Ooi Sang Kuang: Managing risks in mortgage financing

Welcoming address by Mr Ooi Sang Kuang, Deputy Governor of the Central Bank of Malaysia, for the talk on "Managing Risks in Mortgage Financing", Kuala Lumpur, 13 January 2010.

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It is my great pleasure to welcome all of you today to this dialogue on "Managing Risks in Mortgage Financing". This event is jointly organised by Bank Negara Malaysia and Cagamas Berhad to review and exchange perspectives on developments in the area of mortgage financing. At least two factors make this a highly topical subject at this particular time. Firstly, the dramatic events of the global financial crisis have shed the spotlight directly on the mortgage market, prompting many questions to be raised about current practices in mortgage financing. These questions have challenged traditional assumptions that mortgage lending is generally a safe and low-risk activity, and drawn attention to the blind spots that we need to be concerned about. Secondly, the current accommodative stance of monetary policy coupled with the increasing intensity of competition in the mortgage market calls for greater vigilance by banks in monitoring risks in the mortgage portfolio. Expectations of faster and stronger recovery prospects for Asia, and that Asia will begin the process of unwinding of accommodative policies ahead of the rest of the world, could also lead to strong capital inflows and asset price increases. These combined conditions require banks to carefully monitor any changes in the direction of risks emanating from the housing market.

Today's discussion aims to contribute towards a deeper awareness and understanding of the risks and emerging issues in mortgage financing. We hope that this, in turn will be useful to the boards and senior management of financial institutions in framing your own approaches to managing risks in this area.

Tremendous growth prospects exist in the mortgage market in Malaysia. Over the last 5 years, mortgage financing experienced a strong and sustained average annual growth of more than 9%. Such loans now constitute a significant 27% of the total industry loan books. With emerging signs of an early and stronger recovery in the domestic economy, renewed optimism can be expected for more robust growth in the domestic mortgage market. The demand for housing will also receive additional support from continuous efforts by the government to promote home ownership and investments. For example, the new scheme to be launched this year for EPF contributors to fund the purchase of higher value or additional houses is expected to increase consumer purchasing power for homes in the coming years. The growing stream of new entrants in the labour market has also enhanced prospects for an expanded market among first time home buyers.

At present, the overall mortgage financing portfolio in Malaysia remains sound, with gross non-performing loan on a declining trend since 2000. However, while mortgage financing has continued to be a profitable business for most banks, competition has intensified considerably, with lending yields falling dramatically over the last decade. To a large extent, such competition has been the outgrowth of a fundamental change in the general approach to mortgage lending. Traditionally, mortgage financing was approached as a credit rationing process. In contrast, today banks compete aggressively for borrowers by packaging highly competitive spread of home loan products to meet different needs of borrowers. In the more developed markets, this has manifested in more prevalent sales of non-traditional mortgage products to sub-prime borrowers as competition for borrowers has intensified. The rise of investment property has also been striking, with significant growth in this loan class observed in Malaysia relative to owner occupiers.

In this environment, it is important that banks develop a more complete understanding of the full spectrum of risks presented in this business. The dangers of complacency have been clearly demonstrated in the devastating consequences of this global financial crisis. Basic failures in risk management and oversight have been cited as a key characteristic of financial institutions that suffered large losses during the crisis. In many instances, boards and senior management of these institutions neglected to understand and control their institutions' balance sheet growth and the risks that they were exposed to. Some institutions in fact made deliberate strategic decisions to retain large exposures to financial instruments linked to sub-prime assets but failed to take appropriate measures to control or mitigate those risks. In many financial institutions, the rigor of board scrutiny and due diligence was replaced with an over-reliance on external ratings or complex internal models for credit evaluations. This was compounded by incentive structures that were not adequately risk-aligned and inconsistent with long-term value creation, eventually undermining the soundness of banks.

These failures have extracted a high price on affected financial institutions, investors and national economies at large. Some of the large financial institutions that entered aggressively into the sub-prime market are now no longer around, while losses from the write-downs of loans and provisions have been staggering. Between the second quarters of 2007 and 2009, the global write-down of loan provisions had amounted to USD1.3 trillion. In October 2009, the International Monetary Fund indicated that the estimates could rise further to as much as USD2.8 trillion[1].

The events which have since unfolded underscore the fact that effectively managing risks associated with mortgage financing encompasses a much broader set of considerations – including the consequences of an adverse and broad downturn in the housing market. The crisis has reinforced the need for banks to consider the cyclical developments in the mortgage financing market more explicitly in their risk assessments. Factors such as a sustained growth in house prices, low interest rates and modest equity commitment should inform banks of the risk outlook for the mortgage segment and corresponding risk mitigation actions that are needed to avert potential losses.

Changes observed in the market features of the business in other countries also foreshadow what may in time characterise the mortgage market in Malaysia. In some markets, brokers of home loans are commonplace and a growing proportion of loans are protected by insurance.

In an increasingly challenging environment, banks will need to demonstrate that they have sufficiently strong balance sheets, processes, and management plans in place to contain the risks, while providing continued support for portfolio expansion and product innovation in the mortgage financing segment. This will entail continuous assessments of the changing profile of risk and the appropriate consideration of new and alternative ways to manage risks. The board in particular is responsible to ensure that product innovation and the re-packaging of risks in the mortgage portfolio do not outstrip the bank's capacity to manage the associated risks.

Today, we are pleased to have three distinguished speakers address some of these issues and developments in greater depth. They are Dr. Yeah Kim Leng from RAM Holdings Berhad and Dr. John Lee from KPMG who will share an overview and their perspectives on risks in mortgage markets in Malaysia, as well as their experiences with approaches to managing these risks in the light of the many changes taking place in this area.

We are also especially honoured to welcome Mr. Peter Pang, the Deputy Chief Executive of the Hong Kong Monetary Authority, who will speak on Hong Kong's experience in the area of mortgage financing. As you all know, Hong Kong has one of the most developed and healthiest mortgage markets in the region with a delinquency ratio reported at only 0.04% in October 2009[2]. Hong Kong's leadership in advancing innovations in sound mortgage risk

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[1] IMF Global Financial Stability Report, October 2009.

[2] HKMA Monthly Statistical Bulletin.

management practices over the years, including through the role of the Hong Kong Mortgage Corporation (HKMC), provides many useful parallels and lessons that can be drawn for Malaysia. Cagamas is very pleased to have established a strategic partnership with HKMC in 2007 which will allow us to avail of HKMC's significant expertise to provide the banking industry in Malaysia with expanded options for effectively managing mortgage risks.

We are encouraged by the strong turnout from among members of the board risk management committees, senior management and risk managers at this event today. Your roles are critical in bringing visibility and attention to the key risk issues in mortgage financing within your institutions in order to ensure that the associated risks, both present and foreseeable, are identified and effectively controlled. It is particularly useful to bear in mind that vigilance is needed to be alert to problems that can quickly arise in business segments that may not have presented difficulties in the past. By acting proactively to avoid controllable risks, material future losses can be avoided at far lower costs to banks and the society at large. On that note, I look forward to a fruitful and constructive dialogue.

Thank you.