

*SAVINGS AND LOAN ASSOCIATIONS AND BUILDING SOCIETIES: A  
LESSON IN HOUSING FINANCE*

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ABSTRACT

*The savings and loan industry is an outgrowth of the building society movement in Great Britain. Savings and loan associations and building societies have similar housing finance functions as well as similar organizational and balance sheet structures. In the past three years, however, the savings and loan industry has experienced serious difficulties while the building societies have been healthy. Differences in the kinds of deposits building societies can accept and, especially, differences in the type of mortgages they make may explain the differences in the condition of the two industries. Savings and loans faced deposit rate ceilings and made fixed rate loans. Building societies made variable rate loans and have been able to compete for deposits. Although the British experience may not be directly transferable to the U.S., the success of the building societies offers some insight into long-run solutions to the problems of the savings and loans.*

INTRODUCTION

The American savings and loan associations are an outgrowth of the British building societies. Each performs the same housing finance functions. In the last ten years, both savings and loan associations and building societies have faced a similar economic environment of changing interest rates. Yet the performance of the savings and loans and the building societies has been radically different. Savings and loan associations, especially in the last three years, have experienced serious problems. Losses in the industry amounted to a decline in net worth from \$33.3 billion at the end of 1980 to a low of \$24.5 billion in September, 1982 (FRB, 1983), a drop of 26 percent in 19 months. Building societies, on the other hand, have been healthy. An understanding of why these similar institutions have performed so differently may give us some insight into the problems and potential solutions to the problems of the savings and loan associations.

Discussing the problems of the savings and loans may seem out of date. As interest rates in general have fallen and as the yield

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Rudolph

curve has become upward sloping with long-term rates above short-term rates, many of the problems of the savings and loans have decreased in severity. In fact, as interest rates have fallen, savings and loans and other mortgage lenders appear to be ready to return to business as usual. Many consumers prefer fixed-rate loans and lenders seem ready to accommodate them. Given the high degree of variability in interest rates in the last five years, it seems unwise to believe that business will ever be "as usual." A long-term solution to the problems of savings and loan system is needed.

In defense of lenders who are making fixed-rate loans, conventional wisdom indicates that Americans cannot accept the kind of variability in payments that fully flexible interest rates imply. Yet in Great Britain, a fully variable-rate mortgage has been the dominant mortgage contract since the 1930s. Building societies are healthy to a large extent because the interest rate on the mortgages they hold change as market interest rates change. In economics and finance, it is not possible to have laboratory experiments where all factors except one remain constant. The performance of savings and loan associations in the past few years cannot be tested with adjustable rate mortgages and without. But building societies and savings and loans are sufficiently alike that comparing their performance records may allow us to draw some conclusions about the importance of adjustable rates to the providers of housing finance.

To make the comparison between savings and loans and building societies valid, it must be clear that they are similar. The second section of this paper compares the historical development of the building societies and the savings and loans. The status of each within its own mortgage market is discussed and some differences are pointed out. In the third section, the functions of the savings and loans and the building societies are discussed within the context of the balance sheet structure of these institutions. The problems of the savings and loans are presented in Section four. In Section five, the success of the building societies is used to suggest some solutions to the difficulties of the savings and loans associations.

#### *HISTORY AND FUNCTION*

The basic function of both savings and loans and building societies is to accept deposits from individual savers and use these deposits to make mortgage loans. Both are mutual in nature; the members who are depositors own the institution. Many of the differences which do exist can be traced to the different regulatory and competitive environments in which the two financial institutions exist.

Historically, savings and loan associations are an off-shoot of the building society movement. The first savings and loan association was the Oxford Provident Building Association of Frankford, Pennsylvania. It was founded in 1831, 56 years after the first building society was formed in England. Three of the original members of the Oxford Provident were British and supplied the necessary "how to" information to begin a building society. Like their early British counterparts the first savings and loans were terminating. That is, when all of the members had received and

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repaid their loans, the association went out of business (Kendall, 1962). Over time, the link between the depositors and borrowers was broken and both building societies and the savings and loan associations became permanent savings institutions.

The greater concentration of the building societies and the comparative decentralization of the savings and loans reflects one of the major differences between the financial institutions in the U.S. and the U.K. The largest 17 building societies which make up only 6.2 percent of the number of building societies, account for 82.4 percent of industry assets (Boleat, 1982). The largest 10.7 percent of savings and loans account for only 61.8 percent of industry assets (USL, 1981). In the U.K., financial institutions can, and many do, have nationwide branching systems. In the U.S., depository institutions such as banks and savings and loans have not been permitted to branch across state lines.

Another very important difference between the financial systems of the U.K. and the U. S. is the pervasiveness of regulation in the U.S. Many of the specific regulations in place today can be traced back to the attempts at financial reform following the Great Depression. The experience of the British was quite different from that in the United States. Most of the British financial system came through the Depression relatively unscathed. In the U.S., the financial system was severely damaged by the Depression. The number of savings and loans fell from 11,777 to 7,521, a decrease of 36 percent, between 1930 and 1940 (USBC, 1975). In response to this financial disaster, many regulations were imposed to try to safeguard the financial system.

The competitive environment of the savings and loans and the building societies is also different. Each is the largest mortgage lender within its own market, but the building societies, until recently, have experienced little serious competition from other private mortgage lenders. Savings and loans face significant competition from commercial banks, life insurance companies and mutual savings banks.

#### *THE BALANCE SHEETS OF SAVINGS AND LOANS AND BUILDING SOCIETIES*

Building societies and the savings and loans gather the savings of individuals and use these funds to make mortgage loans. The balance sheets of these two institutions in 1980 clearly reflect this function. Mortgage loans are by far the largest asset, making up 78.6 percent of assets for building societies (CSO, 1982) and 79.8 percent of the assets of savings and loans (FRB, 1983). On the liability side of the balance sheet, shares and deposits are the largest liability, accounting for 91.8 percent of total liabilities for building societies and 81.1 percent for savings and loans.

While the structure of the balance sheets of the two types of institutions is similar, the nature of the mortgages and the deposits they hold is quite different. The mortgages in the portfolios of the building societies are long-term, fully variable rate loans. Interest rates on these loans can be varied as market interest rates change

with no limits on the number of changes or the size of the change in the interest rate. Depending on when the loan was made, the lender must notify the borrower between six months to thirty days in advance. The more recently the mortgage was made, the shorter the time required. Borrowers have the alternative of increasing the maturity of their loan and keeping the payment constant as interest rates change. Newer mortgages contain provisions that prevent negative amortization.

The large majority of loans in the portfolios of the savings and loans are either long-term, fixed-rate loans or loans with limited flexibility. The difference in the nature of the mortgages means that as market interest rates change, a building society can, within a short period of time, change the rate on all of its outstanding loans. A savings and loan can change the rate on newly issued mortgages and, to a limited extent, the rate on its variable rate mortgages, but the overall return on its mortgage portfolio adjusts slowly to interest rate changes.

On the liability side of the balance sheet, the nature of the deposits and shares has also been quite different. The building societies' deposits are variable rate. As the market interest rate changes, the building societies can adjust deposit rates. Since 1966, savings and loans have been subject to interest rate ceilings on deposits. The interest rate ceilings are gradually being lifted under the provisions of the Depository Institutions Deregulation and Monetary Control Act of 1980. An increasing portion of savings and loan deposits earn market interest rates.

The building societies have variable rates on both sides of their balance sheet. These rates are recommended by the Building Society Association. The BSA determines the amount of funds they wish to attract and recommends a deposit rate that will attract those funds. The mortgage rate is then determined by adding an acceptable margin to the deposit rate (Gough, 1982). No limitations are placed on the frequency or size of the adjustments. Thus, the building societies are guaranteed a reasonable positive yield spread.

The system of recommended rates has advantages for borrowers as well. The building societies have held the mortgage rate below market levels so that borrowers have paid a below-market rate. Chronic excess demand has meant queuing and other forms of non-price rationing, as well as lower returns, to shareholders and depositors, but the mortgage rate has been lower than it would have been otherwise (Boleat, 1982). The Building Society Association has used this fact to justify the price-fixing system for deposit and mortgage rates.

Savings and loans, on the other hand, have faced ceilings on the return they could offer savers as well as holding portfolios of fixed-rate assets. As interest rates on saving and loan deposits have been decontrolled, they have been able to attract funds, but at a much higher cost. The returns on the savings and loans' mortgage portfolio has not kept pace. The interest rate on new loans increased from 8.80 percent in 1977 to 14.47 percent the first half of 1982, but the average return on all loans was 8.26 percent in 1977 and rose to only 10.29 percent in 1982. The average cost of funds

over this same time-period increased from 6.44 percent to 11.49 percent. The yield spread between the average return on all loans and the average cost of funds fell from 1.82 percent in 1977 to -1.20 percent in 1982 (FHLB, 1982). Decontrol of all deposits will only make matters worse, increasing the cost of funds to the savings and loans still further.

#### *POTENTIAL SOLUTIONS*

The regulatory officials in the U.S. have viewed the situation as serious and are working on ways to deal with the possibility of large scale failures. The insurance fund of the FSLIC could not possibly meet the call for funds if massive failures occurred. Other ways of dealing with the problem have been suggested. (For more complete discussion of policy alternatives, see Carron, 1982). Usually, when a savings and loan or bank is failing, the regulatory agencies involved will try to arrange a merger with another stronger institution. With the size and number of the potential failures, there may not be enough strong savings and loans in the same state with which to merge. Already the FHLB has approved the merger of savings and loans in different states and the merger of banks with savings and loans. Another possibility is to have the savings and loans sell the low interest mortgages to the Federal agencies and to allow the savings and loans to write-off the capital losses gradually over a period of years. These alternatives are basically stop-gap measures to avoid financial disaster. The success of the building societies should give some insight on how to solve this fundamental problem of savings and loans as housing finance institutions.

Like the savings and loans, the building societies are borrowing short and lending long. However, the building societies have broken the link between the long-term maturity of the loans and the long-term interest rate. Even though the loans have a long maturity, because the interest rate can be adjusted over the life of the mortgage, the loan takes on some of the characteristics of a short-term loan.

The obvious long-run solution to the problems of the savings and loans appears to be to allow them to make mortgages with fully variable interest rates. For the past fifteen years, the associations have been experimenting with different types of mortgages introducing some flexibility. The regulatory authorities have given their permission for commercial banks and federal savings and loans to be allowed to make fully flexible mortgages.

Although that would seem to give the go-ahead for the savings and loans to begin issuing these mortgages, none have rushed into the market offering fully variable mortgages. Different types of mortgages are being considered, but none have been introduced on any widespread basis. The fully variable rate mortgages seem the obvious answer. Why have the institutions not rushed to offer them?

Conventional wisdom from lenders, consumers and academics in the U.S. indicates that Americans would not live with the kind of variability in their mortgage payments that the fully variable rate mortgages imply. In other words, most people believe that fully

Rudolph

variable mortgages will not work. Yet the experience in the U.K. makes it clear that the variable rate mortgage is a viable alternative that allows housing finance institutions to deal easily with changing market interest rates.

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