The development of debt markets in Malaysia

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1. Introduction

The capital market in Malaysia has developed significantly in terms of market size, range of instruments and efficiency. This progress has enhanced its role in supporting economic growth and transformation. In particular, these developments were geared towards nurturing the capital market to fill the institutional gap in the financial system and complement the role of traditional lenders.

The Capital Market Master Plan launched in February 2001 provides the framework for the development of the Malaysian capital market in the new decade. Efforts will be directed at increasing the competitiveness of the capital market and at providing an effective mechanism for the mobilisation of funds to meet the growing needs of the economy.

The government also launched the Financial Sector Master Plan, which outlines the strategies for the development of the financial sector, in March 2001. The master plan resolves key issues in a holistic manner and recommends a model structure specifically for the banking sector, taking into consideration the existing domestic environment, regulatory and supervisory framework and infrastructure. From a broader perspective, the master plan provides a clear and common vision for the industry and strategies to be pursued over the short, medium and long term to achieve this vision.

In general, the development of the capital market in Malaysia has been facilitated by a strong infrastructure and a comprehensive legal, regulatory and administrative framework. Underlying its development are the basic prerequisites of political stability and sound macroeconomic policies which create a favourable environment for economic growth with price stability. Equally important have been the high saving rate and large domestic investor base.

2. The government debt

Malaysian government securities (MGS) are interest bearing bonds issued by the government through Bank Negara Malaysia (BNM), the central bank, to raise long-term funds from the domestic capital market to finance the government's development expenditure. MGS are issued by tender via appointed principal dealers. Tendering is done through the Fully Automated System for Tendering, whereby the coupon rate is determined by the weighted average of the successful bids.

In the early years, MGS were issued to meet the investment needs of the Employees' Provident Fund, banks and insurance companies. In the late 1970s and early 1980s, MGS were used to finance public sector development expenditure. From 1989 to 1992, they served to fund part of the government's budget deficit, and in the mid-1990s, to prepay some of the expensive government external loans.

In the 10-year period from 1988 to 1997, new MGS issues slowed, due to the reduction in the government's borrowing programme. The government was scaling back its operations to enhance the private sector's role as the main engine of growth.

One of the noticeable features of the MGS market is the creation of a captive market as the papers are sought to meet mandatory investment requirements for most financial intermediaries, insurance companies and provident and pension funds. Furthermore, MGS are risk-free papers and hence generally held to maturity. Trading is very thin and only picked up from late 1999 onwards.

Recognising the importance of an active and viable secondary market for MGS, several regulatory and operational reforms were introduced to the market. The reforms also met other objectives such as facilitating the conduct of monetary policy, adding greater depth to the market, providing flexibility in the government's management of debt and increasing allocative efficiency.

MGS remained the most actively traded bonds, accounting for MYR 15 billion of the total monthly trading volume of MYR 38 billion in 2001.

3. The private bond market

The development of the private debt securities (PDS) market aimed to meet the financing needs of the expanding Malaysian economy, particularly the funding requirements of privatised infrastructure projects. It aimed to provide an alternative to bank borrowings and complement the more mature and sophisticated market in MGS and equities.

The bond market has been a significant source of finance for various development projects in Malaysia. Though Malaysian government bonds dominate the bond market, constituting about 48% of outstanding issues at end-2000, PDS outstanding grew by nearly 380 times from MYR 0.4 billion as at end-1987 to MYR 152 billion at end-September 2001. The market for PDS is now equivalent to 28% of GDP. This is in line with the government's aspiration to promote the private sector as the engine of growth.

The range of debt securities has also widened in tandem with the growth of the market. In general, the PDS market comprises various types of instruments with the range covering fixed rate, floating rate, zero-coupon, convertible/non-convertible and secured/unsecured. The maturity ranges from three to 20 years.

The bulk of the PDS are offered to investors on a bought deal basis. All tradable PDS must be rated to ensure confidence and assist in the investment decision-making process. The issuers of these PDS comprise private and public companies.

The PDS market also includes issues that are based on Islamic principles, which accounted for 25% of the market at end-September 2001. The most common principle used is the Al-Bai Bithaman Ajil concept, involving the financing of an asset on a deferred payment basis. Other various concepts applied are Musyarakah, Ijarah, Mudharabah and Qardhul Hasan. The issuance of Islamic PDS can be attributed to a higher demand for the instruments by Islamic banking units and Islamic unit trust funds.

4. Market infrastructure

To improve the efficiency of the tendering for securities, BNM introduced the *Fully Automated System for Issuing/Tendering* (FAST**)** to replace the tender form submission. FAST is an automated tendering system whereby the invitations to tender, the submission of bids and the processing of tenders for scripless securities and short-term private debt securities are conducted electronically. The process reduces errors and delays arising from manual handling of tenders. Under this system, BNM acts as the facility agent for both the government and its own issues. For PDS, the companies appoint financial institutions as their arrangers and facility agents. FAST has now been enhanced to be the system to capture all primary issuance of all unlisted instruments.

The *Bond Information and Dissemination System* (BIDS) is a computerised and centralised database on Malaysian ringgit debt securities, providing information on the terms of issue, real-time prices, details of trades done and relevant news on the various government and private debt securities.

The information provided by BIDS facilitates both primary and secondary market activities in the domestic bond market. Financial institutions are obliged to report details of trades done, including price and volume. Rating agencies, on the other hand, are required to update the issuer's ratings in the BIDS corporate homepage. The information is also disseminated via selected information providers such as Bloomberg and Reuters to achieve wider coverage. BIDS is equipped with a surveillance system to monitor the activities of the debt securities listed there.

In July 1999, the deferred net settlement protocol was replaced with the *Real-Time and Gross Settlement System* **(**RENTAS) to enhance liquidity and reduce settlement risks. Online RENTAS reduces settlement risks for market participants as it introduced a delivery versus payment (DvP) arrangement for transactions involving securities. Under DvP, securities transactions will only be effected when securities and funds are available in both the seller's and the buyer's accounts. Currently, the system captures all government and BNM issues and unlisted issues of corporate bonds, which account for approximately 95% of the total market.

To ensure the smooth functioning of both the primary and the secondary market, BNM has issued several codes of conduct and rules. These include the Malaysian Code of Conduct for Principals and Brokers in the Wholesale Money and Foreign Exchange Markets (MCC), rules on FAST, BIDS and RENTAS. As BNM operates the systems and the major players in the market are licensed financial institutions under the purview of BNM, the codes and rules are enforced by the central bank. For example, under the MCC, BNM has the power to investigate any breach of the MCC.

5. Major measures undertaken to develop the capital market

As part of continuing efforts to promote an active secondary market as well as to promote a more dynamic and performance-based dealer system, several measures have been introduced:

System of Principal Dealers

A system of Principal Dealers (PD) was introduced in 1989. They are appointed by BNM to bid for primary issues of specified securities, and trade and make markets for these securities. These securities include MGS, T-bills, BNM bills, Khazanah bonds and Cagamas debt securities.

Since its introduction, the PD system has undergone several reviews aimed at developing more dynamic and performance-oriented market-makers. Their roles have expanded from merely compulsory bidding in the primary issues and providing two-way price quotations to participating in the money market auctions, continuously quoting for selected benchmark securities and maintaining a minimum trading volume for selected papers. Along with the obligations the PD had been given privileges such as accepting repos of less than one month from non-interbank customers and holdings of these papers are exempted from the statutory reserve requirement. PD have also been entrusted with improving the secondary trading of the market, especially the government securities market, to build the benchmark yield curve.

In February 2002, BNM reviewed the incentives extended to the PD. The privilege of accepting repos of less than one month from non-interbank customers was removed but the PD were granted the privilege of participating as both borrower and lender in the newly launched Securities Borrowing and Lending Programme under RENTAS and allowed to participate in the repo/reverse transaction for the purpose of hedging committed treasury activities.

Credit rating system

As part of BNM's continuing effort to develop the PDS market, Rating Agency Malaysia Berhad (RAM) was incorporated in November 1990. RAM is the first credit rating agency in the ASEAN region. The most important functions of RAM are to rate all PDS and to disseminate timely information to potential investors in both the primary and the secondary markets. A second rating agency, Malaysian Rating Agency Corporation Berhad, was established in September 1996.

Establishment of the National Bond Market Committee (NBMC)

The NBMC was established in June 1999 to provide the overall policy direction and rationalise the regulatory framework for the orderly development of the market. It is chaired by the Secretary-General of Treasury from the Ministry of Finance and consists of representatives from BNM, Securities Commission, Economic Planning Unit, Registrar of Companies and Kuala Lumpur Stock Exchange. It has established three working groups, namely the Legal and Regulatory Reform Committee, the Product and Institutional Development Committee and the Infrastructure and Operation Work Group.

Development of an MGS benchmark yield curve

The prerequisite for the development of any bond market is the existence of a benchmark. A significant, liquid, efficient and market-oriented government securities market would contribute to more efficient sovereign debt management, effective monetary operations and financial stability. For the market participants, a benchmark is necessary to price issues against the benchmark. It would also facilitate the intermediation process through efficient market pricing and borrowing and lending decisions in the primary and secondary markets.

In March 2000, the government via the NBMC acknowledged that MGS has a role to play in the development of such a benchmark. Since then, BNM has published the auction calendar for the issuance of MGS on an annual basis. This improves the transparency of the issuance and assists the market players.

To facilitate the creation of the benchmark yield curve, other measures were taken in parallel, such as reopening of the off-the-run MGS issues, implementation of transparent and highly active two-way prices for the benchmark securities via the Benchmark Screen under the BIDS system and closer monitoring of the market activities and PD performance.

6. Issues and challenges

Over the last decade, the Malaysian capital market has undergone tremendous change and development and assumed a significant role in the overall financial sector. Substantial efforts have also been made to foster the development of the market and its continued growth. On this note, there are several issues and challenges in developing the Malaysian market further. These include having a true benchmark yield curve, a more liquid market, widening the issuer and investor base, and having risk management instruments.