

Managing the Development of the Property Sector in the 1990s

Bank Negara Malaysia

Received: June 1998

Abstract

The developments in the property market in recent years have caused some concern on the impact of high bank lending to the property sector. As measures were taken to correct the exposure of the banking system to broad property sector, the country is faced with yet another challenge. Malaysia suffered contagion effects from the financial crisis in South East Asia which affected both the stock and property markets. This paper highlights the measures taken by Bank Negara to ensure a healthy growth of the property sector and a sound financial system.

Keywords: affordability, credit growth, asset inflation, bank soundness.

Introduction

Since the mid-1990s, the strong demand for office and retail space and residential properties has fuelled significant increases in prices of these properties. During this period, lending by the banking system to the broad property sector, comprising residential, non-residential, real estate and construction expanded significantly, raising concerns that this would increase the vulnerability of the banking system to the property cycle. This prompted Bank Negara Malaysia (BNM) to implement a series of measures during the period 1995-97 to curb property lending to prevent the formation of an asset bubble and to ensure stability and soundness of the banking system. Fiscal measures introduced in the 1996 and 1998 Budgets also reinforced these measures. Following the measures and the impact of the regional crisis, the construction sector underwent a sharp adjustment and growth is estimated to have contracted by

10% in the first quarter of 1998. To minimise the adverse effects of the adjustments in the construction sector to the lower income group, the Government has made available funds to finance construction of low and medium-cost houses. This measure forms part of a package of measures that were introduced in May 1998 to assist economic recovery.

Contribution of the Property Industry

The construction sector comprises three sub-sectors, namely, residential, non-residential and civil engineering. The property market, on the other hand, comprises properties in the residential and non-residential sub-sectors. Spurred by the strong economic growth in the last nine years, the construction sector expanded rapidly at an average rate of 14.5 per cent per annum during the period 1990-96 before moderating to 10.6 per cent in 1997.

Although its direct contribution to GDP in terms of value added is relatively small at below 5 per cent, the construction sector has strong linkages with other economic sectors, especially the manufacturing and services sectors. In particular, the construction sector has contributed to the rapid growth of the domestic manufacturing industries involved in producing sawn logs, sawn timber, wood products, petroleum products, construction-related materials, transportation equipment and machinery. Many service industries such as design, consultancy, finance, insurance and business and distributive trade are also dependent on the construction sector. During the period of the Sixth Malaysia Plan (1990-95), employment in the sector grew at an average rate of 9.2 per cent per annum to account for 19 per cent of total job creation. By the end of 1997, the sector accounted for 9.1 per cent of total employment. It also employed the highest number of foreign workers (Table 1).

Developments in the Property Sector in the 1990s

Developments in the early 1990s were characterised by sustained world economic activity, strong private investment, the rapid pace of the Government's privatisation programme, a vibrant export sector and strong expansion in credit growth. The prolonged period of rapid growth had enabled many companies across all sectors to expand and contributed to higher employment and income, thus raising demand for property. This encouraged a boom in construction activities. During the period 1991-97, office space in the Klang Valley increased significantly by 1.7 million square metres or 55.1 per cent of the stock at end-1991 and was absorbed by the market with an average occupancy rate of 97.5 per cent. Retail space, on the other hand, increased by 1.1 million square metres or 198 per cent of the stock in the Klang Valley at end-1991 with an average occupancy rate

Table 1: Construction Sector – Related Statistics

	1994	1995	1996	1997e/
Value added (% share of GDP)	4.2	4.5	4.7	4.8
- Civil engineering (weight, %)	46.1	46.4	46.9	47.7
- Residential (weight, %)	29.3	29.2	29.0	28.8
- Non-residential (weight, %)	24.6	24.4	24.1	23.5
Employment (% of total employment)	7.8	8.3	8.9	9.1
Production of construction-related materials (% change)	13.9	11.7	21.2	11.4
Imports of construction-related materials (% of total imports)	2.8	2.3	2.7	2.4
Imports of iron and steel (% of total imports)	3.2	3.8	3.7	3.9
Imports of machinery for construction and mining (% of total imports)	0.9	1.4	1.7	1.3

Source: Department of Statistics, Bank Negara Malaysia e/ : Estimate

Table 2: Shortfall in Housing for 1994-97 (Units)

Category	1994	1995	1996	1997
Low-cost	14,919	20,575	19,680	8,274
Medium-cost	4,061	17,369	22,835	18,647
High-cost	1,160	-5,533	-3,575	-9,017
Total	20,140	32,411	38,940	17,904

Table 3: Banking System - Loans to the Broad Property Sector

	Outstanding			
	1990	1995	1996	1997
	RM billion			
BROAD PROPERTY	36.0	73.6	104.7	139.7
· Construction	8.2	20.2	27.8	42.5
" Civil engineering	n.a	n.a	3.0	6.1
" Industrial building & factories	0.4	2.0	2.6	3.1
" Infrastructure	1.2	5.5	6.7	10.4
" Commercial complexes	1.6	2.9	3.5	6.3
" Residential	2.2	3.4	4.2	6.6
" Others	2.8	6.4	7.8	10.0

of 90.2 per cent as at end-1997. However, recognising the potential for excess supply, developers had rescheduled the completion of projects according to demand. Nevertheless, another 549 thousand square metres of retail space are expected to come on-stream in 1998. Thus rentals and occupancy rates are now expected to decline, although the correction may not be very severe.

Emergence of Asset Inflation

As shelter represents a basic need and the Government has shown strong support for a house-owning democracy, the residential sub-sector has been the most active segment of the property market in terms of the number of transactions. More importantly, the number of residential transactions for the country grew at a much slower rate (9 per cent per annum)

than the increase in the value of transactions (20 per cent per annum) for the period 1994-96, reflecting higher prices for all types of residential property. Prices had escalated, particularly for properties in the four major towns (Kuala Lumpur, Petaling Jaya, Penang and Johor Bahru). During the period 1994-96, residential property prices in the four major towns rose by 20-25 per cent per annum, compared with the rise in the national house price index of 8-18.4 per cent per annum in 1994-96 and 4.9-25.5 per cent per annum during the preceding period 1991-93. The shortage in the supply of low and medium-cost houses further aggravated the situation. Generally, property prices had increased to a level that was beyond the reach of a majority of households.

Several factors had contributed to the escalation in property prices. The main factors were:

■ Increased affordability

The wealth effect of the high returns from investments in the share market as well as the high premiums earned on Initial Public Offerings were channelled into the property market, thus increasing the demand for property. As demand was too strong, available resources in terms of access to land and labour were inadequate to facilitate a corresponding increase in the supply of housing, as indicated in the BNM findings (Table 2). The limited supply of landed housing units in the major towns had resulted in a sharp price appreciation in the property market. This subsequently fuelled speculative demand, contributing further to the upward spiral in property prices.

■ Strong credit growth in the broad property sector

Lending to the broad property sector by the banking system has increased significantly since 1990, accounting for more than 25 per cent of total loans outstanding. This was partly because financing of activities in the property sector was viewed by the banking institutions as involving lower risk since these loans were secured by the property. As at the end of 1997, lending to the broad property sector amounted to RM139.7 billion or 33.2 per cent of total loans outstanding, compared with RM36 billion at the end of 1990. Of this amount, RM42.5 billion were extended to the construction sub-sector, RM51 billion for the purchase of residential properties, RM28.2 billion for the purchase of non-residential properties and RM18 billion for the real estate sub-sector (Table 3).

■ Foreign demand

Demand by foreigners in certain towns, particularly Johor Bahru, caused upward pressure on prices. Developers took advantage of this strong demand by continuing to test the market with higher prices. The encouraging response was followed by even higher prices for the next launch. Hence, higher prices were attributed mainly to demand pressures.

Asset Inflation and Bank Soundness

In managing the economy, the objective of the Government is to ensure a sustainable pace of growth with price stability. Over the last several years, the developments in the property market have caused concern on the impact of high bank lending to finance property

transactions, on the soundness of the banking system and the overall macroeconomic stability of the country. BNM's concerns on excessive lending to the broad property sector are based on the following:

- The banking institutions are the main intermediaries in the financial system in mobilising savings for lending to finance investment in economic activity. Hence, instability in the banking system could cause a breakdown in the performance of this vital intermediation function.
- For banking institutions to remain healthy, prudence would dictate that they diversify their loan portfolio so that they would not be vulnerable to a downturn in any particular sector. Diversification would place them in a better position to absorb adverse developments that may affect certain sectors of the economy.
- A disproportionate increase in lending by the banking institutions to the property market could expose the banking system to the inherent risks in the property market. The property market is more volatile compared with the other sectors in the economy (other than the stock market) particularly when there are sharp increases in prices which are not based on fundamentals. Such high prices would not be sustainable. In the short term, these prices can be supported as long as confidence is maintained. Confidence in the property sector could be eroded suddenly even though the underlying fundamentals in the economy remain unchanged. A flight of confidence could lead to a severe correction in prices, which in turn would adversely affect the asset quality of the property loan extended by banking institutions.
- A feature of bank lending is that property is normally offered as collateral. Hence, where loans are granted on the basis of the value of the collateral rather than the viability of the loan, the banks would be likely to encounter delinquency. The liquidation of the collateral by the banks would only aggravate the situation, as forced selling would depress prices further. In addition to loans being directed to property financing, the bulk of other loans, including to the manufacturing sector, is also pledged against property. Hence, a severe correction in property prices can cause a severe deterioration in the asset quality of a significant proportion of bank loans.
- A collapse in property prices would cause negative wealth effects. A sharp correction in the property market would cause drops in rental values and property prices, which in turn would lead to severe difficulties in debt servicing by borrowers. Non-servicing of loans would adversely affect the quality of the loan portfolio of banks. When banks' exposure to the property market is too high, a fall in property values would impose risks that the banks' capital would not be sufficient to absorb the losses as asset quality of property begins to deteriorate.

The situation in Malaysia did not become alarming because pre-emptive measures were taken since 1995 to slow down excessive growth in bank lending to the property sector. If sentiments in the property market were allowed to be built up to higher levels and if asset inflation was not addressed by pre-emptive measures, a reversal arising from the current adverse economic developments would trigger a sudden sell-off and precipitate a self-fulfilling downturn. The correction in the

Table 4: Supply of Purpose-built Office and Retail Space in the Klang Valley

Year	Office space		Retail space	
	Previous estimate	Revised estimate	Previous estimate	Revised estimate
Net lettable area ('000 square metres)				
Stock in 1995	3,690	3,690	1,226	1,226
1996	322	322	331	137
1997	1,956	639	220	363
1998e	1,259	1,320	1,077	549

property market in Malaysia would undoubtedly be more severe if early measures were not implemented to arrest asset inflation.

Measures to Control Asset Inflation

As excessive lending to the broad property sector would increase the vulnerability of the financial institutions to financial distress, various measures have been introduced since 1995 to curb the rapid increase of loans to the broad property sector. These have helped avoid the build-up of an asset price bubble. The margins of financing for non-owner occupied houses and for shophouses were reduced to 60 per cent in October 1995. A levy of RM100,000 on the purchase of real estate by foreigners as well as the imposition of a real property gains tax at a flat rate of 30 per cent, irrespective of the holding period for foreigners, was imposed in the 1996 Budget. These measures had some dampening effect on sentiments in the property sector, especially condominiums. The foreign share of the

total transacted value for residential property declined from about 10 per cent during the 1993-95 period to 2.6 per cent in 1996 and 1 per cent in 1997.

However, as bank credit to the property sector continued to remain high, BNM introduced pre-emptive credit measures in April 1997 requiring the banking institutions to limit their exposure to specific sub-sectors in the property sector to not more than 20 per cent of their total loans outstanding. Lending for purchases, development of property to meet social objectives and to expand productive capacity were excluded from the credit limits. Among the lending activities excluded from the credit measures were loans to construction and for purchase of owner-occupied houses costing RM150,000 and below, infrastructure development, industrial factories and buildings. The pre-emptive measures taken by BNM in early 1997 to correct adverse developments have mitigated the sharp and abrupt correction in property prices, thus maintaining confidence

in the banking system. Latest data for April 1998 showed that loans extended to the broad property sector by the banking system (including loans sold to Cagamas) stood at 34.2 per cent of total loans. However, the exposure of the banking system to sectors subject to the credit measures moderated to 12.9 per cent at end-March 1998, well below the 20 per cent limit. With the decision of the Government to defer some of the infrastructure projects and the banking institutions' commitment to be guided by the overall 15 per cent growth in outstanding loans by end-1998, it is expected that loans to the broad property sector would moderate by end-1998.

As a result of the measures, the property sector consolidated in 1997. BNM's survey indicates that a total of 549,000 square metres of retail space would enter the market in 1998, instead of an earlier estimate of 1.1 million square metres. For purpose-built office buildings, the estimates on supply coming on-stream in 1997 and 1998 have also been revised downwards (Table 4). The slowdown was also reflected in a moderate increase of 8.4 per cent in the total value of property transactions in 1997, while the total number of transactions rose marginally by 1.8 per cent (22.9 per cent and 7.4 per cent respectively in 1996). Although house prices continued to increase in 1997 in view of the strong underlying demand and interest in property investment, the rate had moderated quite significantly. The National House Price Index for 1997 showed an increase of 1.9 per cent compared with an increase of 12.9 per cent in 1996.

The pre-emptive measures taken by BNM would allow the property sector to adjust gradually. The exposure of the banking system to this sector would also be corrected as past loan commitments were completed. It was expected that the full effects of the

measures on reducing banks' exposure to the property sector would take at least six months. Unfortunately, Malaysia suffered the contagion effects from the financial crisis in South East Asia. These affected both the stock and property markets.

Latest Developments

The loss of wealth due to the decline in the share market caused the volume and value of transactions to decline significantly for all types of properties in the Klang Valley. For the first quarter of 1998, house prices in certain areas in the Klang Valley declined by up to 25 per cent and by 10-20 per cent for the nation as a whole. The decline is more pronounced in areas where prices had recorded higher rates of increase. The decline in prices reflected significant moderation in demand due both to the loss of wealth as stock market prices declined as well as the increase in interest rates. The higher interest rates were due to the tightening of monetary policy to contain inflation and to restore macroeconomic stability.

The economic slowdown has prompted several developers to postpone or scale down their property projects. Developers have launched mainly projects which are priced below RM150,000, while deferring launches of higher-cost properties. For the secondary market, purchasers and investors are adopting a 'wait and see' attitude as they expect prices to fall further. With the near-completion of several projects and the deferment of new projects, activity in the construction sector is estimated to have declined by 10% in the first quarter of 1998. Growth in the residential sub-sector, however, showed a smaller decline, due to the continued construction of housing projects especially for low and medium-cost housing. The decline in construction activity

was reflected in the lower production of cement and concrete products, iron and basic steel and other construction-related products. For the first quarter of 1998, the number of houses approved for construction by the Housing and Local Government Ministry declined by 34.6 per cent.

Measures to Revive the Property Sector

In the light of the severe adjustment in the property sector following the financial crisis, several incentives were introduced to moderate the adjustment and to continue to ensure that the lower income group continued to have access to affordable housing. Measures were also taken to boost foreign interest in the market. These included the removal of the RM100,000 levy on foreign purchases with effect from 28 August 1997 and the 1998 Budget provisions for reduction of the Real Property Gains Tax to 5 per cent for disposal of properties after the fifth year as well as the relaxation of guidelines on foreign ownership of properties. Effective 22 April, 1998, foreigners are allowed to buy all types of housing units, shophouses, business and office space costing above RM250,000, provided financing for such purchase is not obtained in Malaysia. However, this leeway is only for newly-completed projects or those which were at least 50 per cent constructed.

Recognising that the residential sub-sector can provide the spin-off effects to stimulate growth in the economy in view of its high local content and linkages with other sectors, several measures were initiated to spur the growth of this sector, particularly the low and medium-cost houses costing RM150,000 and below. In particular, the Government has taken steps to ensure the continued availability of funds both for the developers as well as for purchasers. In addition to the RM1 billion made available to the National Housing Company for the construction of

low and medium-cost houses under the 1998 Budget, effective 1 May 1998, BNM provided an additional RM1 billion for bridging finance to developers for the construction of houses costing RM150,000 and below. Given the strong demand for housing, especially in the low and medium-cost category, the additional funding would help support the construction of this category of houses. At the same time, financing will continue to be provided by the banking system for the construction and purchase of houses costing RM150,000 and below. In a move to encourage developers to construct more low-cost houses and to reflect increasing construction and land cost, the Government has increased the ceiling price of RM25,000 for low-cost houses. Effective June 1998, the ceiling price of low-cost houses has been increased to RM30,000, RM35,000 and RM42,000 depending on location, land premium, built-up area, type of house and the prospective buyer's household income. The measures will promote stability in the property market and contribute towards economic recovery.

Conclusion

As a result of the various measures undertaken to restore and increase confidence in the property market, it is expected that the property market will be better placed to weather the current economic and financial crises. The slowdown in building activity in 1998 will mitigate somewhat the oversupply situation in certain segments of the property market and allow the market time to clear the surplus office and retail space and high-end condominiums after several years of over-investment. The contraction, therefore, will contribute to a better balance in demand and supply in the property sector and more sustainable growth in the medium term.