Evolution of Cagamas

Cagamas was established in December 1986 for the purpose of serving as a special vehicle to mobilise low-cost funds to support the national home ownership policy and to spearhead the development of the private debt securities market in Malaysia. The Company has been in operation for 15 years since commencement of business in October 1987. As at end December 2002, total volume of outstanding housing loans purchased by Cagamas amounted to RM14,823 million, while total Cagamas debt securities outstanding amounted to RM24,970 million.

The Malaysian Mortgage and Debt Securities Market Prior to the Establishment of Cagamas

Since the 1970s, the Malaysian Government has been actively promoting widespread ownership of housing, especially amongst the low and middle-income groups. This national objective can only be realised if these groups have ready access to credit facilities. Such access is only possible if there are willing lenders and the cost of paying the interest and principal is within the means of the borrowers. However, the principal providers of housing loans would only be willing lenders if they were able to secure the necessary funds at an economical cost, and sell some of the existing housing loans so that such long-term loans do not constitute an excessive proportion of their total assets.

In the early 1980s, the financial institutions were experiencing a tight liquidity situation as reflected by their loans to deposits ratio which deteriorated to 98.0% as at 30 September 1986, from 89.0% as at the end of 1980. Hence, the financial institutions were reluctant to give out housing loans which are considered to be long-term illiquid assets.

In addition, as the financial institutions borrow short-term (largely in the form of deposits of 12 months or less) and housing loans were long-term (10 to 15 years), the financial institutions were subject to liquidity risk arising from the mismatch of maturities of the funds and the housing loans. The financial institutions also faced financial risk if their source of funds became more expensive than the rate of return on their housing loans, especially in view of the fact that the interest rates on the loans for low and medium-cost houses costing RM100,000 and below were fixed at controlled levels.

Moreover, the private debt securities market was virtually absent until the creation of Cagamas. Up to the 1980s, the debt securities market was dominated by Malaysian Government Securities.

Characteristics of Housing Loans in Malaysia

Presently, housing loans in Malaysia have the following characteristics:

(a) Housing loans have maturities ranging from 15 to 30 years, as against the deposits of the financial institutions (where maturities are primarily 12 months or less), thus exposing the banks to interest rate risk; and

(b) Housing loans have low default rates and foreclosure losses are minimal. Hence, the financial institutions are reluctant to sell them outright.

***The Cagamas Model:
A Unique Secondary Mortgage Market Conduit for Emerging Economies***

The scheme to purchase mortgages formulated by Cagamas was designed to suit domestic conditions and to overcome barriers that could prevent the scheme from taking off.

The following are some of the special features of Cagamas' model that has been accepted in the financial market:

(a) Purchase with Recourse

Under this scheme, Cagamas purchases housing loans with recourse to the primary lender i.e. the latter is responsible for any loss arising from the default of the borrower. As there was a lack of information regarding the credit risks involved in a housing loan, it was prudent for the Company to purchase loans without taking the credit risk. Although Cagamas introduced the purchase of housing loans without recourse in 1999, the financial institutions have not sold any of their housing loans under this scheme. The reluctance to sell is due to the concern that their non-performing loans ratio would deteriorate if good quality loans are taken off from their balance sheet.

In addition, the financial institutions are well capitalised, having a risk-weighted capital ratio of 12.8% as at the end of December 2002 as against the minimum requirement of 8.0%.

(b) Purchase Based on Interest Review Periods

Cagamas purchases housing loans based on an agreed interest review period, whereby, at the end of the period, the primary lenders have the option to repurchase the loans sold to Cagamas if they do not agree to the new interest rate offered by Cagamas. As the financial institutions are reluctant to sell their housing loans on an outright basis, the option to repurchase the loans at a later date was, therefore, a good inducement for them to sell.

(c) Liquid Asset Status for Cagamas Papers

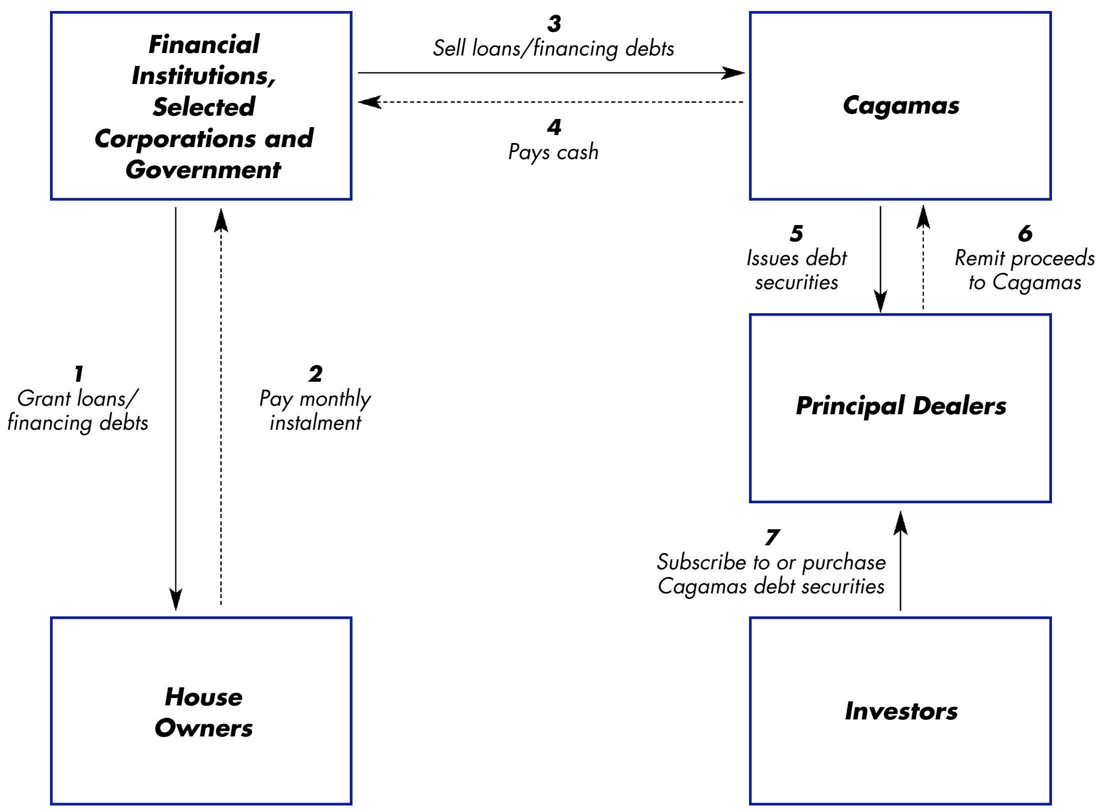
On the funding side, Bank Negara Malaysia (BNM) recognises Cagamas bonds as liquid assets for the purpose of meeting the liquidity requirements imposed on financial institutions.

Since a substantial proportion of the housing loans in the country is subject to a ceiling interest rate imposed by BNM, liquid asset status ensures that funds could be raised by Cagamas at a sufficiently low cost to encourage the sale of such loans to Cagamas.

(d) 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 requirements. This effectively lowered the cost of funds obtained from Cagamas, compared with, say, fixed deposits and thus made it attractive for the primary lenders to sell their loans. This incentive is still in place to enable the Company to continue to pass on low cost funds to financial institutions so that they can grant housing loans at low mortgage rates thereby encouraging home ownership.

Chart 1
The Cagamas Model



Cagamas purchases housing loans from the institutions which originate the loans at the primary level and issues Cagamas debt securities to finance the purchases. In effect, Cagamas turns the housing loans into debt securities at the secondary level through a process, which is tailored to suit the Malaysian market environment.

The process is shown in Chart 1. The originators, namely, the commercial banks and the finance companies, grant housing loans to the house buyers. They subsequently sell these loans to Cagamas with recourse. Cagamas then raises funds from the market to finance these purchases by issuing debt securities, in the form of Cagamas bonds and short-term Cagamas notes, to investors.

Investors include financial institutions, insurance companies, pension funds, non-resident companies and others who are interested in investing in short- and medium-term papers to obtain an income either at a fixed or adjustable interest rate. In essence, this is the way the secondary mortgage market currently operates in Malaysia.

The Cagamas Model: Its Success Story

In its unique way, the Cagamas model can be considered a success as it has benefited both house buyers and institutional players involved in its operations.

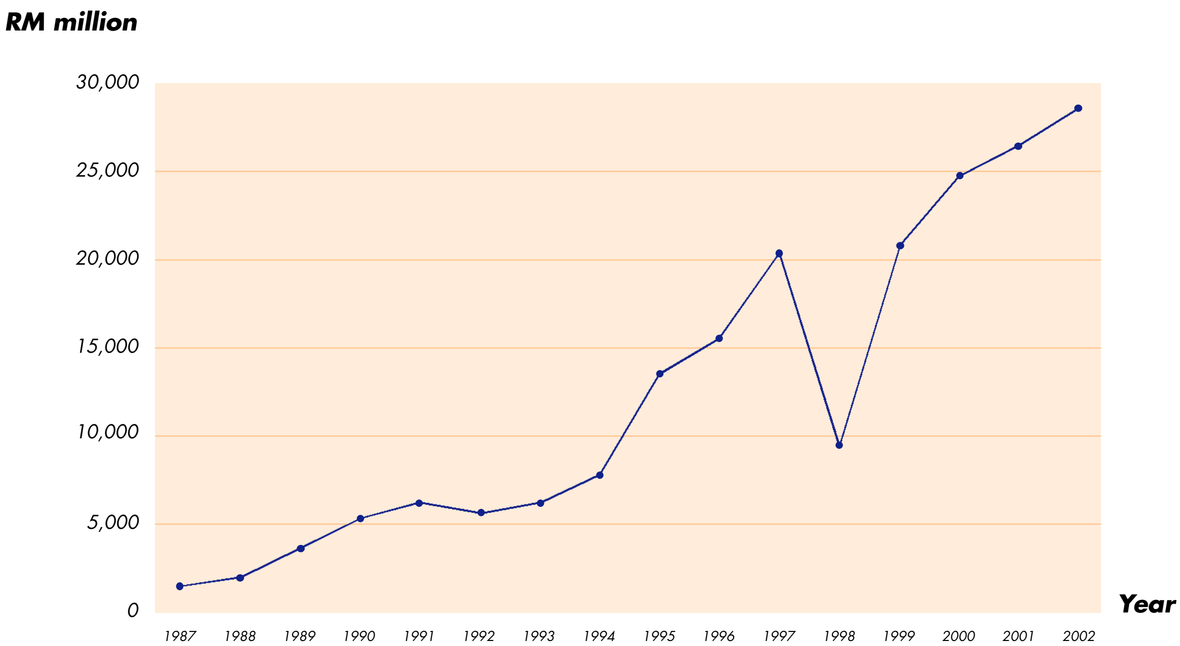
(a) House Buyers

The competitively-priced funds made available to the primary lenders through Cagamas' scheme have enabled house buyers to obtain easy access to housing loans at a reasonable cost. This has in turn encouraged home ownership and helped the development of the housing industry.

(b) Financial Institutions

By selling their housing loans to Cagamas, the financial institutions are able to obtain the necessary liquidity at a competitive cost to enable them to further originate housing loans and enhance their lending operations. This can be seen from the increase in housing loans approved by the commercial banks and finance companies, by more than a thousand-fold from RM1.8 billion in 1987 to RM29.2 billion as at 31 December 2002, as shown in Chart 2. The only exception was 1998 where the amount of housing loans approved dropped sharply as a result of the economic contraction.

Chart 2
Total Housing Loans Approved by the Financial Institutions



Source: BNM Annual Reports and Monthly Statistical Bulletins

The competitively-priced funds obtained from Cagamas also enabled the financial institutions to price their loan products competitively and this provided them with an edge in their business operations. By selling their housing loans to Cagamas, the primary lenders were also able to hedge their interest rate risks, particularly if they had granted fixed rate loans.

(c) Investors

Cagamas securities have been given the highest rating by the two domestic rating agencies in Malaysia. This reflects the high quality of Cagamas papers which provide investors a safe and reasonable return on their investments. Pension and provident funds, insurance companies and commercial banks with large surplus funds find Cagamas securities an attractive investment.

(d) Government and the Economy

The secondary mortgage market has helped the Government to achieve its policy of encouraging home ownership, particularly amongst the low and middle-income groups. This is because in Malaysia, loans to finance the purchase of houses costing RM100,000 or less are subject to an interest rate ceiling of 9.0% per annum imposed by BNM. Cagamas funds, which are competitively priced, enable the financial institutions to meet the policy objective of BNM to make housing loans more affordable to the lower income group without any interest subsidy being incurred by the authorities.

The Cagamas Model: Initial Obstacles and Challenges

The initial years of Cagamas were not without difficulties. The unfamiliarity of its operations and its limited product line were obstacles to its development. It was only after a slow start-up phase of five years that the Company has been able to establish its market niche.

(a) Start-up Phase (1987 - 1991)

When Cagamas commenced operations in October 1987, it only purchased one product, namely housing loans on fixed rate basis for a 5-year period. In 1988, Cagamas began to purchase housing loans from the Government of Malaysia. In 1989 and 1990, Cagamas also extended the purchases on fixed rates for 3- and 7-year periods. The first five years were characterised by low volumes of housing loans being sold to Cagamas. This was due to the following reasons:

(i) The financial institutions were not familiar with Cagamas' operations and the advantages of selling their housing loans to Cagamas; and

(ii) Cagamas only purchased on fixed rate basis. Hence, the financial institutions were not prepared to sell their loans, particularly in 1991 when interest rates were declining rapidly.

As at the end of December 1991, outstanding housing loans with Cagamas amounted to only RM2 billion.

(b) Take-off and Growth Phase (1992 - to date)

This take-off phase which started in 1992 was characterised by active marketing of its products to the financial institutions and the innovation of new products to suit the needs of the market. In 1992, in response to the continued downward trend in interest rates, Cagamas introduced floating rate purchases. In 1993, Cagamas introduced the convertible rate purchases whereby the sellers were given the option to switch from fixed rate to floating rate or vice-versa half way through their purchase period. In addition, Cagamas also started to widen its client base by purchasing housing loans from selected corporations in 1994, in addition to purchases from the financial institutions and the Government.

From its initial product of purchasing housing loans, the Company has extended its range of products as shown in Table 1 below:

Table 1
Range of Cagamas' Products (1992 - to date)

Year Introduced	Product	Purpose
	Purchase With Recourse:	
1994	Islamic house financing debts	• provides liquidity to the Islamic institutions • promotes the creation of more Islamic house financing debts
1996	Industrial property loans	• encourages the development of the manufacturing sector, especially the small and medium-scale enterprises • provides the financial institutions an additional avenue to lock-in their funding position in order to hedge their longer term fixed rate loans
1998	Hire purchase and leasing debts	• provided the finance companies with a much needed source of medium-term financing during the 1997-98 economic crisis • serves as a hedging mechanism for such debts which are granted on a fixed rate basis • eventually enables the finance companies to lower the rates charged to their customers • alleviates the funding mismatch problem and provides the finance companies an avenue to minimise their interest rate risks
2002	Islamic hire purchase debts	• provides Islamic institutions with an avenue to raise fixed rate funds at low cost to hedge their fixed rate assets
2003	Credit card receivables	• provides liquidity to financial institutions which generate credit card receivables • allows the financial institutions to diversify their funding sources
	Purchase Without Recourse:	
1999	Housing loans	• introduced in tandem with the thrust towards asset-backed securitisation • improves the risk-weighted capital adequacy ratio of the financial institutions as Cagamas will bear the credit risk on the housing loans sold to the Company for the remaining life of the loans

Conclusion

Malaysia was the first country in the region and one of the earliest amongst the developing economies, to establish a secondary mortgage market. At the time of the establishment of the market, the business and financial community in Malaysia was not familiar with the concept of a secondary mortgage market and the bond market was still under-developed. Today, Cagamas has established the foundation and framework for other institutions to further develop the mortgage market and to enhance the private debt securities market. Its success today has been recognised by other countries such as Indonesia, Thailand, Kazakhstan, Ghana and Jordan as well as the World Bank and the Asian Development Bank.

With rapidly rising income levels and increased urbanisation, demand for housing will continue to increase. Thus, the availability of housing finance at reasonable mortgage rates will continue to play an important role in ensuring home affordability. In line with its mission to promote home ownership, Cagamas on its part, will continually refine, modify and introduce new products to meet the challenges of ensuring easy accessibility to housing loans at an affordable cost. In addition, the Company will also continue to refine and enhance its existing non-housing loans products to cater to the needs of its customers.