Household debt in Malaysia

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Introduction

An important development in the Malaysian financial sector since the 1997 Asian financial crisis has been the reduction in the banking institutions' credit exposure to businesses and the greater focus on household financing. In recent years, there has been a growing trend among corporations of securing longer-term financing, in larger amounts, from the capital markets. As the corporate sector turns to the capital markets to meet its financing needs, banking institutions are shifting their focus to the household sector as part of their business diversification strategy. The household segment accounted for one third of the banking sector's total loan exposure before the crisis; it now accounts for more than half.

With the shift towards high-volume, low-value loans, the banking sector has diversified credit risks and minimised the potential for large losses stemming from the failure of a few large borrowers. At the same time, as lending to households becomes a larger segment of the financial system, it is crucial for policymakers to be aware of the implications for monetary policy and financial stability. This paper briefly discusses the current development of household finance in Malaysia, its implications for monetary policy, financial stability and some of the policy issues it raises.

Key factors driving household credit

Macroeconomic stability, financial sector development and government policies have all played an important role in influencing the supply of and demand for mortgages and other household credit. Sustained economic growth in Malaysia, averaging 5.9% a year over the past six years, has raised household incomes and boosted consumer confidence, which, in turn, has induced optimistic expectations of future income. Furthermore, the low inflation rate, which averaged 2.2% a year during 2002–07, and low interest rate environment that has reduced the cost of borrowing have increased the incentive for households to borrow in order to smooth their desired path of consumption over the life cycle.

Progressive financial liberalisation, deregulation, financial sector consolidation and technological advances have also contributed to the growth in household credit. The emergence of a more diversified and competitive banking system has resulted in downward pressure on interest rates, expanded credit coverage and increased loan amounts, while the strengthened risk management of household credit portfolios has enabled financial institutions to lend more to households.

Government policies also have facilitated greater allocation of credit to households. In line with the government's efforts to promote home ownership, banks, based on their capacity and business strategy, are encouraged or required to offer housing loans, especially to low-income borrowers, and the government has announced a series of liberalisation measures

[1] The views expressed here are solely those of the authors and do not necessarily reflect the views of the Central Bank of Malaysia. The authors are from the Monetary Assessment and Strategy Department of the Central Bank of Malaysia.

and fiscal incentives for the property market. In terms of funding, a government-sponsored lending institution, Cagamas Berhad, plays a pivotal role in the housing market. Cagamas, a specialised secondary market institution, purchases or refinances mortgage loans from originators (mainly banks) to provide them with long-term funding. Besides these developments in the housing market, the streamlining and reduction of duties on cars have also boosted the demand for household credit.

Trends of household debt

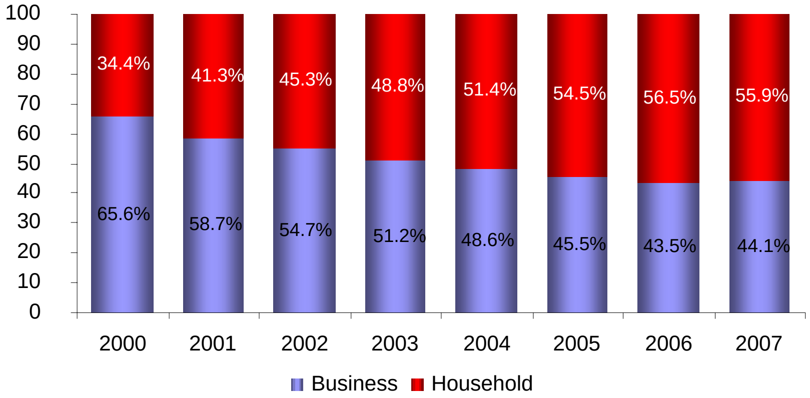
Level and growth rate of household debt

Prior to the 1997 Asian financial crisis, the share of household credit in total outstanding bank loans was relatively small compared to the share of loans extended to businesses. At end-1997, lending to the corporate sector accounted for 67% of total loans outstanding. But consumer financing has expanded considerably from 2000 onwards; the average annual growth rate for the period 2001–07 was 14.8% (Graphs 1 and 2). After six years of rapid growth, household debt grew at the more moderate pace of 7.9% in 2007, in line with the more subdued housing and automotive markets. As at end-2007, household credit accounted for 56% of total outstanding bank loans.

Graph 1

Breakdown of banking system loans

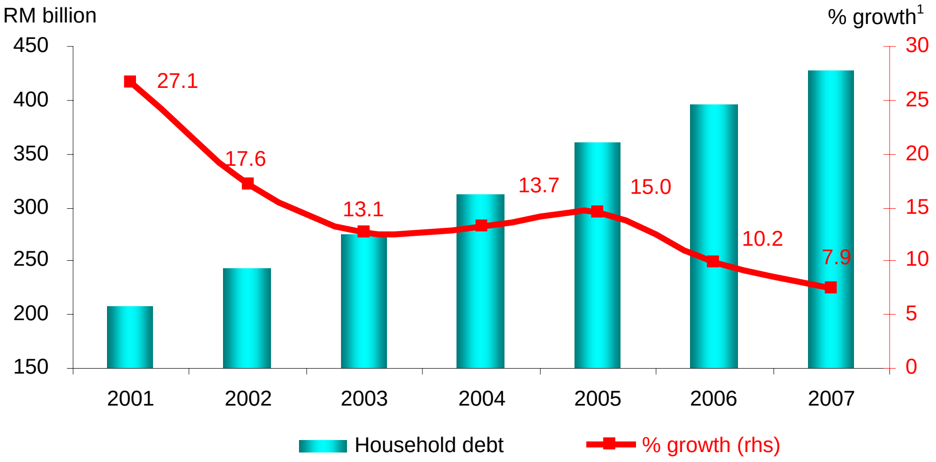
As a percentage of total loans



Source: Central Bank of Malaysia.

Graph 2

Household indebtedness



[1] Year-on-year change, in per cent.

Sources: Central Bank of Malaysia, Treasury Housing Loans Division.

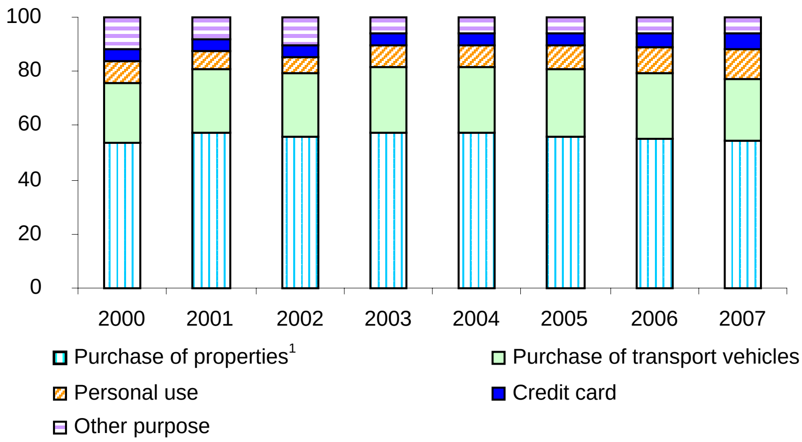
Composition of household debt

The composition of household debt changed little over the period 2000–07. The bulk was for house financing, which accounted for 55% of total household debt as at end-2007 (Graph 3). Total loans for housing purchases grew at an average annual rate of 15% during the period, in line with government efforts to promote home ownership. In addition, financial institutions have been willing to finance residential mortgages because such loans are typically viewed as low risk.

Graph 3

Composition of household debt by purpose

In per cent



[1] Includes residential and non-residential properties.

Sources: Central Bank of Malaysia, Treasury Housing Loans Division.

Loans for the purchase of passenger cars account for the second largest proportion of household debt. As at end-2007, car loans accounted for 23% of total household loans. Strong consumer demand for motor vehicles is attributed mainly to the revision of the tax structure for passenger cars, new launches of mid-range passenger cars and the promotional activities undertaken by car companies to expand their sales.

Financing via non-secured credit cards has been growing faster than mortgage lending, although the amounts are less significant. Reflecting the strong demand for consumer loans, coupled with aggressive marketing and advertising strategies by banks to attract customers, outstanding credit card loans grew by 17.8% a year, on average, over 2001–07. As at end-2007, credit card loans accounted for slightly more than 5% of total household debt.

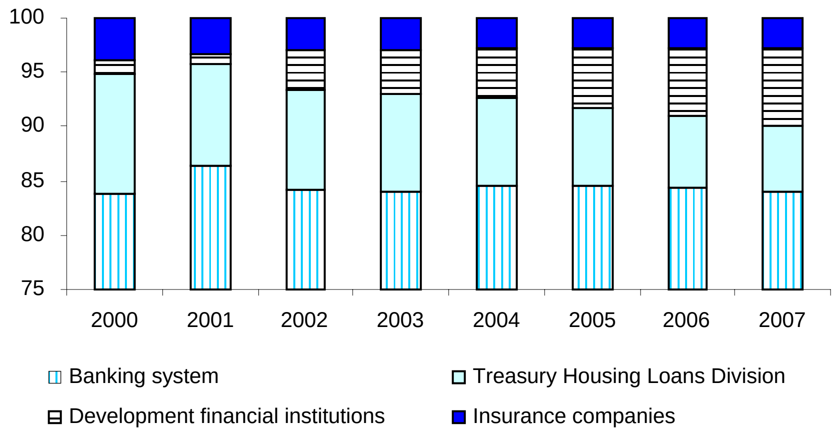
Providers of household credit

The banking system, with its extensive branch network and increasingly flexible financing packages, is the largest provider of household credit in Malaysia, accounting for 84% of total household debt as at end-2007 (Graph 4). As the main mobiliser of funds in the Malaysian economy, the banking sector has been able to meet the increasing demand for financing arising from the growth in household consumption. It also reflected banking system increased dominance in lending to household sector due to the significant rebalancing of banking institutions' loan portfolios into the retail segment.

Graph 4

Composition of credit providers to household sector

In per cent



Sources: Central Bank of Malaysia, Treasury Housing Loans Division.

The role of the development financial institutions (DFIs) is also growing. They overtook the Treasury Housing Loans Division as the second largest provider of household credit in 2007. DFIs' share of the market rose from a mere 1% in 2000 to 7.2% in 2007, mainly on account of increased lending for consumption and real estate purchases.

Types of loans and contracts

In general, banking institutions in Malaysia offer two types of mortgage loans, namely, conventional and Islamic. Conventional loans account for 90% of mortgages. Banks typically offer plain-vanilla mortgages at fixed or variable interest rates or a combination of the two. Approximately 83% of residential mortgages are variable rate mortgages, with adjustable rates pegged to the base lending rate (BLR) of individual institutions. In an increasingly competitive environment, banks also offer mortgage packages with repayment flexibility, such as graduated repayment schemes (lower initial instalment payments that increase gradually over time) and loans with longer maturities. Typically, housing loans have a repayment period ranging from 20 to 35 years or mature when the borrowers turn 60 or 65. It is common for mortgages to carry fixed interest rates during the first three to five years and BLR-based rates subsequently, until maturity. This reflects the "sell-then-build"[2] concept of residential property development.

The products offered under Shariah-based Islamic house financing generally have the same characteristics as conventional mortgages but are based on the concept of *Bai' Bithaman Ajil* (BBA).[3] Islamic mortgages carry mainly fixed interest rates. However, banking institutions have begun to offer variable rate Islamic mortgages following a review of the BBA's variable rate financing mechanism conducted in November 2004 to promote efficiency in the pricing of this mode of financing. Accordingly, Islamic banking institutions are now allowed to determine a reasonable ceiling profit rate, taking into account their risk management, capabilities, business strategies and market outlook.

Housing finance agency

Cagamas Berhad, the National Mortgage Corporation, was established in 1986 to promote the secondary mortgage market in Malaysia. Its corporate mission is to provide financial products and services that improve the availability and affordability of home mortgages, particularly for lower-income households. Cagamas issues debt securities and uses the funds to finance the purchase of housing loans from banking institutions, selected corporations and the government. The provision of liquidity at a reasonable cost to the primary suppliers of housing loans encourages them to offer additional financing on affordable terms.

However, hedging instruments are relatively less attractive as risk management tools in Malaysia, where the financial sector has enjoyed ample liquidity since 1998. The opportunity cost of securitising or reallocating mortgage loans into bond market instruments may not be potentially higher vis-à-vis the potential returns from retaining the mortgages. Thus, although Cagamas provides an avenue for banking institutions to hedge against liquidity risk (with recourse) and credit risk (without recourse), the volume of mortgages that are sold to the agency and securitised remains relatively low. At end-2007, only 0.7% of the outstanding mortgages of the banking system were securitised, compared with 33.4% at end-1996.

Through its single-purpose and wholly owned subsidiary, Cagamas MBS Berhad (CMBS), in October 2004 Cagamas successfully issued Malaysia's first residential mortgage-backed securities (RMBS), which were backed by the government's staff housing loans.[4] This issue augured well for the development of a securitisation market in Malaysia. It is expected to create a yield curve for mortgage-backed securities and serve as a benchmark for other asset-backed securities. As at end-2007, CMBS securitisation activities involved a total of five issues of RMBS backed by the government's staff housing loans, of which two were based on the musyarakah principle.[5]

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[2] A potential homebuyer enters into a contract and makes an initial payment (10% of the sales price) when the sale and purchase agreement are signed. Subsequently, the buyer makes progress payments on the balance at different stages of construction.

[3] BBA refers to the sale of goods on a deferred-payment basis at a price that includes a profit margin agreed upon by both the buyer and the seller.

[4] The lender is the Treasury Housing Loans Division.

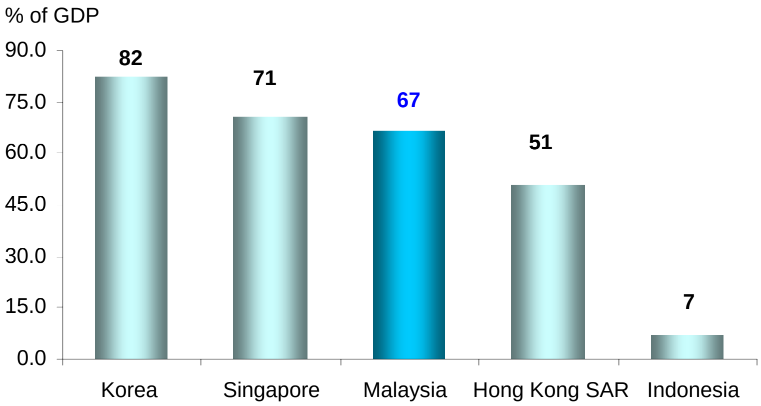
[5] The musyarakah principle refers to a partnership or joint venture for a specific business with a profit motive, whereby the profits are apportioned according to an agreed ratio. Both parties share any losses on the basis of their equity participation.

Financial vulnerabilities and household debt

As a result of heavy borrowing by Malaysian households, the ratio of household debt to GDP grew to 67% in 2007, from 47% in 2000 (Graph 5). As with most forms of credit, the rapid development of household debt can create vulnerabilities, in particular if the debt reaches an unsustainable level. However, the level of household indebtedness in Malaysia, which is comparable to that of other countries in the region, remains manageable. The risk to the financial system is limited, mainly because of the household sector's strong financial position and a resilient banking system. These have been enhanced by the Central Bank of Malaysia's adoption of a comprehensive approach to the preservation of financial stability. The approach encompasses surveillance at both the institutional and the systemic levels, the adoption of regulations to ensure prudent bank practices and supervisory activities.

Graph 5

Household debt to GDP ratio (2007)



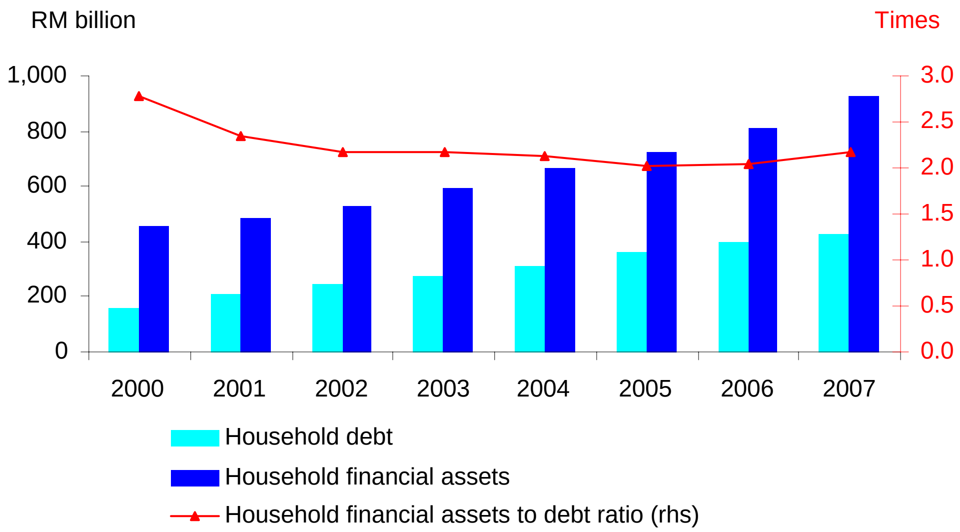
Sources: Central Bank of Malaysia, Financial Stability Reports of respective countries.

Strong financial position of households

Malaysia's household sector has demonstrated a great capacity to withstand shocks. In particular, net worth and income have grown broadly in tandem, supported by stable employment levels and a favourable economic environment. While their debt has grown rapidly, households have also accumulated sizeable financial assets. Since 2002, financial assets, which remain relatively stable at more than double household debt, have provided households with the flexibility to adjust to changes in the economic environment (Graph 6).

Graph 6

Household financial assets to debt ratio



Sources: Central Bank of Malaysia, Treasury Housing Loans Division, Employees Provident Fund, Securities Commission.

The very high level of the household sector's liquid assets underscores the sector's capacity to service its debt even in the short run. Indeed, during the first half of 2006, despite higher interest rates amid greater inflationary pressures, the debt servicing capacity of borrowers not only did not deteriorate but actually improved. The ratio of repayments to disposable income dropped to 39.8% in 2006, from 41.3% in 2005 and a high of 46% in 2002.

Equally important, the bulk of the increase in credit card balances did not involve cash advances. Credit card cash advances have been on a downward trend, accounting for 5.8% of total credit card transactions in 2007 (6.6% in 2004). Moreover, the repayment ratio[6] for credit cards –the average amount of debt is paid in full – rose slightly in 2007, to 58.4%, from 57.8% on average during 2000–06, indicating that credit cards continue to be used as a means of payment rather than as a mode of financing.

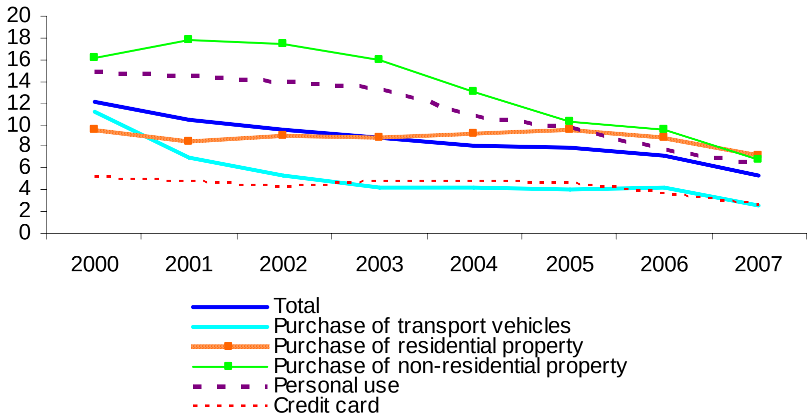
Overall, aggregate household non-performing loan ratios continued to trend downwards, to 5.3% in 2007 from a high of 12.1% in 2000 (Graph 7). Collectively, these indicators suggest that the vulnerability of household finances to adverse shocks continues to remain low.

6 Repayment ratio = [(Total spending + cash advance) – outstanding balance]/(Total spending + cash advance).

Graph 7

Non-performing loan (NPL) ratio of household sector

In per cent



Source: Central Bank of Malaysia.

A more resilient banking sector

Banking institutions in Malaysia have made considerable progress since the 1997 Asian financial crisis. The strong capitalisation of the banking system was reflected in the risk-weighted capital ratio of 13% as at end-2007. In addition, banks have made great improvements in pricing borrowing risks, in particular, implementing substantial and comprehensive measures allowing them to gain a better understanding of household asset and debt portfolios. These measures include progressively strengthening risk management infrastructure and practices, such as retail credit scoring; improving information and portfolio management systems; and enhancing loan administration, monitoring, management and recovery processes.

Implications and policy issues

The developments in Malaysia's household finance markets have thus far supported the growth in private consumption and made positive contributions to other sectors in the economy. In addition, house prices have been relatively stable, with moderate increases driven by fundamental factors such as demographics and income growth. Nonetheless, policymakers will need to be vigilant as increased household indebtedness has important macroeconomic implications.

Increased indebtedness means that the household sector has more exposure to interest rate risks and shocks to household income and house prices. Households whose debt carries mostly floating interest rates are vulnerable to rising interest rates. Higher interest rates and the corresponding increases in debt servicing costs, in turn, result in a reduction in disposable income and, hence, consumption. The risks are more significant if households have taken advantage of low borrowing rates to increase the size of their mortgage excessively.

Monetary policy and the increased sensitivity of the household sector to interest rate changes

In principle, changes in monetary policy affect consumer behaviour through both interest rate and income channels. Higher indebtedness would, therefore, increase the sensitivity of households' behaviour to changes in interest rates, amplifying both effects. This argues for incremental changes in the policy interest rate, particularly when structural changes in the economy and financial system create uncertainty about the monetary transmission mechanism. Smooth, steady changes in the policy rate, in turn, reinforce the importance of forward-looking monetary policy. Ultimately, concern over the impact of household debt from the perspective of monetary policy would be entirely in terms of the implications for growth and inflation.

The need for enhanced information on the household sector

The ability to detect and assess emerging vulnerabilities in the financial system arising from developments in household debt is critical, so as to allow appropriate policy measures to be implemented in a timely manner to contain such risks. Therefore, it is essential for policymakers to have timely and frequent data on the household sector. While aggregate information on household indebtedness and delinquency patterns is well established in Malaysia, micro level information such as household incomes, expenditures and wealth – in particular the distribution of wealth across various asset classes and income groups – are not readily available, are less comprehensive and of lower frequency and cover only a small sample of the population. Given the variations in the debt burden across income and occupational groups, actions such as changing the policy interest rate are likely to have different impacts on different households. Efforts are being made to enhance the collection of data on the financial assets and liabilities of a wider spectrum of households as well as to collect micro level data on the financial position of households.

The need to enhance the financial capability of consumers

The Central Bank of Malaysia's initiatives on consumer protection and education are aimed at empowering households to take responsibility for their own financial position. The strategies are two-pronged: strengthening the consumer protection regulatory infrastructure and enhancing consumer education. The Central Bank of Malaysia has undertaken efforts to educate consumers on financial management to enable them to make informed decisions and to manage financial risks in a proactive and constructive manner. In April 2006, the Central Bank of Malaysia established the Credit Counseling and Debt Management Agency to assist individuals seeking advice on credit, financial management and education and debt restructuring.

Prudential regulations and supervisory oversight

On the supervisory front, the Central Bank of Malaysia has conducted an industry-wide assessment of the adequacy, robustness and effectiveness of the banking sector's risk management infrastructure, standards and practices with respect to its exposure to households. The assessment covered governance, market conduct, product development, loan origination and underwriting processes, collateral valuation and management, portfolio management, loan maintenance and recovery and information management and reporting systems.

The Central Bank of Malaysia also established the Centralised Credit Reference Information System (CCRIS), which has provided banking institutions with valuable information, thereby enabling them to screen out non-viable borrowers. The CCRIS contains extensive information on the leverage position and quality of all borrowers in the banking system, regardless of the value and performance of the exposures. Efforts are being made to enhance the information content of the CCRIS to improve further the quality of financial institutions' credit assessment and risk modelling. From a financial stability perspective, the CCRIS provides important information for the conduct of surveillance – for example, the exposure of the banking sector to a particular borrower or industry and its quality.

Meanwhile, to enhance the existing capital adequacy framework, there is a need for differentiated treatment of different risk classes to take into account the risk profile of loan exposures. This would ensure that banking institutions maintain sufficient capital to support the expansion of financing for the household sector.

The financial surveillance framework is also continuously being enhanced, including through stress-testing the impact of a possible weakening of the household sector's financial position on both the banking system and individual institutions. Going forward, the challenges facing the Central Bank of Malaysia include ensuring that the scenarios in the stress tests are realistic and that the linkages among financial institutions are understood, and achieving a better understanding of the secondary impact of a potential weakening of the household sector's financial position on the economy and the feedback effect on the financial system.

Conclusion

From the financial stability perspective, as household lending continues to play an important role in the banking system, a more comprehensive and responsive risk management system is critical in preserving the soundness of each banking institution and the resilience of the banking sector as a whole. This is to ensure that banking institutions are able to effectively manage the risks at all times and under all economic conditions. In terms of monetary policy, when setting the policy rate it is imperative to take into account the increased potency of monetary policy as a result of the increased sensitivity of household consumption and debt servicing capability to interest rate changes.