The Secondary Mortgage Market in Malaysia

by Huang Sin Cheng

In Malaysia it is not possible to discuss the secondary mortgage market without mentioning Cagamas, as it is currently the only institution in the country undertaking securitization activities. Without Cagamas, there is, therefore, no secondary mortgage market, as its activities form the heart of the market. The name Cagamas actually stands for Perbadanan Cagaran Malaysia or the National Mortgage Corporation. As implied by its name, the company purchases housing loans from the institutions which originate the loans at primary level and issues bonds as well as short-term notes to finance the purchases. In effect, Cagamas turns the housing loans into debt securities at the secondary level through a securitization process.

CAGAMAS BERHAD

Cagamas was incorporated in 1986 and commenced business in 1987 following deliberations between the Central Bank, the financial institutions and consultants from an American financial institution. Cagamas was set up with the blessings of the government to facilitate and encourage homeownership in Malaysia and to contribute to the development of the debt security market. To achieve this, it acts as an intermediary between the primary lenders and long-term investors. By doing so, the company alleviates the maturity mismatch of the primary lenders which grant housing loans with repayment periods of up to 30 years and finance them with funds of mainly less than one-year maturity.

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Additionally, by purchasing the housing loans, Cagamas also takes over from the originators the interest-rate risks inherent in these loans. The debt securities, particularly fixed-income securities issued by the company, create additional investment options for investors. Thus, the secondary mortgage market in Malaysia was created when Cagamas began operations in 1987; even today, Cagamas remains the only institution providing securitization facilities in Malaysia.

SHAREHOLDERS

Bank Negara Malaysia, which is the Central Bank, owns 20% of Cagamas. All the remaining shares are held by the financial institutions regulated by the Central Bank, comprising commercial banks, finance companies and merchant banks.

The Chairman of the Board of Directors is the Governor of the Central Bank; other members of the Board are prominent senior members of the banking industry.

The good pedigree of the company is an important factor in explaining why Cagamas debt securities are so highly rated and well received in the market. It is the foundation for its success in securitizing housing loans.

SECURITIZATION PROCESS

The securitization process itself is very simple. The primary lenders, such as the commercial banks, grant housing loans to the house buyers. They subsequently sell these loans to Cagamas. Cagamas raises funds from the market to finance these purchases by issuing debt securities in the form of the longer term Cagamas Bonds and the shorter term Cagamas Notes to investors. Investors include the financial institutions, insurance companies, pension funds, non-resident companies and others who are interested in investing in short- and medium-term papers to obtain an income either at a fixed or adjustable interest rate.

Through the secondary mortgage market, therefore, Cagamas effectively converts a long-term illiquid asset in the form of housing loans into debt securities which are tradable in the secondary market. This process enables the investors to earn an income from Cagamas securities which is derived from the interest paid by the house buyers on their housing loan and also enables the primary lenders to turn their housing loans into cash at any time by selling them to Cagamas.

TYPES OF MORTGAGE PURCHASE FACILITIES

Cagamas stands ready to purchase, at any time, housing loans from the originator at a quoted interest rate known as the Cagamas Rate. The transaction will be subject to price review periods of three, five or seven years. At the end of the contracted review period, a new rate of interest is offered by Cagamas. The institution which sold the housing loans has the option to repurchase the housing loans from Cagamas if it deems the interest rate quoted by Cagamas at the end of the review period to be unacceptable.

Cagamas purchases housing loans either at a fixed, floating or convertible rate. Fixed-rate purchase means that the transaction is based on an interest rate that is not adjustable during the review periods of three, five or seven years. Under the floating rate purchase facility, Cagamas purchases housing loans based on an interest rate that is pegged to the three-month or six-month Kuala Lumpur Interbank Offer Rate ("KLIBOR"). The interest chargeable on such purchases is reset at three- or six-month intervals during the review period of three-to-seven years. "Convertible" means that the selling institution can switch from a fixed to a floating rate or vice versa during the course of the review period. In addition, interest-free housing loans granted under the Islamic principles can also be sold to the company, based on the principle of Bai al-dayn (debt trading).

STRUCTURE OF MORTGAGE PURCHASE FACILITY

The sale of housing loans to Cagamas is done with full recourse to the selling institutions; i.e., the selling institution is required to repurchase any housing loan which is subsequently found to be not of the quality specified by Cagamas. The housing loans in Cagamas' portfolio are, therefore, of good quality, and the Company does not carry any credit risk. As an additional safeguard, Cagamas is very selective as to whom it purchases housing loans from. At present, the Company only purchases mortgage loans from the financial institutions regulated by the Central Bank and staff housing loans from selected large corporations which are majority-owned by the government, and the government itself.

The primary lender, i.e., the selling institution, would act as the servicer, trustee and custodian for Cagamas upon selling its loans. The primary lender as servicer would be responsible for collecting the monthly housing loan installments and remitting them to Cagamas.

TYPES OF MORTGAGE-BACKED SECURITIES

With regard to the funding side of the company's business, Cagamas issues four types of debt securities to fund its mortgage purchase activities: fixed-rate bonds, floating-rate bonds, short-term discount notes (known as Cagamas Notes) and Cagamas Mudharabah Bonds, which are interest-free bonds issued under the Islamic principle of profit sharing.

Cagamas securities are all unsecured obligations of the company, are issued scripless and are tradable electronically in book-entry form through an electronic clearing house known as the Scripless Securities Trading System, operated by the Central Bank of Malaysia.

The interest on the fixed-rate bonds is payable semi-annually. The bonds are redeemed at face value on maturity. These bonds are issued for tenors of three-to-seven years to match the price review period of the company's mortgage purchases. The interest rate for the floating rate bonds is pegged to the three- or six-month KLIBOR and is reset accordingly at three- or six-month intervals.

These bonds are redeemable at face value. Cagamas Notes are issued for short terms not exceeding one year. But unlike the fixed- and floating-rate bonds, they are issued at a discount from the face value. These discount notes are issued to obtain funds to meet Cagamas' short-term liquidity and hedging requirements.

The Cagamas Mudharabah Bonds do not carry any interest, but dividends are payable semi-annually based on a specified profit sharing ratio. They are used to finance the company's purchase of Islamic house financing debts.

SPECIAL ATTRIBUTES OF CAGAMAS SECURITIES

The Cagamas bonds and short-term Cagamas Notes are recognized by the Central Bank as liquid assets for the purpose of compliance by the financial institutions with the statutory liquidity requirements. The eligibility of Cagamas securities as liquid assets has the effect of enhancing demand among the financial institutions for the securities and thus lowers their coupon rate. This concession is given by the Central Bank to make the end financing for houses more affordable.

Due to the good pedigree of the company and recognizing that its debt securities are backed by the housing loans purchased, all debt securities issued by Cagamas have been assigned the highest rating of AAA (longer term securities) and PI (short-term securities) by Rating Agency Malaysia and AAA (longer term securities) and MARC-1 (short-term securities) by Malaysian Rating Corporation, the two local rating agencies.

The fixed-rate bonds comprised about three-quarters of the total amount of Cagamas debt securities outstanding at the end of December 1996, while the short-term discount notes accounted for another 16%; the balance consisted of floating-rate bonds and Islamic bonds.

While the volume of Cagamas debt securities has been growing rapidly since the establishment of the company, trading of these securities on the secondary market has been rather slow and inconsistent. As a result, one of the weaknesses in the Malaysian debt securities market is the lack of benchmark bonds. This is, therefore, one area of the secondary mortgage market that needs urgent development.

FINANCIAL HIGHLIGHTS

Since the establishment of the company about 10 years ago, the volume of housing loans securitized has grown rapidly, as shown below:

Table 1. Volume of Housing Loans

	Purchased and Outstanding		
At end of	*RM million*	*US$ million (equivalent)*	*% Change*
1992	RM5,345	$2,138	—
1993	6,076	2,430	13.7%
1994	9,944	3,978	63.7
1995	11,882	4,753	19.5
1996	16,142	6,457	35.9

At the end of 1996, Cagamas had securitized RM16.1 billion (US$6.4 billion) or 27.2% of the total volume of housing loans granted in Malaysia, compared with RM5.3 billion (US $2.1 billion) or 14.1% of the total as of the end of 1992. The commercial banks and the finance companies, which together granted RM 39.7 billion (US$15.9 billion) or 67.0% of the total housing loans of RM59.3 billion (US$23.7 billion) outstanding in Malaysia at the end of 1996, were the main group of institutions that securitized their loans, accounting for RM13.3 billion (US$5.3 billion) or almost 83% of the total amount (RM16.1 billion or US$6.4 billion) of housing mortgages securitized by Cagamas.

Reflecting the success of the company in securitizing housing loans, the volume of debt securities issued has risen equally rapidly:

Table 2. Amount of Cagamas Securities

	Issued and Outstanding		
As of the End of	*RM million*	*US$million (equivalent)*	*% Change*
1992	RM5,137	$2,055	—
1993	5,940	2,376	15.6%
1994	9,485	3,794	59.7
1995	11,322	4,529	19.4
1996	15,737	6,295	39.0

The operations of Cagamas have been profitable since it began business, with pre-tax profit rising from RM4.3 million (US$1.7 million) in the company's first year of operation in 1987 to RM131.0 million (US$52.4 million) in 1996. Consequently, the shareholders' funds in the company have risen from RM52.3 million (US$20.9 million) at the end of December 1987 to RM344.2 million (US$137.7 million) at the end of December 1996.

WHAT THE FUTURE HOLDS

Cagamas has been successful in developing the secondary mortgage market. Through its securitization operations, the company has provided the liquidity that is so essential for the development of the housing loan market. In fact, it is the availability of Cagamas facilities that has made housing loans so easily accessible and affordable in Malaysia. Over the last 10 years, the securitization facilities provided by Cagamas have enabled the average tenor of housing loans in Malaysia to lengthen from approximately 15 years to about 25 years. This has helped to place house ownership within reach of a large cross-section of the population, particularly the lower income group. This, in turn, laid the foundation for the rapid growth experienced by the Malaysian housing industry in recent years.

For the future, the securitization activities of Cagamas are expected to encourage further growth in the volume of housing loans extended by the financial institutions. Cagamas would enhance this trend by introducing new products such as pass-through securities to meet the evolving requirements of the secondary mortgage market. Given the low level of development in the capital market at the time when Cagamas was set up, purchasing housing loans with recourse to the loan originators was then the best course of action. With the rapid development of the capital market over the last 10 years, the transitional phase is over and Cagamas should soon be ready to introduce pass-through securities in order to bring the secondary mortgage market to a higher stage of development.