

The Development of a Corporate Bond Market: The Malaysian Experience

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The development of a corporate bond market is a key strategic priority for capital market development in Malaysia. Although the government has made significant strides in this direction since 1990, the development of the corporate bond market still has some way to go. The need to continue developing the Malaysian corporate bond market was further emphasized by certain weaknesses in the financial system highlighted during the recent Asian economic crisis. Nevertheless, there are some useful insights that can be gained from Malaysia's experience, by looking at the historic role of the bond markets in financing Malaysia's economic growth, the development efforts so far, the present structure of the corporate bond market, and some of the key issues that still need to be addressed.

Malaysia has experienced tremendous economic growth in the past decade, averaging 7% or more, despite the effects of the 1997-1998 Asian crisis. Over this last decade, the economy has shifted from a principally agricultural base to a manufacturing base. Some aspects of this growth are particularly noteworthy. There has been a

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strong pro-business environment. The government of Malaysia also initiated policies to ensure that most of the funding for economic growth was carried out by the private sector in line with its privatization efforts in the 1980s. Malaysia has had considerable infrastructure development needs, which require more long-term financing. Projects such as the Kuala Lumpur International Airport and the North-South Expressway, among others, have provided a strong impetus to the market. As a result of these policies, as well as the recent infrastructure development efforts, Malaysia's financing needs have risen sharply. According to the Seventh Malaysian Plan for the period 1996–2000, long-term financing needs are around US\$140 billion. Although a substantial amount of these financing needs had been funded by bank loans, the corporate bond market also began to play an increasing role, growing from 1.5 billion ringgit of private debt securities outstanding in 1989 to approximately 47 billion ringgit in 1997.

Furthermore, liberalization of the financial markets, which ensured the diversification of funding sources, as well as Malaysia's high savings rate, which has averaged above 40% of GDP for the last few years, have provided additional catalysts for the significant growth of the corporate bond market during this period. Therefore it is important to note that the need to develop the bond market has always been recognized by the government, and the growth over the last decade can, in fact, be traced to the Malaysian government's strong strategic push for the market's development.

One of the specific steps taken to develop the bond market during this period focused on the regulatory framework. The central bank introduced basic guidelines on the issuance and trading of corporate bonds, as well as criteria to be used in evaluation of corporate bond proposals. These issuance guidelines provided a degree of transparency and certainty to the market at the initial stage of the market's development. In addition, several amendments were made to legislation to encourage greater investor participation, such as allowing unit trusts to invest in bonds with a BBB rating and insurance companies to invest in unsecured bonds with an A or P2 rating. Another key development was the incorporation of Cagamas Berhad (the Malaysian National Mortgage Corporation) by the Malaysian government in December 1986 with the objective of pro-

moting the development of a secondary market in Malaysia by purchasing mortgages from primary lenders and issuing debt securities. Cagamas began operations in October 1987 with a purchase of RM120 million in housing loans from commercial banks and the issue of RM100 million of mortgage loans.

Another notable effort was the establishment of the Rating Agency of Malaysia (RAM) in 1990, to provide an expert and independent view of the credit quality of private debt securities (PDS). The rating agency was set up as a private limited company with equity participation by the financial institutions in the country. This was followed by the establishment of a second rating agency, the Malaysian Rating Corporation (MARC) in 1995. In addition, from 1996 all unlisted PDS issues were made scripless and trade through the electronic inter-bank funds transfer and scripless book-entry system (SPEEDS), a computerized scripless securities trading system operated by the central bank. This made the secondary market trading environment for unlisted corporate bonds more efficient.

One significant development in terms of benchmark securities was the issuance of Khazanah bonds. As Malaysia moved towards a diminishing government deficit financing requirement, there was a fall in the level of government securities being issued. This lack of supply became a concern to the government in its attempts to sustain an efficient benchmark yield curve. Khazanah is the Malaysian government's investment corporation, and these bonds were designed to provide an alternative to Malaysian government securities as the benchmark bond. The Khazanah bond was introduced in 1997 to provide a regular issue of paper along the lines of the successful exchange fund notes issued by the Hong Kong Monetary Authority, which provide a good benchmark proxy for bond issues in Hong Kong.

Furthermore, in an effort to enhance secondary market transparency, a Bond Information and Dissemination System (BIDS) was established in October 1997, which allowed a range of market price information to become available to market participants. On the fiscal side, efforts focused on reducing the transaction costs of investing in these markets. A key issue that emerged was the level of stamp duty on the issuance of corporate bonds. There was a waiver for Malaysian government securities, but a similar waiver did not

exist for corporate bonds. By way of a fiscal incentive, the government extended the waiver to corporate bonds: a tax exemption was given for the interest earned by individuals on corporate bonds listed on stock exchanges; in 1993 nonlisted bonds also became subject to the exemption, as long as they were rated by the rating agency. As a further incentive, some exemptions were granted for income received by unit-trust and closed-end funds.

Credit-risk issues were examined also. In 1991–92, a compulsory system of rating bonds was introduced. Investment grade requirements were established for issuers to ensure that paper coming into the market was of high quality. In addition, the government decided that ratings for bank-guaranteed issues should reflect ratings of individual guarantor banks. However, although the investment grade restriction, for instance, worked well in the initial stages of bond market development, it may be having an adverse effect on the diversity and supply of paper today. Malaysia is therefore looking closely at allowing non-investment grade paper onto the market in the future. Although the market has seen some growth and various initiatives have been introduced, the corporate bond market still has some way to go to match the average financing profile of developed countries. This can be seen from the composition of the financial markets in 1998: the equity market accounted for about 134% of GDP, banking about 160% of GDP, and the bond market, particularly the corporate bond market, only about 25% of GDP.

The Asian crisis certainly helped to further focus attention on the underdevelopment of bond markets. Over-reliance on the banking sector brought tremendous strains because of exposure to potential credit withdrawals. Maturity mismatches created another problem. The limited opportunity to diversify portfolio risk arguably aggravated capital flight. These difficulties created a further impetus and prompted the Malaysian government to push ahead with greater urgency towards the development of the bond markets.

In order to appreciate the relevance of initiatives to be taken to develop the corporate bond market in the future, it is essential to understand the current structure of the market today. In terms of the regulatory structure, several authorities play a role in the issuance process for listed bonds. First, the central bank evaluates issuance proposals based on a set of PDS guidelines as well as for monetary

policy concerns. Second, the Securities Commission is involved in evaluating the issuance of listed bonds from a disclosure and utilization of proceeds perspective. Third, Malaysia still has a registrar of companies looking at prospectus content issues. Fourth, the rating agencies have to rate issues to ascertain whether they meet investment grade requirements. Fifth, the stock exchange also comes into the picture for listed bonds with its listing guidelines. All these institutions create a regulatory structure that is quite fragmented and cumbersome to the issuer. As a result, it can take four to six months for a corporate bond to become listed on the stock exchange.

The secondary bond market structure today can be divided into the unlisted, over-the counter (OTC) market, which is run by the central bank, and the listed exchange-traded market which is regulated by the Securities Commission. It should be noted that the unlisted corporate bond market is much more active than the listed market. Market makers on the OTC market are, however, restricted to financial institutions that are governed by the Banking Act or specifically approved by the central bank. This therefore excludes securities houses from participating in this market. This fragmented trading structure, as well as restrictions on the number and scope of participants in the over-the-counter market, has caused the secondary market for bonds to be relatively illiquid.

In terms of the range of instruments available in Malaysia, one major issue needs to be addressed. Many issues that have come onto the Malaysian market have been corporate bonds with equity “sweeteners” such as Transferable Subscription Rights (TSRs) and Irredeemable Convertible Unsecured Loanstocks (ICULs). These hybrids are extremely popular, particularly because the Malaysian market typically has a strong appetite for equity exposure.

Moving forward, certain critical issues have been identified that need to be addressed in relation to the overall development of the corporate bond market. One of the key concerns is that Malaysia does not have an appropriate liquid benchmark yield curve. In order to establish an appropriate benchmark yield curve, the benchmark security should be fungible, default-risk free, sufficient in size and frequency of issuance, and also span the maturities required. Malaysian government securities, Khazannah bonds, and Cagamas bonds are among the viable alternatives being considered as the

benchmark security. However, whether the establishment of a liquid benchmark yield-curve requires the rationalization of these alternatives or whether several benchmarks can coexist is an issue that needs to be addressed, as well as issues related to issuance in a surplus budget environment for government securities.

As for the secondary markets, Malaysia needs to free up some of the restrictions that have been imposed that create a captive demand for government securities, which by its nature has the most market acceptance as the benchmark security. Because of certain investment, statutory reserve, and liquid asset requirements, much of the government paper issued is locked in. For example, the Employees Provident Fund (a statutory fund), which has significant investment capacity, is required by statute to have a very large amount of its funds invested in government securities. As this fund holds on to these government securities until maturity, partly because of the shortage in the supply of these securities, there is a lack of secondary market liquidity in government securities and this has inhibited the development of an efficient yield curve.

Repurchase agreements (repos) or, more generally, securities lending and borrowing provide efficient mechanisms for financing positions and generally are considered to facilitate secondary market liquidity. Repos enable market intermediaries to take long and short positions in a flexible manner, buying and selling according to customer demand on a relatively small capital base. While a repo market currently does exist in Malaysia, it is not sufficiently deep to support liquidity in the government securities market. Therefore, the range of participants in the repo market will need to be looked at to allow other selected participants (such as institutions licensed under the Securities Industry Act and fund managers) to conduct repo transactions with the banking institutions. Liquidity and efficient price discovery in secondary markets are also hampered by the lack of an organized futures market offering interest rate futures and options on government securities.

The regulatory framework is also another priority in terms of current reform efforts. The entire process of obtaining approvals of all the relevant authorities currently can take about 4–6 months from the date of making the first submission to the rating agency. The problems that may arise within this regulatory process include ex-

posure to interest rate movements, regulatory overlap in exercising the functions of the three respective regulatory bodies (the Securities Commission, Central Bank and Registrar of Companies) and the preference for bank loans, which in contrast take no more than two weeks to process. The government of Malaysia has taken steps towards establishing a more efficient issuance process by announcing that all the necessary laws and regulations should be amended to provide the Securities Commission with sole authority over the corporate bond market and that a shelf-registration system should be introduced, where only a one time approval is necessary for the registration of the prospectus with the Securities Commission. Furthermore the current process of moving towards a disclosure-based regulatory framework is also likely to facilitate issuance.

Among the proposals identified to help diversify and widen the issuer base are the setting up of a Financial Guarantee Insurer, as a substitute for bank guarantees, which might reduce costs substantially, and allowing non-investment grade paper on to the market, which would let more Malaysian companies issue debt as an alternative source of financing. Furthermore, promoting policies and a framework for asset securitization would allow the increasing amount of credit card, hire purchase and housing mortgage loans to become tradable. The key reform needed on the investor side is to increase the involvement of pension funds in bond investments. Malaysia will also be promoting retail participation by encouraging the establishment of more bond funds. In general, a lot of effort has gone into developing collective investment vehicles and ways to overcome the impediments to their increased participation in the bond market.

In terms of developing the current market microstructure, the issue is one of determining the most appropriate alternative to facilitate secondary market liquidity while ensuring its integrity. Several factors must be considered when choosing the trading platforms. First is the type of investor. It has been argued that OTC markets are more suited to institutional activity while exchange-traded markets are more conducive to retail participation. Next, the issue of competition needs to be reviewed. Having several competing systems may drive the market to adopt the most cost-effective and efficient trading platforms available and lower the cost of trading. However, this must be weighed against the possibility of market frag-

mentation where the existence of several platforms can unduly fragment the market at the cost of efficient price-discovery. Furthermore it might also be argued that the integrity of the clearing and settlement system requires it to be independent of regulators. Hence, there is a need for a complete review of the existing structures with a view to determining the most appropriately organized and centralized trading, delivery and settlement system for the corporate bond market.

One of the major government initiatives taken since the Asian crisis has been the establishment of the National Bond Market Committee (NBMC) to provide policy direction and to rationalize the regulatory framework for development of the bond market. As an initial step to rationalize the regulatory framework, NBMC announced that the Securities Commission would be the single regulatory authority for the supervision and regulation of the corporate bond market. The members of NBMC consist of the Ministry of Finance, Economic Planning Unit of the Prime Minister's Department, Central Bank, Securities Commission, the Registrar of Companies, and the Kuala Lumpur Stock Exchange.