The corporate bond market in Malaysia

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Introduction

The growth of the Malaysian bond market can be traced back to the 1970s, when the government started issuing bonds to meet the massive funding needs of the country's development agenda at the time. By the mid-1980s, the private sector assumed a more important role in the strategic development of the Malaysian economy, with the aim of making it the main driver of growth as well as finance. During that period, the corporate sector was heavily reliant on finance from banks, which led the government to pursue the development of the corporate bond market as a key strategic priority. The 1997-98 Asian financial crisis brought home the folly of over-reliance on bank loans. Lessons learnt from the crisis led the government to step up its efforts to develop the corporate bond market, in order to offer the private sector alternative sources of finance and reduce funding mismatches.

Historically, because of the lack of a well-developed bond market, most of the credit intermediation in the country was done through the banking system. Potential credit withdrawals and the eventual credit squeeze suffered by the corporate sector during the Asian crisis highlighted the importance of risk diversification within the financial system. Consequently, development of the corporate debt market gained greater importance and was accelerated to allow greater diversification of credit risk among economic agents, as well as to provide funding with the appropriate maturity structures.

For the past 15 years, efforts to develop the Malaysian bond market have been fruitful. In terms of relative size of the bond market versus domestic bank credit, growth in the former has been quite significant. Another notable achievement is the successful promotion of the Islamic bond market. Islamic bonds, which comply with *Shariah* principles, have played a major role in Malaysia's capital market development, contributing to the significant growth of the country's Islamic financial system. Through this niche market, Malaysia is poised to play a strategic role in global Islamic finance.

The increasing demand from the private sector for innovative forms of finance continues to fuel the development of Malaysia's corporate bond market. Growth has also been spurred by the increasing presence of institutional investors, such as pension funds, unit trust funds and insurance companies. The Malaysian corporate debt market has enjoyed enormous growth, rising from MYR 4.1 billion in private debt securities (PDSs) outstanding in 1989 to approximately MYR 188 billion in 2004, an increase of 45 times. In addition, the Malaysian corporate bond market represents 37% of the country's GDP - by this measure, one of the largest in the world (IMF (2005) and Table 1). Furthermore, the Malaysian bond market accounted for 8% of the total Asian bond market (excluding Japan) in 2004.

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Table 1

Size of local currency bond market as a percentage of GDP

End-March 2005 data

	Government	Corporate	Financial institutions
China	19.5	0.7	10.8
Hong Kong SAR	9.4	38.1	**
Japan	146.8	16.6	26.1
Korea	26.1	22.0	37.4
Malaysia	40.6	37.3	16.7
Singapore	40.3	31.6	**
Thailand	21.9	13.6	6.5
United States	47.0	21.5	90.2

Note: ** Hong Kong and Singapore: corporate data include financial institutions. For others, corporate refers to non-financial corporate issuers.

Sources: Asian Development Bank; Asian Bonds Online.

1. Key developments in the Malaysian bond market

The building of a comprehensive regulatory framework and a strong infrastructure, along with certainty of vision, political stability and sound macroeconomic policies, laid the foundation for the development of the Malaysian bond market.

Regulatory framework and market infrastructure

During the early years, the BNM, the government agency responsible for corporate bond issuance, took several initiatives to strengthen the legal/regulatory framework and market infrastructure in the underdeveloped primary and secondary markets. In March 1993, the Securities Commission (SC) was established to act as the single regulatory body to promote the development of the capital market, in particular to rationalise securities market regulations. (Prior to the establishment of the SC, a set of guidelines for PDS issuance was introduced in 1988.)

In addition, the Rating Agency Malaysia Berhad (RAM) and the Malaysian Rating Corporation Berhad (MARC) were established in 1990 and 1995, respectively, to provide independent opinions on the potential default risk of debt issuers and disseminate all appropriate information to existing and potential investors in a timely fashion. The Bond Dealers Association was established in June 1996 to represent the industry’s views and work with regulatory authorities to promote the bond market. The Financial Markets Association of Malaysia (ACI Malaysia) was established in 1974 to monitor, develop and improve industry standards, and to bring them in line with international best practice. ACI Malaysia, whose membership comprised staff from treasury operations of Malaysia’s financial institutions (including insurance companies) had adopted a Code of Conduct for the industry. To qualify as a member of ACI Malaysia, a rigorous qualifying examination must be passed.

On the operational front, various processes were computerised and put online by BNM to enhance cost-effectiveness and efficiency. These included the introduction of the Fully Automated System for Tendering (FAST) in September 1996, to speed up securities tendering, and the Real-Time Gross Settlement System (RENTAS) in July 1999, to reduce settlement risk. RENTAS was developed as a computerised scripless trading system to facilitate faster and more efficient trading, registration and settlement of securities. The Bond Information and Dissemination System (BIDS) was introduced in October 1997 to facilitate efficient trading and promote transparency of information related to domestic debt securities. In an effort to further improve liquidity in the market, the Securities Borrowing and Lending (SBL) Programme was introduced in December 2001 via the RENTAS system, and the Institutional Securities Custodian Programme (ISCAP) was implemented in October 2004 to promote lending of securities to the central bank. For the Islamic bond market, an internet-based platform system (Islamic Interbank Money Market - IIMM) was launched in September 2004 to provide transparency of information on Islamic financial products.[2]

An important milestone in the broader bond market development agenda was the creation of the National Bond Market Committee (NBMC) in 1999. Its members comprised senior representatives from the Ministry of Finance, the Economic Planning Unit, BNM, SC, Bursa Malaysia and the Registrar of Companies. Its purpose is to oversee the policy direction for the development of the bond market, and to identify and recommend appropriate implementation strategies. As a first step, the NBMC has authorised the SC to be the single regulatory body to regulate and promote the development of the corporate bond market.

To chart future growth, the Capital Market Masterplan (CMP) was unveiled in 2001. A Capital Market Strategic Committee (CMSC) consisting of high-level representatives from the SC and the private sector was established in September 1999 to facilitate the development of the CMP. The CMP is the strategic blueprint for the Malaysian capital market over the next decade, of which six broad objectives are spelt out:

- to be the preferred fund-raising centre for Malaysian companies;
- to promote an effective investment management industry and a more conducive environment for investors;
- to enhance the competitive position and efficiency of market institutions;
- to develop a strong and competitive environment for intermediation services;
- to ensure a stronger and more facilitative regulatory regime; and
- to establish Malaysia as an international Islamic capital market centre.

The CMP has been divided into three stages, spanning a period of 10 years and involving 152 detailed recommendations that seek to fulfil the realisation of a robust and dynamic Malaysian capital market. (See Table 2.) By end-June 2005, 96 recommendations (63%) had been put in place, while the remaining ones are still at the implementation stage.

CMP initiatives were directed at key specific areas, and have included the enhancement of the fund-raising process, ensuring the robustness and efficiency of the bond market microstructure and expanding both the issuer and investor base.

With the essential building blocks in place, the development of the bond market has proceeded at a steady pace towards the accomplishment of key goals, such as the establishment of a benchmark yield curve, improvement in secondary market liquidity and the introduction of new asset classes to the market. (See Table 3 for specific initiatives.)

Table 2

Implementation plan for the CMP

Phase 1 (2001–03)	**Phase 2 (2004–05)**	**Phase 3 (2006–10)**
Strengthen domestic capacity, and develop strategic and nascent sectors	Further strengthen key sectors and gradually liberalise market access	Further expansion and strengthening of market processes and infrastructure towards becoming a fully developed capital market, and enhancing international positioning in areas of comparative and competitive advantage

Source: The Securities Commission.

[2] The website (http://iimm.bnm.gov.my) provides information on Islamic money market operations, forthcoming tenders and post-issuance prices of Islamic securities, live information on last done prices of actively traded securities and news related to the Islamic market.

Table 3

Strategic developmental initiatives for the Malaysian bond market

Strategy	Initiatives
Introducing an efficient and facilitative issuance process	Release of Guidelines on the Offering of PDSs - 2000
	Introduction of a shelf-registration scheme - 2000
	Release of Guidelines on the Offering of Asset-backed Securities (ABSs) - 2001
	Release of Asset Securitisation Report - 2002
	Introduction of Guidelines on the Offering of Islamic Securities - 2004
Establishing a reliable and efficient benchmark yield	Introduction of an auction calendar for Malaysian Government Securities (MGS) - 2000
	Review of the principal dealers system
Widening the issuer and investor base	Broadening of the investor base under the Securities Commission Act for the OTC market
	Universal Brokers are allowed to trade in the OTC market - 2002
	ABSs are introduced together with tax-neutral framework and tax deductions on issuance expenses - 2003
	Islamic PDSs are accorded various tax incentives (eg stamp duty waiver, tax deductions on issuance expenses) and a tax-neutral framework - 2003, 2005
	Multilateral development banks, multilateral financial institutions and multinational corporations are allowed to raise ringgit-denominated bonds - 2004
	Removal of withholding taxes on interest income earned on investments by non-resident companies in ringgit-denominated Islamic securities and securities issued by the Malaysian Government - 2004
Improving liquidity in the secondary market	Non-financial institutions are allowed to enter into repurchase transactions - 2000
	The Securities Borrowing and Lending Programme is introduced via the RENTAS system - 2001
	Institutional Securities Custodian Programme (ISCAP) is put in place to encourage institutional investors to lend securities to BNM - 2004
Facilitating the introduction of risk management instruments	Introduction of three-, five- and 10-year MGS futures - 2002, 2003
	Introduction of Guidelines on Regulated Short-selling of Securities - 2005

Sources: Bank Negara Malaysia; Securities Commission.

Regional cooperation

The Malaysian domestic bond market has also benefited from regional cooperation in East Asia. Local and cross-border impediments have been addressed through the sharing of experiences and technical expertise, as each country has strived to add depth and breadth to its own domestic market. Three regional forums have been at the forefront of financial development in the region, namely the Asia-Pacific Economic Cooperation (APEC), the Association of Southeast Asian Nations Plus 3 (ASEAN+3) and the Executives' Meeting of East Asia and Pacific (EMEAP) Central Banks. These three forums focus on different aspects of local bond market development.

The successful launch of Asian Bond Fund I (ABF1) by EMEAP, which pooled USD 1 billion in reserves from 11 central banks and invested in USD-denominated bonds of sovereigns and quasi-sovereigns, led to the recent launch of the second fund, Asian Bond Fund II (ABF2). The second fund involves the creation of local currency bond funds in each EMEAP market, and consists of the Pan-Asian Bond Index Fund and eight single market funds. Launching these funds has forced participating central banks to face market impediments head-on, and address them as a group.

The listing of Malaysia's first exchange-traded fund (ETF), the ABF Malaysian Bond Index Fund, in July 2005, marked another important milestone in bond market development. The ETF was the second country sub-fund to be launched, following the successful listing of the ABF Hong Kong Bond Indexed Fund in June 2005. The fund consists of investments in government and quasi-government securities and tracks an index, which by design is replicable and transparent, paving the way for the introduction of other innovative products by the corporate sector in future. The listing of the ETF on Bursa Malaysia (the Malaysian Stock Exchange) should also generate interest on the part of domestic and international investors in the local bond market.

2. The corporate bond (PDS) market

At the end of 1986, the PDS market was virtually non-existent in Malaysia. This was in contrast to the equity and government debt markets, both of which had achieved a reasonable level of sophistication and maturity by that time. PDSs outstanding in 1987 amounted to only MYR 395 million (0.5% of GDP), versus the market capitalisation of the Kuala Lumpur Stock Exchange (KLSE) of MYR 73.8 billion (91% of GDP) and the outstanding amount of Malaysian Government Securities (MGS) of MYR 48.8 billion (60.2% of GDP).

Importance of a functioning corporate debt market

The period of strong economic growth in the early 1990s created high demand for funds from the corporate sector. Therefore, the development of the corporate bond market was aimed at meeting the financing needs of the expanding Malaysian economy, particularly those of privatised infrastructure projects. Specifically, the PDS market was intended to provide an alternative means of financing to bank borrowings, and complement the more mature and sophisticated market in MGS and equities. The PDS market would also serve as a new avenue for savings in a wide range of financial assets, in the context of a high domestic saving rate.

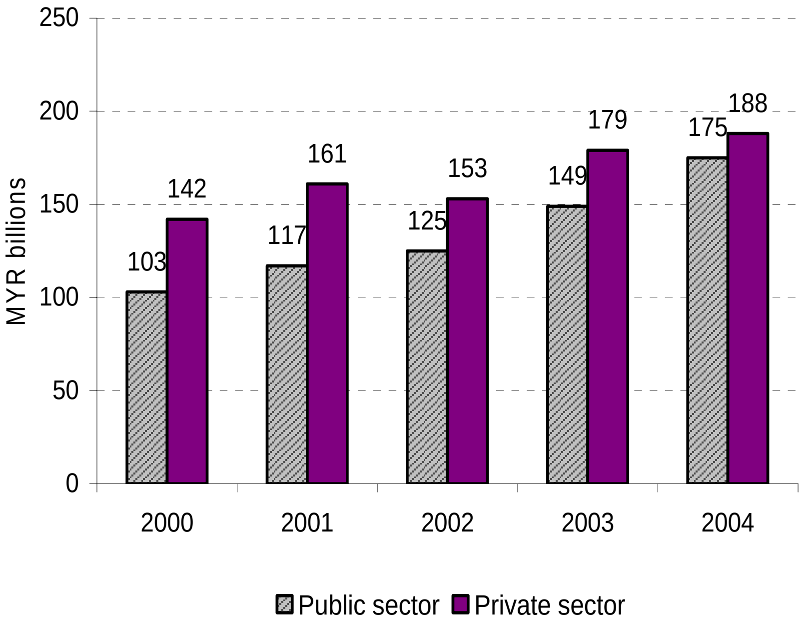
It is a well-recognised fact that a diversified financing structure, comprising financial intermediaries from the equity, bond and banking markets, is needed for an economy to allocate resources in the most efficient manner. Such diversification also provides businesses the opportunity to address capital needs more effectively, and allows corporates to match their asset-liability profiles. A well-developed corporate bond market also plays a vital role in risk diversification of the financial system, and adopting a market mechanism in the allocation and pricing of credit would also ensure greater efficiency in the allocation of funds to borrowers.

Characteristics of the Malaysian corporate bond market

Through the efforts of the government and market participants, and reinforced by strong economic growth, the Malaysian PDS market has expanded considerably over the years. Ample liquidity and an accommodative interest rate environment have supported the growth of the bond market by enabling the private sector to source funds at a competitive cost. Since 2000 onwards, private debt issuance has exceeded public debt issuance. (See Graph 1.)

Graph 1

Total bonds outstanding



Source: BNM Annual Report 2004.

Table 4

Size of local currency bond market

End-March 2005 data

	Total size (USD billions)	% share	
		Government	Corporate**
China	527.7	62.9	37.1
Hong Kong SAR	79.6	19.8	80.2
Indonesia	52.8	87.1	12.9
Japan	8943.8	77.5	22.5
Korea	606.5	30.6	69.4
Malaysia	114.7	42.9	57.1
Singapore	78.2	56.0	44.0
Thailand	70.2	52.1	47.9

**Note: Corporate data include financial institutions.

Sources: Asian Development Bank; Asian Bonds Online.

Compared with selected economies in Asia, Malaysia has achieved a balance in terms of debt composition between its public and private bond markets. At 57%, Malaysia has the third highest proportion of debt issued by the private sector, behind Hong Kong (80%) and Korea (69%). (See Table 4.) Below we discuss the various factors that have brought the market to this stage of development.

Improved issuance procedures

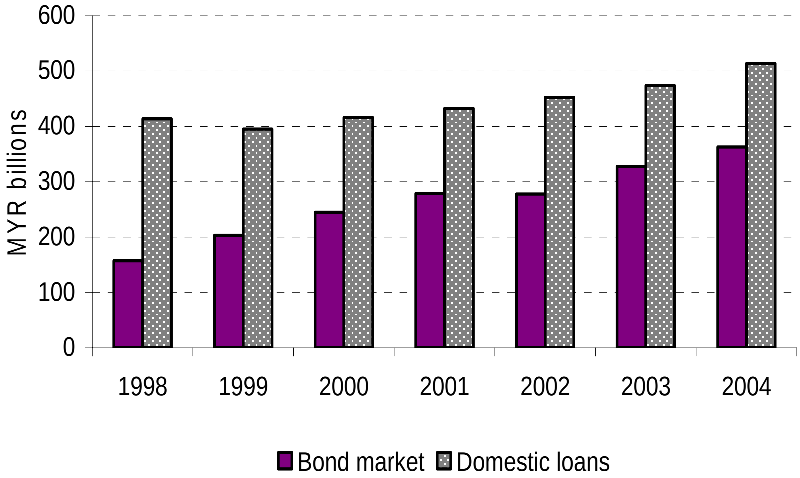
To streamline the issuance process, the merit-based regulation (MBR) was replaced by the disclosure-based regulatory (DBR) framework. The SC's *Guidelines on the Offering of Private Debt Securities*, which came into effect in July 2000, have played an important role in promoting an efficient issuance process.

In the mid-1990s, the approval process for bond issuance could take from nine to 12 months. The long waiting period created uncertainty - and therefore a disincentive for companies to seek funding through the bond market, where timing is a crucial element in determining the success of an issue. Thanks to the introduction of the PDS guidelines, an issuer can now secure an approval within 14 days after submission of complete documentation.

The introduction of a shelf-registration scheme has also provided issuers additional flexibility in timing of issuance. The scheme allows eligible corporations to make multiple issues of debt securities within a two-year period with one-time approval, subject to certain criteria. The efficiency of the issue process, in particular the large financing potential of the shelf-registration scheme, has started to convince the private sector that financing through the bond market may offer a viable alternative to bank loans and the equity market (see Graph 2).

Graph 2

Size of bond market vs domestic loans



Source: BNM statistics.

The liberalisation of issuance procedures has made it more attractive for issuers to tap funds in the corporate bond market than in the equity market. In 1997, PDS issues accounted for 44.3%[3] of the total gross domestic funds raised via the capital market (ie bond and equity) by the private sector - and in 2004, this figure had reached 81.2%. Currently, the corporate bond market accounts for approximately a quarter of the total debt financing (including bank loans) in the economy, compared to approximately 10% in 1997.

Product diversification

As the bond market has evolved over the years, the corporate funding scene has become more active and financing solutions have become more innovative and sophisticated to meet the diverse risk-return profiles and needs of both issuers and investors. Also, regulatory frameworks have kept pace with market developments. Specifically, guidelines such as *Guidelines on the Offering of Asset-backed Debt Securities* (2001) and *Guidelines on Offering of Islamic Securities* (2004) have facilitated the registration and issuance process and promoted the creation of new asset classes.

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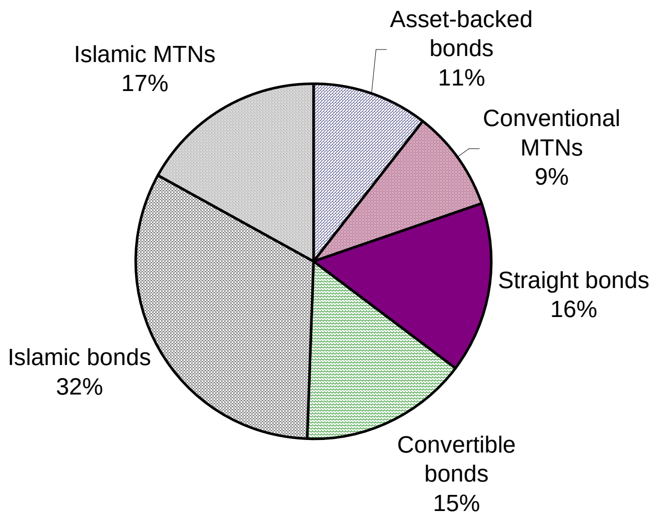
[3] Data exclude Cagamas bonds. Cagamas, or the National Mortgage Corporation, was incorporated in December 1986 to support the national home ownership policy. Cagamas purchases housing loans from financial institutions and securitises them into Cagamas bonds. The exclusion of Cagamas issues provides a better picture of the corporate debt market.

Graph 3

Issues by instrument type (excluding Cagamas)



Source: BNM Annual Report 2004.

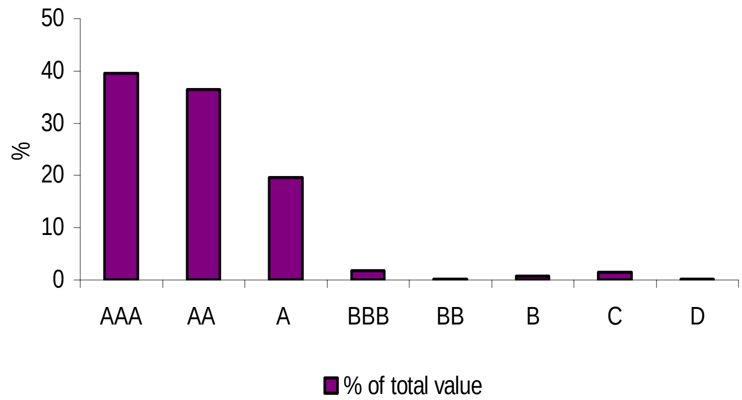
Over the years, Islamic PDSs (including Islamic Medium-Term Notes, or MTNs) have become the preferred means of debt funding, accounting for 49.4% of total issuance in 2004. (See Graph 3.) This development is quite understandable given that both Islamic and non-Islamic investors can invest in *Shariah*-compliant products. The bigger investor base for these products has led to more competitive bidding, which has driven down issuance costs - making it increasingly attractive to issue *Shariah*-compliant instruments.

Rating requirements

Prior to July 2000, all corporate bond issues in Malaysia were subject to a mandatory minimum rating requirement of BBB or above, which not only instilled confidence in issuance, but also indirectly helped Malaysia's relatively new rating agencies (RAM and MARC) to develop. However, this minimum rating rule was subsequently lifted.

Graph 4

Rating distribution of outstanding PDS issues (end-2004)



Sources: MARC; RAM.

Even though the minimum rating requirements on credit ratings have been scrapped (mandatory rating is still required), the credit profile of corporate bonds remains skewed towards the higher end of the credit spectrum (A and above), with approximately 5% of outstanding issues rated BBB or below. (See Graph 4.) This reflects investors' risk preference for high-quality debt issues, and can be seen in the yield spread. The wide spread between A and BBB bonds (see Table 5) is probably a reason for smaller issuance of bonds rated BBB and below: at these levels, it would be cheaper for lower-rated credits to raise funds via other alternatives.

Table 5

Spot yield matrix

End-October 2005 data

Type	**Class**	**Tenor**			
		1Y	**3Y**	**5Y**	**10Y**
Government	MGS	3.10	3.38	3.64	4.29
Corporate	AAA	3.47	3.91	4.23	5.13
	AA	3.51	4.19	4.49	5.27
	A	4.05	4.75	5.09	5.95
	BBB	4.72	6.47	7.08	8.89
	BB	6.84	10.57	11.22	13.59
	B	10.2	17.29	17.88	21.60

Source: Bondweb Malaysia.

Nevertheless, with continued strong demand by investors, companies with strong credit ratings will continue to tap the corporate bond market at competitive rates. Despite the lifting of rating requirements, market norms dictate that bond issues should still carry credit ratings. Moreover, experience has shown that ratings promote greater acceptance among investors for fixed income securities, as they allow both investors and issuers to gauge returns and analyse the cost of raising funds.

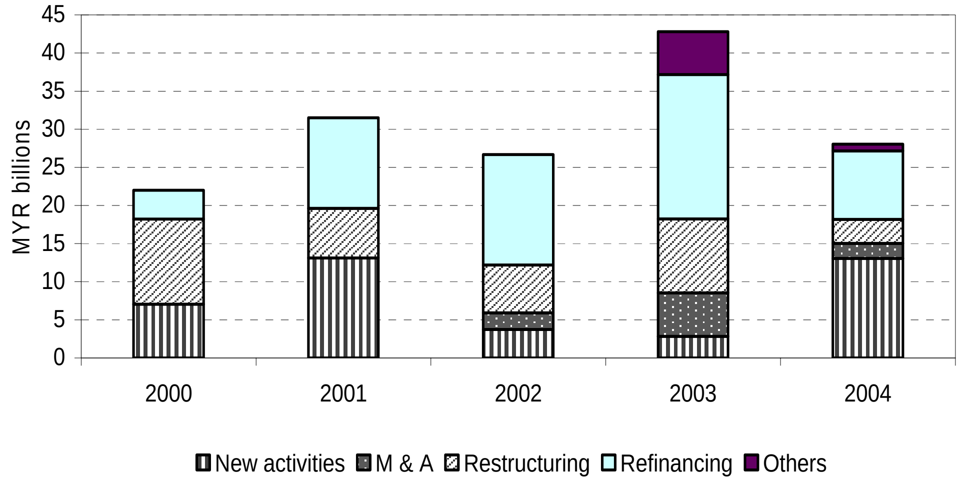
Sector allocation and maturity profiles

Due to the economy's strong growth, the bulk of corporate bond issuance in the mid-1990s was for infrastructure (transportation and communication systems), utilities (electricity, gas and water) and construction.

Between 2000 and 2003, a significant proportion of issuance was for restructuring, made necessary by the adverse financial position of companies in the wake of the crisis. This type of issuance has fallen considerably since then, reflecting the completion of most corporate restructuring exercises. With the expanding economy, funds raised are now used for new activities, ie investments in positive NPV projects and business expansion, and because of the low interest rate environment, bonds are also issued for refinancing purposes. (See Graph 5.)

Graph 5

PDS issues by purpose



Source: BNM statistics.

In 2004, companies from the construction and utilities sectors were the main PDS issuers, raising 31.5% and 28.0% of total funds, respectively. (See Table 6.) Issuers from these sectors are the country's major infrastructure developers, water authorities and independent power producers, all of whom require long-term and flexible financing.

Table 6

New PDS issues (excluding Cagamas) by sector

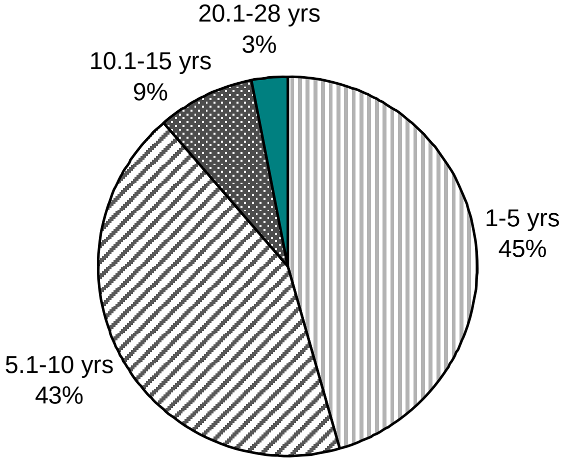
	2000	2001	2002	2003	2004
Total issuance (MYR millions)	21,991.9	31,502.4	26,660.4	42,790.4	28,049.9
	% share				
Agriculture, forestry and fishing	0.2	0.2	3.6	2.3	0.0
Manufacturing	6.2	8.0	6.7	21.2	11.6
Construction	8.9	10.5	8.2	14.1	31.5
Electricity, gas and water	15.3	32.0	5.1	8.0	28.0
Transport, storage and comm.	34.1	12.0	34.1	20.1	2.8
Finance, insurance, real estate and business services	21.5	16.3	20.7	19.6	17.0
Government and others	0.0	20.2	17.4	14.7	4.7
Wholesale and retail trade, restaurants and hotels	13.8	0.8	4.2	0.0	4.4

Source: BNM statistics.

Reflecting the significant financing requirement of companies of this nature, a large proportion of the corporate bonds were issued with tenures of five to 10 years. An encouraging development on this front has been the increasing number of companies able to tap longer-term funds, with one bond issued in 2003 with a maturity of 28 years. (See Graph 6.)

Graph 6

PDS issuance (excluding Cagamas) by tenor, 2004



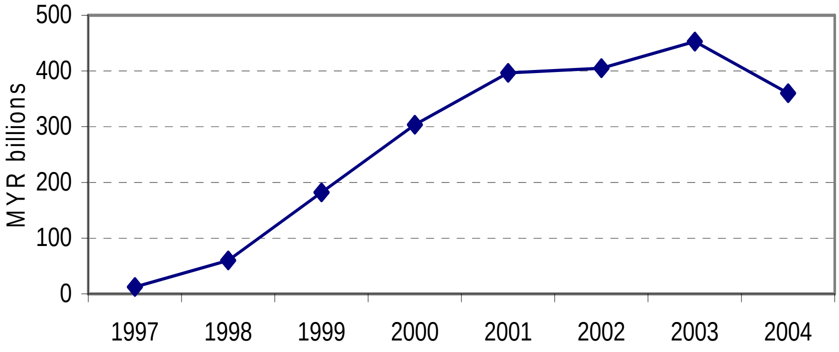
Source*: BNM Annual Report 2004*.

Secondary market

Liquidity in the corporate debt market is still improving, attributed to various efforts to enhance trading activity, such as the introduction of a principal dealers system and improvement of the information dissemination mechanism in the OTC market. (See Graph 7.) However, liquidity in the secondary market continues to be hampered because of a shortage of paper available for trading, reflecting small issue sizes and the buy-and-hold investment strategy adopted by insurance companies, asset managers and large institutional investors dominated by the government-controlled funds (such as the Employees Provident Fund and savings institutions such as the Pilgrims Fund Board).

Graph 7

Turnover of debt securities



Source: BNM statistics.

Post-trade transparency

To facilitate efficient trading and increase liquidity in the OTC debt securities market, the Bond Information and Dissemination System (BIDS) was introduced in October 1997 to enhance transparency of bond information. BIDS is a central computerised database of ringgit debt securities, providing information on issue terms, real-time prices, transaction details and relevant news on the various government and private debt securities. Financial institutions are obliged to report details of transactions, including price and volume, while rating agencies are required to update issuers' ratings in the BIDS corporate homepages.

Fiscal incentives

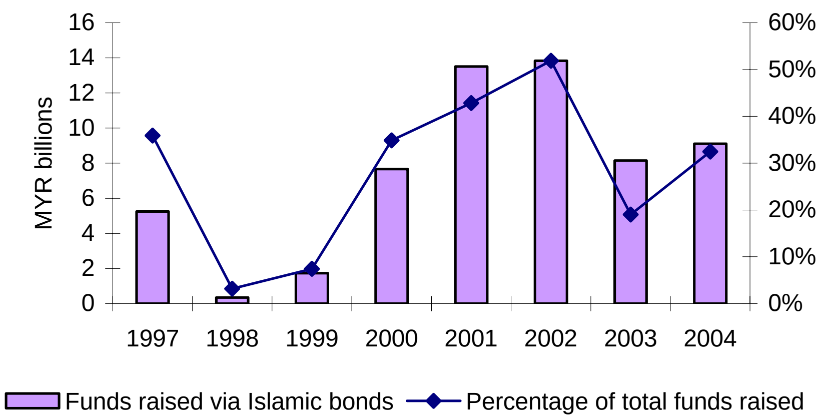
Tax incentives have also played a major role in the continuous growth of the corporate debt market. For example, stamp duty waivers and tax exemptions on income earned on securities have been granted to widen the issuer and investor base. In addition, a tax-neutral framework has been introduced, whereby ABS issues and Islamic PDS issues are treated like conventional securities for purposes of taxation

3. The Islamic PDS market

The Malaysian Islamic PDS market has shown remarkable progress since its introduction in 1990. Malaysia has successfully created a niche market in this area: it is estimated that 85% of the total global Islamic bonds that have been issued were issued in Malaysia, making Malaysia one of the world's largest Islamic bond markets. The growth of Malaysia's Islamic bond market is demonstrated by the issue size of Islamic PDSs. (See Graph 8.) In 2004, Islamic PDS issuance amounted to MYR 9.1 billion, accounting for 32.5% of total PDS issuance.

Graph 8

Islamic bond issuance (excluding Cagamas) in Malaysia



Note: Issuance does not include Islamic MTNs.

Source: BNM statistics.

In 2001 and 2002, Islamic bonds were extremely popular with issuers and investors alike, eclipsing conventional bonds and accounting in both years for more than 50% of issuance - up significantly from 34.9% in 2000. Demand for Islamic paper by Islamic and conventional investors was strong, and major issuers, in particular the toll road concessionaires and power supply companies, took advantage of lower issuance costs as the demand led to more competitive bidding.

Structure of Islamic products

A prerequisite for Islamic bonds, or *Sukuk,* is compliance with the *Shariah* (Islamic laws), which prohibits the charging of interest (*riba*). A *Sukuk* instrument is structured so that it involves an exchange of *Shariah*-compliant assets for a financial consideration that allows the investors to earn profits and rentals from transactions in the future.

There are various types of Islamic-based structures used for the creation of Islamic bonds, but the more prominent are sale and purchase of an asset based on deferred payment (*bai' bithaman ajil*); leasing of specific assets (*ijarah*); and a profit- and loss-sharing scheme (*musyarakah*). There are also a number of innovative instruments recently pioneered by market players involving the gamut of Islamic financial principles, including *istisna* (project finance), *murabahah* (cost-plus sale), *mudharabah* (profit-sharing), and *qard* (interest-free loan).

In the case of Malaysia, the majority of Islamic bonds are debt-based instruments, ie *murabahah* and *bai' bithaman ajil*. With the new *Guidelines on Offering Islamic Securities* issued in 2004 by the SC, issuers are no longer constrained by the legal concept of debentures (debt-based), as required for conventional products. It is envisaged that these guidelines will promote the development of new Islamic products, and, in particular, encourage the issuance of products that are based on profit- and loss-sharing, such as *mudharabah* and *musyarakah*. In an effort to promote issuance of Islamic debt securities via the principles of *mudharabah*, *musyarakah* and *ijarah*, expenses incurred by issuers are allowed as deduction for computation of income tax for a period of five years.

Growth and acceptance of Islamic bonds

The increasing popularity of Islamic bonds is attributable to several factors. First, Islamic PDSs provide an avenue for Islamic-based investors who need to invest in *Shariah*-compliant instruments. Second, Islamic products have also appealed to conventional investors who are constantly looking for liquid, attractively priced instruments to obtain capital gains and income. The strong demand by investors also provides the opportunity to issuers to finance borrowing at a lower cost. Third, the Malaysian government has been actively involved in creating an efficient price discovery process for Islamic securities through its issuance of Malaysian Islamic Treasury Bills (MITBs) and Government Investment Issues (GIIs), which has led to the establishment of an Islamic benchmark yield curve.

Over the years, Islamic capital market products have garnered universal acceptance as viable alternatives to conventional products. There has been clear evidence of the acceptability of the products to non-Muslims, both issuers and investors. As an indication of the success of Malaysia's Islamic capital market, 49.4% of funds raised in the PDS market in 2004 were through Islamic products. The success of "mainstreaming" Islamic bonds could be replicated internationally, considering the estimated size of the global Islamic financial system and the latent demand for *Shariah*-compliant financial instruments.

Malaysia as an Islamic capital market centre

The CMP also provided a detailed long-term strategy to promote the Islamic capital market in line with Malaysia's core areas of competitive advantage. Recent measures by the authorities have facilitated cross-border issuance and investment of Islamic bonds, including:

- allowing supranationals and multinational corporations to issue MYR bonds;
- allowing investors to invest in foreign securities on exchanges recognised by Bursa Malaysia;
- allowing sophisticated investors to execute secondary trades in non-MYR bonds without SC approval; and
- liberalising the framework for issuance of foreign currency denominated bonds

4. Liberalisation measures

In an effort to further widen the issuer base and diversify credit risks, the foreign exchange administration rules were further liberalised in 2004 to allow supranationals and multinational corporations to issue MYR-denominated bonds in the domestic market. This was a major step forward in attracting international participation and bringing the Malaysian corporate debt market to another level of development.

Efforts proved to be successful, as there were three issues by multilateral development banks within 12 months of the new measures:

- November 2004 - Issuance of MYR 400 million Putra Bonds (fixed rate bonds) by the Asian Development Bank
- December 2004 - Issuance of MYR 500 million Wawasan Bonds (Islamic debt securities) by the International Finance Corporation
- May 2005 - Issuance of MYR 760 million Wawasan Bonds by the International Bank for Reconstruction and Development.

The three issues reflected the maturity and sufficient depth of the Malaysian market as a reliable source of competitively priced funds. The depth of the market also reflected the increase in non-resident holdings of Malaysian PDSs, which was partly attributable to the other measures introduced, whereby withholding tax on non-residents for investment in Islamic PDSs was abolished in 2004 and hedging arrangements by residents and non-residents are allowed for trading of debt securities effective April 2005.

5. Policy issues and challenges

Although the Malaysian corporate bond market has undergone tremendous change and growth over the last decade, several issues and challenges remain. In particular, liquidity in the secondary market needs to improve to a level comparable to that in Malaysian government securities. Other areas that require further development include:

- deepening of the swap market;
- creation of additional risk management tools, eg futures and forwards;
- further diversification of the issuer and investor base;
- enhanced participation by non-residents;
- promotion of larger issue size by corporations; and
- creation of a financial guarantee mechanism to enhance credit ratings.

In addition, the varying stages of bond market development within the region hinder market integration and harmonisation. Regional cooperation organisations, such as APEC, ASEAN+3 and EMEAP Central Banks, will provide an important platform for the further reduction of impediments to cross-border integration. The overall development of the corporate bond market within the region is key because it will create competition enabling issuers and investors to venture into multiple markets in pursuit of better pricing and returns.

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For further information on the Malaysian bond market, please visit:

http://www.bnm.gov.my

http://rmbond.bnm.gov.my

http://fast.bnm.gov.my/fastweb

http://iimm.bnm.gov.my

http://www.sc.com.my

http://www.bondweb.com.my