



Malaysia

Chapter 5

The Mortgage-Backed Securities Market in Malaysia

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The Fixed-Income Securities Market

BACKGROUND AND STATUS

Until the early 1960s, the debt securities market was practically nonexistent in Malaysia, and until the 1980s, the market consisted only of Malaysian government securities (MGSs). Before 1986, the MGSs market was largely a captive market. Provident funds, financial institutions, and insurance funds in Malaysia were required to invest a prescribed part of their funds in government securities. As investing institutions tended to hold the MGSs to maturity, there was effectively no secondary market.

Recognizing the importance of having a secondary market, the government in late 1986 took measures to liberate the MGSs market and to add depth to the market by widening the range and distribution of MGSs. At the same time, the government also decided to take positive action to develop the debt securities market as a whole.

The corporate bond market was thus launched in October 1987 with the maiden issue of five-year fixed-rate unsecured bearer bonds with a nominal value of RM100 million by Cagamas Berhad, which had been established by the government the year before to develop the private debt securities market.

LONG-TERM FIXED-INCOME SECURITIES

Long-term fixed-income securities in Malaysia are of three types: Malaysian government securities (MGSs), Cagamas bonds, and corporate

bonds. Cagamas bonds and corporate bonds are classified as private debt securities.

Malaysian Government Securities (MGSs)

MGSs are fixed-rate bullet bonds issued by the government of Malaysia, the single largest issuer of fixed-income securities in Malaysia. First issued by the Treasury in 1959 to finance public-sector development programs, these securities have maturities ranging typically from two to 21 years. About 70 percent of the outstanding issues have maturities of 11 years or more. More than 75 percent of the bonds are held by social security and financial institutions to satisfy statutory requirements.

At the end of 1998, the total amount of MGSs outstanding stood at RM 75.012 billion. The supply of MGSs has remained static in recent years as the government has downsized its market borrowings. From 1996 to 1998, there were only 11 issues of MGSs totaling RM 23.95 billion, with tenors ranging from three to 20 years. Table 1 summarizes the MGSs issues from January 1996 to December 1998.

Table 1 MGSs Issues, January 1996 to December 1998 ■

Issue Date	Amount (RM billion)	Tenor (years)	Yield (%)
Jan. 1996	2.00	5	6.480
Feb. 1996	2.00	7	6.586
March 1996	2.00	10	6.812
Jan. 1997	1.00	10	7.284
Feb. 1997	2.00	5	8.157
Jan. 1998	2.00	3	8.112
Feb. 1998	2.50	5	9.031
March 1998	2.45	7	7.424
Oct. 1998	3.00	15	8.000
Oct. 1998	3.00	20	8.000
Dec. 1998	2.00	10	7.005

Source: RAM Bond Newsletter, August 1998

Cagamas Bonds

Cagamas bonds, first issued in 1987, are medium-term obligations of Cagamas Berhad, the National Mortgage Corporation. The company is by far the largest issuer of fixed-income paper in the Malaysian private sector. The typical maturity of the bonds is three years, although seven-year bonds

have been issued. Cagamas bonds have a fixed- or floating-rate coupon with bullet maturity. All Cagamas bonds have been rated AAA by the two local credit-rating agencies.

Like MGSs, Cagamas bonds have a largely captive market. Fixed-rate Cagamas bonds, which are denominated exclusively in the local currency, ringgit, are mainly held by commercial banks, merchant banks, and finance companies to satisfy liquidity requirements. Other significant holders include insurance companies and pension provident funds. Financial institutions and insurance companies together hold the bulk of outstanding Cagamas securities, in line with statutory requirements.

Corporate Bonds

Corporate bonds are long- and medium-term obligations issued by the Malaysian private sector. The issuers are varied, ranging from independent power producers, which issue bonds to finance infrastructure projects, to manufacturing and infrastructure development companies. Central bank guidelines require issuers of corporate bonds to have a minimum paid-up capital of RM 25 million and to have their issues rated by local credit-rating agencies. The guidelines also require issues to have a minimum size of RM 25 million and a minimum tenor of three years. The typical maturity of corporate bonds is three years to seven years.

Issued bonds vary widely from conventional bonds, convertibles and bonds with equity warrants, and puttable or callable bonds, to plain-vanilla paper. Fixed-rate corporate bonds account for only a small proportion of the existing issues. Investors consist mainly of discount houses, banks, and provident funds. Foreign investors are also active in the corporate debt market.

CAGAMAS BERHAD

The history of Cagamas dates back to 1980 when a committee set up by the central bank, Bank Negara Malaysia (BNM), with representatives from the banking industry, recommended the establishment of a secondary mortgage market. But market conditions and interest-rate trends at the time did not favor the creation of such a market, and so the committee's proposal was shelved.

In February 1986, the Technical Committee on the Development of a Secondary Mortgage Market, comprising representatives from the central bank and the banking industry, was set up with the following objectives:

- To explore the feasibility of a secondary mortgage market in Malaysia;
- To propose viable instruments for such a market; and
- To determine the requirements for the incorporation and operation of a financial institution that would act as intermediary between primary lenders of housing loans and investors in long-term funds and fixed-income securities.

In a report completed in November 1986, the committee expressed the view that it was feasible and timely to establish a secondary mortgage market. The committee also urged the creation of a national mortgage corporation to act as intermediary between primary lenders and investors in long-term funds, and to issue secondary mortgage securities. The national mortgage corporation should be a priority, according to the committee, as it would help the country surmount the ongoing recession.

The proposal was approved by the government and a national mortgage corporation, Cagamas Berhad, was incorporated in December 1986 under the Companies Act of 1965.

The first issue of private debt securities by Cagamas in October 1987 coincided with the implementation of the system of principal dealers. Selected dealers were appointed by Bank Negara Malaysia to underwrite and to make a market in issues of debt securities. In 1989, their functions were extended to include underwriting and making a market in primary issues of MGSs, as part of the major reforms carried out by the government, and open-market operations of Bank Negara Malaysia were conducted through these primary dealers. The reforms also primed the discount houses for a more active role in the debt securities market by liberalizing their operations.

Tight Bank Liquidity

Bank liquidity in the early 1980s had become increasingly tight, reflecting mainly excess demand for bank credit relative to deposit growth. The loans-to-deposits ratio of the banking system had deteriorated to 98 percent by the end of September 1986, from 89 percent at the end of 1980 and 94 percent at the end of 1985. The factors exerting pressure on bank liquidity included substantial commitments to the property sector in prior years, lower government disbursements, and the general decline in nominal income. With the creation of Cagamas, it was hoped that liquidity in the market would increase.

Housing Objectives of the Fifth Malaysia Plan

The Fifth Malaysia Plan provided for the construction of 701,500 new housing units within the plan period, 1986–1990. Of this total, 552,500 units, including 240,000 low-cost housing units, were to be built by the private sector. Eighty thousand low-cost units were to be built each year from 1986 to 1988 under the Special Low-Cost Housing Program, which was intended to revive the economy and lift it out of the recession.

To ensure enough funds for housing, the BNM, in its lending guidelines of March 1986, required financial institutions to make firm commitments to finance the purchase of at least 100,000 new housing units, each costing up to RM 100,000, by 31 December 1987. Cagamas was given the specific role of encouraging banks and finance companies to provide more housing loans for the program.

Need for Longer-Term Housing Loans

To stimulate housing demand during the recession, the repayment periods for housing loans also had to be lengthened from the usual 10–15 years to 25 years to facilitate loan servicing. But this would have aggravated the funding mismatch of primary lenders. Banks and finance companies generally borrow short and lend long, and there was a wide gap between deposits, most of which had maturities of only up to 12 months, and ten- to 15-year housing loans.

In addition to the liquidity risk arising from the maturity mismatch, financial institutions also faced the risk of loss if they were to source their funds at higher rates than the rate of return on their housing loans, especially since interest rates on smaller loans were fixed at controlled levels. At that time, the yearly interest rate on a house costing less than RM 60,000 was 10 percent and for a house costing from RM 60,000 to RM 100,000, 11 percent. Cagamas was expected to reduce the funding gap.

Status of Fixed-Rate Debt Securities

Table 2 gives the total volume of MGSs and fixed-rate Cagamas bonds issued and outstanding for the last ten years. There are no available data on the volume of fixed-rate private debt securities issued.

As shown in Table 2, MGSs and Cagamas bond issues have grown in volume over the last ten years, from a combined total of RM 48,894 million at the end of 1987 to RM 89,071.72 million at the end of 1998.

Fixed-rate Cagamas bond issues increased from RM 100 million at the end of 1987 to RM 14,060 million at the end of December 1998; MGSs issues, on the other hand, have not grown as rapidly in the 1990s, except in 1998, when they increased by 13.2 percent.

Table 2 *Fixed-Rate Debt Instruments Issued and Outstanding, 1987–1998*
(nominal value in RM million) ■

Year	Malaysian Government Securities		Cagamas Bonds		Total
	Nominal Value	% Increase	Nominal Value	% Increase	
1987	48,794.00	—	100.00	—	48,894.00
1988	55,830.80	14.4	1,800.00	1,700.0	57,630.80
1989	58,213.40	4.3	2,500.00	38.9	60,713.40
1990	62,106.10	6.7	2,900.00	16.0	65,006.10
1991	65,263.10	5.1	2,900.00	0.0	68,163.10
1992	66,642.60	2.1	2,900.00	0.0	69,542.60
1993	66,018.10	-0.9	2,980.00	2.8	68,998.10
1994	64,969.10	-1.6	6,860.00	130.2	71,829.10
1995	64,719.10	-0.4	8,432.00	22.9	73,151.10
1996	66,910.10	3.4	11,207.00	32.9	78,117.10
1997	66,261.70	-1.0	14,712.00	31.3	80,973.70
1998	75,011.72	13.2	14,060.00	-4.4	89,071.72

Sources: Bank Negara Malaysia Annual Reports

Secondary market trading in MGSs and fixed-rate Cagamas bonds has also expanded since 1988 but the growth has not been steady. In 1998, RM 42,506 million worth of MGSs and Cagamas debt securities (mostly fixed-rate) was traded in the secondary market, 5.6 times the RM 7,656 million traded in 1988 (see Table 3).

PRIMARY AND SECONDARY MARKET INFRASTRUCTURE

The primary and secondary bond markets in Malaysia have a relatively sophisticated infrastructure. Cagamas bonds and Malaysian government securities are issued through a tender panel of 16 principal dealers appointed by Bank Negara Malaysia.

Transactions in both primary and secondary markets are recorded, cleared, and settled electronically. The various components of the market infrastructure are described below.

Table 3 Secondary Market Trading Volume, 1987–1998 (RM million) ■

Year	Malaysian Government Securities	Cagamas Debt Securities	Total
1987	—	—	—
1988	—	7,656	7,656
1989	5,750	5,703	11,453
1990	6,818	5,665	12,483
1991	7,699	66	7,765
1992	5,467	1,301	6,768
1993	18,808	3,854	22,662
1994	10,887	8,604	19,491
1995	3,846	16,159	20,005
1996	25,374	4,177	29,551
1997	12,367	15,230	27,597
1998	27,326	15,180	42,506

Source: Bank Negara Malaysia

Network of Principal Dealers

The 16 principal dealers (PDs) underwrite auctions of MGSs that are issued by tender (MGSs with original maturities of up to ten years), Treasury bills, and Cagamas debt securities. All tenders for these securities must go through the PDs, who can and must bid at the primary level. The tenders are made through the FAST system, which is described below. Bids are secret and competitive, and are based on the market. The PDs must bid for at least 10 percent of the amount offered for tender, either for their own account or on behalf of their customers. Responsible for ensuring liquidity in the market, they must provide two-way quotes in all market conditions for the debt securities issued.

PDs are appointed and supervised by Bank Negara Malaysia from among the commercial banks, merchant banks, and discount houses. Their composition may be changed by BNM from time to time. Regulations distinguish between discount-house PDs and non-discount-house PDs. Discount-house PDs can tender for primary Treasury issues but can tender only for MGSs and Cagamas debt securities with an original maturity of up to ten years. Non-discount-house PDs can tender for MGSs and Cagamas debt securities with original maturity of up to ten years.

After subscribing to the debt securities at the primary level, the PDs may market and sell their debt securities to other investors.

Apart from the auction system, MGSs and Cagamas securities can also be issued through private placement. Cagamas has issued conventional and Islamic bonds through private placement. Private debt securities can also be issued through competitive tender among a panel of subscribers set up by the arranger for the purpose or by private placement.

Fully Automated System for Tendering (FAST)

The Fully Automated System for Tendering is an electronic tendering system comprising personal computers on the premises of the participating institutions which are linked in a secure network to a central host computer at Bank Negara Malaysia. The system replaces manual tendering and facilitates the processing of bids from the PDs for designated debt securities offered for tender at the primary level. These securities are Malaysian Treasury bills, Malaysian government securities, government investment issues, Bank Negara bills, and Cagamas debt securities. BNM, the PDs, and Cagamas all subscribe to FAST. All issuers, including issuers of private debt securities, may use FAST for the tendering of their short- or long-term debt securities issues.

BNM designed FAST to improve the efficiency, security, and transparency of tendering for debt securities and to reduce errors and delays arising from manual handling. The system has safeguards against unauthorized access and provides audit trails and administration with house-keeping functions.

FAST allows Bank Negara Malaysia and Cagamas Berhad to invite tenders for the designated debt securities at least three business days before the tender closing date. FAST member institutions have online access to all information about forthcoming tenders. They enter their bids at their respective workstations, and the central host computer automatically sorts and ranks the bids after the predetermined cutoff time, and then allots to the successful bidders proportionate amounts of the debt securities issued. Bid results are made known to all FAST members within two to three hours and are also broadcast through information providers such as Reuters and Telerate. FAST is interfaced with SPEEDS to allow electronic settlement, including payment for the securities and registration of the successful bidders.

Bond Information and Dissemination System (BIDS)

The Bond Information and Dissemination System, an electronic debt securities information system, went online in October 1997. It is a centralized electronic database providing information on the terms of debt securities issues, real-time prices, details of trades in the secondary market, and other relevant news on new and existing debt securities issues. Currently it also reports on unlisted debt securities issued by the government and its agencies and by the private sector, including Cagamas. Short-term (one-month) to long-term (up to 26 years) debt securities are covered by the system.

BIDS was instituted to answer the information needs of the bond market particularly at the secondary level. The dearth of information was cited by the industry as a reason for the lack of a secondary market. By providing information on bonds issued, BIDS is expected to facilitate trading and to enhance liquidity in the market. The system also improves the ability of financial institutions to give investment information and advice to their customers.

BIDS collects data electronically from various authorized sources which enter the data through its front-end system. Lead arrangers and rating agencies enter primary data and ratings for debt securities to be issued. Cagamas, a major issuer of debt securities, enters details of its primary issues. This information is used by licensed financial institutions, including PDs, in their secondary market activities. Trades in debt securities, which are negotiated by phone, are entered into BIDS daily, so that the latest information is available daily to all member institutions. Other information relevant to the debt securities market is also disseminated by the member institutions through their corporate homepages and special and general announcement pages in BIDS. The BIDS central host computer at Bank Negara Malaysia centralizes the information and disseminates it in real time through the BIDS front-end system.

As of 22 September 1998, there were 141 issuers listed in the BIDS including the government, Khazanah Nasional Berhad, Cagamas Berhad, and other issuers of private debt securities.

SPEEDS

SPEEDS (for *Sistem Pemindahan Elektronik Untuk Dana dan Sekuriti*, Malaysian for Electronic Transfer System for Funds and Securities) is a computerized scripless trading system introduced by BNM to facilitate

the transfer of funds between member financial institutions, and the registration, trading, and settlement of government debt securities and Cagamas securities.

This system is now being reviewed by BNM which plans to replace it with the more advanced Real-Time Gross Settlement System (RTGS) in 1999.

SPEEDS has two components: the Interbank Funds Transfer System (IFTS) and the Scripless Securities Trading System (SSTS).

Interbank Funds Transfer System (IFTS)

The Interbank Funds Transfer System, launched in December 1989, allows participating financial institutions to make electronic interbank fund transfers and settlement automatically at the end of each business day. They key in their instructions at the workstation on their premises, and the system automatically debits their accounts with the central bank. The transactions are made in a secure environment.

Financial and other institutions that are not members of the IFTS can subscribe to electronic funds transfer services provided by major banks whose systems are linked to the IFTS.

Scripless Securities Trading System (SSTS)

The other component of SPEEDS is the Scripless Securities Trading System, which was implemented by the central bank in 1990 to facilitate the clearing of transactions in designated debt securities. The system of paperless clearing and settlement, and registration of debt instruments in customers' and dealers' accounts, has eliminated the danger of loss, theft, and destruction of scrip. By reducing paperwork, the system has also speeded up the clearing and transfer of debt securities, enabling the market to cope with higher volumes and to compete more effectively with other markets in sourcing funds. The system has thus been a vital factor in encouraging the growth in the volume of debt securities transactions in the Malaysian market.

Interagency Committee

To accelerate the development of the market in debt securities, the government has set up an informal committee of concerned agencies. The committee meets twice a year (the first meeting was in August 1996) to exchange information, to discuss current issues relating to the private debt

securities market, and generally to promote coordination in the capital market, at the primary and secondary levels. Represented in the committee are the Ministry of Finance, the Securities Commission, the Registry of Companies, Rating Agency Malaysia Berhad, Malaysian Rating Corporation Berhad, and such corporate entities as Cagamas Berhad, the Association of Merchant Banks, and the Bond Dealers Association.

Investors

The main investors in fixed-income securities are banking institutions (commercial banks, finance companies, and merchant banks), discount houses, other institutions such as the National Savings Bank, provident and pension funds, and insurance companies.

Commercial banks accounted for about 53.1 percent (RM 7,464.1 million), finance companies 13 percent (RM 1,823.4 million), and merchant banks 5.8 percent (RM 813.1 million) of the total outstanding Cagamas fixed-rate debt securities of RM 14,060 million as of 31 December 1998. Discount houses, provident and pension funds, trust companies, insurance companies, nonresident companies, and other nonbanking institutions held the remaining 28.1 percent (RM 3,959.4 million). Details of the holdings of Cagamas fixed-rate securities are given in Table 4.

Table 4 Holdings of Cagamas Fixed-Rate Securities, as of 31 December 1998
(amounts in RM million) ■

Investing Institutions	Amount Held	%
Commercial banks	7,464.1	53.1
Finance companies	1,823.4	13.0
Merchant banks	813.1	5.8
Discount houses	226.0	1.6
Financial institutions other than commercial banks, merchant banks, finance companies, and discount houses	59.7	0.4
Nonfinancial corporations	39.2	0.3
Trust companies, including unit trusts and property trusts	2.0	0.0
Insurance companies	2,538.3	18.1
Government agencies	88.9	0.6
SOCISO, provident and pension funds	633.7	4.5
Individuals	0.0	0.0
Nonresident companies	371.6	2.6
Total	14,060.0	100.0

Source: Cagamas Berhad

PRIVATE DEBT SECURITIES

Requirements for Issuers

Corporations that propose to issue private debt securities must have at least RM 25 million in shareholder's equity and must submit an application to BNM. Public limited companies are required to submit a separate application to the Securities Commission. Cagamas, however, has blanket approval from BNM and the Securities Commission to issue debt securities. Issuers must also inform BNM of their underwriting and guarantee arrangements, the proposed use of the proceeds, the type of debt securities to be issued, and the mode of issuance (private placement, bought deal, or public issue).

Issues are commonly arranged through merchant banks in view of the many regulations and approvals that are needed. They must be rated by a local rating agency (this BNM guideline took effect 2 May 1992), be worth at least RM 25 million, have a minimum tenure of three years, and be underwritten by commercial or merchant banks. Floating-rate issues should have a coupon rate that is based on the Kuala Lumpur interbank offered rate (KLIBOR), and pay interest at least quarterly.

Rating Agencies

The Rating Agency Malaysia Berhad (RAM) was established in November 1990 and Malaysian Rating Corporation Berhad (MARC) in October 1995 as part of the continuing efforts to develop the private debt securities (PDSs) market. These agencies rate all issues of private debt securities and disseminate timely and relevant information to existing and prospective investors at both the primary and the secondary level. They also rate financial institutions, corporations, and Islamic capital market instruments.

RAM was incorporated with a paid-up capital of RM 10 million. Its shareholders comprise thirty-three commercial banks, five merchant banks, ten finance companies, and two other institutions. The rating agency has a technical relationship with Duff and Phelps Credit Rating Co. (DCR), a well-known US-based international rating organization which is listed on the New York Stock Exchange.

MARC has a paid-up capital of RM 10 million and is owned by stock-brokerage companies, major insurance companies, and discount houses. Each of these shareholders holds less than 4.9 percent equity, to maintain the agency's impartiality. MARC has a technical cooperation agreement with Thomson BankWatch (TBW).

Being local, RAM and MARC have the advantage of being more familiar with the Malaysian economy, local politics, corporate culture, and shareholding structure than foreign rating agencies. In addition, their partnership with international rating agencies enables both RAM and MARC to provide not only local but also international ratings through a single due-diligence process, saving time and cost.

As of the end of August 1998, RAM had rated 428 PDSs issues valued at RM 68.27 billion. The ratings were divided equally between short- and medium- term paper and long-term bonds. MARC, on the other hand, had rated 29 corporate debt issues totaling RM 13.6 billion.

Underwriters

Underwriters assume the risk of undersubscribed PDSs issues and assure the issuer of liquidity. The issue arranger, besides inviting licensed financial institutions to underwrite the issue, could also be an underwriter, depending on its limits and its appetite for the paper.

Bidding is normally done through open tender by the members of the tender panel appointed by the issuer. If the issue is undersubscribed, the arranger notifies the underwriters. For note issues, underwriters bid at a discount; for bond issues, depending on the coupon, bids are based on yield.

Underwriters generally charge a flat participation fee of 0.25–0.505 percent of the underwritten amount, and an underwriting fee based either on the cost of funds plus a spread, or on the base lending rate plus a spread.

Authorized Depository Institutions

Authorized depository institutions (ADIs) are dealers that are allowed by Bank Negara Malaysia to hold Scripless Securities Trading System (SSTS) securities on behalf of customers who are not members of the SSTS. For members of the SSTS, BNM is the authorized depository, holding Cagamas debt certificates until maturity, crediting bondholders with scripless bonds for trading and transfer according to the code of conduct and market practices for scripless trading, and recording the holdings and transactions of each SSTS member institution.

ADIs offer protection to customers with regard to the payment of interest and redemption proceeds. They ensure secrecy of accounts, issue statutory acknowledgment receipts and monthly statements detailing

account holdings and transfers, and carry out the various responsibilities of depository institutions to their customers. ADIs use the MGSs in a customer's account only with the customer's approval.

Dealers that act as ADIs maintain two accounts with the SSTS: one for their own holdings, and another account for all the securities they hold in custody, through which non-SSTS members' transactions are cleared and settled. ADIs are required to maintain a separate account for each customer.

DEVELOPMENT OF THE PDSs MARKET

A striking feature of the development of the Malaysian capital market in recent years has been the emergence and rapid growth of the market in PDSs, particularly in the fixed- and floating-rate notes issued by prime corporations and statutory bodies. Privatized companies have had a significant presence in the PDSs market, raising total funds of RM 12 billion, or 28 percent of all bond issues in 1993–1996.

The first major move by the authorities to promote a PDSs market was realized with the setting up of Cagamas Berhad in 1986. The primary role of Cagamas was to purchase housing loans from the loan originators and repackage them into fixed-rate bearer bonds.

The success of Cagamas bonds has encouraged several large corporations with good credit standing to raise funds by issuing floating- or fixed-rate term notes. Funds raised through debt securities rose from RM 225 million in 1987 to RM 609 million in 1988 and RM 577 million in 1989, then leaped to RM 1.7 billion in 1990 as more companies turned to PDSs as a means of financing. The emergence of the PDSs market was assisted by favorable domestic monetary conditions: there was ample liquidity and a low and stable interest-rate environment from 1987 to mid-1990.

The significant measures that have been taken to stimulate the growth of the PDSs market are summarized in Table 5.

The development of the PDSs market reflects the following:

- The expanded investment needs of the economy and the growth in demand for increasingly more avenues for investment in a wide range of financial assets with rising savings.
- A relatively well-developed market for Malaysian government and secondary mortgage bonds, with market-makers and a large volume of paper with varied maturities. A PD network for government and Cagamas securities is in place.

Table 5 *Measures Taken to Develop the PDSs Market, 1988–1997* ■

Date	Action Taken
1988	Introduction of BNM guidelines for PDSs issues
1989	Waiver of stamp duty for PDSs issuance and transfer; implementation of the Interbank Funds Transfer System (IFTS)
1990	Establishment of Rating Agency Malaysia Berhad (RAM); implementation of the Scrippless Securities Trading System (SSTS) and SPEEDS
1992	Establishment of the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE); implementation of the Central Depository System, managed by a subsidiary of the Kuala Lumpur Stock Exchange
1993	Establishment of the Securities Commission to regulate and supervise the capital market
1995	Establishment of the Malaysian Rating Corporation Berhad (MARC)
1996	Establishment of the Malaysian Monetary Exchange (MME)
1997	Issuance of benchmark bonds by Khazanah Holdings to facilitate bond pricing and secondary trading of bonds; implementation of the Bond Information and Dissemination System (BIDS); implementation of the Fully Automated System for Tendering (FAST)
n.a. ^a	Granting of tax exemptions on PDSs interest earned by resident individual investors

^an.a. = not available

Source: BNM Annual Report and other publications

- Downsizing of the government in the 1990s, reducing its domestic borrowing requirements and, hence, the expected growth in the volume of Malaysian government securities. Privatization efforts, on the other hand, are foreseen to intensify.
- The need for more sophisticated alternatives to bank borrowing, including different types of bond and equity financing, as the borrowing requirements of Malaysian corporate and institutional borrowers change.
- Increased need for better asset-liability management because of the interest-rate volatility resulting from the currency turmoil in the region. The PDSs and interest-rate futures markets are two ways by which financial institutions, exposed to interest-rate risk and asset-liability maturity mismatch, can hedge and minimize their exposure.
- The attractiveness of asset securitization to companies looking for a relatively lower-cost way of raising funds than bank borrowings and direct issuance of PDSs, particularly in view of the increasing risk aversion of investors.

REGULATORY STRUCTURE OF THE FIXED-INCOME SECURITIES MARKET

The two main regulatory agencies for the bond market are the Securities Commission and Bank Negara Malaysia.

The Securities Commission (SC), set up in March 1993 under the Securities Commission Act of 1992, is the sole regulatory body for the capital market, including securities and futures trading. It is a self-funded statutory body with regulatory, investigative, and enforcement powers. Fixed-income securities cannot be issued without its prior approval.

Bank Negara Malaysia, the central bank, is mainly concerned with the regulation of the banking system. It issued the first guidelines on PDSs issuance in December 1988.

The Companies Act of 1965 also requires the Registry of Companies to approve the prospectus and trust deed for public issues of debt securities. In addition, the Kuala Lumpur Stock Exchange (KLSE) must approve the listing of debt securities on the exchange.

RELATED DEVELOPMENTS

BNM lowered the statutory reserve requirements (SRR) from 6 percent to 4 percent on 16 September 1998 to improve liquidity, and there are indications that the SRR may be reduced by another 2 percent by the end of 1998. But unless the central bank comes up with other liquidity-boosting measures, simply lowering the SRR may fall short of the desired effect.

Two new agencies with complementary roles in the economic recovery program have been established. Danamodal Nasional Berhad (Danamodal) has been operating since September 1998 to recapitalize and consolidate the banking sector. Pengurusan Danaharta Nasional Berhad (Danaharta), the national asset management company, is concerned mainly with revitalizing the Malaysian financial sector by buying nonperforming loans from financial institutions and maximizing their recovery value.

Preliminary BNM estimates place at RM 16 billion the total amount that will be required by Danamodal to bring the risk-weighted capital ratio of all domestic banking institutions to at least 9 percent. The funds will be raised in the form of equity, hybrid instruments, or debt in both the domestic and international markets. As of 30 September 1998, BNM had provided seed capital of RM 1.5 billion, and it will soon inject another RM 1.5 billion to assist in the recapitalization program.

An additional RM 8 billion will be raised from the banking system, through the 2-percentage-point cut in SRR implemented last 16 September 1998. To gain access to the funds, Danamodal will issue bonds to financial institutions at competitive rates. The process will be market-

driven and the quantum of bonds held will depend on their liquidity. On 21 October 1998, Danamodal issued RM 7.7 billion worth of five-year bonds (RM 11 billion in nominal value). Banking institutions were able to subscribe to the bonds with the extra funds resulting from a lower SRR. Since the funds remained within the banking system, interbank rates were not affected by the bond issue.

Danaharta, for its part, plans to buy loans that are each worth at least RM 5 million. Excluded from consideration will be borrowers under liquidation orders or covered by restructuring schemes endorsed by their creditors and the courts under Section 176 of the Companies Act of 1965.¹ To pay for the loans, Danaharta will issue each month government-guaranteed bonds with an initial tenure of five years and a rollover option exercisable at Danaharta's discretion for another five years. The bonds will be zero-coupon and will have yields that approximate those of MGSs with similar tenure. In addition, the bonds will be considered investment instruments, will carry zero risk weight for capital adequacy computation purposes, and will be regarded as class-I liquefiable assets under the new liquidity framework.

A new liquidity framework for banking institutions, issued in July 1998, is also on a six-month parallel run. The required liquid asset ratio will be reduced gradually to ease the transition to the new framework. On 16 September 1998, the ratio for commercial banks was reduced from 17 percent to 15 percent of total eligible liabilities. The reduction will help lower the holding cost of the banks' liquid assets. For finance companies and merchant banks, however, the required liquid asset ratio will still be 10 percent for those not issuing negotiable instruments of deposit, and 12.5 percent for those issuing negotiable instruments of deposit.

Activities in the secondary bond market as of 6 October 1998 reflected the prevailing interest rates. BNM's new intervention rate of 7.5 percent (as of 5 October 1998) and the 7.4 percent rate for three-month KLIBOR indicate the willingness of the government to bring down interest rates to a comfortable level to stimulate economic growth. This development, plus the corresponding increase in bond prices, has given market players some room to be active.

¹Amendments to the Companies Act of 1965 that took effect on 7 October 1998 inhibit borrowers from seeking court protection under Section 176(10) without the consent of the creditors who hold at least half of the value of their debt. Such changes are necessary to protect the creditors particularly in the current period of economic difficulties.

There has been a perceptible shift in investor interest away from short-term commercial paper toward government paper, despite its generally lower yields. The shift toward more secure and more tradable instruments has been prompted by the growing number of companies that have defaulted on their loan payments and been downgraded by rating agencies. Investors are setting their sights on good issuers with strong cash flow such as Petronas, Shell, Esso, and Tenaga Nasional. Secondary trading in Cagamas paper and government or government-guaranteed instruments such as Khazanah bonds and MGSs has accordingly been active.

Despite all this, the development of the capital market, especially the bond market, is no less critical. When the Malaysian economy recovers, the business sector will need to raise funds for expansion. Corporates will want to match the duration of their financing facilities to their funding needs. Malaysia must be ready to meet the challenge of a growing PDS market.

Constraints on the Development of the Fixed-Income Securities Market

NEED FOR LONGER-TERM BONDS

Lengthening the tenure of PDSs, including mortgage-backed bonds, will help develop the secondary debt securities market. Cagamas bonds have maturities of up to seven years, the longest price review period for the housing loans the company buys.² But the life of the outstanding mortgage-backed bonds in the market at the end of 1997, in fact, averaged less than seven years. Most bonds had a term of only three years, matching the three-year price review period of the bulk of Cagamas' housing loan purchases. Financial institutions are generally reluctant to lock in their rates for longer than three years.

LACK OF A MARKET-BASED BENCHMARK

Slow and inconsistent secondary market trading in Cagamas debt securities, as well as in Malaysian government securities and Treasury bills, has

²At the end of the price review period of three, five, or seven years, the selling institution may buy back its housing loans from Cagamas if the rollover rate is not attractive enough.

held back the development of a benchmark bond. Some financial institutions do quote bond prices, but the quotations may not truly reflect market prices since there are so few transactions in the secondary market. A market-based benchmark would help issuers and investors in their financing and investment decisions.

The government has designated Khazanah bonds as benchmark bonds.³ The first issue of RM 1 billion on 18 September 1997 comprised three-year zero-coupon securities based on Islamic principles. After that, the government issued Khazanah bonds with the same tenure and nominal amount as the first in March 1998, five-year Khazanah bonds amounting to RM 1 billion on 18 June 1998, and RM 850 million worth of three-year bonds on 18 September 1998. On 18 December 1998, five-year Khazanah bonds worth RM 1 billion were issued. The total amount of Khazanah bonds outstanding as of 31 December 1998 was RM 4.85 billion. The bonds are guaranteed by the government and the proceeds are used mainly for investments in both quoted and unquoted companies in Malaysia. But whether Khazanah bonds will succeed as benchmark bonds remains to be seen.

In relation to securitization, the lack of a benchmark yield curve hinders Cagamas from quoting an accurate price to potential sellers of housing loans. As Cagamas buys the loans before issuing debt securities to fund the purchases, it relies on the constant availability of reliable information on the price of Cagamas bonds or MGSs to quote competitive mortgage purchase rates. The ready availability of price information would also enhance secondary market trading of mortgage-backed securities.

INSUFFICIENT INFORMATION ON BOND TRADING

Lack of information on bond trading makes investors (especially foreigners) uncertain, and therefore reluctant, to participate in the market. BNM has therefore set up an electronic bond information and dissemination system (BIDS) that allows dealers to report information on bond prices, volume of secondary market transactions, etc., which is made available almost instantaneously to market participants from a central electronic source.

³Khazanah Nasional Berhad is the investment arm of the government. The government hopes to create a benchmark yield curve in the bond market by issuing regularly Khazanah bonds that can be used as benchmarks.

LOW SUPPLY OF BONDS

Institutional investors, such as the Employees Provident Fund and insurance companies, invest in bonds over the longer term.⁴ Because suitable instruments have not emerged fast enough to absorb the investable funds of such investors, they have been willing to take up any issue of good-quality bonds at the right price. The bond market, especially the market for fixed-income securities, can thus be called captive. Despite strong growth in recent years, debt securities are not plentiful enough to fuel an active secondary market.

Moreover, the liquid-asset status accorded by the BNM to all MGSs and most Cagamas debt securities (95.4 percent as of 31 December 1997) has made financial institutions reluctant to lower their liquid-asset ratio by selling their holdings. Demand for Cagamas debt securities has, meanwhile, grown, and yields have accordingly stayed low, as the government has decelerated its borrowings in recent years and has slowed down the issuance of Malaysian government securities. To rectify the “buy and hold” problem, Cagamas will finance the purchase of industrial property loans by issuing debt securities that do not qualify as liquid assets and that therefore carry a more market-oriented yield.

The best way to increase the supply of paper is to liberalize the bond market and thus reduce the interest rates at which prospective borrowers can issue long-dated fixed-rate paper. At the current yields of primary issues, the reserve and liquidity costs and interest-rate risk premium result in high negative carrying costs for secondary traders, discouraging trading activity. As of 22 September 1998, most financial institutions were required to keep 4 percent of their eligible liabilities in non-interest-bearing accounts with BNM and 15 percent in liquid assets.⁵ The high transaction and carrying costs must be eliminated or at least reduced.

NO BOND FUTURES MARKET

A bond futures market will help reduce or eliminate reserve and liquidity costs and reduce the interest-rate risk premium by providing investors and speculators alike with opportunities to hedge and transfer risks to those who are willing to bear them. Compared with trading in the physical

⁴Banks and fund managers, on the other hand, generally invest over the short term.

⁵As mentioned earlier, the liquid-asset ratio requirement for finance companies and merchant banks is 10 percent for those not issuing negotiable instruments of deposit and 12.5 percent for those issuing negotiable instruments of deposit.

market, where the required investment is the face value of the contract, the required cash outlay for futures trading is very low.

The lack of a bond futures market in Malaysia, and hence the lack of liquidity, has discouraged speculators and may also turn away genuine investors. Without the hedging opportunity offered by a bond futures market, an investment position could turn speculative if a cash crunch were to force the investor to liquidate his physical position prematurely.

But without a properly developed cash market, it will be difficult to develop a market in financial futures.

The Malaysian Monetary Exchange is studying the feasibility of implementing a suitable bond futures market.

NARROW INVESTOR BASE

Financial institutions now hold the bulk of the debt securities issued by Cagamas. At the end of 1998, commercial banks, finance companies, and merchant banks collectively held 80.8 percent of the outstanding debt securities.

In computing the single-customer limit imposed by BNM, banking institutions must aggregate their holdings of approved commercial paper⁶ and other credit facilities granted to the issuer. These institutions tend to hold the securities to maturity because of their liquid-asset status, inhibiting active trading in the secondary market.

To stimulate the growth of the debt securities market, other institutions must be encouraged to participate. Pension funds, mutual funds, insurance companies, and cash-rich corporations, as well as high-net-worth individuals, must be educated on the advantages of investing and trading in bonds, including mortgage-backed paper, rather than leaving their surplus funds in fixed deposits or shares. The bond issuance and trading process, which is currently geared to wholesale transactions, should also be changed to make the bond market more liquid and more easily accessible to retail investors.

It is hoped that more participants in the market would lead to a larger supply of bonds and step up the volume of trading in the secondary market.

⁶These are defined as short-term paper rated at least P3 or MARC-3 or its equivalent by the rating agencies and approved by BNM. Exempted from consideration are bank holdings of approved corporate bonds (long-term bonds rated BBB and above by the rating agencies and approved by BNM) which, in any case, must not exceed 10 percent of the banks' capital funds. The computation of the single-customer limit on private debt securities excludes Cagamas debt securities.

HIGH LIQUIDITY AND RESERVE COSTS

Besides the banks and fund managers (short-term investors) and the institutional investors (long-term investors), other financial intermediaries that actively mobilize deposits for money-market investments and loans have stayed out of the bond market partly on account of the high reserve and liquidity costs.

In the early days, when there were no principal dealers as such, only the BNM attempted to play the role of market-maker, quoting two-way prices. But since it fixed the prices of MGSs and determined, at its own discretion, the amount of bonds it would buy or sell, its market-making role was limited. This fact, along with the perception that a captive market depresses yield, compounded the liquidity problem.

In 1989, the BNM set up a system of PDs for MGSs and Cagamas bonds. Now new issues were being auctioned, and so their allocation could be related directly to the bid prices received. PDs were allowed to bid either at a premium or at a discount. The implication was that issue size and yields should be determined by the market, unlike the previous advance subscription system. Also, the requirement imposed on all PDs to quote a two-way price for bonds within a 15-sen spread helped ensure the existence of a secondary market for bonds.

The PD system appears to have worked well during the period of stable interest rates. But when interest rates rose between 1990 and 1992, the PD system did not work as well, despite the exclusive access to funding given to PDs through noninterbank repos (repurchase agreements) of less than one month.

The decline in the market-making role of PDs coincided with the sharp rise in the statutory reserves that they were required to maintain against their net deposit liabilities and interbank borrowings. The failure of many PDs to make a market prompted calls for a reexamination of the system of appointing PDs.⁷ However, given current regulations and the present state of the market, carrying an MGSs inventory entails high cost and risk but limited opportunities for profit. PDs thus have little or no incentive to make a secondary market in bonds.

There is, first of all, the direct cost of funding the inventory. PDs can cover this cost by taking deposits of an equivalent maturity to avoid interest-rate risk. But they are bound to incur a funding loss equal at least to

⁷The BNM reviews the process each year on the basis of the previous year's performance.

the premium that would induce an investor to place its funds with the PDs, and assume credit risk, rather than invest in a riskless government bond.

PDs can choose to finance their holdings of longer-dated paper with shorter-dated funds, but they would then be taking a position on interest rates that may not be to their liking. Alternatively, they can hedge their cash position by going short in the futures market, except that a bond futures market does not yet exist in Malaysia. Therefore, in the absence of a hedging opportunity, the PDs should be paid a premium for bearing interest-rate risk.

Two other costs—reserve cost and liquidity cost—are borne by the inventory holder in the Malaysian market if it is a financial institution supervised by the BNM. Reserve cost refers to the cost of holding statutory reserves with the BNM against the deposits or interbank borrowings with which the PD funds the inventory. Liquidity cost is the cost of maintaining liquid assets against such deposits or borrowings. Liquid-asset requirements and interbank rates push up the cost of funding bond investments 25–38 basis points higher than for those institutions that are not subject to the requirements.

For the PDs' market-making role to be profitable, therefore, the yield and capital gain they get from holding and trading their MGSs or Cagamas paper inventory must cover their direct funding cost, reserve and liquidity costs, and administrative costs. PDs must also be compensated for bearing interest-rate risk and committing capital to the business. Under such circumstances, PDs are likely to carry an inventory and make a market in MGSs only if the yield curve is very steep.

To develop an active secondary market in bonds in Malaysia, reserve and liquidity costs must be reduced or eliminated outright by amending liquid-asset regulations. Economies with well-developed bond markets are observed to have low or nonexistent reserve and liquidity costs. They, moreover, have an active bond futures market for transferring risk to those willing to bear it.

Liquid-asset requirements should be liberalized to free yields, reduce liquidity costs, and encourage financial institutions to trade PDSs in the secondary market. To reduce reserve cost, the central bank should rely less on variations in statutory reserves as a tool of monetary policy, pay compensatory interest on such reserves, or exempt financial institutions from maintaining reserves against their bond inventory.

NO BORROWING AND SHORT SELLING

Another important reason for the illiquid cash market in bonds is the absence of borrowing and short selling of paper, a practice that is, in fact, discouraged by existing guidelines. In theory, market players should be able to borrow securities for short selling because a repo market has existed in Malaysia since 1979.⁸ But the use of repos to borrow securities against cash collateral is almost unheard of in Malaysia.

Institutionalizing the practice of securities lending through repurchase agreements would allow market players to run a long or short bond position without necessarily having the required instruments in their physical possession, and thus help create a more active and liquid cash market in instruments such as MGSs and Cagamas paper.

REGULATORY CONSTRAINTS

The issue of private debt securities, including fixed-income debt instruments, at the primary level is subject to regulatory guidelines issued by the BNM. First announced in December 1988, these guidelines have been liberalized over time. For instance, the minimum issue size has been halved to RM 25 million, and financial covenants with respect to capital and gearing have been relaxed. But the guidelines require all PDSs issues to be rated investment grade by the rating agencies, and financial institutions to comply with reserve requirements when investing in PDSs issues.

A prospectus, exactly like the one needed for an equity issue, is required for a debt issue if there are at least ten subscribers and the issue is not placed with prescribed corporations.⁹

A long and involved process of approval for new issues will make such borrowings more expensive and risky and thus discourage the issuance of PDSs. The longer the approval process, the greater the interest-rate risk to the issuer.

Residential Mortgage Financing

HOUSING DEVELOPMENT POLICY

Housing is a matter that concerns both the federal and state governments. Federal entities set housing policies and strategies, as well as housing

⁸A well-developed market in repos and reverse repos enables an institution to borrow cash with readily marketable money- and bond-market instruments as collateral, and to borrow securities against cash collateral.

⁹These are defined as licensed financial institutions, insurance companies, provident funds, and statutory bodies, which number about 200 at present.

targets, define licensing and enforcement regulations, and guide financial institutions in providing bridge and end-financing. State governments and local authorities play a primary role in physical planning and housing investments. Local authorities require all housing developments to have their plans and utility connections approved.

As stated in the Seventh Malaysia Plan, the main objective of housing policy for the plan period (1996–2000) is to provide adequate, decent, and affordable housing with the basic amenities. Like the previous national development plans, the current plan emphasizes the provision of housing for the poor and low-income groups. Government strategies and programs are aimed at delivering a sufficient number of housing units that all sectors of society can afford.

A total of 800,000 housing units have been planned for construction under the plan. Of this total, the public sector is to deliver 230,000 housing units (29 percent) and the private sector, 570,000 (71 percent). The private sector is expected to serve the housing needs of all levels of society. The public sector, on the other hand, will concentrate on the delivery of housing units to the lower-income groups. Playing an “enabling” role, it will provide incentives and facilities for housing development.

Housing for the hard-core poor and low-medium-cost housing are two new programs in the current plans other than the low-, medium-, and high-cost categories. Housing for the hard-core poor is provided for free or with interest-free loans to target groups with an average household income of less than RM 500 a month. Households with an average income of RM 500 to RM 750 a month are the targets for the 200,000 housing units costing less than RM25,000 each to be delivered under the plan.

In the private sector, licensed housing developers will continue to be the leading players in housing development. They are expected to deliver 555,000 units during the plan period, at a rate of at least 110,000 units per year. The government has also emphasized the role of the private sector in the production of low- and medium-cost houses ranging from RM 26,000 to RM 60,000 per unit.

In addition, the private sector is to continue with the delivery of 140,000 low-cost housing units. In this task private developers will have the support of state governments, which are encouraged to continue providing incentives and facilities similar to those under the Special Low-Cost Housing Program and to allow private developers to adopt mixed development and cross-subsidy.

HOUSE OWNERSHIP

Most housing units in Malaysia are owned by their occupants. Of the 3.4 million occupied housing units in the 1991 housing census, 67 percent, or about 2.3 million units, were used by the owners themselves, although only 3,422,200 of the over four million housing units surveyed on census day in 1991 were actually occupied. The occupied housing units covered by the survey were inhabited by 3,257,600 households, for an average of 1.03 households per occupied housing unit. In urban areas, however, many occupied housing units had three or more households each.

For single-story and double-story terrace houses, the land area normally ranges between 100.3 sq m and 174.2 sq m. For bungalow lots, the land area ranges between 371.6 sq m and 929 sq m. The norm in Malaysia is for housing developers to develop housing estates comprising mainly single- and double-story terrace houses. Some developers also include semidetached houses (single- or double-story), flats, apartments, or condominiums in their housing estates, but housing estates with a mixture of different types of premises are quite rare. Mixed-development housing estates can also have low-, medium-, and high-cost houses.

LAND TENURE

The purchaser of a housing unit is mainly concerned with the type of title, freehold or leasehold,¹⁰ granted to the property. Freehold titles are preferred to leasehold titles but are becoming a rarity these days and so command a premium. For leasehold land, questions revolve around the remaining tenure of the lease, the possibility of extending that tenure, and at what cost.

The state government has absolute power over all state lands within the state boundary under Section 76 of the National Land Code (NLC), and has sole power to alienate or dispose of state land. It may issue land title, constituting proof of ownership of a piece of land, through its alienation process. Under the NLC, all land within the boundaries of the state is considered state land until the land title is registered, even if its alienation has been approved.

¹⁰A freehold is a land title issued in perpetuity. A leasehold is a land title issued for a period of 99 years.

Some titles prohibit the transfer of the property without the approval of the ruler in council or the state authority. Certain laws, such as the Malay Reserve Enactment and the Customary Land Enactment, forbid the transfer of land title for designated properties to those not specifically permitted to hold such properties.

TAXES

Real Property Gains Tax

As of 27 October 1995, persons (as opposed to companies) who dispose of chargeable assets must pay 5–30 percent tax on the profits from the sale depending on the length of time they owned the assets, on a tax scale of two to five years. Those who are not citizens or permanent residents of Malaysia are subject to 30 percent property gains tax irrespective of the period of ownership.

Stamp Duty

Ad valorem stamp duty is imposed on the sale and transfer of assets. If it is applied to the sale of assets from the originator to the special-purpose vehicle in securitization, the transaction would not be cost-effective. Securitization should therefore be given special exemption to make it cost-effective. The Ministry of Finance has exempted Cagamas from stamp duty for its mortgage and bond-related transactions to encourage the development of the secondary mortgage market.

RESIDENTIAL MORTGAGE FINANCING IN RELATION TO BANK LOANS, ASSETS, AND GDP

As of the end of September 1998, commercial banks had originated RM 301,032.4 million in loans; of this amount, RM 42,303.2 million (including housing loans sold to Cagamas), or 14.1 percent, financed the acquisition of houses. Housing credit represented 9.5 percent of commercial banks' total assets of RM 443,836.1 million at the end of September 1998.

During the same period, finance companies had provided RM 12,827.7 million in housing credit (including housing loans sold to Cagamas)—13.4 percent of their total loan portfolio of RM 95,820.2 million. Housing loans made up 10 percent of their total assets of RM 128,593.8 million at the end of September 1998.

The outstanding housing credit granted by commercial banks represented 15.1 percent of the country's GDP of RM 279,816 million as of the end of September 1998, while finance companies accounted for another 4.6 percent. Total housing credit, including the housing loans provided by other primary lenders such as housing credit companies and the government, exceeded 15 percent of GDP.

PRIMARY MARKET LENDERS

Malaysia Building Society Berhad

The Malaysia Building Society Berhad (MBSB), which was set up as a building society in the early 1950s, is a housing credit institution that has been granting housing finance on a term-loan basis with a repayment schedule that is fixed at the outset. Most of its funds are in the form of loans from its major shareholder, the Employees Provident Fund (EPF), and BNM, as well as shareholders' funds and savings and fixed deposits placed with it by private-sector institutions.

MBSB is not restricted in its lending activities by the BNM. It is not subject to statutory reserve and liquid-asset requirements, and charges interest rates that are generally competitive with those charged by commercial banks and finance companies. Furthermore, it is not required to grant a specified number of loans for houses costing RM 100,000 or less. But for houses costing RM 25,000 or less (low-cost houses), MBSB receives earmarked subsidized funds from the government and the BNM for financing at concessionary rates. The government implements this low-cost housing finance program from time to time.

Borneo Housing Mortgage Finance Berhad

Borneo Housing Mortgage Finance Berhad (BHMF) is another housing credit company that is not regulated by the BNM. It extends mortgage finance only for the purchase of houses in Sabah and Sarawak. The major sources of its funds are shareholders' funds, long-term loans from the state governments of Sabah and Sarawak, and statutory provident funds, as well as deposits placed with it by state governments and various institutions.

Strong competition from commercial banks and finance companies, which entered the end-financing market in the late 1960s, has pulled down the market share of MBSB and BHMF. Commercial banks, as one-stop providers of a wide range of financial services, have a distinct competitive advantage over specialized financial institutions, which are limited to

property and construction finance. Building societies ceased to be the biggest originators of housing loans in the early 1970s, and now account for only an insignificant portion of total housing credit in the country.

National Housing Corporation

The National Housing Corporation was set up in 1996 to help speed up the construction of low-cost housing. Its initial capital of RM 1 billion was provided by Petroleum Nasional Berhad (Petronas), the national petroleum company. The corporation purchases low-cost houses from private developers and resells these to the public at the government-controlled price, and buys land from state authorities for the construction of low-cost housing. It does not provide end-financing for houses.

Employees Provident Fund

The EPF provides supplementary housing finance under its Housing Withdrawal Package, which allows contributors to withdraw up to 30 percent of their savings as a lump sum to purchase a house. Any type of house may be purchased, but the amount withdrawn cannot exceed the price of the house. However, EPF members who have obtained 100 percent end-financing from other sources may withdraw only 10 percent of the purchase price of the house or 30 percent of their savings, whichever is lower.

Members who have not reached 50 years of age may also withdraw up to 30 percent of their contribution at five-year intervals to reduce or settle their housing mortgages.

Treasury Housing Loans Division and Public Utility Companies

The Treasury Housing Loans Division of the Ministry of Finance also emerged as a major player (along with commercial banks) in the housing loans market in the mid-1970s, providing end-financing to public-sector employees at a subsidized rate. Large public utility companies, particularly the privatized national telecommunications company (Telekom Malaysia Berhad) and the national electric energy company (Tenaga Nasional Berhad), also provide a large amount of end-financing to their employees at subsidized interest rates.

The share of each type of originator of housing finance is shown in Table 6. Table 7 shows the outstanding housing loans in the industry, both including and excluding the loans sold to Cagamas.

Table 6 Sources of Housing Credit, 1986–1997 (amounts in RM million) ■

Year	Commercial Banks		Finance Companies		THLD	
	Amount	%	Amount	%	Amount	%
1986	7,039	39	2,076	12	6,801	38
1987	7,563	37	2,265	11	8,396	41
1988	7,712	37	2,333	11	8,968	43
1989	9,243	37	3,000	12	10,731	43
1990	11,076	39	3,787	13	11,774	41
1991	13,035	40	4,772	15	12,787	39
1992	15,032	40	5,798	15	14,028	37
1993	17,214	40	7,056	17	15,245	36
1994	19,873	42	8,096	17	15,517	33
1995	23,815	45	9,239	17	16,495	31
1996	28,995	48	10,685	18	16,356	27
1997	27,329	49	9,519	17	15,395	27

Source: Cagamas Berhad, *Housing the Nation: A Definitive Study*

Table 7 Housing Loans, 1987–1997 (RM million) ■

Year	Commercial Banks		Finance Companies	
	Excluded	Included	Excluded	Included
1987	7,543.0	7,846.7	2,265.0	2,367.9
1988	8,070.0	8,449.5	2,606.0	2,883.1
1989	8,141.0	9,243.4	2,671.0	2,999.6
1990	9,587.0	11,067.0	3,365.0	3,787.4
1991	11,588.0	13,035.0	4,289.0	4,771.7
1992	12,203.0	15,032.0	4,963.0	5,798.1
1993	14,508.0	17,214.0	6,040.0	7,057.4
1994	14,041.2	19,873.0	6,466.7	8,096.0
1995	16,741.3	23,816.0	7,322.3	9,239.0
1996	18,538.8	28,994.8	7,421.5	10,684.9
1997	22,848.0	36,314.8	6,522.0	12,291.0

Note: Amounts in the columns labeled "Excluded" do not include housing loans sold to Cagamas. Amounts in the columns labeled "Included" include housing loans sold to Cagamas.

Sources: Bank Negara Malaysia Annual Reports

TYPES OF MORTGAGE LOANS

Financial institutions offer two types of mortgage loans: conventional and interest-free Islamic house financing. Conventional housing loans may carry fixed or variable interest or be subject to an interest-rate ceiling.

Fixed-Interest Housing Loans

A leading insurance company offers fixed-interest housing finance. Some commercial banks and finance companies also offer fixed-rate housing loans for initial periods of three to five years with the option at the end of that period to convert to a floating rate or continue paying a fixed rate

MBSB		BHMFB		Others		Total	
Amount	%	Amount	%	Amount	%	Amount	%
1,482	8	462	3	226	1	18,086	100
1,400	7	469	2	269	1	20,362	100
1,285	6	466	2	291	1	21,055	100
1,201	5	434	2	318	1	24,927	100
1,196	4	414	1	416	2	28,663	100
1,339	4	410	1	638	2	32,981	100
1,514	4	414	1	988	3	37,774	100
1,772	4	423	1	1,012	2	42,722	100
1,826	4	450	1	1,401	3	47,163	100
1,751	3	477	1	1,752	3	53,529	100
1,676	3	472	1	1,569	3	59,753	100
1,590	3	480	1	1,969	3	56,282	100

Government		Others		Total	
Excluded	Included	Excluded	Included	Excluded	Included
7,715.0	7,715.0	2,128.0	2,128.0	19,651.0	20,057.6
8,935.0	9,676.0	2,045.0	2,045.0	21,656.0	23,053.6
9,670.0	10,732.0	1,957.0	1,957.0	22,439.0	24,932.0
10,601.0	11,773.6	1,950.0	1,950.0	25,503.0	28,587.0
11,657.0	12,786.9	2,377.0	2,377.0	29,911.0	32,970.6
12,347.0	14,028.0	2,808.0	2,808.0	32,321.0	37,666.1
12,897.0	15,250.5	3,269.0	3,269.0	36,714.0	42,790.9
13,349.5	15,518.0	3,448.7	3,448.7	37,306.1	46,935.7
13,624.2	15,827.0	3,293.2	3,293.2	40,981.0	52,175.2
14,619.4	16,356.4	3,244.6	3,244.6	43,824.3	59,280.7
15,157.7	17,023.7	3,558.6	3,558.6	48,086.3	69,188.1

based on the market. Fixed-rate housing finance now constitutes only an insignificant proportion of housing loans granted in Malaysia but is bound to gain in popularity once interest rates subside from the current high levels.

Variable-Interest Housing Loans

Most housing loans extended in Malaysia for houses costing more than RM 100,000 are based on an adjustable rate pegged to the base lending rate (BLR) of the financial institution. The typical lending rates of primary lenders as of 20 September 1998 are given in Table 8.

Table 8 Lending Rates of Financial Institutions, 1998 ■

Financial Institution	Base Lending Rate (BLR)	Landed Properties		Strata Properties	
		Term	Overdraft	Term	Overdraft
A	8.90%	1.50% + BLR	n.a.	1.50% + BLR	n.a.
B	9.05%	1.75% + BLR	2.25% + BLR	1.75% + BLR	2.25% + BLR
C	9.05%	1.75%–2.25% + BLR	n.a.	1.75%–2.25% + BLR	n.a.
D	9.05%	3.00% + BLR	n.a.	n.a.	n.a.
E	9.05%	0.00%–1.50% + BLR	0.00%–1.50% + BLR	0.00%–1.50% + BLR	0.00%–1.50% + BLR
F	9.05%	1.30%–1.50% + BLR	2.30%–2.50% + BLR	1.30%–1.50% + BLR	2.30%–2.50% + BLR
G	9.05%	1.00% + BLR	2.25% + BLR	1.00% + BLR	2.25% + BLR
H	9.05%	1.30%–1.75% + BLR	2.25%–2.50% + BLR	1.30%–1.75% + BLR	2.25%–2.50% + BLR
I	9.05%	1.50% + BLR	2.00% + BLR	1.50% + BLR	2.00% + BLR

Note: Landed properties have individual titles, while strata properties do not. High-rise developments are strata properties.
Source: *The Sun*, 20 September 1998

Housing Loans with an Interest-Rate Ceiling

Financial institutions charge variable interest pegged to the BLR but only up to 9.0 percent yearly on loans granted for the purchase of houses costing RM 100,000 or less. The BNM has set this ceiling to make housing loans more affordable to the lower-income group.

The BNM also makes sure that individual financial institutions provide a minimum amount of such loans by requiring them to comply with an annual quota.

Islamic House Financing

The tenure of housing loans based on Islamic principles normally ranges from 15 to 25 years with a significant number of the loans clustered at the higher end. As in the case of conventional housing finance, many loans have tenures of up to 30 years.

Islamic house financing loans are computed on a cost-plus-margin basis and are paid in fixed installments with no interest over their tenure.

BANK SPREAD

The base lending rate is the benchmark against which floating-rate housing loans are commonly pegged. The components of BLR for commercial banks are:

- The average three-month interbank offer rate announced monthly by BNM;
- An adjustment for the cost of the statutory reserve requirement;
- A discount of 20 percent for current-account balances (on which interest is not paid); and
- An additional 2.5 percent (to cover administrative and other costs).

The BLR of finance companies has the same components, except for the 20 percent discount for current-account balances which finance companies are not permitted to hold.

As of 20 September 1998, the BLR of a financial institution was typically 9.05 percent, while the spread over BLR charged to borrowers ranged from 0 percent to 2.50 percent, depending on the institution, as shown in Table 8.

As seen above, the lending rates of financial institutions are pegged to a margin above the cost of three-month money in the interbank market.

AVERAGE LOAN SIZE

A survey carried out in 1997 showed that, as of 31 March of that year, two-thirds of housing loans granted in Malaysia amounted to less than RM 150,000 each. Financial institutions had RM 22,008 million in outstanding housing loans for houses costing less than RM 150,000; of this total amount, RM 10,709 million had been sold to Cagamas Berhad. For houses costing more than RM 150,000 the total amount of outstanding housing loans was RM 11,000 million, including RM 2,402 million sold to Cagamas Berhad. The details of the survey are shown in Table 9.

Table 9 Outstanding Housing Loans of Financial Institutions, 31 March 1997
(amounts in RM million) ■

	Sold to Cagamas		Not Sold to Cagamas		Total
	Amount	%	Amount	%	
Houses costing RM 150,000 or less					
Commercial banks	7,948	74	7,280	64	15,228
Finance companies	2,761	26	4,019	36	6,780
Subtotal	10,709	100	11,299	100	22,008
Houses costing more than RM 150,000					
Commercial banks	2,175	91	6,503	76	8,678
Finance companies	227	9	2,095	24	2,322
Subtotal	2,402	100	8,598	100	11,000
Total	13,111	40	19,897	60	33,008

Source: Cagamas Berhad, *Survey of Outstanding Housing Loans of Financial Institutions, 1997*

CREDIT EVALUATION OF HOUSING LOAN BORROWERS

A prospective borrower is subjected to credit evaluation to assess his creditworthiness and ability to repay the mortgage loan. The primary lender examines the applicant's financial circumstances including his past and present employment earnings, bank account balances, asset ownership, and expenditures. The specific details of the assessment vary between financial institutions.

General Eligibility Criteria

Borrowers are generally classified into two broad categories, namely, salaried borrowers and self-employed borrowers. Whether salaried or self-employed, the borrower should be at least 18 years of age to qualify for a housing loan. Other financial institutions require a minimum age of 21. The maximum repayment period of the loan is 25 to 30 years or it can extend to the borrower's 55th birthday, whichever comes first.

Documentary Support

The applicant for a housing loan is normally required by the loan originator to provide as documentary evidence his identification card, the sale and purchase agreement for the property, and a copy of the title, if any.

The following other forms of documentary evidence are required.

Salaried borrowers

The salaried borrower must present the latest copy of his income tax assessment form (Form J) issued by the Inland Revenue Department, the most recent payslips issued by his employer, and a certification of employment signed by his employer.

In determining whether borrowers can repay their housing loans financial institutions generally consider the following types of income: fixed monthly salary, fixed allowances (such as for entertainment and transportation), contractual bonus, rental income, dividends, and interest on fixed deposits.

Self-employed borrowers

The self-employed borrower must present profit-and-loss statements and balance sheets for the last three years, his certificate of business registration, income tax assessment form (Form J), bank statements for the last six months, form filed with the Registry of Companies (Form 49), and memorandum and articles of association of his company, if incorporated.

Factors Determining the Eligible Loan Amount

Monthly installments, including interest, should not exceed one-third of the borrower's gross income. The maximum amount of the loan is also based on the loan-to-value ratio for each type of residential unit, as follows: 90–100 percent for low-cost housing (costing up to RM 25,000); 80–90 percent for medium-cost housing (costing more than RM 25,000 and up to RM 100,000); 70–80 percent for high-cost housing (costing more than RM 100,000).

The value of the property bought directly from developers is its sale and purchase price. For second-hand property, financial institutions require a valuation report.

Guarantee Requirement

A guarantor is required if the applicant cannot present the required documents to support his income statement, or if his income is just enough to pay the monthly installment or is slightly less than the minimum required income (three times the monthly installment), or if his employment is of doubtful stability.

The guarantor's ability to repay the housing loan if the borrower cannot do so is assessed in the same way as the borrower's capacity to pay. All documents showing proof of the guarantor's income must be provided to the financial institution concerned.

Assessment of Collateral

Financing for half-wood and half-brick or all-wood properties is extended selectively or not at all. Financial institutions accept freehold as well as leasehold properties for financing. However, different financial institutions require different minimum remaining leasehold periods. Some institutions require a minimum remaining leasehold period that is not less than the loan period, whereas others require a minimum remaining leasehold period of 30 to 50 years.

Financial institutions accept both properties with individual titles (landed properties) and properties without individual titles (strata properties, mostly high-rise developments).

For properties whose titles have restrictions on their charging, disposal, or transfer, borrowers must have the lien approved by the relevant state authorities before the financial institution will grant a housing loan. If the properties are located in Malay Reserve lands or native

lands, the financial institution can finance the property only after being gazetted in relevant enactments of the state with the power to take a charge over such lands.

LATEST DEVELOPMENTS IN THE PROPERTY SECTOR

To help reduce interest rates, Bank Negara Malaysia imposed exchange-rate controls on 1 September 1998 and fixed the US\$/RM exchange rate at RM 3.80. Lower interest rates will result in lower interest expense and, hence, reduced risk of default in the property sector. BNM has also reclassified the property sector from nonproductive to productive.

Soon after these measures were announced, demand for property increased, primarily in anticipation of market liquidity due to the projected repatriation by 1 October 1998 of some RM 25 billion parked offshore. The central bank sparked a further rise in demand when it directed banking institutions to make loans cheaper and more easily obtainable so as to achieve a loan growth objective of 8 percent by the end of 1998.

On 6 October 1998, Bank Negara Malaysia abolished the cap of 60 percent on loans and cut interest rates further. This move is expected to clear the way for banks and finance companies to set their own credit margins for the purchase of land and residential properties. To curb property speculation, BNM in 1996 had set a 60 percent limit on the purchase of residential properties that were worth at least RM 150,000 and were not occupied by their owners.

Loan applications under the Special Scheme for Low- and Medium-Cost Houses are also being streamlined to speed up approval. Developers can now submit their applications for financing directly to institutions participating in the program without having to obtain an endorsement from Syarikat Perumahan Negara, the national housing company.

On 5 October 1998, Bank Negara Malaysia reduced the three-month intervention rate to 7.5 percent per annum, bringing interest rates closer to the market rate, which is below 7.5 percent. A decline in maximum base lending rates is therefore expected, to 8.5 percent for commercial banks (0.42 percent less than previously), and to 8.5–10.06 percent for finance companies (0.52 percent less).

Overall, however, a glut in the market, especially for commercial properties, and the nagging concern about jobs have weakened demand. Potential buyers, hoping for another drop in property prices, are staying on the sidelines.

Legal and Institutional Framework for Asset Securitization

Asset securitization is not the subject of specific laws, but a secondary mortgage market, based on Malaysian laws relating to property ownership, legal charges, and transfer of charges has existed since 1986, when the national mortgage corporation, Cagamas, was launched. The market has grown by leaps and bounds since Cagamas first securitized housing loans in 1987.

Cagamas has successfully operated within a legal framework comprising mainly the National Land Code of 1965 (NLC), the Securities Industry Act of 1983, the Securities Commission Act of 1993, the Banking and Financial Institutions Act (BAFIA) of 1989, and the Companies Act of 1965. Where necessary for the success of securitization, the company has obtained exemptions and incentives from certain legal provisions to reduce transaction costs or improve its competitiveness in the market.

LEGAL AND REGULATORY TREATMENT OF HOUSING FINANCE

The National Land Code of 1965 (NLC) governs the legal and administrative procedures for the transfer and charging of landed properties, among other matters. The National Land Code is based on the Torrens system of land registration.

Registration of Instruments Under the Torrens Charge System

Land laws in Malaysia deal, among others, with instruments of charge for individually titled alienated lands that are offered as collateral for housing loans or banking facilities. Properly created and registered instruments of charge become Torrens charges that are universally binding. They are registered encumbrances that are created from the registered land titles.

A Torrens charge, besides requiring registration under Torrens law, must be prepared in the prescribed statutory form and duly executed and attested. In addition, the creation of the charge must not violate other existing laws.

Transfer of Charges

Transferability of charge documents

Another issue concerns the administrative practices and laws pertaining to landed properties in Malaysia. For the secondary mortgage market

to progress, the security documents for the housing loans must be readily transferable from the primary lender to a third party such as Cagamas or to the bondholders' trustees in the case of pass-through securities.

At present, where a house title restricts the right to charge, deal, or dispose of the property, each borrower must obtain the prior written approval of the relevant land authority to charge the property to a primary lender. If an existing charge with such a restriction is to be transferred from a primary lender to a secondary mortgage market institution like Cagamas, the approval of the relevant land authority is also required. The length of time it takes to get the necessary approvals makes it difficult to securitize housing loans with such restrictive titles. Besides, the authorities may or may not approve the transfer.

For this reason, Cagamas does not securitize housing loans that carry a restriction on the transfer of charges. The pool of housing loans eligible for sale to Cagamas is therefore limited. To expand the secondary mortgage market, the restriction on the transfer of charges should be removed, at least for securitization purposes.

Restrictions on the transfer of charges over Malay Reserve land

A further issue concerns the legal restrictions on the transfer of charges over Malay Reserve land and customary land. Cagamas has been gazetted by most authorities as an institution that can accept charges over such land, but there is no specific mention of the transfer of charges. It is not clear whether Cagamas, having been permitted to accept charges on Malay Reserve land, is also permitted to receive the transfer of charges on such land from other chargees. Authorities in the state of Selangor have taken this silence on the part of the law to mean that a party that has been authorized to take a charge on Malay Reserve land cannot also accept a transfer of an existing charge on the property.

This ambiguity should be cleared up. An institution that is authorized to take a charge over Malay Reserve land should automatically also be permitted to accept a transfer of charge over such land. If this issue is not resolved, it would hinder the securitization of housing loans granted for the purchase of houses on Malay Reserve land.

SECURITIZATION PROCESS

A financial institution sells its mortgage loans to Cagamas under a master sale and purchase agreement with Cagamas. The agreement sets forth the gen-

eral terms and conditions of the sale and includes a declaration by the selling institution that it holds in trust for Cagamas the mortgage loans sold to Cagamas, the mortgage instruments, and all monies received but not yet paid to Cagamas. The borrower's (or charger's) consent for the sale is not necessary since a provision in the charge instrument allows the financial institution to transfer the charge or assign its rights and interests to another party.

The charge over the property securing the housing loan is still registered in the name of the financial institution (the originator) and it is still the assignee of the rights to the property. However, when it sells the mortgage loans to Cagamas, it appoints Cagamas and its assignees to be its attorney, authorizing Cagamas to take over the charge.

The financial institution executes a purchase contract for each tranche of housing loans sold to Cagamas. By selling and assigning the loans to Cagamas, it thus conveys beneficial interest in the loans to the latter.

Foreclosure

After an instrument of charge is registered at the relevant Land Office, the charger must comply with the covenants or risk being served a statutory notice of default in the prescribed form. If he does not rectify the breach of compliance in the manner and within the time specified in the notice, the aggrieved chargee is entitled under the National Land Code of 1965 to apply for an order of sale. This order of sale, once made by the court or the Land Office, is final and may not be changed or set aside until after the auction, which is usually held up to three times, until it is successful. If the auction does not succeed even after the third time, the court may issue other directions.

The moment the defaulting charger cannot justify his noncompliance to the satisfaction of the court or the Land Office (the latter is relevant if the title is a *mukim* title¹¹), the latter is bound to order the sale of the charged property through public auction. An order for sale by private treaty is outside the jurisdiction of the court, and the property cannot be sold by private treaty after a date has been set for the auction.

The order of sale is a very special statutory right conferred on the aggrieved chargee by Sections 256 and 260 of the National Land Code of 1965 for registry land¹² and for *mukim* land, respectively. This right is

¹¹A registered document of title to land held in perpetuity.

¹²Town or village land, country land not over 10 acres, or land that is part of the foreshore or seabed.

for the sole benefit of the chargee and is independent of any other action that the chargee may take against the defaulting charger under the provisions of the registered instrument of charge or under any other law.

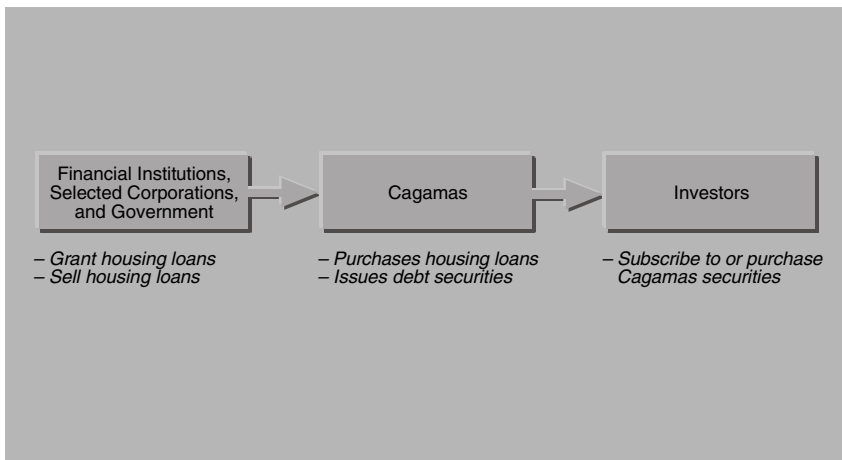
Lengthy foreclosure proceedings

The length of time it takes for properties to be auctioned and the proceeds to be realized is another hindrance to the development of the secondary mortgage market. Currently a piece of property is auctioned following a default on a housing loan only after a year from the start of foreclosure proceedings. Then it could take another year, or even longer in some cases, for the auction proceeds to be released by the High Court or the Land Office. The long time-lag in the realization of a charge is a cost that has to be considered when securitizing housing loans, particularly if the housing loans are to be sold without recourse to Cagamas. This would hinder the development of a market for pass-through securities. Ideally, the land laws should be amended specifically to accommodate securitization transactions.

SECURITIZATION MARKET PLAYERS

Cagamas is the only institution that is active in the Malaysian secondary mortgage market and is, by far, the largest single issuer of PDSs in Malaysia. Figure 1 illustrates Cagamas' securitization process.

Figure 1 Securitization Process ■



The major players are the primary lenders such as the commercial banks, the finance companies, and the Treasury's Housing Loans Division which grant housing loans to house-buyers. These primary lenders subsequently sell their housing loans to Cagamas, which finances the purchases by issuing debt securities in the form of the longer-term Cagamas bonds and the shorter-term Cagamas discount notes. Investors in Cagamas debt securities include financial institutions, insurance companies, pension funds, nonresident companies, and others who invest in short- and medium-term paper to obtain a fixed- or adjustable-rate income.

The debt securities are issued by Cagamas through secret tender by a panel of principal dealers. There are 16 of these dealers at present, appointed by the BNM from among the commercial banks, merchant banks, and discount houses to make a market in the debt securities. The principal dealers must enter a minimum bid of less than 10 percent of the announced issue amount. Successful bidders either hold the securities for their own account or sell them to other investors at the secondary level.

Table 10 summarizes the major market players in the securitization process.

Table 10 *Securitization Market Players* ■

Regulators	Bank Negara Malaysia, Securities Commission, and Registry of Companies
Primary Lenders	Commercial banks, finance companies, Treasury's Housing Loans Division, and selected institutions
Loan Securitizer	Cagamas Berhad
Principal Dealers	Selected commercial banks, merchant banks, and discount houses
Investors in PDSs	Financial institutions, insurance companies, other institutional investors, provident and pension funds, and nonresident companies

REGULATION OF THE PDSs MARKET

No authority specifically regulates asset securitization in Malaysia. However, to facilitate the orderly development of the primary and secondary markets in PDSs, Bank Negara Malaysia introduced a set of guidelines in December 1988 to streamline the approval and administrative process for the issuance of such securities. The objective of the guidelines was to clarify the basic legal and administrative framework for bond financing and to encourage corporations to raise funds through this channel. Among the criteria set out in the guidelines are:

- All issuances of PDSs must be approved beforehand by BNM.
- Issuers must have minimum shareholder's equity of RM 25 million.
- The minimum size of an issue must be RM 25 million.

These guidelines, as later amended, also provide that all PDSs issues must be rated investment grade by a rating agency based in Malaysia, and that financial institutions, while allowed to invest in PDSs issues, must do so subject to reserve requirements.

The Companies Act requires a prospectus for debt issues that have at least ten subscribers and that are not placed with prescribed corporations (licensed financial institutions, insurance companies, provident funds, and statutory bodies). The Securities Commission Act of 1993 requires public companies to have their debt issues approved by the Securities Commission. The prospectus and the trust deed for public issues must also be approved by the Registry of Companies.

The regulatory power of BNM is a significant factor that determines the viability of housing loan securitization in Malaysia. It sets terms and conditions for the sale of housing loans to Cagamas by financial institutions that are regulated by BNM. Only housing loans for houses costing up to RM 150,000 can be sold to Cagamas. The proceeds from the sale of these loans do not have to meet liquidity and statutory reserve requirements, thus effectively reducing the cost of the funds obtained from Cagamas. But even after the sale, the originators continue to bear the credit risk for the loans, which are sold with recourse to them. The loans thus continue to be subject to a 50 percent risk weight when computing the capital adequacy ratio. BNM also considers Cagamas bonds and notes issued to finance the purchase of the housing loans as liquid assets of the financial institutions for the purpose of compliance with their liquidity requirement.

Banking statutes moreover require financial institutions to keep their customers' identity and other information confidential. On the other hand, a key securitization issue for investors and rating agencies is transparency and accessibility of information relating to the securitized pool of assets. Therefore, to allow securitization of assets, financial institutions that plan to issue asset-backed securities must have the confidentiality laws relaxed for them. (By the same token, they should also be exempted from stamp duty on the sale and transfer of assets.)

It must be noted in this regard that the fairly recent computerization (only within the last five to ten years) of the databases of most Malaysian companies and financial institutions may diminish their usefulness for the extensive statistical analysis required by rating agencies and financial guarantee institutions. This structural impediment could be addressed by greater prudence in credit enhancements, but may nonetheless add unnecessary or prohibitive costs to the originator.

Feasibility of Mortgage-Backed Securities

The secondary mortgage market in Malaysia began in 1986 with the incorporation of Cagamas Berhad as a special-purpose vehicle with a role similar to that of the Federal National Mortgage Association in the US. The potential benefits of securitizing housing loans led to the establishment of Cagamas.

BENEFITS OF MORTGAGE-BACKED SECURITIES

To House-Buyers

The competitively priced funds made available to the primary lenders through securitization have given house-buyers easy access to reasonably priced housing loans and, in the process, have encouraged home ownership and helped develop the housing industry.

To Financial Institutions

By selling their housing loans to Cagamas, the financial institutions get the necessary liquidity at a competitive cost that allows them to originate more housing loans and expand their lending operations. The competitively priced funds they obtain from Cagamas also enable them to price their own loan products competitively, giving them an edge in their business operations. By selling their housing loans to Cagamas, the primary lenders, particularly those that have granted fixed-rate loans, are also able to pass on their interest-rate risk to Cagamas.

Cagamas is finalizing plans to purchase housing loans from financial institutions on a without-recourse basis. In that case, the financial institutions would also be able to pass their credit risk on to Cagamas and improve their capital adequacy ratio.

To Investors

The Cagamas bond and note issues have, thus far, been rated triple-A by the two rating agencies in Malaysia. These debt instruments provide investors, particularly those requiring a safe and reasonable return on their investments, with high-quality paper. Pension funds, employees' provident funds, insurance companies, and banks with large surplus funds would find Cagamas securities attractive investments.

To the Government and the Economy

The securitization of housing loans provides the market with the necessary liquidity to encourage the growth of the housing industry and helps the government to carry out its policy of encouraging home ownership. In addition, housing loans for the purchase of houses costing up to RM 100,000 are subject to an interest-rate ceiling of 9 percent yearly, as imposed by the BNM. Given the competitive pricing of Cagamas bonds, financial institutions can meet the policy objective of the central bank to make housing loans more affordable to the lower-income group without any interest subsidy from the government.

MBSs DEMAND AND SUPPLY

Market demand for Cagamas debt securities is expected to be fueled by the need of financial institutions to hold liquid assets to satisfy their liquid-asset requirements, and by the need of certain investors to include investment-grade securities in their investment portfolios. Pension funds, employees' provident funds, and insurance companies would provide strong demand for MBSs in view of the insufficient supply of MGSs and AAA-rated and other investment-grade long-term paper in the market. The high demand for Cagamas mortgage-backed securities was evident in the bids received from principal dealers in 1998, which amounted to RM 41,091 million, or twice the amount of Cagamas debt securities issued. The continued growth of the Malaysian economy would no doubt result in increased demand for investment-grade instruments, including MBSs.

The future supply of MBSs will depend largely on the amount of new housing loans granted by the financial institutions and made available to Cagamas for securitization. The more housing loans there are for transaction, the larger will be the volume of MBSs issued. Table 11 shows that 800,000 residential units are slated to be built under the

Seventh Malaysia Plan (1996–2000). Of this total, 235,000 units will be low-cost houses and 480,000 units will be medium-cost residences. These new units will mean more housing loans that can be securitized by Cagamas.

Table 11 *Cost of Houses Constructed under the Malaysia Plans, 1986–2000* ■

Type of House	No. of Units			Total Cost (RM billion)		
	1986– 1990	1991– 1995	1996– 2000 ^a	1986– 1990	1991– 1995	1996– 2000 ^a
Low-cost (RM 25,000/unit)	164,396	261,386	235,000	4.2	6.6	5.9
Medium-cost (RM 60,000/unit)	116,782	282,436	480,000	7.0	8.3	28.8
High-cost (RM 200,000/unit)	19,750	103,638	85,000	4.0	3.1	17.0
Total	300,928	647,460	800,000	15.2	18.0	51.7

^aSeventh Malaysia Plan targets

In 1996, value-added in residential construction rose strongly by 12 percent in response to the sustained strong demand for private housing. In addition, the number of houses approved by the Ministry of Housing and Local Government for construction by private developers remained high in 1996 at 113,923 units, compared with 113,183 units in 1995. The statistics also showed that 98,699 residential housing units, or 12.3 percent of the 800,000 housing units targeted for completion during the Seventh Malaysia Plan period, were completed in 1996.

Apart from the supply of houses, the expected growth in residential mortgage loans in the longer term will depend on two primary factors, namely, the financial institutions' exposure to the property sector and the expected demand for residential houses. This is important in view of the country's current liquidity problem, which has forced lenders to be more selective in their lending. Poor response by lenders to requests for end-financing, or unfavorable financing rates for non-interest-controlled loans, could curtail the growth of new housing loans. Nevertheless, the growth of priority-sector loans (for houses costing up to RM 100,000) is expected to remain strong.

THE SECONDARY MORTGAGE MARKET

The secondary mortgage market in Malaysia began with the start of operations of Cagamas Berhad in 1987. Originators of housing loans were, for the first time, able to sell their housing loans to increase their liquidity and, to a certain extent, hedge their interest-rate risk.

The concept of the secondary mortgage market began in the US where mortgages originated by primary lenders were securitized and sold in the secondary market. Many variations of the secondary mortgage market concept are currently practiced around the world, each one suited to the characteristics and circumstances of the local housing market.

In its simpler form, as currently practiced in Malaysia, a secondary mortgage market refers to the origination of pools of housing loans by primary lenders, such as commercial banks and finance companies, which sell the loans (on a full-recourse basis) to a mortgage corporation, which in turn issues private debt securities to finance the purchases. For full-recourse purchases, the beneficial ownership of the housing loans is passed only to the mortgage corporation. Bondholders do not directly own the housing loans sold to the mortgage corporation or bear credit risk, which remains effectively with the primary lenders. In its more sophisticated form, as in the US, the secondary mortgage market involves the outright transfer of ownership and credit risk to the investors in the mortgage bonds.

Cagamas Berhad

Cagamas is a convenient and euphonic abbreviation for Perbadanan Cagaran Malaysia, the National Mortgage Corporation. Its single largest shareholder is Bank Negara Malaysia, which owns 20 percent of Cagamas shares. The other shareholders are commercial banks with a combined shareholding of 45 percent, finance companies with 25 percent, and merchant banks with the remaining 10 percent of the share capital of Cagamas. The Governor of Bank Negara Malaysia sits as chairman of the Cagamas board. The other directors are prominent members of the banking community who are nominated by the Association of Banks in Malaysia, the Association of Finance Companies of Malaysia, and the Association of Merchant Banks in Malaysia. The involvement of Bank Negara Malaysia was intended to ensure compliance with national policy and to provide Cagamas with the high credit standing it needed to minimize the cost of its borrowing and, ultimately, the cost of housing loans that it helps to refinance.

Cagamas began operations in October 1987 by purchasing the first pool of housing loans from three commercial banks and issuing the first mortgage-backed bonds to finance the purchase. The securitization of these housing loans marked the start of the secondary mortgage market in Malaysia.

The Securitization Process

Securitization in Malaysia is a very simple process. Commercial banks, finance companies, the Treasury's Housing Loans Division, and other primary lenders grant housing loans which they then sell to Cagamas. To finance the purchases the latter issues debt securities in the form of Cagamas bonds (longer-term) and Cagamas notes (shorter-term). Among the investors in Cagamas debt securities are financial institutions, insurance companies, pension funds, nonresident companies, and others who are drawn by the prospect of a fixed- or adjustable-rate income to invest in short- and medium-term paper.

Cagamas therefore effectively converts a long-term illiquid asset in the form of housing loans into debt securities which are tradable in the market. The mortgage interest paid by house-buyers on their housing loans constitutes investors' income from the securities.

Purchase Facilities Available

Cagamas offers five types of mortgage purchase facilities to primary lenders, as follows.

Fixed-rate mortgage purchase facility

Under this facility, primary lenders sell their housing loans at a fixed rate of interest for review periods of three, five, or seven years. At the end of the review period, the selling institutions can either roll over the sale for a further period of three, five, or seven years, on the basis of the interest rates quoted by Cagamas at the rollover date, or repurchase the housing loans if they find the quoted rates unacceptable.

Floating-rate mortgage purchase facility

The floating-rate facility allows primary lenders to sell their mortgages to Cagamas at an adjustable rate pegged to either three- or six-month KLIBOR. The floating rate for mortgages sold under this facility is reset every three or six months. The originators can sell their housing loans under this facility for review periods of three to seven years.

Convertible-rate mortgage purchase facility

Under this facility, primary lenders can sell their mortgages for a period of three years, with one or two options to convert the mode of the interest rate from a fixed to a floating rate or vice versa at a prescribed

future date during the term of the transaction. At the conversion option date, the transaction will be repriced at the interest rate then quoted by Cagamas, whether or not the option to convert the interest-rate mode is exercised.

Islamic house financing debt purchase facility

Interest-free Islamic house financing debts originated on the principle of *bai bithaman ajil* (deferred-payment sale)¹³ can be sold to Cagamas on the basis of the Islamic principle of *bai-al-dayn* (debt trading). Like conventional mortgage purchase facilities, these debts can be sold for review periods of three, five, or seven years.

Industrial property loan purchase facility

Financial institutions may also sell their industrial property loans to Cagamas for review periods of three, five, or seven years at a fixed or floating rate.

Hire-purchase and leasing debt purchase facility

Starting December 1998, financial institutions may sell their hire-purchase and leasing debts to Cagamas on a fixed-rate basis for review periods of three, four, five, six, or seven years.

Without-recourse housing loan purchase facility

Starting March 1999, financial institutions may sell their housing loans to Cagamas on an outright fixed-rate basis without any price review period and with no recourse to the sellers if the housing loans should become nonperforming. The eligibility criteria are different and more stringent than those for the existing schemes.

Housing Loans

Purchase terms and conditions

An institution that wishes to sell its housing loans to Cagamas executes a master sale and purchase agreement with the latter, specifying the terms of the transaction. Cagamas buys conventional housing loans with recourse to the originators, that is, the selling institution undertakes to repur-

¹³The financier buys the house from the developer at cost and sells it at a predetermined profit to the borrower. The borrower thus owns the property but charges it as collateral for the loan.

chase from Cagamas any housing loan that is later found to be lower in quality than that specified by Cagamas.

Originators sell their housing loans to Cagamas at a value equal to the outstanding principal balance of the loans. The primary lenders act as servicers, trustees, and custodians for Cagamas when they sell their loans. They continue to be the legal chargees of the loans sold to Cagamas and retain custody of the security documents. The sellers, however, undertake to transfer the security documents in favor of Cagamas when required to do so. Thus, as it currently operates, Cagamas is only the beneficial owner of the loans it purchases, but is legally authorized to take over the mortgages if the seller defaults on the payment of installments to Cagamas or in other cases.

Eligibility criteria

Housing loans sold to Cagamas must:

- finance or refinance the purchase, construction, or renovation of residential properties that cost not more than RM150,000;
- be fully disbursed;
- not be more than three months in arrears at the time of sale;
- have a remaining life that expires on or after the review date;
- be secured by a first charge or assignment of rights to the mortgaged property; and
- comply with other criteria that may be specified.

Purchase of Islamic house financing debts

The arrangements for the purchase of Islamic house financing debts (IHFDs) are generally the same as for the purchase of conventional housing loans. As in the case of a conventional housing loan, before the sale of an IHFD, the financial institution must execute a master sale and purchase agreement and a master servicing agreement which govern the general terms of the transaction with Cagamas. After the sale, the selling institution retains custody of the security documents and the legal charge on them. Each month it transmits to Cagamas the installments it receives from the borrowers less the monthly service fee for the servicing function.

The amount of the service fee is predetermined by the seller and Cagamas at the time of sale of the debts and is reviewed every three, five, or seven years, as provided in the purchase contract. The size of the service fee, in effect, determines the cost of funding to the seller. At the end of the review

period, the selling institution may repurchase the debts from Cagamas if it does not agree to the new service fee offered by the company.

Benefits to Financial Institutions from the Sale of Housing Loans to Cagamas

Financial institutions derive various benefits by selling their housing loans to Cagamas.

Exemption from statutory reserve and liquidity requirements

Funds obtained by commercial banks, finance companies, and merchant banks from the sale of housing loans to Cagamas are exempted from the statutory reserve and liquidity ratio requirements. As such, unlike fixed, savings, and other deposits, the selling institutions can use these funds in their entirety, reducing the effective cost of the funds relative to the cost of deposits.

Increased liquidity and profitability

By selling their loans, financial institutions are able to convert their otherwise illiquid housing loans into liquid funds which they can then use to grant more housing loans, in the process increasing their profits. As Cagamas stands ready to purchase housing loans at the quoted rate, primary lenders can raise funds in the secondary mortgage market on very short notice to tide them over any temporary liquidity problem.

Reduced maturity mismatch

By securitizing their housing loans, primary lenders gain access to medium- and long-term funds that match the tenor of their long-term housing loan assets more closely than their traditional source of funds (deposits that are primarily less than one year in tenor).

Cost advantage

Cagamas' high credit standing, as well as the concession from Bank Negara Malaysia granting liquid-asset status to its securities, enable the company to borrow a large amount of funds in the capital market at a reasonably low cost. This cost advantage is passed on to primary lenders.

Interest-rate risk management

The availability of Cagamas purchase facilities adds to the flexibility of primary lenders and offers them a way to manage their interest-rate risk.

Institutions that sell their housing loans in the secondary mortgage market under the fixed-rate purchase facility, for example, can hedge the interest-rate risk associated with their fixed-rate loans.

Diversified funding base

Funds obtained from the sale of housing loans are for fixed periods of at least three years. These relatively long-term funds are a stable funding base for financial institutions whose other fund sources such as deposits are generally much shorter term and unstable since they can be withdrawn by depositors without notice or at short notice.

Funding of Housing Loan Purchases

Cagamas buys housing loans with funds raised through PDSs issues and, to a lesser extent, borrowings from the money market. Cagamas issues three types of conventional debt securities to fund its purchase of interest-based housing loans: fixed-rate bonds, floating-rate bonds, and discount notes (Cagamas notes) and issues mudharabah bonds to finance its acquisition of IHFDs.

Fixed-rate Cagamas bonds are straight bonds with a nonadjustable interest rate payable semiannually. They are redeemable at par upon maturity. Their tenor ranges from 1.5 to seven years.

Floating-rate Cagamas bonds are, like the fixed-rate bonds, of the plain-vanilla variety. Their coupon rate is pegged to three- or six-month KLIBOR and is reset quarterly or semiannually depending on whether they are pegged to three- or six-month KLIBOR. They have original maturities ranging from two years to seven years.

Discount notes, which have maturities of less than a year, are issued at a discount to their nominal value and are redeemable at face value upon maturity. They have the same characteristics as Malaysian Treasury bills.

Mudharabah bonds are interest-free securities issued under the Islamic profit-sharing principle whereby bond investors and Cagamas share the profit generated from the specified pools of mortgages according to a predetermined ratio. Dividends are payable on these bonds at a variable rate at half-yearly intervals. Mudharabah bonds have tenors ranging from three to seven years and are redeemable at face value upon maturity. However, bondholders face the risk of diminution in the principal amount invested in the bonds.

Characteristics of Cagamas Debt Securities

Cagamas securities, including the Islamic bonds, are all unsecured obligations of Cagamas and are issued scripless. They are tradable electronically in book-entry form through an electronic clearing house, the Scripless Securities Trading System, which is operated by Bank Negara Malaysia. The company's debt securities are issued at the primary level through a tender panel of financial institutions (known as principal dealers) specially selected by Bank Negara Malaysia. After the issuance, the debt securities can be purchased by investors in the secondary market.

The bonds issued by Cagamas to fund purchases of housing loans are known collectively as tier-1 bonds, while those issued to finance the purchase of industrial property loans are known as tier-2 bonds. Tier-1 bonds, together with the shorter-term Cagamas discount notes and the mudharabah bonds, are recognized as liquid assets by Bank Negara Malaysia for the purpose of compliance with liquidity requirements. They are popular with financial institutions and are priced lower than tier-2 bonds.

Tier-2 bonds do not qualify as liquid assets and are, for this reason, priced more competitively with the market. Investors who do not have to comply with the liquidity ratio find the bonds attractive. Compared with the 50 percent risk weight assigned to housing loans for the purpose of compliance with the capital adequacy requirement, the risk weight given to Cagamas debt securities is low: 10 percent for commercial banks and finance companies, and 30 percent for discount houses.

Cagamas' good record and pedigree have earned for all its long- and short-term debt securities the highest rating of AAA and P1 from the Rating Agency Malaysia Berhad, and AAA and MARC-1 from the Malaysian Rating Corporation Berhad.

Profile of the Secondary Mortgage Market

Although established only about ten years ago, the secondary mortgage market in Malaysia has grown rapidly and is now an important factor in the housing finance market as well as the capital market. The success of the secondary mortgage market in Malaysia is reflected in the growth of the volume of housing mortgages securitized by Cagamas.

In less than a decade, the volume of housing loans securitized by Cagamas has grown by more than 16 times, from RM 1,396 million outstanding at the end of 1988 (the first full year of operations of the secondary mortgage market) to RM 22,475 million at the end of 1998. A break-

down of the housing loans that have so far been securitized by Cagamas is given in Table 12.

Table 12 *Securitized Housing Loans in the Secondary Mortgage Market, 1987–1998*
(RM million) ■

Year	Government		Commercial Banks		Finance Companies		Corporations		Islamic Banking Inst.		Total	
	Vol./Year	Outst. Vol.	Vol./Year	Outst. Vol.	Vol./Year	Outst. Vol.	Vol./Year	Outst. Vol.	Vol./Year	Outst. Vol.	Vol./Year	Outst. Vol.
1987	—	—	306	304	103	103	—	—	—	—	409	407
1988	750	741	134	378	197	277	—	—	—	—	1,081	1,396
1989	350	1,062	864	1,100	117	329	—	—	—	—	1,331	2,491
1990	150	1,173	607	1,487	172	422	—	—	—	—	929	3,082
1991	0	1,130	211	1,447	143	483	—	—	—	—	354	3,060
1992	600	1,681	1,719	2,829	472	835	—	—	—	—	2,791	5,345
1993	1,360	2,353	309	2,706	374	1,017	—	—	—	—	2,043	6,076
1994	200	2,168	3,931	5,832	873	1,629	290	286	30	29	5,324	9,944
1995	255	2,203	2,852	7,074	798	1,917	400	660	0	28	4,305	11,882
1996	0	1,737	4,258	10,456	1,776	3,263	0	630	30	56	6,064	16,142
1997	237	1,866	4,481	13,085	2,997	5,769	0	597	57	85	7,772	21,402
1998	1,232	2,515	2,632	12,918	824	5,362	0	567	70	151	4,758	21,513

Source: Cagamas Berhad

Commercial banks are, by far, the largest group of primary lenders that have sold housing loans to Cagamas, originating RM 12,918 million, or 60.1 percent of the total volume of housing loans in Cagamas' portfolio at the end of 1998. Finance companies accounted for another 24.9 percent (RM 5,362 million) of the total loans securitized, while staff housing loans sold by the government to Cagamas made up a further 11.7 percent (RM 2,515 million) of the total. Large corporations and an Islamic institution accounted for the remaining 3.3 percent (RM 718 million) of the total volume of securitized housing loans.

As of the end of 1998, fixed-rate purchases amounting to RM 14,529 million composed the majority (67.5 percent) of the RM 21,513 million of housing loans acquired by Cagamas. Another RM 3,613 million, or 16.8 percent of the total, was in the form of floating-rate purchases, while convertible-rate purchases and purchases of Islamic house financing debts accounted for the remaining RM 3,371 million, or 15.7 percent.

Cagamas debt securities were held mainly by banking institutions (commercial banks, finance companies, merchant banks, and discount houses), which collectively accounted for 80.8 percent of the total Cagamas debt

securities outstanding of RM 21,274 million at the end of 1998. Commercial banks were the largest single group of holders of Cagamas debt securities, holding more than half (RM 13,324 million, or 62.6 percent) of the total amount outstanding at the end of 1998, while finance companies accounted for another 11.2 percent (RM 2,386 million), merchant banks 5.8 percent (RM 1,225 million), and discount houses 1.2 percent (RM 248 million). The balance (RM 4,091 million, or 19.2 percent of the total) was held by a variety of investors including provident and pension funds, property trusts, insurance companies, nonfinancial corporations, and nonresident companies.

Fixed-rate bonds totaling RM 14,060 million composed the majority (66.1 percent) of the Cagamas securities outstanding at the end of 1998. Floating-rate bonds amounting to RM 850 million made up another 6.3 percent and short-term discount notes amounting to RM 6,210 million accounted for another 29.2 percent. The remaining RM 154 million consisted of three issues of Cagamas mudharabah bonds. Table 13 shows the volume of Cagamas debt securities issued since 1987.

Table 13 Volume of Cagamas Debt Securities Issued, 1987–1998 (RM million) ■

Year	Fixed-Rate Bonds	Floating-Rate Bonds	Cagamas Notes	Mudharabah Bonds	Total
1987	100	—	—	—	100
1988	1,800	—	—	—	1,800
1989	2,500	—	—	—	2,500
1990	2,900	—	—	—	2,900
1991	2,900	—	—	—	2,900
1992	2,900	1,365	872	—	5,137
1993	2,980	2,035	925	—	5,940
1994	6,860	2,035	560	30	9,485
1995	8,432	850	2,010	30	11,322
1996	11,207	1,960	2,510	60	15,737
1997	14,712	1,960	4,700	84	21,456
1998	14,060	850	6,210	154	21,274

Source: Cagamas Berhad

While the volume of Cagamas debt securities has been growing rapidly since the inception of the secondary mortgage market, trading in these securities in the secondary market has been rather slow and inconsistent, just as in the case of Malaysian government securities and Treasury bills.

The total secondary market turnover in Cagamas debt securities, for example, increased substantially from RM 66 million in 1991 to RM 16,159 million in 1995 but declined sharply to RM 4,177 million in 1996. In 1997, however, the turnover increased sharply to RM 15,230 million. In 1998, the total turnover of Cagamas debt securities in the secondary market amounted to RM 15,180 million. Cagamas debt securities were actively traded in the secondary market throughout the year, but picked up greater momentum in the second half, spurred by the declining domestic interest rates and bond yields. In terms of share of total turnover in the secondary market, the volume of Cagamas debt securities traded in the secondary market held steady at 8.8 percent in 1998, compared with trading in MGSs, which rose sharply from 6.7 percent (RM 3 billion) in 1997 to 15.9 percent (RM 15 billion) in 1998 as a result of a large issue of MGSs during the year. On a quarterly basis, the volume of secondary market transactions was also inconsistent, with the volume of activity fluctuating from quarter to quarter. (See Tables 14 and 15 for more details.)

The low and inconsistent volume of activity in Cagamas securities in the secondary market was due mainly to the shortage in the supply of the paper. Because most Cagamas bonds and notes qualify as liquid assets, financial institutions that acquire the securities tend to hold on to them instead of trading them in the market.

Overall, therefore, the securitization market has been successfully established, but the capital market, particularly the trading of Cagamas mortgage-backed securities, has been rather weak. Nevertheless, the success of Cagamas in securitizing housing mortgage has encouraged and accelerated home ownership in Malaysia by making housing loans more affordable and accessible.

Table 14 Secondary Market Trading Volume, 1993–1998 ■

Instruments	% of Total Turnover					
	1993	1994	1995	1996	1997	1998
Malaysian government securities	24.4	10.2	2.8	13.9	6.7	15.9
Cagamas bonds	5.0	8.1	11.7	2.3	8.2	8.8
Treasury bills	4.8	3.3	2.7	1.6	2.3	3.9
Negotiable instruments of deposit	30.2	35.1	28.4	30.1	30.3	25.1
Banker's acceptances	29.2	38.0	45.5	44.4	45.8	46.2
Bank Negara bills	6.4	5.3	8.9	7.7	6.7	0.0
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Bank Negara Malaysia

Table 15 Secondary Market Trading in Cagamas Debt Securities, 1991–1998 ■

Period	Volume (RM million)	Share of Market Turnover (%)
1991	66	0.0
1st quarter	3	0.0
2nd quarter	0	0.0
3rd quarter	0	0.0
4th quarter	63	1.0
1992	1,301	2.0
1st quarter	147	1.0
2nd quarter	63	0.0
3rd quarter	681	5.0
4th quarter	410	3.0
1993	3,854	5.0
1st quarter	313	2.0
2nd quarter	567	3.0
3rd quarter	1,255	6.0
4th quarter	1,719	7.0
1994	8,604	8.0
1st quarter	1,461	6.0
2nd quarter	3,105	13.0
3rd quarter	3,628	12.0
4th quarter	410	
1995	16,159	12.0
1st quarter	3,927	12.0
2nd quarter	8,361	20.0
3rd quarter	3,658	10.0
4th quarter	213	1.0
1996	4,177	2.0
1st quarter	1,623	4.0
2nd quarter	570	1.0
3rd quarter	682	1.0
4th quarter	1,302	3.0
1997	15,230	8.0
1st quarter	2,207	4.0
2nd quarter	3,416	7.0
3rd quarter	4,951	10.0
4th quarter	4,656	12.0
1998	15,180	9.0
1st quarter	3,660	11.0
2nd quarter	2,067	6.0
3rd quarter	3,802	8.1
4th quarter	5,651	10.2

Sources: Cagamas Berhad; BNM

Key Success Factors

The ability of Cagamas to securitize a huge volume of housing loans is attributed to several factors, including:

- The high creditworthiness of Cagamas. Bank Negara Malaysia is its largest single shareholder; its other shareholders are commercial banks, finance companies, and merchant banks, which are all regulated by the central bank. Prominent members of the banking community sit on its board of directors, which is headed by the Governor of Bank Negara Malaysia as chairman. This strong pedi-

gree has helped to make Cagamas debt securities highly acceptable to the market, and enabled the company to raise funds at a relatively low yield and, hence, to purchase housing loans at a competitive price.

- The recognition given by Bank Negara Malaysia to tier-1 Cagamas bonds as liquid assets for the purpose of compliance with statutory liquidity requirements by financial institutions under its supervision. This effectively reduces the cost of funds to Cagamas as its securities are in greater demand, compared with other private debt securities that are nonliquid assets.
- The exemption from the statutory reserve and liquidity ratio requirements granted by Bank Negara Malaysia for the proceeds obtained by financial institutions from the sale of housing loans to Cagamas. This lowers the cost of funds for the financial institutions compared with, say, fixed deposits, which are subject to the statutory requirements.
- The exemption from stamp duties granted by the Ministry of Finance for housing loan transactions with Cagamas and dealings in Cagamas debt securities. This has the effect of keeping transaction costs low.
- The exemption granted by the Securities Commission to Cagamas from the requirement to obtain the approval of the commission before issuing debt. The company, as a prescribed corporation under the Companies Act of 1965, is also exempted by the Registrar of Companies from having to circulate a prospectus for its debt issues. These exemptions expedite the bond-issuing process and reduce the administrative cost of raising funds.

Success of the Secondary Mortgage Market

The secondary mortgage market was set up mainly to provide liquidity to financial institutions and make home financing more accessible and affordable, particularly to the lower-income group. The development of the capital market, especially the PDSs market, is another objective. The secondary mortgage market has largely succeeded in its mission, and has been especially successful in encouraging the granting of housing loans.

The securitization of housing loans has generated strong competition among financial institutions, including those under the controlled interest-rate regime, in granting housing loans. Before the establishment of the

secondary mortgage market, these institutions were less than eager to extend housing loans, particularly for houses costing up to RM100,000, because of the ceiling imposed on the interest rates they could charge. Now, by securitizing the loans, they can obtain competitively priced funds, cover their administrative costs, and also lock in a profit. As a result, access to affordable housing loans is not a problem in Malaysia.

The liquidity provided by Cagamas' securitization facilities has also made it possible for financial institutions to extend the term of housing loans from 15 years to 25 or even 30 years. Because longer-term loans are easier to service and thus more affordable, demand for houses has strengthened. Before the establishment of the secondary mortgage market in Malaysia, financial institutions were reluctant to extend the repayment period because it would have aggravated their then-existing problem of funding mismatch (the bulk of their funds had a maturity of less than one year).

In addition, Cagamas was instrumental in encouraging financial institutions to provide a new housing loan product besides their traditional housing loans which were based on an adjustable rate pegged to their base lending rate (BLR). Lately, some financial institutions have begun to lend fixed-rate housing loans to match the fixed-rate funds available from Cagamas. This development has provided house-buyers with another financing alternative.

The capital market in Malaysia has similarly benefited from securitization. The large volume of long- and short-term debt paper issued by Cagamas has given investors new instruments for investing their surplus funds. Although secondary market trading in Cagamas securities has not been sufficiently large and consistent in volume to create benchmarks, it nonetheless presents an opportunity for bond dealers, for the first time in Malaysian financial history, to transact on a large scale in private debt securities in the secondary mortgage market.

Additionally, the success of Cagamas in issuing bonds has inspired other corporations to raise funds in the domestic market by issuing private debt securities instead of borrowing from financial institutions. When Cagamas began operations there were no private debt securities in the market. Since 1987, when RM100 million worth of Cagamas bonds were first issued, the total amount of private debt securities (including Cagamas bonds) floated in the market has risen rapidly, to RM45.6 billion at the end of 1996.

Related Issues and Problems

Although the secondary mortgage market is now well established and a considerable number of mortgages are securitized regularly, there is still room for improvement. Further progress will depend on finding solutions to a number of issues.

The secondary market for mortgage-backed securities must be improved. As already mentioned, secondary market trading in Cagamas bonds is still inconsistent and, as a result, no benchmark issues are available. Although some financial institutions do quote bond prices, there are not enough transactions in the secondary market to determine whether these quotes truly reflect market prices.

The lack of benchmark issues also makes it difficult for Cagamas to quote an accurate price to potential sellers of housing loans. Cagamas purchases the loans before issuing debt securities to fund the purchases; therefore, reliable information on the prices of Cagamas bonds must always be available to enable it to provide competitive quotations and to enhance secondary market trading in mortgage-backed securities.

Among the factors that account for the underdeveloped secondary market in mortgage-backed securities are the following.

Lack of information on bond trading

The lack of information on bond trading makes investors uncertain and therefore reluctant to participate in the market. Bank Negara Malaysia has taken action to correct this problem. In 1997, it set up an electronic bond information system which makes dealer-provided information on bond prices and trading volumes almost instantaneously available to market participants from a centralized electronic source.

Low supply of bonds, including mortgage-backed securities

The supply of such securities has been growing strongly in recent years but is still of insufficient volume to sustain trade. The supply problem is aggravated by the reluctance of financial institutions to sell their Cagamas bondholdings, most of which are considered liquid assets by Bank Negara Malaysia for the purpose of compliance with liquidity requirements. Cagamas has accordingly begun the purchase of industrial property loans financed with debt securities that do not qualify as liquid assets and that therefore carry a more market-oriented yield.

Narrow investor base

Financial institutions hold the bulk of the debt securities issued by Cagamas. Other institutions, such as pension funds, mutual funds, insurance companies, and cash-rich corporations, as well as high-net-worth individuals, should be told about the advantages of investing and trading in bonds, including mortgage-backed paper, instead of leaving their surplus funds in fixed deposits or shares. The process of bond issuance and trading is, moreover, geared to wholesale transactions; it should be restructured to make the bond market more liquid and more easily accessible to retail investors. A greater number of market participants might be expected to lead to a larger supply of bonds as well as a high and sustained volume of trading in the secondary market.

Low availability of housing loans for securitization

Financial institutions in Malaysia grant housing loans primarily on the basis of adjustable mortgage rates that move with the market. These primary lenders are therefore shielded from interest-rate risk and feel no urgency to sell their loans to Cagamas as they can always pass on any increase in their cost of funds to borrowers. In this situation, there is a limit to the securitization of housing loans. Ideally, primary lenders, rather than borrowers, should bear the interest-rate risk. This would occur only if the housing loans were based on fixed interest rates. In this scenario, primary lenders would, as a matter of course, securitize their fixed-rate housing loans to minimize their interest-rate risk. The originators should regard themselves only as servicers of the loans, earning a fee income for the service while the long-term bond investors provide the financing and assume the interest-rate and credit risk.

Cagamas has therefore embarked on a campaign to encourage financial institutions to grant fixed-rate housing loans to give house-buyers more choice in deciding on the end-financing of their homes, and as a way to enhance the securitization of housing loans. Several institutions have recently begun offering such fixed-rate financing facilities and there are early indications of a positive response to such loans from potential borrowers.

Need for longer-term mortgage-backed bonds

Cagamas issues bonds with maturities of up to seven years to match the price review periods of the housing loans it purchases. The average

life of the outstanding mortgage-backed bonds in the market as of the end of 1998, was, in fact, considerably shorter than seven years. Most of the bonds were for three years, since the bulk of Cagamas' housing loan purchases are for three years. This fact indicates that financial institutions do not like to take a long-term view of their interest-rate position and prefer to keep their options open by selling at a short tenor to Cagamas. As long as financial institutions hold to this view, it will be difficult for a market in bonds with long maturity periods of, say, ten years or more to develop. It would be even more difficult to implement a scheme to issue pass-through mortgage-backed securities, which would require the outright sale of housing loans without any price review period.

Restrictive administrative regulations and practices

Another issue concerns administrative practices and laws pertaining to landed properties in Malaysia. For the secondary mortgage market to develop further, the security documents for the housing loans must be readily transferable from the primary lender to a third party such as Cagamas or, in the case of pass-through securities, to the trustees for the bondholders. At present, if a house title restricts the right to charge, deal, or dispose of the property, the borrower can charge the property to a primary lender only after obtaining the written approval of the relevant land authority. If an existing charge with such a restriction is to be transferred from a primary lender to a secondary mortgage market institution like Cagamas, the relevant land authority must also approve the transfer of the charge. Housing loans secured with such restrictive titles would be difficult to securitize because of the time required to obtain the approval of the authority for the transfer of the charges. Whether the authorities will ultimately approve the transfer is also uncertain.

For this reason, housing loans with a restriction on the transfer of charges are not at present eligible for securitization by Cagamas. The recent land alienation practice indicates that an increasing proportion of residential property titles will have this restriction, to that extent limiting the pool of housing loans that can be sold to Cagamas. For the secondary mortgage market to expand, it is therefore essential that the restriction on the transfer of charges be removed, at least for securitization purposes.

Restriction on the transfer of charges over Malay Reserve land

Another issue concerns the restriction imposed by the various laws on the transfer of charges over Malay Reserve land and customary land. Cagamas has been gazetted by most authorities in the schedules of land laws as an institution that can accept charges over such land, without any specific reference to the transfer of charges. It is therefore unclear whether Cagamas, besides being authorized to accept charges on Malay Reserve land, can also receive the transfer of charges on such land from other chargees. Authorities in the state of Selangor have put a restrictive interpretation on the lack of a specific provision in the law. According to their reading, a party that has been authorized to take a charge on Malay Reserve land cannot also accept a transfer of an existing charge on the property.

The authorities concerned should clear up this ambiguity and authorize institutions that take a charge over Malay Reserve land to also accept a transfer of charge over the land. Otherwise, housing loans granted for the purchase of houses on Malay Reserve land cannot be securitized.

Long-drawn-out foreclosure proceedings

The time taken to auction properties as well as to receive the auction proceeds is another factor that is hampering the development of the secondary mortgage market. Current practice entails a waiting period of at least a year after the start of foreclosure proceedings for property to be auctioned, and another year at least for the proceeds to be released by the High Court. This long delay in the realization of a charge is a cost that has to be factored in when securitizing housing loans, particularly if the loans are to be sold to Cagamas without recourse. Therefore, unless the land laws are amended specifically to accommodate securitization transactions, the circumstances are hardly ideal for a market for pass-through securities to develop.

CONCLUSION

Malaysia was the first country in the region, and probably one of the earliest among the less developed economies, to establish a secondary mortgage market. At the time the market was established, the business and financial community in Malaysia was not familiar with the concept of securitization and the bond market was still underdeveloped, with MGSs being the only type of debt security available.

The evolution of the mortgage-backed securities market in Malaysia began in 1987 with the purchase of housing loans totaling RM 110 million for an interest review period of five years, and the issuance of RM 100 million of unsecured fixed-rate bearer bonds of the “plain-vanilla” variety to fund the purchase. In 1989 and 1990, Cagamas introduced the purchase of housing loans for review periods of seven and three years. In 1992, Cagamas issued for the first time bonds amounting to RM 465 million with a floating-rate coupon adjustable every six months. In the same year, the company issued its first short-term discount notes (Cagamas notes) totaling RM 500 million.

The company progressed with the implementation of a convertible-rate purchase facility, which gives the seller the option to convert from a fixed rate to a floating rate or vice versa midway through the transaction period. In 1994, Cagamas appointed the Rating Agency Malaysia Berhad (RAM) to rate its debt securities. The agency gave the highest ratings of AAA and P1 to its the bonds and notes, respectively.

To provide liquidity to the Islamic banks and banking institutions providing interest-free facilities, Cagamas in 1994 made its first purchase of Islamic house financing debts totaling RM 30 million for a review period of three years, under the *bai al-dayn* (debt trading) principle. To fund the purchase, Cagamas issued *mudharabah* (profit-sharing) bonds amounting to RM 30 million. The company’s outstanding purchases of housing loans exceeded RM 10 billion for the first time in January 1995, seven years and nine months after it began operations. In 1996, the company implemented a two-tier system for its mortgage purchase and bond issuance operations. Under the system, purchases of housing loans for houses costing RM 100,000 were funded with tier-1 bonds, which qualified as liquid assets, while purchases of housing loans for houses costing above RM 100,000 were funded with tier-2 bonds, which did not qualify as liquid assets.

In 1997, Cagamas stopped purchasing housing loans for houses costing above RM 150,000. Henceforth, Cagamas tier-1 bonds referred to bonds issued to finance the purchase of housing loans for houses costing RM 150,000 or less. In the same year, the company purchased for the first time industrial property loans amounting to RM 100 million. Later that year, Cagamas’ outstanding mortgage purchases and debt securities broke the RM 20 billion mark for the first time.

Consistent with Cagamas’ commitment to promote home ownership, especially among the lower-income group, Cagamas adopted a differential

pricing policy effective February 1998 which offered a lower “preferred Cagamas” rate to financial institutions selling housing loans for houses costing up to RM 100,000. Since March 1998, the preferred Cagamas rate, pegged at 5 basis points below the standard Cagamas rate, has been charged for the purchase of housing loans for houses costing above RM 100,000 up to RM 150,000. In 1998, housing loans purchased at the preferred Cagamas rate amounted to RM 1,722.3 million, or 36.2 percent of total new purchases, while housing loans purchased under the standard Cagamas rate amounted to RM 3,035.4 million, or 63.8 percent.

In the last quarter of 1998, Cagamas introduced the purchase of housing loans on a without-recourse basis. This scheme, which was to be officially launched on 30 March 1999, was designed to intensify and broaden the scope of the company’s securitization efforts as well as the capital (debt) market. Under the scheme, housing loans for houses costing above RM 150,000 up to RM 1 million will be eligible for sale on a fixed-rate and outright basis to Cagamas for the remaining tenure of the housing loans. The mortgage-backed debt securities to be issued will be secured against the individual pool of housing loans purchased under the scheme. Cagamas also introduced its purchase of hire-purchase and leasing debts in the last quarter of 1998.

Housing loans securitized and debt securities issued by Cagamas are given in Tables 12 and 13.

Given the circumstances, Cagamas had to devise a securitization scheme that suited the local conditions and could surmount the barriers to its success. The following are some of the special features of the Malaysian securitization model that have made the securitization concept more acceptable in the financial market.

Purchase with Recourse

Under the existing securitization scheme, Cagamas purchases housing loans with recourse to the primary lender, that is, the latter is responsible for any loss arising from default by the borrower. This has been a necessary interim step as, at the time Cagamas was established, there was a lack of information about the credit risks involved in housing loans and it was safer for the company to purchase loans without taking the credit risks involved. Purchase with recourse therefore suited both the primary lender and Cagamas. The loan originator was comfortable with the credit risks involved in the granting of housing loans and even preferred to sell

with recourse to obtain liquidity at a lower cost. In the case of loans where transferability of charge and the long foreclosure process were problems, purchase with recourse was also a good solution.

Purchase Based on Interest Review Periods

Cagamas purchases housing loans based on an agreed interest review period. At the end of the period, the primary lender may repurchase the loans sold to Cagamas if it does not agree to the new interest rate offered by Cagamas. As securitization was a concept still unfamiliar to financial institutions, they would have been hesitant to sell their loans outright to Cagamas. The option to repurchase the loans at a later date was therefore a good inducement for them to sell. Moreover, in the case of the sale to Cagamas at a fixed rate, the primary lenders would prefer to take a shorter position by selling for a specified period rather than committing themselves for the remaining life of the loan. With experience in reading interest-rate directions, the financial institutions would, it is hoped, be less reluctant to sell their housing loans outright, without any interest-rate review and repurchase option, in the future.

Liquid-Asset Status for Cagamas Paper

On the funding side, the BNM recognized Cagamas bonds as liquid assets for the purpose of the maintenance of the liquidity requirement by the financial institutions, for two reasons. Firstly, this would ensure a ready market for Cagamas bonds, which were the first mortgage bonds ever issued.¹⁴ Secondly, since a major proportion of the housing loans in the country were subject to an interest-rate ceiling imposed by BNM for social reasons, Cagamas bonds had to be granted liquid-asset status to ensure that Cagamas could raise funds at a sufficiently low cost to allow it to securitize the loans.

Exemption from Statutory Reserve and Liquidity Requirements

To make it even more attractive for the financial institutions to sell their loans, BNM permitted funds obtained from Cagamas to be free from the statutory reserve and liquidity ratio requirements. This measure effectively

¹⁴Since then, with the growing familiarity of the market with private debt securities, Cagamas has also issued bonds that do not qualify as liquid assets.

lowered the cost of funds obtained from Cagamas, compared with, say, fixed deposits and thus made it attractive for primary lenders to sell their loans. BNM granted this incentive to help Cagamas to overcome the initial inertia associated with the introduction of a new product in the market, particularly a market that was not familiar with securitization.

The above measures were thought necessary to “kick-start” the establishment of a secondary mortgage market in a Malaysian economy without a sophisticated bond market that would readily accept securitization. The special adjustments made by Cagamas to suit the local circumstances were therefore crucial in encouraging financial institutions to accept the securitization concept and in hastening the development of the secondary mortgage market.

After ten years of operations, with an increasingly sophisticated market and stronger acceptance of the securitization concept, Cagamas feels that it can go on to the next stage of development of the secondary mortgage market in Malaysia. It is finalizing plans for the implementation of a program to purchase housing loans without recourse to the originator and to issue mortgage-backed bonds.

LATEST DEVELOPMENTS

Cagamas was allowed to start purchasing housing loans on a without-recourse basis in December 1998. Cagamas plans the outright purchase of housing loans with remaining maturities of between seven and 12 years on a fixed-rate basis. To finance the purchase, Cagamas will issue fixed-rate unsecured debt securities (UDSs) that reflect the principal rundown of the underlying pool of housing loans. The UDSs will be bullet-repayment bonds secured with a specific pool of housing loans.

Cagamas also started purchasing hire-purchase and leasing debts on a with-recourse basis in December 1998. Cagamas purchases HP&L debts with price review periods of three, four, five, six, or seven years, on a fixed-rate basis only. Cagamas issues UDSs to fund the purchases and these debt securities have the same characteristics as the existing tier-1 debt securities issued to finance the purchase of housing loans under the purchase-with-recourse basis.

It is hoped that, with the issuance of UDSs with tenors beyond three years, Cagamas will be able to tap the excess funds of longer-term investors such as pension funds and insurance companies. In this way, Cagamas

would be able to satisfy the investment needs of a wider range of investors by issuing short-, medium-, and long-term debt securities. In addition, the company would be able to create a reference yield curve for its debt securities with different remaining maturities. Cagamas would thus be able to price its purchases more competitively in the future.