Muhammad bin Ibrahim: Insights from the financial market in 2015, expectation and direction going forward

Opening speech by Mr Muhammad bin Ibrahim, Deputy Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Annual Dinner of Persatuan Pasaran Kewangan Malaysia (PPKM), Kuala Lumpur, 13 November 2015.

*   *   *

This annual dinner is an important event for it presents an opportunity for us and the market to reflect upon all the challenges in the financial market, and draw lessons as we move into the new operating year.

The year 2015 has been a very interesting year for all of us here, industry players and regulators alike. During the year, we witnessed significant capital outflows as markets responded to the global economic developments. In particular, every commentary or data release hinting at policy normalization in the US was met with gyrations in financial markets. Emerging currencies, felt the brunt of such volatility, especially commodity exporting countries given the significant decline in commodity and energy prices and moderation in growth for the China's economy. For Malaysia, we saw ringgit weakened as much as 18%, while in the bond market, we saw relative stability even though yields went up by 30 to 50 bps given by the negative sentiment in the domestic and global markets.

Insights from the financial market in 2015

In the midst of all the global economic uncertainty and financial market volatility, I would like to highlight some observations and comments.

Our currency, the ringgit, has been subjected of market volatility throughout this episode of global economic uncertainty. While most emerging markets currencies depreciated following the reversal of capital flows, the extent of ringgit weakness has gone beyond fundamentals and rational thinking. While market liquidity remains sufficient, on certain days, FX spreads have widened to 100 pips in the interbank market, and led to spikes in the movements of the ringgit exchange rate. Market volatility has almost doubled from around 8% to 14–15%.

I believe that the recent adverse market conditions with thin liquidity in the FX market have been exacerbated by irrational market behavior and risk aversion. In the current market environment, our own analysis has revealed that the higher interbank volume and the higher market volatility were due to this risk aversion. A small client's order gets passed around among interbank players like a "hot potato", and the exchange rates move each time it changes hand. These irrational behaviors have significant repercussions on the real sector of the economy. Banks, fearing rapid movement in the ringgit, quoted widen spreads to corporates and this gets amplified when corporates themselves get increasingly nervous and rush to fulfill their foreign currency requirements. As a result, trades in small volume can lead to a disproportionate impact on the exchange rate. This is in contrast to Malaysia's strong economic fundamentals, steady and sustained growth, high level of international reserves, low unemployment and a resilient and diversified financial system, etc.

Given the strong data, this is not what and how a developed market should behave as there is ample FX market liquidity.

If we look at the recent daily volume of FX trade, although lower than last year, it was still double the amount 5 years ago, between USD5-6 billion for the USD/MYR pair and between USD8-10 billion for all other currency pairs. What we need to do now is to remind ourselves and each other constantly that we need to put things in proper perspective. As a group, we constitute the market and individuals, we should behave responsibly.

On the other hand, despite the adverse market conditions, we noted that the Malaysian bond market has been holding up quite well despite lower level of liquidity, thanks to domestic institutional players' support. Nevertheless, we also realized that significant foreign participation in our financial market can be both a boon and a bane for the industry. While high foreign participation has led to better liquidity and lower cost as what we have experienced in the past, it has also brought risks and vulnerabilities. The percentage of non-resident holdings itself has evolved into a risk indicator, regularly quoted by market commentators, where 48% is the number frequently quoted as the percentage of non-resident government security holdings. There was also the argument that large holdings by non-residents might leads to sell offs during period uncertainty, thus causing financial market instability. This is erroneous and misleading. In fact, non-residents only hold 29% of government securities which should include the Sukuk or MGII. Furthermore, most of the outflows by non-residents arise from the sale of short-term bonds associated with short-term views while investors of Malaysia's long-term bonds have remained steadfast in their investment holdings. We also observe since October 2015 the non-resident portfolio flows has becomes positive.

In 2015, as part of our effort to improve transparency, we have embarked on an initiative to gather statistics on the ultimate beneficiary owners of Malaysian bonds and sukuks to give the market a clearer picture on the types and behavior of investors in our market. Preliminary data showed that of the total non-resident holders of Malaysian debt securities, 70–80% were stable long-term investors while the remaining minority was short-term investors. We are now looking at measures on how we can enhance the disclosure requirements of our bond holdings to be even more transparent so that our financial market would be on par if not better than the best practices adopted by advanced markets.

Over the years, we have liberalized the foreign exchange administrative rules to promote competitiveness and reduce cost of doing business, attract foreign investors and create business opportunities for our local players. Ringgit bonds were allowed to be traded freely offshore, with some restrictions placed on ringgit funding and FX derivatives markets to contain speculation, with the aim to ensure financial stability. An unintended consequence of this liberalization was the emergence of offshore transactions relating to Ringgit such as NDF and NDIRS. BIS estimates that the average daily MYR forwards traded offshore is 4 times the amount onshore. This should not be the case as MYR is not an internationalized currency, and that all forwards should be backed by firm trade transactions.

Given the sizeable volume and the opaque nature of such markets, I cannot help but ask: "What are we missing here? Who are the players in the ND markets? Are they hedging or speculating? "

Is it the lack of capacity of our local players to serve certain players? Or is it that the local regulatory and operating environment needs to be adjusted? These gaps should be identified and remedies formulated as the offshore market represents a loss of business opportunity for the onshore players. Fundamentally since the transactions are related to Ringgit, its activities should be captured onshore and transacted through the onshore market players. Ringgit exchange rate should be determined by onshore players, reflecting the underlying demand and supply of foreign currencies in the economy. It should not be dictated by any market other than Kuala Lumpur.

Expectation and direction going forward

As 2015 draws to a close, let us not allow the increasing challenges to stop us from advancing forward. Volatility is not likely to go away any time soon. It would be the norm. A new normal. Let us persevere, learn from the past and as a group forge ahead into the future. It is appropriate to have a retrospective here.

First, given the unpredictable and dynamic nature of the financial market, there is urgency for us to keep our fingers on the pulse of the market and have access to real time information.

There is much scope for cooperation between the central bank and industry players in this area. In addition to being familiar and observance of the rules and regulations of the financial market, we expect market participants to know the details of their clients' transactions to aid us in understanding the nature of the market conditions.

Everyone has an important role to play in maintaining the stability of the market and remain vigilant on all financial market activities. This is necessary to prevent activities that could threaten financial stability and create unnecessary volatility, or incidents that could damage the integrity of our domestic financial market.

Secondly, while I'm on the topic of enhancement of market stability and integrity, I should stress on the importance of upholding individual ethics and professional conduct. The market is made up of individuals including institutions. The glue that binds individuals and institutions that constitute the market is TRUST. A case in point, on rate rigging, several global banks paid hefty fines to regulatory authorities because of individuals rogue traders. Many dealers were convicted of wrong doings, and investors are still taking lawsuits against the banks. TRUST was violated. While no Malaysian dealers were caught red handed in market misconduct, we should not be complacent. In any financial market, misconduct is often driven by greed and greed is something no system could be tempered proof. Greed creates mistrust. And mistrust damages confidence. But greed can be mitigated. This can be achieved by establishing a system of consequence management. It is certainly possible to limit or mitigate cases of greed if as a collective, we would not tolerate any case of wrong doing within our community. As a group, we should expect individuals to behave according to the highest professional standards and held accountable for their actions. On this aspect, PPKM had instituted a mechanism to prevent staff with questionable conduct from moving freely between banks without full disclosure of his or her professional history. It is in the interest of the industry that PPKM continue the role as a gatekeeper in setting professional standard with a view to uphold the highest standard of professionalism and conduct among its members.

And, this brings me to a third point, we need to enhance market participant's professional qualification, knowledge and skill set. Financial market is dynamic and evolving, and players need to keep abreast of both domestic and global developments. There are ample financial market courses and programmes offered here in Kuala Lumpur, however majority of these program are still at entry level courses. PPKM together with the Asian Institute of Chartered Bankers will cooperate in the future to develop a series of high quality, advanced level financial market forums and seminars, thus creating a platform to expand network, develop expertise and to advance the Malaysian financial market community to another level of professional and technical excellence.

Fourth, technology has become a crucial enabler in the financial industry as it continues to provide benefits by reducing financial transaction cost and enhancing trade execution efficiency. We need to embrace new technology, such as electronic platform. Technology also greatly facilitates market surveillance and transparency by offering real-time information. This is particularly critical in a fast moving market, where delay in information mean loss of opportunities for banks, and delay in taking action to stabilise market. The need for real-time information in a fast moving market is urgent. For instance, trades that are still being concluded through traditional voice broking and conversational dealing screens are already obsolete in developed markets.

Technological advancement requires behavioral change

As we move forward, financial market participants who rely on the traditional ways for dealing and communicating, they must relook at how they strategize their business to remain relevant in this era of rapid technological innovation. If we fail to change, the consequence is obvious, loss of business and demise of your business.

Fifth is the trend towards further regional integration. With the implementation on ASEAN Banking Integration Framework, regional markets will be more integrated. Domestic financial institutions must be ready and becomes an active player in the ASEAN economic integration process. On this issue BNM has started investing our international reserves in the regional financial markets, and increasingly a large portion of our reserve management business was being done with Malaysian financial institutions. With this mandate, we hope that Malaysian banks can play a greater role and expand their business by improving regional expertise and reach. Central to this is capacity building as more regional business opportunities will be accessible once we have the capability to offer cross border financial products and services. In this regard, for strategic positioning and to ensure long-term competitiveness, Malaysian banks operating across borders, should position themselves to be the first port of call for foreign investors who are considering to do business in this region.

In line with the objective of supporting regional integration, Bank Negara Malaysia has recently signed a Memorandum of Understanding (MOU) with the Bank of Thailand to promote the use of Malaysian ringgit and Thai baht by the private sector to settle cross-border trades and direct investment. The cooperation is motivated by the strong trade relationship between the two countries. We expect Malaysia-Thailand trade links to reach RM100 billion in 2015.

While the US dollar is still the dominant trade settlement currency, the THB and MYR are second and third most used currency by Malaysians and Thais – indicating potential for greater acceptance to settle trade in domestic currencies.

The framework we are developing with the Bank of Thailand contains key features which include the appointment of selected financial institutions in Malaysia and Thailand to facilitate local currency settlement. These financial institutions will be accorded certain foreign exchange administration flexibilities. If the initiative proves successful, we plan to expand the framework to other ASEAN trade partners as well.

Conclusion

As we keep our eyes firmly on the future, a humble reflection on the past and honestly looking at our short comings would certainly lead us to a brighter future. Financial markets should continue to play its intermediary role for the purpose of funding to the real economy, efficiently allocate capital where it is needed and assist economic agents to manage financial risks associated with investments, production and trade. These should always remain our core objectives.

I also wish to congratulate PPKM on your achievements this year and the successful organisation of this event. May tonight's dinner, themed "Friday Night Fever", be a night of joy for all of us today.

Thank you.