housing costs. During the late 1970s boom, house price rises had been much above general rates of inflation and interest rates had risen to new post-war peaks, both in nominal and in real terms. After 1979, however, national economies were affected by world recession, leading to stagnation of real incomes and substantial rises in unemployment. With the exception of Britain, the housing market slump of the early 1980s was accompanied by sharp falls in nominal house prices, although in the USA this was confined to regions whose industrial structures were particularly affected by the economic depression. But, at national levels, housing markets recovered by the mid-1980s with the exception of the Netherlands, where the process took much longer.

The case of the Netherlands is particularly interesting, as the extreme cycle of housing market boom and slump had disastrous consequences for the mortgage banks. Dutch mortgage banks had experienced an unprecedented growth in the demand for their services during the housing market boom of the second half of the 1970s. However, during the housing boom they faced serious problems in raising sufficient funds to meet the high level of mortgage demand as competition in capital markets had become severe. In the earlier 1970s, their share of bond issues in capital markets was 60 per cent, but, by 1980, government borrowing took 80 per cent. To improve the marketability of mortgage bonds, mortgage banks had to undertake growth for growth's sake (Bakker, 1986). Competition for capital market funds further added to the costs of borrowing for mortgage banks. This raised the interest costs of their mortgages, leading to a loss of competitiveness. Solutions were tried through diversification and specialisation in up-market housing sectors. New investment outlets were found in commercial property, and — more significantly — in funding property developers in the housing sector. Thus, when house prices started to fall in 1979, mortgage banks were left with huge amounts of bad debt. Many of the property speculators they had backed went bankrupt and the outstanding debts could not be fully recovered from house sales. Although all housing lenders were affected by

the down-turn in the housing market, mortgage banks were affected the worst, because of their orientation towards the two housing market sectors where house prices fell most substantially: luxury housing and previously down-market, nineteenth-century, inner-city, working-class housing. Both were high-risk sectors where property developers had been most active.

The institutions that gained by the collapse of the Dutch mortgage banks were the insurance companies, which, together with the pension funds, were encouraged by the National Bank to take over major parts of housing and other bad loans held by the mortgage banks. The National Bank sought to prevent the possibility of the collapse of mortgage banks, as this would lead to a serious loss of confidence in the Dutch financial market. Keen to gain entry into capital markets, insurance companies and also the Post Office Savings Bank negotiated major shareholdings in the, until then, independent mortgage banks. The result was a major breach of the earlier policy of the Dutch National Bank, which had aimed to keep the main financial sectors (banking, insurance and mortgage banking) separate and independent. With the housing market crisis of the 1980s, mortgage bank activities in housing loans shrank to near insignificance and all have now become integrated in either commercial banks or insurance companies.⁴

The response of the Dutch mortgage banks is not necessarily exceptional, when considering recent policies of some of the American Thrift institutions. The diversified asset powers which were given to them during the early 1980s encouraged many troubled Thrifts to engage in speculative ventures in property development in attempts to achieve quick growth. This often only added to their problems, as property development was risky and undertaken with insufficient knowledge, particularly when such investments occurred across state borders.

The down-turn in private housing markets in the early 1980s, may not have affected specialised housing lenders elsewhere as badly as the Dutch mortgage banks and some of the American Thrifts. But generally, the increasing instability of owner-occupied housing markets has meant that the profitability of mortgage lending had tended to work on an 'accordion principle'. Demand for loans grows substantially during up-turns, particularly when house prices rise and mobility increases, but during slumps, specialised mortgage lenders are adversely

affected. The negative impact is heightened when specialist housing finance institutions are exposed to highly diversified competitors, which have other outlets to turn to.

A general rise in the number of mortgage defaults and forced sales has also added substantially to the costs of the housing loan business. Losses from forced sales have been particularly significant in West Germany, Denmark and, of course, the Netherlands during the first half of the 1980s, when the prices of existing housing declined substantially. In the Netherlands, however, the widespread use of public guarantees on mortgages for individual house-buyers cushioned the effect on most banks. Instead, the massive losses were covered by central and local governments and the previous home-owners, who will have to repay their debts to the public authorities.

PRESSURES FOR CHANGE AND POLITICAL RESPONSES

Pressures for the deregulation of the specialised housing finance institutions have come from both inside and outside the sector. Deregulation and the trend towards financial supermarkets is not specific to the mortgage finance industry. Competition in financial markets is still intensifying, not only at domestic, but also at international levels. It has generated a general trend towards the development of universal banking institutions, which incorporate all types of financial services that traditionally were divided between specialised institutions like commercial banks, savings banks, investment banks, brokers and insurance companies. New technological developments, and especially computerisation, are encouraging the demise of these traditional divisions (Ball et al., 1986). Pressures towards universal banking are also making state regulatory powers less effective. Crises within housing finance, as occurred in the USA and the Netherlands, put further pressure on regulatory policies. In order to save the failing Thrifts and mortgage banks without causing financial destabilisation, mergers or take-overs were generally arranged with stronger financial institutions, often outside the specialised housing finance sphere. The rescue of the Dutch mortgage banks by insurance companies, as noted earlier, caused a reassessment of financial sector policies. Similarly, large banking firms and Thrifts in the USA could develop a national presence, forbidden in principle since the

1930s, by negotiating new powers that circumvented inter-state banking laws in exchange for taking over failing Thrifts.

Attempts to transform themselves into large financial super-markets have become a goal of many large specialist housing finance institutions. The development is perhaps best illustrated by the British building societies. For them deregulation and restructuring have not explicitly been induced by crisis, as was the case with the American Thrifts, but emerged through ambitions generated in an era of prospering business.

Building societies grew to be major financial institutions after 1945. Growth occurred in a relatively sheltered environment with little competition on either retail funding or investments. Between societies competition was also limited by the interest rate fixing cartel they operated, but competition was fierce through other means, such as expansion of branch offices and advertising. Non-price competition was to the advantage of the larger societies as they could spread the costs of attracting customers over a large turnover (Ball et al., 1986). Mergers have been a major feature of growth and many societies have developed from regional to national institutions. The sector is now highly concentrated with the largest five owning more than half of the industry's total assets.

Pressures for deregulation in Britain have mainly come from the building societies. From about the mid-1970s onwards, competition in retail markets increased and societies had to adopt new strategies to secure their inflow of funds. Unlike the American Thrifts, building societies never had government-imposed interest ceilings on their savings deposits and had always offered variable interest rate loans, allowing them to adjust interest rates on mortgages to fluctuations in the cost of borrowing. But their ability to attract sufficient retail funding had become increasingly unstable and greater variations in market interest rates added to the problems. In response to competition, societies started to offer higher interest savings accounts, which were financed by charging higher interest on mortgages. Such strategies led to increased inter-society competition and eventually to the abolition of the interest rate cartel by the end of 1983.

The first proposal for deregulation concerned the wish of societies to secure their inflow of funds by extending their borrowing powers to wholesale money markets (Stow Report, 1980). Such funds were not only readily available, but had also

become cheaper than retail funds during the high interest rate period of the early 1980s. High rates of interest also posed a new threat to the societies' dominance over the mortgage market, as it allowed other, more diversified, institutions to develop a strong mortgage presence. Clearing banks, in particular, did so successfully during the 1980-82 period, which coincided with a slump in the housing market.

There has been an up-turn in the housing market since 1983. The boom reduced the banks' market share in new mortgage lending, though their business has still expanded substantially in absolute terms. In the mid-1980s, building societies' growth was at an unprecedented rate. Their volume of outstanding mortgage loans increased by 54 per cent in real terms between 1980 and 1985. House prices rose substantially in the mid-1980s, particularly in southern England, and the scale of the government's council house sales programme further added to the housing finance boom. But despite the current rate of growth, building societies have come to realise that future expansion in mortgage lending is limited. The increase in home-ownership will slow down and has 'artificially' been raised by policies to privatise public housing. Growth through existing home-owners' capitalising on house price inflation and trading up is also less likely to be a long-term perspective with the current low general rate of inflation. In addition, house prices have started to become stagnant in some parts of those regions which are in economic decline.

Expansion in the business of mortgage lending is increasingly cyclical, which does not fit the ambitions of the managers of the larger building societies, who aim for continuous growth. Pressures for deregulation have been building up within the movement since the early 1980s, particularly for a diversification of the assets societies are empowered to hold (see BSA, 1983 and 1984). A new act became effective in January 1987, giving societies virtually all they asked for. Funds can now be tapped wholesale and investments can be extended to most retail banking and housing services. The latter include estate agency, insurance broking and lending on second mortgages. Societies can now also own and manage housing and go into land holding. Already before the 1987 act, societies had started to develop new activities, usually in co-operation with clearing banks and housing associations, depending on the type of service in question. A further indication of the 'financial

supermarket' trend within the sector arises from stipulations in the act whereby diversification powers of building societies are limited to certain percentages of asset volume. As a result, mergers within the sector have continued to develop, including between the largest ten.

Bausparkassen in West Germany also had problems in maintaining their market share in mortgage lending during the 1970s in the face of increased competition from the universal banks. Commercial banks, savings banks and credit co-operatives all expanded into issuing loans above the 60 per cent house price limit, the lending area traditionally dominated by the *Bausparkassen*. The competitive position of *Bausparkassen* in attracting funds from personal savers also eroded with the general rise in market rates of interest, since the collective savings scheme they operate implies rates that are fixed at low levels. Government subsidies to *Bausparkassen's* collective savings schemes have not compensated for the rise in market rates of interest. On the contrary, from the mid-1970s onwards, income eligibility limits for savings premiums have not been adjusted to inflation and the premium subsidy itself has been reduced a number of times (Ball et al., 1986). Problems for the *Bausparkassen* culminated during the early 1980s, when market interest rates peaked and housing market activities reached a new low. Competition from other mortgage lenders intensified and the volume of new savings contracts signed with *Bausparkassen* declined. One implication of the closed scheme operated by *Bausparkassen* is that a reduced inflow of funds prolongs waiting periods before loans are allocated and, therefore, reduces the attractiveness of the collective savings scheme. Diversification has also been the response for the *Bausparkassen* to their problems.

Like the British building societies and American Thrifts, *Bausparkassen* are legally constrained in expanding their sources of funds and range of investments. But other solutions have been found, as is shown by the history of the largest private *Bausparkasse*, Wüstenrot. Wüstenrot decided as early as the mid-1960s to diversify, partially in response to the move towards the centralised provision of housing finance services under the dominance of the universal banks. Barred from founding financial subsidiaries (a house-building daughter was accepted by their supervisory body in early days), Wüstenrot found a solution by setting up a new holding company which

would own the *Bausparkasse*. A bank and an insurance company were added to the holding company in 1968 and one year later a real estate company was founded together with the Deutsche Bank, West Germany's largest commercial bank (Schäfer et al., 1986).

Until the 1980s, the *Bausparkasse* business remained the central activity of the Wüstenrot holding company. The other subsidiaries mainly provided services in support of the collective savings scheme. The bank, for instance, specialised in building loans and intermediate loans. The latter are loans offered to the *Bausparkasse* customers to bridge the period until the contract loans are allocated. The insurance company allowed for a more efficient use of branches and sales agents linked to the *Bausparkasse* activities. But a major shift occurred during the early 1980s when market rates of interest were at unprecedentedly high levels. As a consequence, the significance of the collective saving and loan scheme reduced and the banking and insurance activities gained much importance; Wüstenrot started to present itself as a provider of comprehensive financial services, rather than as a *Bausparkasse* (ibid.).

DEREGULATION: ECONOMIC NECESSITY OR POLITICAL CHOICE?

The trends towards despecialised housing finance institutions and towards large financial conglomerates that offer all types of financial services seem to be universal, seemingly inevitable under the pressure of international competition in financial markets. Sheltered circuits of housing finance are breaking down and housing finance is developing into systems of funding from a mixture of sources. Deregulation further implies an abolition of the advantages linked to specialisation, so that housing lenders have to compete directly with other financial institutions for funds and investments. British clearing banks, for instance, recently received some of the same tax advantages linked to deposit taking as those already given to building societies. In the USA, there is still a tax incentive for Thrifts to specialise, but its effect is much reduced and only used by the smaller ones because they are not really in a position to compete with the large banks.

Despite massive competitive pressures from financial markets,

there is one case in our survey which shows that deregulation of specialised housing lenders is not inevitable, but can be prevented by political power. The Danish MCIs, the country's largest type of financial institution, are prevented from extending their sphere of activities. Unrestrained, MCIs would probably diversify and acquire shares in other types of financial institutions, like banks and stock broking companies. Against the wishes of the MCIs, the Danish government argues for the economics of specialisation: the pillars of the Danish financial system are kept separate to maximise the advantages of specialisation and scale. It is argued that MCIs' specialised knowledge avoids risks and creates low overhead costs, which makes their business more efficient. Another major reason used to justify continued protection of a specialised housing finance circuit is the support that the current system gives to the construction industry. The government itself gains from the low costs of intermediation as about half of MCI bonds are issued on their behalf. It remains to be seen to what extent the Danish government can resist deregulatory pressures; these are aided by EEC directives aimed at equalising regulatory powers over financial markets between European countries.

The Danish political objectives are in complete contrast to those of successive US governments, as summarised well in a major policy document, *The Report of the President's Commission on Housing* (1982). It recommends the total elimination of the specialised system of mortgage lending. Housing, instead, should compete for funds in national and international financial markets. So, in the USA, the provision of housing finance is to become fully integrated in the capital markets from which it was so carefully separated during the 1930s.

Deregulation of financial markets in the USA can be seen as a retreat from political support for housing in general, despite the predominance of private provision in the country. But the new Building Society Act in Britain requires a different interpretation. The act complies with the current housing policy objectives of the Thatcher government, which aim at encouraging heavily subsidised, private provision with extended involvement of the building societies. Of central concern here is the extended housing service powers given to the societies. After individual council house sales peaked in 1982, a new stage in privatisation policies has been designed and introduced in a new Housing and Planning Act, allowing for the sale of whole

council housing estates to private developers. Building societies can now directly participate in such schemes, not only as providers of finance, but also as buyers and housing managers. In conjunction with developers, they can further undertake the rehabilitation of these estates for sale to individual homeowners. Housing investments urgently need to be done in Britain, but contrary to earlier post-war policies, the government hopes to leave this largely to the private market.

Why Should Deregulation Interest Consumers and Housing Policy-makers?

A well-known argument for deregulating specialised housing finance institutions is that it will benefit consumers. There will be more choice between financial institutions in the types of mortgage and housing related service they offer. Competition will make the market more efficient, it is argued, and will therefore reduce lending costs. The British National Consumers' Council, for instance, welcomed the proposed new Building Society Act for these reasons. In practice, however, real interest rates on mortgage loans are higher now than ever. Increased competition for funds, particularly in retail savings markets, has pushed up the costs of borrowing for all financial institutions. Anyone offering more attractive deposit instruments is soon followed by others, not wishing to lose their market share. In the early 1980s, the costs of short-term funds exceeded those from capital markets for the first time since the war. Competition also had other cost effects which were passed on to consumers, in the expenses of branching networks and advertising campaigns to attract extra customers, and in the massive investments in new technology, which did not always raise efficiency as hoped for.

Another aspect of diversified lending powers is that housing finance institutions have become less dependent on the fortunes of housing markets. Investments are only likely to be made there when the rate of return is highest (Meyerson, 1986). Thus during periods when the housing market expands and mortgage lending proves very profitable, funds are readily available. In a competitive environment, extra lending to lower-income households is taken on and mortgage debt ratios pushed up. But, during market down-turns, other, more profitable investment

outlets will be looked for and the introduction of restrictive and discriminatory policies on housing loans becomes more likely. High house prices and down-payment requirements then inhibit access to home-ownership for lower-income households generally. But, in addition, there may be a recurrence of red-lining or of restrictive lending policies applied to areas where there are high concentrations of low-income households and ethnic minorities. Such policies usually affect inner-city working-class areas, but may well include badly serviced parts of suburbia. In the Netherlands, this is already the case. Restrictive lending policies were introduced, particularly in older inner-city areas, where house price falls were most substantial. It also followed government policies to limit the issuing of public mortgage guarantees to individual buyers of second-hand dwellings in 'high risk' areas.

Discriminatory lending policies may also be imposed via instruments which link mortgage loans to capital markets. At least for the USA, it has been suggested that the increased reliance on secondary mortgage markets as a source for housing credit may well lead to greater inflexibility in mortgage lending. Properties that do not conform to a standard secure type may well become discriminated against (Meyerson, 1986). Such policies may also enhance inequalities in housing markets between regions. Housing lenders have generally developed a national presence and become less dependent on the fortunes of local housing markets. Their ability to draw funds from different sources and shift these around may well enhance gentrification processes in one area by making credit readily available, whilst developments in areas of stagnating house prices may be inhibited.

Generally, it seems that increased competition in housing finance further increases affordability problems. Upper-income households may benefit from the greater availability of finance and the wider range of services provided, but the advantages for other housing consumers are less clear cut. Housing loans may be easily available for lower-income households during housing market booms, but rising house prices and an upward trend in real costs of borrowing reduce access in the longer run. High-income debt ratios, in addition, make home-owners far more vulnerable to default and may increase the risk of them eventually losing their home altogether. Default on mortgage payments and repossession by financial institutions, in fact,

have already increased substantially in all the countries included in our survey in the 1980s, irrespective of the state of their national housing markets.

The long-term effects of the mortgage finance 'revolution' are, of course, difficult to predict and it is also not our aim to make such forecasts. Instead, this chapter has described the traditional specialised mortgage finance systems of five countries and analysed some reasons for their recent transformation. The existence of specialised mortgage lenders has been a major condition for the growth of private housing markets (and in some countries also for social housing provision). But without wishing to give unqualified support for the traditional institutional system of mortgage lending, we have tried to outline some of the, in our view, likely consequences of deregulated housing finance systems for housing consumers and for future developments of housing markets. Features that may emerge in the future include sharper fluctuations in housing market cycles; an upward pressure on the costs of housing loans; an increased likelihood of the introduction of discriminatory lending policies during market down-turns; and higher risks of home-owners defaulting on mortgage payments. Also, the transformation of institutions active in mortgage lending is not likely to be over yet, due to the changed nature of the environment in which they operate.

NOTES

1. The findings of this chapter are based on two research projects, which were conducted by the author in conjunction with Michael Ball and Michael Harloe. One project, funded by the Anglo-German Foundation studied recent changes in housing finance systems in West Germany and Britain. The Economic and Social Research Council funded a study of mortgage finance institutions in the USA, the Netherlands, Denmark and Britain. Much of the information discussed here is based on interviews we had with representatives of financial institutions in the various countries. British and German developments in housing finance systems are described in more detail in Ball, Martens & Harloe (1986).

2. Mortgage banks were, however, never set up in Britain, even though they were made possible by the 1865 Mortgage Debenture Act. But, as the act was never put into practice, it was eventually abolished in 1958. The only bond-issuing institution Britain has known was the Agricultural Mortgage Corporation, founded in 1928 (see Pleyer & Bellinger, 1981). Very recently the founding of the National Home

Loans Corporation has for the first time introduced mortgage lending refinanced by securities issued to investors in capital markets.

3. *Bouwfondsen* are specialised housing lenders. Their market share of housing loans is around four per cent. There has been little change in either this share or their operations. *Bouwfondsen* were founded after the war by the Dutch Council of Local Authorities. Their main shareholders are the local authorities and regional specialisation has limited competition between them. Funds are derived by borrowing directly from pension funds and insurance companies (*onderhandse leningen*). There is no legal context in which supervision over *Bouwfondsen* takes place. They are not regarded as financial institutions, as a result of which *Bouwfondsen* are not allowed to attract funds from personal savers. Mortgage loans issued by *Bouwfondsen* traditionally carry long-term fixed interest rates and they specialise in lending to individual buyers of newly built, premium subsidised housing.

4. 'The Postbank gambled and lost' was a succinct newspaper headline about the affair (*Volkskrant*, 21.1.87). The former Post Office Savings Bank, it was announced, had to write off all of its shares in the FGH, the second largest independent mortgage bank, to a major insurance company, Aegon. Problems for the FGH were much worse than initially expected and a new financial rescue operation had to be arranged by November 1986, which this time included Aegon. In the process Aegon managed to buy out all minor and major shareholders (at extremely low current nominal market values), and after the Postbank had allocated to the mortgage bank a substantial, low interest rate loan. Apart from money, the Postbank also lost its entry to capital market borrowing, which it had hoped to realise via its stake in the mortgage bank.

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The International Restructuring of Housing Production

Michael Ball

INTRODUCTION

At varying times, from the mid-1970s through to the early 1980s, virtually every advanced capitalist country experienced a collapse in its housing output. Unlike previous post-war house-building cycles, it was obvious that this particularly dramatic slump was not a temporary setback. The world of housing production was about to change. Output would recover, at least partially, from the depths of recession, but it would be produced under different forms of provision.

New forms of housing provision may imply changes in the ways in which housing is produced. Some of the biggest transformations of housing production, for instance, have occurred in countries with previously large social house-building programmes. But it would be wrong to see the current transformations of production simply as part of a general back-to-the-market trend for housing. Housing production, whatever the tenure, has always been overwhelmingly market based. More subtle, but no less dramatic, transformations within capitalist house building, therefore, are of concern here.

Changes in housing production depend on a wide constellation of pressures and on the nature of pre-existing building industries. There is little international competition in house building; although one of the characteristics of the current restructuring is that such competition is growing. In housing production, international competition plays little part in forcing the building industry to adopt new techniques and organisational forms. Most pressures for change derive from the country in question itself.