Mohammad bin Ibrahim: The development of the Malaysian financial markets

Opening remarks by Mr Mohammad bin Ibrahim, Deputy Governor of the Central Bank of Malaysia, at the Persatuan Pasaran Kewangan Malaysia (PPKM) Gala Dinner, Kuala Lumpur, 12 November 2010.

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Allow me to express my thank you to the organizer, Persatuan Pasaran Kewangan Malaysia, in short PPKM, for inviting me to tonight's 2010 PPKM Gala Dinner. It gives me great pleasure to deliver the opening remarks. My address will specifically focus on the development of the Malaysian financial markets. The future of the financial markets is of interest to us all here today.

I am pleased to note the significant progress that the Persatuan has achieved since its establishment in 1973. It has contributed significantly in representing the interest of the dealer community and in providing feedback and developmental ideas on issues relating to the development of the Malaysian financial markets. PPKM also plays an important role as a bridge to the relevant regulatory authorities. The relationship had been productive to the overall development of our financial market. Indeed, through this cooperation, the Malaysian financial markets have come a long way and have grown steadily in size, breadth and depth over the years. This has received acknowledgement in the recent World Economic Forum's overall Financial Development Index (the Index refers to three broad areas: Factors, policies and institutions, Financial intermediation and Financial access), where Malaysia is now ranked 17th, up 5 notches from 22nd place previously. This is a commendable achievement but we still have a lot to do.

As Malaysia moves forward with the economic transformation programme, the demands for the financial sector as enabler, catalyst and driver of growth will increase. The financial sector as a whole is expected to grow in size, from 4.6 times GDP now to 5–6 times GDP by 2020. The significance of financial markets, relative to funds raised through financial intermediaries such as banks, will continue to rise. In meeting the needs of the new high value added economy, our financial sector needs to be developed further and innovative in its approach in order to facilitate higher levels of domestic and international trade and investments. One such innovative approach is the development of a comprehensive and vibrant Islamic financial industry.

It is our aspiration to transform Malaysia as the Islamic Financial Hub. Crucial to the transformation is intensifying of our efforts to further develop the foreign currency markets in Malaysia. In particular, we should seek to capitalise on our competitive advantage in Islamic financial markets and move beyond our previous focus of advisory and promoting primary market issuances and move up to build an end-to-end value chain capability – where we should also focus on secondary market trading, settlement and custody services.

But this aspiration of ours could only be achieved if there is a collaborative effort between the industry and the authorities. One such platform is the Malaysia International Islamic Financial Centre (MIFC) initiative that comprises a community network of the country's financial and market regulators, including Bank Negara Malaysia (Central Bank of Malaysia), Securities Commission Malaysia, Labuan Financial Services Authority and Bursa Malaysia (Kuala Lumpur Stock Exchange); Government ministries and agencies together with industry participation from the banking, takaful, capital market institutions, human capital development institutions and professional services companies which are participating and working collaboratively in the field of Islamic finance. The creation of International Islamic Liquidity Management Corporation (IILM) recently was the outcome of the High Level Taskforce on Liquidity Management that was formed by the Islamic Financial Services Board (IFSB). It is a collaborative effort to develop a liquidity framework that can provide widely acceptable liquidity solutions to Islamic financial institutions, to promote better liquidity management. IILM will be an issuer of Shariah compliant financial instruments that are highly liquid and tradable in the secondary financial market. This is an important infrastructure capacity building since it would expand the scope of business for Islamic finance globally and was achieved through collaborative effort.

Another initiative is the creation of a Sukuk Investment Fund – foreign currency funds to be disbursed to selected Islamic Fund Management Companies (IFMCs) to invest primarily in foreign currency sukuk issued out of Malaysia. The Fund would support the proliferation on the buy side for the issuance of sukuk out of Malaysia, besides providing a platform for the Islamic fund management industry, including start-ups to build their track record in managing foreign currencies fund denominated. Complementary to this initiative is the creation of a Malaysian-based sukuk index for foreign currency and also an extension of our domestic settlement capabilities to include foreign currency securities.

This is the moment when we need the cooperation from the private sector in support of government's measures to generate business and to stimulate the economic growth. There are enormous opportunities for the industry to benefit from these initiatives.

The strengthening and the transformation of the financial sector contributed by financial deregulation, opening of markets and integration have created a more competitive environment. In aligning to the rapidly changing and increasingly challenging global environment with significant growth in world trade and enhanced international linkages with global economies, the foreign exchange administration (FEA) rules have been progressively liberalized to promote flexibility and competitiveness of the economy while safeguarding monetary and financial stability.

The philosophy on the liberalisation of the foreign exchange administration rules takes into account the readiness of the economy which includes sound macroeconomic fundamentals and prudent fiscal policy, a well diversified financial market with sound and stable financial system that is able to withstand external shocks, liquid and efficient capital market and healthy balance of payments position that is supported by an effective and well functioning surveillance mechanism. The country's improved economic fundamentals and the resilient financial system have enabled the gradual pace of liberalisation of the FEA rules since 2003.

A fact that is often over looked is that, during the recent crisis, contrary to actions undertaken by many, Malaysia had further liberalized the FEA rules to promote greater efficiency in the conduct of international trade, promote a conducive business environment and to allow the use of domestic currency in the settlement of trade with the country's major trading partners. This is a timely measure, given the country's strong linkages with the global and regional economies in particular, the Asian economies.

The various measures put in place by the authorities have enabled Malaysia to be ranked as the Top 10 most competitive nation in the World Economic Report by IMD, Switzerland. On ease of doing business, FEA's ranking had also improved significantly from 13th (which is one of the most problematic) in 2005/2006 to 2nd place (easiest for doing business) in 2009/2010 reflecting partly the stakeholders' positive assessment on FEA to support the conduct of business in Malaysia. The country's easy and facilitative regulatory environment including FEA rules, had also contributed to Malaysia's recent upgrading from a "Secondary Emerging Market" to a "Advanced Emerging Market" status in the FTSE's Country Classification Index, hence the potential increase in non-residents' investments in Malaysia following the increase in Malaysia's weightage in the index from the current level of 2.41% by June 2011.

In spite of the above and based on our interactions with some of you, there remain a lot of myths and misconceptions on Malaysia's FEA rules, even amongst the banking fraternity. It is my hope that I am able to dispel these misperceptions surrounding Malaysia's FEA rules specifically on activities that can be undertaken by non-residents for investments in Malaysia.

It is also my hope that you will make the effort to convey this message to your colleagues, clients and international counterparts.

Let me now share with you five of the misconceptions

Myth 1: FEA rules are restrictive

We recognized that for an investor, capital mobility is important. Malaysia has always ensured that the rules are not restrictive to capital flows or do not penalise investors who contribute to the development of the country. Today, ***non-residents*** are ***free to transfer their funds into Malaysia for investments*** in any type of ringgit assets and also **remit out *of Malaysia, all income as well as proceeds from the divestments*** of these ringgit assets in foreign currency. Also, there is no levy imposed.

Myth 2: FEA rules are restrictive on non-residents to manage risk on investments in Malaysia

Apart from free capital mobility, the ability to manage risks of investments is equally essential for an investor. In recognizing this need, the current FEA rules freely allows non-residents ***to hedge ringgit exposures*** of their investments in ringgit assets with the onshore banks supported by underlying commitment. Such transactions can be settled on gross or net basis and there is also no restriction on the minimum tenure of the hedge.

Myth 3: FEA rules are restrictive on non-ringgit transactions undertaken onshore by non-residents

Non-residents are free to undertake any type of non-ringgit transactions with the onshore banks. They are also free to open any number of foreign currency accounts with the onshore banks with no limits imposed on the maintenance of funds in these accounts. Funds in these accounts are also free to be remitted abroad.

Myth 4: FEA rules are restrictive on accessibility to onshore financing by non-residents

There has never been any restrictions on the accessibility to ***foreign currency financing*** by non-residents from onshore banks. They are free to borrow any amount in foreign currency from the onshore banks as well as from non-banks residents which do not have any domestic ringgit borrowing. For prudential purposes and for efficient allocation of domestic resources, limits are currently only applicable on foreign currency lending by resident lenders which have domestic ringgit borrowing and are converting ringgit into foreign currency for the lending.

With the progressive liberalisation of the FEA rules, non-residents are also free to obtain any amount of ***ringgit financing*** from the onshore banks and non-bank residents to finance real sector activities and for purchase of immovable properties in Malaysia. In line with Malaysia's aspiration to be a leading international Islamic financial hub, flexibility is granted for non-residents to raise ringgit through issuance of sukuk in Malaysia as part efforts to attract higher level of foreign participation and promote diversity of market players and products in the Malaysian Islamic financial markets. The sukuk market now accounts for more than fifty percent of our bond market and has drawn participation from a wide range of international corporations and multilateral agencies in raising funds and investing in sukuk issuances out of Malaysia.

Myth 5: FEA rules are restrictive on accessibility to ringgit offshore by foreign investors for settlement of their investments in Malaysia

Many may not have realised that since 2007, non-residents have been allowed to access ringgit offshore through any appointed overseas branches within the same banking group of the onshore banks to purchase or sell ringgit on a spot or forward basis based on firm underlying commitment for investments in ringgit assets. This was to maximise the potential and seamless opportunities through the widening of international investors' participation into the Malaysian capital market. As onshore banks, you should capitalise on these opportunities to reap the benefits and at the same time, contribute to the enhancement in the development of the domestic financial market. These FEA rules were also designed to facilitate investment by foreign companies into the real sector. It is our intention that the FEA rules will facilitate and ease foreign investment into the country.

I will conclude by extending my appreciation to the organizing committee for extending me the invitation to this dinner. I wish you a very pleasant and enjoyable evening, and look forward to further strengthening the mutually beneficial relationship between Bank Negara Malaysia and the Persatuan.

Thank you.