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Regional banks compete for home loans

Nomura Research Institute, Ltd.

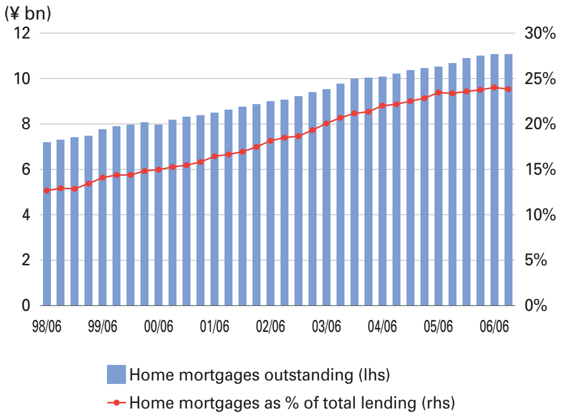
Competition among financial institutions for home loans has increased since banks realized that they were more stable assets than commercial loans. Competition has now expanded from price to product design, and success requires a variety of skills. A key question now is how regional financial institutions will overcome their lack of resources relative to the megabanks.

Home loans and bank management

In the latter half of the 1990s, financial institutions were forced to recognize the potential for default on commercial loans and their high risk correlation during recessions. The same period saw a growing global demand for stricter risk management at financial institutions, and residential mortgages were assigned a lower risk weight than commercial loans. Both factors encouraged banks to take a favorable view of home loans.

As the economy began to recover in 2000, the housing market finally bottomed and banks decided the expansion of home mortgage lending would be one of their key strategies. As Exhibit 1 shows, the balance of outstanding home loans at Japanese banks and shinkin banks has risen steadily from 1998 to the present. Residential mortgages' share of total lending has also risen consistently during this period.

Exhibit 1. Residential mortgages outstanding and as percentage of total lending



Note: Domestic banks and shinkin banks.
Source: Bank of Japan

But with fierce competition driving down mortgage rates, some now fear a decline in the profitability of these assets.

Second wave of residential mortgage competition

Competition between lenders for residential mortgages has now shifted from price to other factors. Last year, for example, a housing loan offered by Sumitomo Mitsui Banking Corporation that came with insurance against three major illnesses received an outstanding products and services award from Nikkei. The ability of new product concepts to lift sales is demonstrated by the many institutions that now offer a similar product.

While this report will not examine this particular product, it should theoretically be possible for insurers to provide the same coverage more cheaply than if sold as a separate policy because there are no marketing costs. If so, this type of hybrid product should be capable of satisfying lenders, insurers, and borrowers alike.

Also popular are new loans offering preferential loan rates to customers with high credit scores or the potential to generate significant income for the bank. Detailed analysis of customer characteristics makes it possible to offer lower rates—taking into account risk and customer revenues—while ensuring a profit for the lender. By taking into account both risk and revenues it is possible to design products that benefit both banks and their customers.

Attracting new borrowers

The product development competition described above involves traditional banks and traditional borrowers, and in that sense is simply a scramble for pieces of the same pie. But some institutions are actually trying to expand the pie by developing loans that appeal to a wider spectrum of borrowers.

Some regional banks, for example, are offering home loans to borrowers who would not be eligible under traditional criteria.[1)] Typically, a foreign securities company will tie up with a Japanese bank to acquire loans originated by the latter. GE Consumer Finance was a pioneer in this field and was soon followed by Lehman Brothers Securities, Morgan Stanley Japan Securities, and Merrill Lynch Japan Securities. These companies have established tie-ups with regional banks with the aim of securitizing future loans.

At the same time, some Japanese banks are using their own balance sheets to break into this field. Suruga Bank, for example, is seeking to boost profits by offering loans to traditionally ineligible borrowers.

These products are aimed at expanding the customer base to include borrowers that would have been overlooked in the past. Like the mortgage-and-insurance bundle described above, these loans are capable of satisfying the needs of borrowers, lenders, and investors (in the case of securitized products) alike.

Selectively focusing resources

As Exhibit 2 shows, competition among lenders for residential mortgages began as a simple test of who could offer the lowest interest rates. Now, however, competition has spread to concepts—such as the bundling of medical insurance with mortgages—preferential interest rates based on an analysis of customer characteristics, and the development of different kinds of borrowers.

Exhibit 2. Home loan competition and risks

Method	Strategy	Risk-related considerations
Simple price competition	Strongest lender wins	Reduced profitability
Preferential rates	Analysis of customer attributes	Analysis of customer attributes
Bundled insurance	Analysis of customer psychology	(same as before)
New customers	Expanding the pie	More sophisticated credit risk analysis

To survive this competition banks need to enhance their product development and risk management skills. Regional banks, with their limited financial resources, will have to accept that developing and maintaining such skills will cost them more as a percentage of total lending and profits than it does the megabanks. New megabanks incorporating the characteristics of regional financial institutions are also set to emerge in the form of the newly privatized postal savings and postal life insurance operations. While they lack expertise in the field of home mortgage lending, their massive financial resources will represent a major threat.

Under these conditions, creative efforts will be needed to maintain home loans as a key offering. For example, in the approach described above of pairing with investment banks, the local bank focuses on providing products and outsources risk management and some product development. Suruga Bank's decision to concentrate its resources on home mortgages and other consumer products can be seen as an attempt to boost the efficiency of its product development and risk management operations.

Potential merits of scale

Efficiency would further improve if banks could agree to jointly develop products and, if possible, manage risk together. There would be almost no disadvantages to such a plan for regional banks as long as there was no overlap in terms of customers or geographical coverage.

Among the examples of lending to individuals with lower credit scores, Hachijuni Bank and the other banks belonging to the Judankai association appear to have established a tieup with Morgan Stanley Japan Securities. In our view, it is more effective for regional lenders to forge alliances with investment banks as a group and share their best ideas than to approach larger institutions on their own.

Joint product development would not only help to save energy and effort at individual banks but would also make it easier to obtain favorable terms when negotiating with potential tieup partners.

Note

1) Newly eligible borrowers include company employees with relatively few years of service, temporary and contract employees, and the self-employed.

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