Muhammad bin Ibrahim: Financial markets and the ringgit - our journey forward

Opening remarks by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Financial Market Association (PPKM) Annual Dinner "Financial Markets and the Ringgit: Our Journey Forward", Kuala Lumpur, 18 November 2016.

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It is my great pleasure to address the members of the financial market industry at the Financial Market Association of Malaysia's annual dinner. This dinner regularly held towards the end of the year, has developed its own unique tradition and camaraderie.

Another year is passing by and we find ourselves in a very familiar situation; heightened volatility and uncertainty, low growth and low interest rates. The specificities or circumstances behind these may be different and indeed some of these developments were considered highly unexpected or even irrational. Hindsight, which gives us 20/20 vision, does not necessarily provide us with a better understanding. The global markets continue to be imbued with financial market and policy uncertainties. To add to this, are the evolving geopolitical uncertainties and challenges arising from Brexit and the impending changes following the recently concluded US presidential elections. 2016 is turning out to be a year of many surprises, something that policy makers tend to be uneasy with. I hope 2017 will bring less of these, but then for financial market players, surprises, volatilities and uncertainties are not totally undesirable as they also bring along lucrative trading opportunities.

For the ringgit exchange rate market, the past two years have been uniquely challenging. At the end of 2014, the situation appeared rather benign. The ringgit was stable, market liquidity was good, trading activity was healthy with market volumes averaging USD11.8 billion daily while the volume for USD/MYR pair averaged USD8.3 billion in 2014. The subsequent period however, precipitated by the weakening external conditions, falling oil prices and domestic uncertainties have laid bare these notions. Volume and liquidity declined, bid-offer spreads widened and at times, there were one-way markets which exacerbated any movements. Given these developments, 2015 was a year where our actions were primarily geared towards stabilizing the markets. While this was clearly achieved, it was not without cost; a reduction in foreign exchange reserves, a markedly less liquid and volatile foreign exchange market, and a weaker currency. In the midst of this, an important observation that became increasingly evident is the continued vulnerability of our markets to the arbitrary and unpredictable devices of the offshore markets.

Adverse conditions brought on by the NDF market

Activities in the offshore market, in particular the ringgit non-deliverable forward (NDF) market, had brought on observable adverse impacts to the onshore market. To our disappointment, onshore players had become followers rather than leaders in determining domestic market rates. Consequently, taking the lead from the NDF market, the ringgit exchange rate has been quite volatile since last year, peaking at 23.1% for its 1-month historical volatility and is the highest among regional currencies for this year. Of late, it has been trending down, but the average volatility remains high at 10.1% compared to its 5-year average of 8.2%.

On a day-to-day basis, the ringgit was also volatile, particularly prior to the USD/MYR fixing time even though it can be quiet throughout the rest of the day. As trade related FX transactions are done throughout the day, it is highly perplexing as to why trading activities and observed volatility have to be concentrated just prior to the fixing time. The only plausible reason for the above phenomena is that it emanates from the fixing orders from non-resident financial institutions

(NRFI), the transactions of which are driven by NDF market activities. As NDF is settled using fixing rate, NRFI have been using fixing orders to square their offshore NDF positions. As a consequence of such speculative activities, the ringgit fixing rate has significantly diverged from the onshore traded ringgit prices. The ringgit fixing rate was clearly out of sync with real trades and investment activities done throughout the day.

The impact of NDF market volatility has been clearly pervasive in the onshore market. Several FX traders in the domestic market were observed to be looking towards the NDF market to provide cues in determining the opening market price for ringgit. And this behaviour continues throughout the day in the pricing of the ringgit. Unfortunately, our media and public were also drawn into taking the lead from these offshore rates as well. The sum effect of these behaviours is that we inadvertently imported the NDF volatility into the onshore market. Given the importance of this, let me dwell a little further on the dynamics of the situation.

The offshore market, which is driven by speculative interest, lacks the onshore market's diverse spectrum of market participants and information. This was notably mentioned by the Federal Reserve Bank of New York paper in May 2005, that an estimated 60 to 80 percent of NDF volume is generated by speculative interest. Because of this, NDF tends to promote herd behavior which compounds the lack of two-way market liquidity. Prices may move rapidly in one direction or another driven purely by fickle sentiment, as well as leveraged positions taken on by the speculators, making them inherently unsuitable to represent an efficient and objective price discovery process for the ringgit. Compounding this further, the offshore NDF markets are highly opaque and information on these markets can only be gleaned through the BIS' triennial survey and other sources such as through mandatory reporting of derivatives and swap data repositories on US financial institutions.

Actions by BNM/the market

With increasing concern over the offshore market negative spill-over impacts, BNM has taken a broad spectrum of actions to reduce the speculative and damaging influence of NDF activities. Because of the estimated volume and its opaqueness, the NDF market clearly has the potential to undermine the integrity and financial stability of the onshore market. BNM has the responsibility to ensure orderly functioning of the foreign exchange market and to maintain public confidence in the financial system. We have, over the years, taken proactive actions to slowly root out the speculative elements in the onshore market.

From end 2014, we have significantly reduced the availability of short-term central bank papers that were used for short-term investments that support the NDF market and speculation on the ringgit. Such actions were taken despite our cognisance that such papers provide an efficient liquidity management instrument to our own market players. But increasingly, over the years, it had become an instrument of choice in facilitating the speculative flows. Holding of these papers had been dominated by the NRFI. At one time, as much as 96 percent of our BNM short term papers were held by NRFI. The yields on these papers have consistently trended below the policy rate showing the extent of speculative elements, which would not happen under normal circumstances. Consequently, we no longer issue these papers on a regular basis.

In 2015, to ensure a more reflective pricing mechanism of the domestic market, a more direct attempt to cut off the pricing linkage between onshore and the offshore market was made. Banks were prohibited to quote fixing orders to NRFI that do not have firm underlying trade commitments. As NDF is settled offshore based on ringgit fixing rate, the prohibition ultimately raised the basis risk, and financial cost, of hedging NDF transactions in the onshore market. While this measure may appear harsh, it has worked to some extent to reduce the NDF related flows into the onshore financial market.

In mid-2016, following extensive discussions with financial market players through the FMA, we reviewed the ringgit fixing mechanism to enhance its integrity. The new fixing, now known as KL

USD/MYR reference rate, uses transaction data in the determination of the reference rate.

While it enhances the credibility of the fixing mechanism, the new methodology has also greatly reduced the ability of the offshore NDF related transactions to capitalize on the reference rate process. The initiative, which was implemented smoothly with positive market response, also had the desired outcome in further reducing the volume of ringgit speculative flows.

Throughout the year, we have also strengthened our monitoring of compliance to the existing Foreign Exchange Administration (FEA) rules. FIs have been strongly reminded to be cautious in facilitating FX transactions, particularly with NRFI, to ensure that they do not become unwitting facilitators of ringgit speculative activities. Accordingly, we expect banks to conduct robust due diligence and Know-Your-Customer (KYC) process to fully understand clients' transactions. We believe that the enhancement of such processes will enable banks to detect transactions that could be related to NDF activities in ringgit. Prompt supervisory intervention will be taken against any individuals and banking institutions that are found to facilitate NDF market activities.

Another area which we looked at was the exchange traded ringgit products in the offshore markets. As part of our policy of non-internationalization of ringgit, we prohibited the trading of ringgit assets and products outside of our jurisdiction. It undoubtedly the opaque pricing mechanism has adverse impact on the domestic financial market, price discovery process and the stability of the financial market.

Accordingly, when there were reports of ringgit futures contracts being introduced on offshore exchanges, we issued reminders to onshore financial institutions and corporations against participating in them. The prohibition also encompassed engaging in any onshore FX transaction with non-residents that could be deemed as facilitating offshore ringgit transactions. These rules are not new but have been there all this while.

We also instituted several measures this week as volatility also picked up sharply after the US Presidential election result. Because of adverse consequences on genuine investors and businesses, we should no longer tolerate the NDF market and its damaging influence over the onshore pricing of ringgit.

Let me make it doubly clear on this. Onshore banks are reminded against quoting onshore ringgit opening price referencing to the offshore prices. Markets should not price ringgit excessively or out of sync with the underlying fundamentals. We have also reminded onshore banks to avoid dealing in FX with non-resident banks suspected of engaging in NDF speculative activities except for those that provide confirmation of their non-involvement in the offshore ringgit NDF market. This week has seen many noises surrounding these measures. There is no new policy on capital flows.

There is no proxy capital control either. In fact, Malaysia's capital account remains free with free mobility of inflows and outflows of capital for investments. The market remains open to all market participants and we shall ensure the necessary liquidity to the market.

In essence, the measures that were instituted over the past week are consistent with our long standing policy of non-internationalisation of the ringgit and one that we expect banks to fully adhere to without exception. We do not recognize or condone the non-deliverable ringgit offshore market. Those who engage in NDF or NDF-related transactions are doing so at their own peril.

I understand that to some, these are challenging measures but as I mentioned earlier, they are not new. We need to remove the negative influence of the NDF activities that impacts the smooth functioning and stability of the onshore financial market. We need to protect the interest of genuine investors and businesses, irrespective of whether they are foreign or domestic. Only through a concerted effort by all the stakeholders of the ringgit market, can this objective be achieved. We need to remember, that integrity and proper functioning of our financial market is in the interest of every market participant, and all of us have a role to play towards achieving this objective.

Way forward

To overcome these challenges and to take on new direction and impetus, we had formed the Financial Market Committee (FMC) earlier this year. Besides tackling the various issues, risks and challenges of navigating these uncertain and volatile times, the FMC has been mandated to formulate and propose strategies to take the financial market development forward. I would like to thank the members of the Financial Market Committee and industry association representatives for collaborating with us for the common and greater good of market development.

The FMC and its subcommittees have met several times. Some of the initiatives have already been rolled out; such as the extending of trading hours for the FX market and the KL USD/MYR reference rate. Some are going through the woodworks of development. I would like to discuss a few here.

1. We are embarking on a progressive journey of a more liberalized and conducive financial market operating environment. As a concrete step, I would like to announce the introduction of a pilot program for the USD/MYR and CNH/MYR markets. Under this program, residents will be allowed to undertake hedging transaction for USD and CNH against ringgit without the need for sighting of the underlying documents. Subject to a position limit, only a declaration by the customers will be sufficient. Accordingly, cancellation of the hedging will also be freely allowed.
2. To further complement this, the Bank is also currently working with the Securities Commission and Bursa Malaysia to facilitate the introduction of USD and CNH against Ringgit futures for the onshore exchange. Similar to the interbank market, these will, for now, be subjected to position limits, and for now only applicable to residents. We shall review this policy from time to time, with a view to further liberalise the rules.
3. The Financial Market Committee (FMC), through an industry-driven effort, is in the final stages of rolling out an operational framework for Foreign Exchange Administration (FEA) compliance. This will be an industry standard that sets the minimum due diligence and list of documents required for FEA. Further to this, a standard summary of the relevant FEA rules to facilitate common understanding and consistent interpretation among market participants is being formulated. It is expected, through this important initiative, there would be better clarity and greater efficiency for the financial institutions and their customers, in undertaking FX and hedging transactions.

Taken together, these three measures are targeted at residents such as the Small and Medium Enterprises with a view to expand their access to hedge freely and directly with onshore banks. This flexibility will provide the avenue for simplified processes and flexible hedging activities within prudential limits and incentivise residents to use onshore banks for their hedging needs.

These are but first steps. We will be looking at further measures, similar to these. The idea behind these measures is to make our onshore financial market more flexible, facilitative and competitive. In other words, we are deepening the onshore markets towards becoming the main actor to conduct the foreign exchange needs of our economy. This journey will be exciting and require some behavioural changes. But we have no doubt that with the full support of the industry, we can achieve these outcomes.

I envisage the FMC and the industry to further collaborate and come up with the new strategies and ideas to deepen and support the development of our onshore market. Beyond trade or real sector activities, we should look at financial investments, in particular the non-resident investors in our bond market. We have 33.7% of our Government bond market held by such investors. There are opportunities in this domain.

Where are they hedging their foreign exchange exposures? What product can the industry offer for them to hedge onshore? Given these obvious opportunities, we need to develop solutions that will benefit the industry as a whole.

The significant overseas investments by residents and foreign currency exposures arising from trade activities create a need for the domestic hedging market to be further deepened. In 2015, FX market transactions volume reached a staggering USD2.52 trillion, yet currency derivatives such as FX forwards and options only made up 5 and 1 percent of the total volume, respectively. Similar concerns also exist for the bond market. Both government and corporate bonds are still primarily held by residents, and we have one of the largest corporate bond markets in the region. Yet, this does not translate into the development of active hedging market activities. Credit derivatives made up less than 1 percent of ringgit derivatives volume in 2015. This prompts several questions. Are our investors able to hedge effectively or efficiently manage the exposures of their portfolios? What instruments are on offer or traded in our markets that can serve as such tools? What are the policy changes that require rethinking to enable us to develop a deep and liquid hedging market? These are all issues that the FMC will deliberate and offer solutions.

We all share the aspiration for our onshore financial market to become a highly competitive market. Not just the foreign exchange market but across all its market segments; money, interbank, bond and the derivatives markets. A market where pricing of ringgit assets are fully determined by a robust price discovery process onshore, driven by real trades and non-speculative investment activities.

We envision a financial market, where it has the breadth to cater to increasingly sophisticated needs of diverse market participants, going beyond trade and financing towards facilitating more effective and efficient risk management activities. A financial market, where it also has the depth to sustain and face any volatility in the market. A financial market, that has ample liquidity across different instruments in all market segments, and extends beyond the ringgit, to the point where it can anchor regional trades and investment activities. Ultimately, we want our onshore financial market to be the market of choice for all market participants, including non-residents, to meet all their financial needs.

Before I end my speech, I would like to announce an award that will be presented to a leading derivative bank at the next annual PPKM dinner. The rationale is to give public recognition to an institution that contributes towards raising the volume and value of transactions in the FX derivatives market.

Last but not least, let me take this opportunity to congratulate the FMA on its accomplishments this year. FMA recently signed a collaboration agreement with the Asian Institute of Chartered Bankers and Asian Business School that would contribute towards enhancing the integrity, ethical standards and professionalism of market participants. FMA certainly has been an important driver and partner to bring the financial market development to a higher level. And organizing this annual event is also one of its perennial successes. On this note, I wish tonight’s dinner will be an occasion for us to enjoy and cherish.