HONG KONG MONETARY AUTHORITY
香港金融管理局

Circulars

17 Sep 2009

Residential Mortgage Loans (RML)

Our Ref.: B4/1C

17 September 2009

Mr Peter Wong
Chairman
The Hong Kong Association of Banks
Room 525, Prince's Building
Central
Hong Kong

Dear Peter,

Residential Mortgage Loans (RML)

It has come to our notice that competition on mortgage pricing has intensified recently among authorized institutions (AIs) with some AIs offering mortgage rates as low as P - 3.25% for the entire term of the mortgage. While mortgage pricing is a commercial decision for individual AIs, we are concerned that intense market competition might have driven some AIs to price their mortgages aggressively to such an extent that they might not have given due regard to the reputation risk, interest rate risk and liquidity risk potentially associated with their pricing.

Experience shows that if AIs compete by offering large discounts to Prime rate during a period when the spread between Prime and HIBOR is relatively wide, a subsequent reversal of that spread to a more normal level will effectively erode their interest margin and force them to raise their Prime rate at a pace faster than that of the adjustment in the HKMA's Base Rate (which is adjusted in tandem with the US Fed Funds Target Rate). This situation last occurred in 2005[1], when AIs were criticised for raising their Prime rates faster than the change in the Base Rate and in the deposit rates they offered to their customers.

Drawing on this experience, AIs should be mindful that the present intense price competition is not sustainable and could lead to consequences similar to those of 2005 if the current easy monetary conditions are reversed and the Prime-HIBOR spread starts to narrow. To avoid a repetition of the 2005 experience, all AIs should endeavour to manage their Prime-HIBOR basis risk vigilantly by, among other things,

- pricing-in a reasonable margin to cater for basis risk,
- fixing mortgage rates having regard to the long-term average spread (around 390 b.p. in the last 5 years) between Prime and HIBOR, rather than by reference solely to the

prevailing market spread (around 500 b.p. for AIs whose Prime rate is 5.25% or 475 b.p. for others whose Prime rate is 5%), which is exceptionally wide and can change rapidly, and

- developing appropriate stress tests to assess the impact on funding cost as well as interest margin in the event that the Prime/HIBOR spread returns to a normal level.

Another important consideration in this regard is AIs' liquidity management under stressed liquidity situations, when AIs might have to make use of their RMLs to obtain liquidity through different channels such as securitisation, sale to a third party or pledge with the HKMA as collateral for Lender of Last Resort support (provided that the pre-conditions and criteria for such support are met). In this context, it is important for AIs to ensure that their RMLs are reasonably priced so that they can be effectively used for liquidity purposes in case of need. If an AI has priced its RMLs aggressively without a reasonable spread, this could substantially affect its ability to obtain liquidity quickly by the use of such RMLs should the need arise.

The HKMA expects AIs to set their mortgage rates with due regard to the long-term average Prime-HIBOR spread (the 390 b.p. mentioned earlier). The rates set should also be sustainable on a long-term basis and provide a reasonable margin after taking into account reasonable operational and administration costs and expected loan losses. In this connection, the HKMA will approach individual AIs to understand their pricing strategy. We will also ask them to demonstrate that their current pricing is reasonable and sustainable, and does not expose them to undue reputation, interest rate, or liquidity risk.

I would be grateful if you would inform your Members of our concern. I am writing in similar terms to the Chairman of the Deposit-taking Companies Association.

Yours sincerely,

Y. K. Choi

[1] Base Rate (which normally moves closely in line with the US Fed Fund Target Rate) rose by 1.00% during Jun-Nov 05 from 4.5% to 5.5%, while the Prime rate of the majority of local banks increased by 1.75% during the same period from 6.0% to 7.75%.

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