Financial Markets

Financial Markets

Overview

The operating environment in the financial markets was influenced by episodes of larger capital flows, upward pressures on oil prices and inflation against the backdrop of ample liquidity situation and a higher degree of risk appetite. The relatively low yields in the bond market provided a favourable condition for financing activity by the corporate sector. Volatility in the exchange rates of the major currencies, the floating of the ringgit with reference to a basket of currencies and expectations of interest rate hikes led to increased hedging activity in the foreign exchange and financial futures markets.

Favourable conditions in the financial markets contributed to active fund raising exercises by the private sector.

In 2005, net funds raised in the capital market totalled at RM41.7 billion, albeit marginally lower than the amount raised in the previous year (2004: RM42.7 billion). The sustained large volume of funds raised in 2005 reaffirmed the vital role played by the capital market in mobilising and allocating funds on the basis of market-based competitive financing. Of significance, net funds raised by the private sector accounted for a larger share of 62.1% of total funds raised (2004: 37.5%), attributed to the higher financing needs on the back of the strengthening of private sector activity during the year.

The private debt securities (PDS) market experienced active fund raising activity during the year. Corporations stepped up issuances of PDS to capitalise on the flattening yield curves at the longer-end and the low real yields in an environment of excess liquidity amidst demand for long-term securities. Total net PDS issuance amounting to RM19.6 billion was the highest recorded since 2000. As at end-2005, PDS financing accounted for 24% of total debt financing to the private sector, complementing the banking system in providing long-term financing to the corporate sector. Meanwhile, total funds raised in the equity market were only slightly lower despite the less encouraging market performance during the year. A total of 79 companies sought listing in Bursa Malaysia and more than half (46 companies) of these listings were small to medium capitalised companies which were listed on the MESDAQ Market. The MESDAQ Market remained an important alternative avenue for these companies to raise equity financing.

Funds raised by the public sector declined by 40.6% due mainly to the lower issuance of government securities as the Government continued on its fiscal consolidation phase. The Government made an inaugural issuance of a 20-year Malaysian Government

Graph 9.1
Net Funds Raised in the Capital Market by the Public and the Private Sectors

Table 9.1
Funds Raised in the Capital Market

	2004	*2005p*
	RM million	
By Public Sector		
Government Securities (gross)	43,173	28,276
Less Redemptions	18,200	15,800
Less Government holdings	0	0
Equals Net Federal receipts	24,973	12,476
Khazanah Bonds (net)	-1,198	833
Government Investment Issues (net)	1,423	1,000
Malaysia Savings Bond/Merdeka Savings Bond (net)	1,474	1,516
Net Funds Raised by Public Sector	**26,671**	**15,825**
By Private Sector		
Shares	6,475	6,315
Debt securities		
Issuance (gross)	36,340	38,196
Less Redemptions	26,814	18,617
Equals Net Issues	9,526	19,579
Net Funds Raised by Private Sector	**16,001**	**25,894**
Total Net Funds Raised	**42,672**	**41,719**
Short-term papers and notes (net)[1]	-3,208	1,579
Total	**39,465**	**43,297**

[1] Refers to Commercial Papers and Cagamas Notes.
p Preliminary

Securities (MGS) and a 7-year Government Investment Issues, with the purpose of lengthening the benchmark yield curve for the conventional and Islamic debt markets.

The Kuala Lumpur interbank foreign exchange market recorded a significant rise in both spot and swap transactions on the back of increased hedging activity for trade and investment purposes, following the large volatility in the exchange rates of the major currencies. In addition, sizeable movements of short-term speculative flows and the depegging of the ringgit also contributed to higher market activity.

Activity in the money market was marginally lower. The smaller volume of interbank deposits offset the modest growth recorded in the money market papers. Trading in money market papers centred on the MGS, with significant increases in the repo transactions following the introduction of Institutional Securities Custodian Programme (ISCAP) and the introduction of a securities lending facility for principal dealers by the Bank to improve the repo market.

On Bursa Malaysia Derivatives, although trading activity was concentrated on Crude Palm Oil (CPO) futures and KLCI futures (92.3% of total trade), the interest rates-related 3-month KLIBOR Futures and the 3-year MGS Futures recorded higher volume. Open interests of these financial futures rose in the fourth quarter, reflecting the increased participation by financial institutions in taking hedging positions against anticipated interest rate hikes. Meanwhile, trading activity of CPO futures declined due mainly to the reduced volatility in CPO prices.

On the developmental front, the Bank and the relevant authorities took further measures to enhance the infrastructure and the efficiency of the financial markets. Specific measures were also implemented to develop the Islamic financial markets. Measures introduced, among others, were aimed at promoting liquidity in the bond market, liberalising rules on foreign exchange transactions, broadening risk management tools, facilitating the introduction of new products and enhancing the information dissemination system. Details are contained in the box **Key Capital Market Measures in 2005**.

Money Market

Activity in the money market was marginally lower in 2005. The trading volume of interbank deposits was smaller compared to 2004, while the trading volume in money market papers recorded a modest growth.

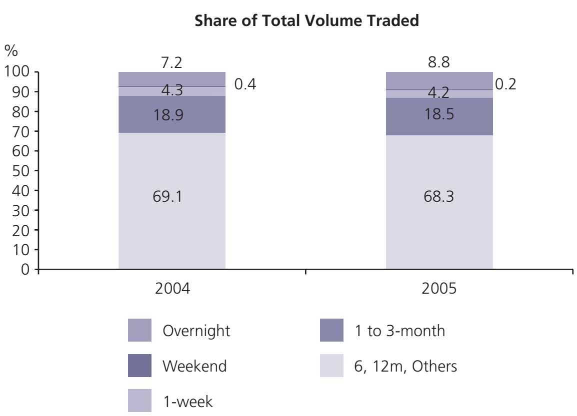
Table 9.2
Money Market[1]

	2004		2005	
	Volume (RM billion)	Annual change (%)	Volume (RM billion)	Annual change (%)
Total money market transactions	**1,665.9**	**3.0**	**1,622.0**	**-2.6**
Interbank deposits	**1,057.5**	**-2.5**	**887.6**	**-16.1**
Money market papers	**608.4**	**14.3**	**734.5**	**20.7**
Repurchase Agreements	118.6	170.8	264.4	122.9
Malaysian Government Securities (MGS)	193.3	-16.5	179.4	-7.2
Malaysian Treasury Bills	17.1	72.1	12.9	-24.6
Bank Negara Bills	74.1	18.5	72.8	-1.8
Cagamas Bonds	38.6	50.7	16.3	-57.9
Cagamas Notes	4.4	-72.8	0.0	-100.0
Bankers Acceptance (BAs)	48.0	28.6	44.2	-8.0
Negotiable Instrument of Deposits (NIDs)	36.3	-15.8	39.0	7.5
Government Investment Issues	35.9	4.0	43.2	20.5
Khazanah Bonds	17.6	-6.3	20.0	13.6
Malaysian Islamic Treasury Bills	1.2	n.a.	4.5	265.6
Islamic Cagamas Bonds	2.1	2,397.6	1.8	-14.1
Bank Negara Negotiable Notes	21.2	137.6	36.1	70.5

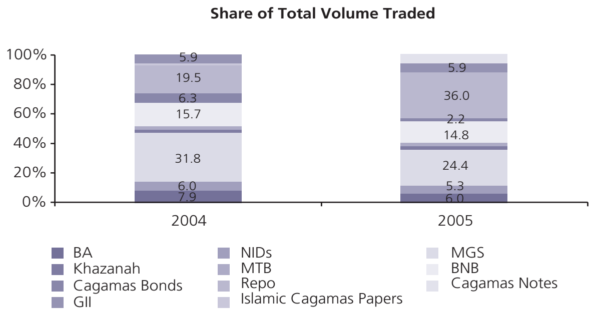
[1] All data are sourced from the Fully Automated System for Issuing/Tendering (FAST), except for BAs and NIDs which are sourced from money market brokers.

At RM887.6 billion, the volume of interbank deposit transactions was lower in 2005 (2004: RM1,057.5 billion). The bulk of trading continued to be concentrated in the shorter-end of the market with the overnight and weekend tenures continued to be actively used for settlement and liquidity purposes. The lower interbank deposit transactions reflected, to some extent, the slight reduction in liquidity in the interbank deposit market following the outflow of short-term speculative

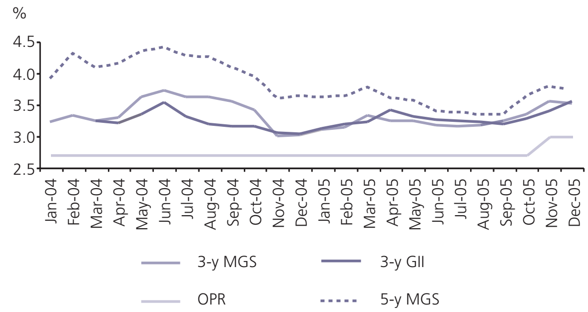
Graph 9.2
Interbank Deposits



Graph 9.3
Money Market Instruments



Graph 9.5
Yields of Long-term Money Market Instruments



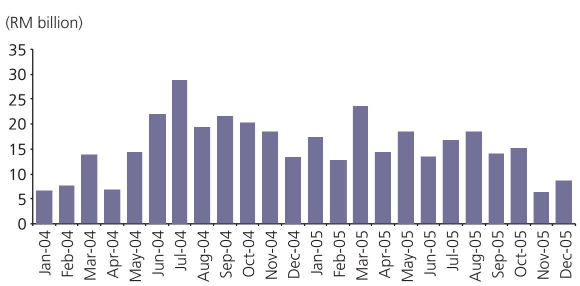
foreign funds and also market preference to trade in money market papers.

In terms of trading in money market papers, the volume of transactions increased to RM734.5 billion in 2005 (2004: RM608.4 billion). There was a significant increase in repo transactions during the year, as reflected by the increased activity in the repo market for Malaysian Government Securities (MGS). The increased utilisation of repos, following the introduction of ISCAP (Institutional Securities Custodian Programme), and the introduction of a securities lending facility for principal dealers in 2005, had a significant impact on the trading volume of MGS in the repo market. The introduction of ISCAP facilitated the release of captive holdings of MGS by institutional investors, while the securities lending facility created more market-making activity, including the use of the repo market to cover short selling positions.

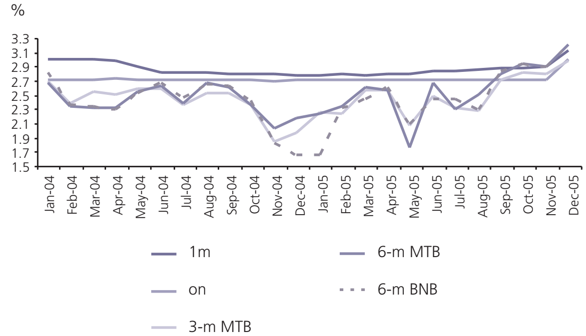
Overall trading volume in the outright purchase and sale of instruments was lower compared to 2004, mainly on account of the lower outright transactions of MGS, amounting to RM179.4 billion in 2005 (2004: RM193.3 billion). This was an outcome of the lower net issuance of MGS by the Government during the year, which at RM12.5 billion, were only half as much as in the previous year (RM25 billion in 2004). In addition, outright transactions in the MGS market were also influenced by expectations on the direction of interest rates. In the final quarter of the year, demand was affected by uncertainty over the supply of MGS. While non-resident activity in the trading of MGS increased during the year, their activity had minimal impact on the volume of transactions and yields of MGS, as demand for MGS by domestic investors remained strong. This was particularly evident in the fourth quarter, when strong demand by domestic investors mitigated MGS prices from correcting sharply following sales by non-resident investors.

During the year, demand for long-term Islamic bonds in the outright market continued to increase. This was clearly evident in the higher trading volume of the Government Investment Issues (GII) and Khazanah Bonds, which increased to RM43.2 billion and RM20.0 billion respectively (2004: RM35.9 billion and RM17.6 billion respectively). In 2005, a new profit-based GII, with a maturity of 10 years, was introduced as an additional instrument to the existing discount-based GII.

Graph 9.4
Volume of Traded MGS



Graph 9.6
Yields on Short-term Money Market Papers & Deposits



The issuance of the profit-based GII was aimed at meeting the growing demand for Shariah-compliant securities.

In terms of Cagamas bonds and notes, including Islamic Cagamas papers, the trading volume was lower at RM18.1 billion (2004: RM45.1 billion) due mainly to the lower issuances of RM2.5 billion during the year (2004: RM9.3 billion).

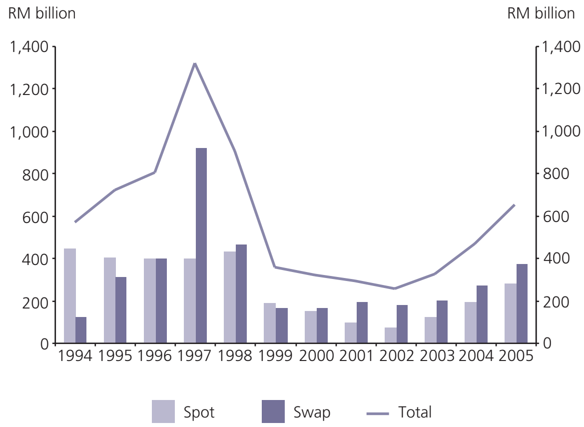
Trading in money market papers with maturities of less than 1-year was mixed. During the year, higher deposits in the banking system spurred the banking institutions to increase the creation and trading of NIDs. On the other hand, the trading volume of the Malaysian Treasury Bills was lower given the smaller total issuance and low yields. The trading volume of Bank Negara Bills was only marginally lower in 2005, amounting to RM72.8 billion (2004: RM74.1 billion), reflecting the stronger demand by non-resident investors.

In contrast, the trading volume of both Bank Negara Negotiable Notes (BNNN) and Malaysian Islamic Treasury Bills (MITB) were higher at RM36.1 billion and RM4.5 billion respectively (2004: RM21.2 billion and RM1.2 billion respectively). This development reflected, to some extent, the increased supply of these instruments amid growing demand from money market players for liquid Shariah-compliant assets, as well as, from the significant amount of non-resident trading activity.

Foreign Exchange Market

In the Kuala Lumpur interbank foreign exchange market, the average daily volume of interbank foreign exchange transactions (spot and swap) increased by 40% in 2005. Spot transactions rose 45%, while swaps registered an increase of 36%. The rise in the volume of transactions was due largely to increased hedging activity for trade and investment purposes, arising from the volatility in the exchange rates of the major currencies during the year. Market participants also sought to actively manage their exposure to currency risk, both prior to, and after the move from a fixed exchange rate to a managed float of the ringgit against a basket of currencies. The Kuala Lumpur foreign exchange market also experienced larger portfolio flows during the year, which contributed to the higher market activity. This increase in volume was more significant in the period after the shift in exchange rate regime on 21 July 2005. Consequently, the volume of transactions was higher in the second half of the year and accounted for 57% of total transactions during the year.

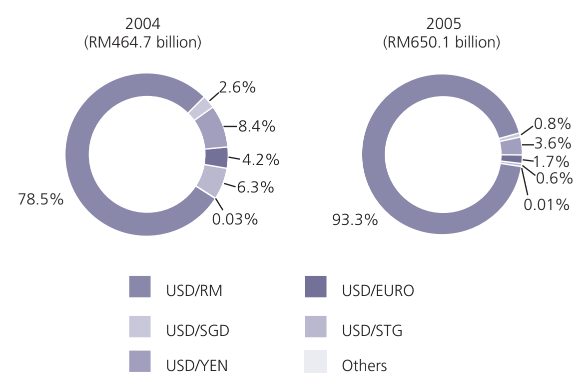
Graph 9.7
Volume of Interbank Transactions in the Kuala Lumpur Foreign Exchange Market



Note: Data from 2002 onwards is based on the new Ringgit Operations Monitoring System (ROMS), whereas observations for previous years are based on transactions of the eight Authorised Dealers.

By composition, the Kuala Lumpur foreign exchange market comprised mainly of transactions involving the ringgit, yen, euro, Singapore dollar and pound sterling against the US dollar. The US dollar continued to be the currency of choice in the settlement of trade and capital account transactions and thus, the domination of transactions in the US dollar against the ringgit. The share of US dollar - ringgit transactions in total foreign exchange transactions increased further, by 66% in 2005 compared to 2004. As a result, the share of US dollar - ringgit transactions continued to trend upwards, and in 2005 accounted for 93.3% of the total transactions at the Kuala Lumpur foreign exchange market. Following the

Graph 9.8
Transactions in the Kuala Lumpur Foreign Exchange Market by Currency

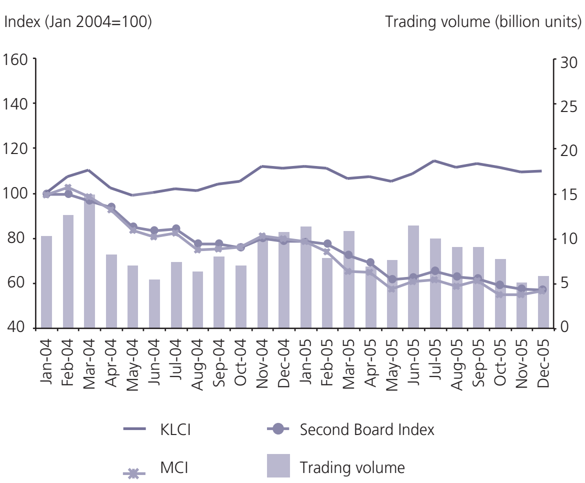


unpegging of the ringgit exchange rate, the share of US dollar - ringgit transactions in total transactions rose, from 91.8% over the 1 January – 21 July 2005 period to 94.8% over the 22 July – 31 December period. Conversely, the share of transactions involving the other currency pairs decreased. The share of transactions involving the yen and euro decreased from 8.4% and 4.2% in 2004 to 3.6% and 1.7%, respectively in 2005. Similarly, there was a decrease in transactions involving the Singapore dollar and pound sterling, from 2.6% and 6.3% of total transactions in 2004 to 0.8% and 0.6% in 2005, respectively.

Equity Market

Throughout 2005, the equity market was affected by concerns over the implications of global developments, primarily high oil prices, on domestic inflation and growth prospects. The year began on an optimistic note with the benchmark Kuala Lumpur Composite Index (KLCI) hitting a four and a half year high of 930.6 points on 11 January. Thereafter, developments such as continued escalation of oil prices, increasing global interest rates, and their consequent impact on the economy, adversely affected market sentiments. In addition, several domestic corporate developments in particular below market expected earnings, contributed negatively to the performance of the KLCI during the year. Nevertheless, Bursa Malaysia remained an important avenue for financing as the number of new companies seeking listing continued to increase.

Graph 9.9
Kuala Lumpur Composite Index (KLCI), Second Board Index, MESDAQ Market Composite Index (MCI) and Bursa Malaysia's Trading Volume



Source: Bursa Malaysia

Table 9.3
Bursa Malaysia: Performance of Sectoral Indices

	2004	2005
	Annual change (%)	
Kuala Lumpur Composite Index	14.3	-0.8
EMAS	9.6	-4.9
Second Board	21.2	-27.4
MESDAQ Composite Index	-19.3	-29.1
Plantation	9.4	15.8
Industrial	10.9	3.8
Trading/Services	14.3	-1.7
Finance	15.3	-3.5
Consumer products	7.3	-5.0
Shariah	8.9	-5.0
Industrial products	4.6	-12.3
Mining	6.7	-12.8
Construction	8.9	-25.9
Properties	4.5	-26.8
Technology	-28.5	-37.8

Source: Bursa Malaysia

The performance of the KLCI in 2005 lagged that of other major global and regional indices. The KLCI ended lower at 899.79 points or weaker by 0.8%, compared to 2004's performance. Market capitalisation declined by 3.7% to

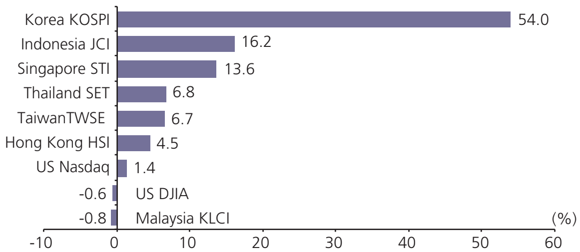
Table 9.4
Bursa Malaysia: Selected Indicators

	2004	2005
Price Indices:		
Composite	907.43	899.79
EMAS	214.26	203.85
Second Board	110.87	80.44
MESDAQ	122.84	87.09
Total Turnover:		
Volume (billion units)	108.0	102.3
Value (RM billion)	216.7	177.1
Average Daily Turnover:		
Volume (million units)	435.5	414.3
Value (RM million)	873.7	716.9
Market Capitalisation (RM billion)	722.0	695.3
Market Capitalisation / GDP (%)	160.6	140.6
Total Number of Listed Companies:	963	1,021
Main Board	622	646
Second Board	278	268
MESDAQ	63	107
Market Liquidity:		
Turnover Value / Average Market Capitalisation (%)	31.9	25.2
Turnover Volume / Number of Listed Securities (%)	36.4	31.4
Market Concentration:		
*10 Most Highly Capitalised Stocks / Market Capitalisation (%)	34.4	36.1
Average Paid-Up Capital of Stockbroking Firms (RM million)	167.0	152.5

* Based on market transactions only.

Source: Bursa Malaysia

Graph 9.10
Performance of Selected Stock Markets Indices (% change from end-2004 to end-2005)



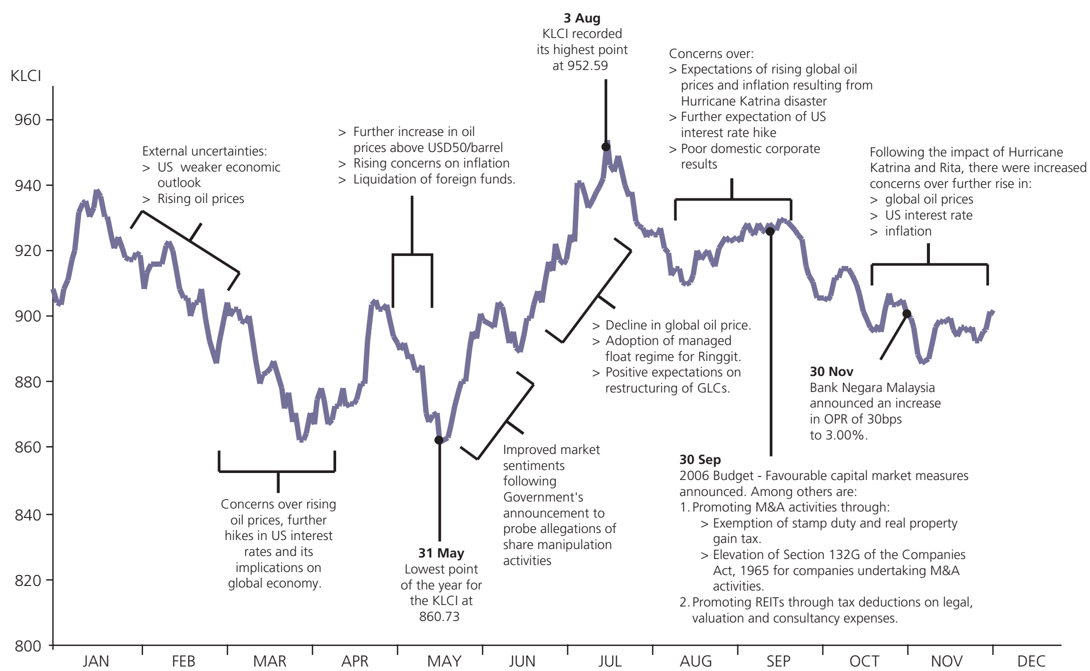
Source: Bursa Malaysia

RM695.27 billion. Market activity was lower, with the annual market turnover at 102.3 billion units, which were valued at RM177.1 billion (2004: 108 billion units; RM216.7 billion). Market liquidity, in terms of average daily turnover, fell to 414 million units (2004: 435 million units).

To a large extent, the weaker financial performance of public listed companies (PLCs) affected market sentiment. Based on a sample of 351 listed non-financial corporations (representing close to 84.4% of Bursa Malaysia's total market capitalisation), the performance of Malaysian PLCs deteriorated in 2005. A drop of 10.5% in cumulative net profit was recorded in the first three quarters of 2005, compared with the same period in 2004. Annualised return-on-equity for the sample also declined to 8.3% in the third quarter of 2005 (3Q 2004: 9.7%) mainly due to a drop in the operating profit margin to 11.8% (3Q 2004: 13.4%). Weaker corporate earnings were particularly evident in the construction, properties, manufacturing and agriculture sectors. Slower global demand for electrical and electronics products, and increased competition contributed significantly to the lower figures reported.

A marginal deterioration in debt servicing capacity was observed. Interest coverage ratio as at third quarter of 2005 was 3.93 times (2004: 4.69 times). Debt-to-equity ratio for the same period dropped slightly to 0.60 times (2004: 0.63 times), mainly reflecting the corporate sector's move to retire old debts and lock-in new rates with new debt financing. Therefore, the indebtedness level of the corporate sector remained sustainable as the debt-to-equity ratio for the third quarter of 2005 was slightly better than the average ratio of 0.61 after the Crisis.

Graph 9.11: Performance of the Kuala Lumpur Composite Index in 2005



In terms of total number of new listings, Malaysia's equity market remained an important source of capital for Malaysia's corporate sector in 2005. Bursa Malaysia attracted 79 Initial Public Offerings (IPOs), which was the highest number of listings since 1998. New listings on the

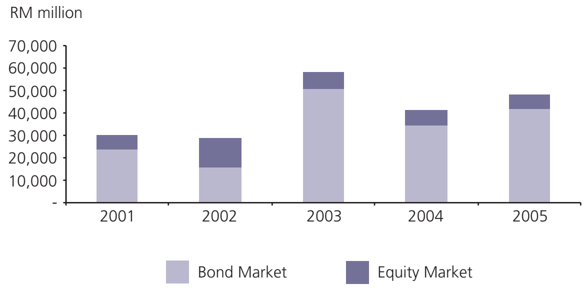
Despite its lacklustre performance, Bursa Malaysia remained an important source of equity financing for the Malaysian corporate sector, especially the small and medium-sized companies. 79 companies sought listing in Malaysia's equity market, which was the highest number since 1998.

Main Board remained strong with an annual increase of 6.7% (2004: -6.7%), while new listings on the Second Board declined by 34.6% (2004: +18.2%). Over the years, a higher number of small and medium capitalised companies sought financing from Bursa Malaysia. In 2005, slightly more than one-third of the total IPOs was made by companies from the technology sector. The MESDAQ Market remained effective as a platform for high growth potential companies to seek financing and new investors. IPOs in the trading/services and industrial products sectors accounted for 22.8% and 24.1% of new shares listed in 2005, respectively. While the IPOs comprised mainly small and

Graph 9.12
Bursa Malaysia:
Number of New Listings

Source: Bursa Malaysia

Graph 9.13
Funds Raised by the Private Sector in the Capital Market



medium capitalised companies, seven large companies and funds sought listing on Bursa Malaysia. As at end-2005, the total number of listed companies on Bursa Malaysia was 1,021 (2004: 963).

Although the total number of IPOs increased in 2005 on an annual basis, total funds raised through the equity market dropped marginally by 3.1% to RM6.3 billion, compared to RM6.5 billion in 2004. As in past years, the bulk of these funds were raised through IPOs which amounted to RM5.3 billion, while rights issues amounted to RM1 billion (2004: RM4 billion and RM1.5 billion respectively). Most of the IPOs were oversubscribed, indicating continued strong investor interest in new listings. 39.5% of the funds raised through IPOs were by the industrial products sector. The property and finance sectors garnered 24.7% and 20.6% of the funds raised, respectively. Net funds raised in the equity market constituted about 24.4% of the total net funds raised by the private sector in the capital market in 2005 (2004: 40.5%).

In line with the continued efforts to enhance product diversification and innovation in the Malaysian financial system, the year 2005 witnessed a further broadening of the Malaysian equity market in terms of new products. Following the success of Real Estate Investment Trusts (REITs) in other regional countries and the Government's efforts to accelerate the development of such investment vehicles, the Guidelines on REITs were released in January 2005. In 2005, three REITs were listed on Bursa Malaysia. With the release of the Guidelines on Exchange-traded Funds (ETF) in June, the first ETF, the ABF Malaysian Bond Index Fund, was listed on Bursa Malaysia in July 2005.

In 2005, the introduction of new initiatives and measures for the equity market were directed at further enhancing market efficiency, liquidity and integrity. A summary of the measures introduced during the year is contained in the white box on **Key Capital Market Measures in 2005**.

Key Capital Market Measures in 2005

Capital market measures introduced in 2005 focused on further strengthening the capital market by enhancing liquidity, efficiency, risk management, integrity, as well as promoting and accelerating the growth of the Islamic capital market. Key measures introduced in 2005 are summarised, as follows:

Enhancing Liquidity in the Ringgit Bond Market

- On 7 January, the Bank introduced several measures to further enhance the efficiency of the domestic bond market by increasing liquidity in the bond market and improving the price discovery process. The measures were:
  i. **Repurchase agreements (repo) would be actively used as a monetary instrument** to manage liquidity in the banking system.
  ii. Through the **Institutional Securities Custodian Programme (ISCAP)**, the Bank would borrow securities, mainly Malaysian Government Securities (MGS) from major institutional investors, for its repo operations.
  iii. **Securities lending facility for principal dealers (PDs)** was enhanced to facilitate the market-making activities.
- On 31 March, the **ringgit-denominated bonds issued by Multilateral Development Banks (MDBs) and Multilateral Financial Institutions (MFIs)** were **included as eligible securities** to be transacted under repo operations with the Bank.

Enhancement of Risk Management Tools in the Bond Market

- With the liberalisation of foreign exchange administration regulations announced by the Bank on 1 April, **residents and non-residents were allowed to enter into hedging arrangements** with licensed onshore banks for committed inflows and outflows of funds.
- On 7 October, the Bank issued the **Guidelines on Regulated Short-Selling of Securities**. The regulated short-selling framework for MGS in the wholesale market was accorded to PDs, interbank participants and universal brokers.

Removal of Restrictions on the Utilisation of Proceeds from Bond Issuance

- With effect from 28 March, **the National Bond Market Committee's Negative List was repealed**, and restrictions imposed on the utilisation of proceeds derived from bond issues were removed. Nevertheless, the restrictions imposed by the Exchange Control Guidelines on Private Debt Securities for Lead Arrangers remained.

Infrastructure Development and Better Information System for the Bond Market

- On 4 July, the Bank introduced a new version of the **Fully Automated System for Issuing/Tendering (FAST)**. The new version was developed as a web-based application that is available to both FAST members and the public. The new version provided better controls as well as greater flexibility in performing primary market activities.
- Since 25 July, **information on indicative yields to maturity of government securities (conventional and Islamic) was published daily** to provide market participants with information on the market value of government securities.
- On 5 December, the Securities Commission (SC) **allowed a wider group of investors to access the Information Memoranda and Trust Deeds of ringgit-denominated bond issues database**, which would assist investors in making informed investment decisions. Previously, the database was only available to primary subscribers of bonds.

Promoting the Development of Real Estate Investment Trusts (REITs)

- On 3 January, the SC released **Guidelines on REITs** in an effort to accelerate capital market growth and establish a vibrant and competitive REIT industry in Malaysia. Key features included the relaxation of restrictions on REITs for the following transactions:

- Borrowings limits;
- Acquisition of leasehold properties; and
- Acquisitions of real estates that are encumbered by financial charges.

- In order to promote the development of REITs or Property Trust Funds (PTFs), REITs or PTFs approved by the SC were given the following tax treatment:
  - Chargeable income distributed to unit holders was exempted from income tax; and
  - The accumulated income that has been taxed and subsequently distributed was eligible for tax credit by unit holders.

Promote the Growth of the Islamic Capital Market

- On 21 November, the SC issued **Guidelines for Islamic REITs** to further facilitate the development of a new Islamic capital market product and thus, made Malaysia the first jurisdiction in the global Islamic financial sector to issue such guidelines. These guidelines were expected to serve as a global benchmark for the development of Islamic REITs.
- A new **profit-based Government Investment Issues (GII)** was introduced as an additional instrument to the existing discounted-based GII. The profit-based GII would be issued at par via the Islamic concept of *Bai Bithamin Ajil* and would be characterised by the element of profit, payable every half-yearly until its maturity. This instrument was poised to be the new benchmark for the issuance of long-term Islamic bonds and consequently, promote market liquidity.

Enhancing Liquidity in Exchange-traded Products

- On 28 June, the SC released guidelines to facilitate the **introduction of Exchange Traded Funds (ETF)**, which are open-ended investment funds that track specific indices, in an effort to create greater liquidity within the equity market.
- On 28 October, the SC issued **enhanced Guidelines to facilitate issuance of structured warrants** aimed at developing the equity derivatives market, building greater market liquidity and safeguarding market integrity. In addition, the SC also allowed the **introduction of Bull Equity Linked Structures (Bull ELS)**, an investment-yielding instrument linked to designated shares, which provides investors with returns depending on the closing price of the underlying shares on maturity.

Promoting Quality of MESDAQ Companies

- To promote the quality and investibility of MESDAQ companies, **new MESDAQ Market guidelines on entry requirements** were released on 29 November. These guidelines focused on ensuring companies seeking listing are of high quality companies, encouraging efficient and effective price-discovery process, enhancing the method of securities distribution and improving corporate governance.

Liberalisation of Central Depository System (CDS) Accounts Requirements

- Effective 21 October, the SC announced the **liberalisation of CDS accounts requirements** to allow a wider group of individuals to hold securities on behalf of others.

Providing Greater Flexibilities for Merged Stockbrokers

- **Stockbroking companies which completed 1+1 mergers** were permitted to **undertake additional activities of business**, as follows:
  - Allowed to undertake a full range of corporate advisory services, subject to certain criteria, such as shareholders' funds of at least RM100 million;
  - Permitted to operate futures broking activities within the stockbroking entity; and
  - Allowed to do unrestricted branching from 2006 onwards.

Enhancing Investor Protection

- On 15 March, the SC introduced compliance **guidelines for fund managers to further strengthen the level of investor protection**, which required fund managers to adhere to best practices for the following operations:

- – Trading and portfolio management;
- – Meeting 'know your clients' obligations;
- – Proper execution of the roles and responsibilities of the Board of Directors and Compliance Officers;
- – Safeguarding of clients' assets; and
- – Compliance with the Anti-Money Laundering Act 2001.

Further Liberalisation in the Capital Market

- On 15 September, the SC introduced several measures to facilitate the diversification of investments by domestic investors and further enhance the efficiency of the Malaysian capital market. These measures include:
  i. The framework on investments in foreign securities was revised to **allow investors to invest in foreign securities listed on recognised foreign exchanges**;
  ii. Regulations on secondary market trading of non-ringgit bonds were liberalised to allow 'sophisticated investors' (i.e. commercial banks, merchant banks, Islamic banks, universal brokers or consolidated brokers) to **execute secondary trades of non-ringgit bonds without seeking approval from the SC**;
  iii. The framework for primary offerings of non-ringgit bonds were revised to give **flexibility for the issuance of foreign currency-denominated bonds to 'sophisticated investors'**; and
  iv. The **offering of foreign shares in Malaysia** was permitted subject to the SC's approval.

  The above measures complemented the liberalisation of foreign exchange administration rules by the Bank on 1 April.

Improving Efficiency through Electronic Means

- On 17 February, the SC launched the **Electronic Licensing Application System (ELA)** to facilitate online submission and retrieval of information between SC and market participants. This effort was followed by the rollout of the **Continuing Professional Education (CPE) Tracker System** on 25 February.
- On 28 April, the SC released **guidelines of electronic contract note** in an effort to provide value-added services to investors.

Facilitating Corporate Sector Development

- To further facilitate faster execution of corporate proposals that require SC's approval (such as share buybacks, mergers and executions, etc.), prospectuses received by the SC will be **reviewed on a post-vetting basis** beginning 3 October. Hence, companies would be able to issue a prospectus within two weeks upon lodgement with the SC. In addition, to reduce the time to market, companies involved in takeovers would be required to issue offer documents containing detailed conditions within 21 days from the date of takeover notice, compared to 35 days previously.
- To encourage public listed companies to expand and compete globally, **exemptions were given for stamp duty and real property gains tax on merger and acquisitions (M&As)** undertaken by companies listed on Bursa Malaysia. This exemption was given to M&As approved by the SC from 1 October 2005 to 31 December 2007. Such M&As must be completed not later than 31 December 2008.

Providing a Facilitative Framework for Approval of Negotiable Instruments of Deposit

- The SC issued Practice Note 3 to the Private Debt Securities (PDS) Guidelines and Practice Note 3 to the Islamic Securities (IS) Guidelines on 6 April and 12 December respectively, to provide a more **facilitative framework for the approval of negotiable instruments of deposit (NIDs) and Islamic NIDs** with tenures of more than five years. The PDS Guidelines and IS Guidelines would no longer govern the approval process for NIDs and Islamic NIDs issuances by licensed institutions or Islamic banks. The new framework would facilitate a faster approval process.

Bond Market

The bond market continued to be an important source of funds, mobilising total net funds of RM35.4 billion for the year 2005 (2004: RM36.2 billion). As a result, the size of the ringgit bond market registered a 9.5% growth, with the total bonds outstanding reaching RM397.6 billion (80.4% of GDP) as at end-2005. Of significance, the net private debt securities (PDS) issuance of RM19.6 billion in 2005 was the highest since 2000, and thus contributed to a larger share of 55.3% of total net funds raised (2004: 26.3%).

The fiscal consolidation by the Federal Government resulted in a lower net funds raised, totalling RM13.5 billion (2004: RM26.4 billion). The Federal Government issued and reopened a total of 13 Malaysian Government Securities (MGS) and two Government Investment Issues (GIIs). The auctioning of the Government securities were carefully planned to ensure a smooth functioning of the market as well as to minimise the financing costs to the Government. During the year, the Government made an inaugural issuance of a 20-year MGS, continuing its efforts to lengthen the benchmark yield curve. Similarly, the maturity for GII was also lengthened from 7-year to 10-year for building the Islamic benchmark yield curve, a critical component for the development of the Islamic bond market. In addition, the Government introduced a new profit-based GII, based on the *bai' bithaman ajil* concept, as an additional instrument to the existing discounted-based GII. The new GIIs are poised to be the new benchmark for the issuance of long-term Islamic bonds and consequently, will promote market liquidity for Islamic papers. Meanwhile, the Bank continued to issue Merdeka Savings Bond (MSB) on a quarterly basis, providing additional investment instruments for senior citizens, retired Malaysian Armed Forces personnel and Malaysian citizens who have retired on medical grounds. Inclusive of the issuance of Khazanah bonds, the public sector raised net funds of RM15.8 billion (2004: RM 26.7 billion).

Table 9.5
Funds Raised in the Bond Market

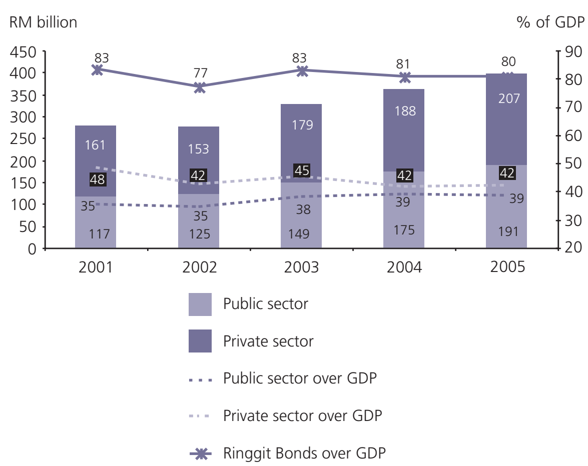
	2004	2005*p*
	RM million	
By Public Sector		
Government Securities (gross)	43,173	28,276
Less Redemptions	18,200	15,800
Equals Net Federal Receipts	24,973	12,476
Government Investment Issues (net)	1,423	1,000
Khazanah Bonds (net)	-1,198	833
Malaysia Savings Bond (net)	1,474	1,516
Net Funds Raised	**26,671**	**15,825**
By Private Sector		
Private Debt Securities (gross)	36,340	38,196
Straight Bonds	4,313	3,869
Bonds with Warrants	60	0
Convertible Bonds	4,301	3,745
Islamic Bonds	9,104	9,537
Asset Backed Securities	2,958	6,210
Medium Term Notes	7,315	12,296
Cagamas Bonds	8,290	2,540
Less Redemptions	26,814	18,617
Private Debt Securities	19,648	13,432
Cagamas Bonds	7,166	5,185
Net Funds Raised	**9,526**	**19,579**
Net Funds Raised in the Bond Market	**36,197**	**35,404**
Private Debt Securities, (excluding Cagamas) gross	*28,050*	*35,656*
Net Funds Raised in the Bond Market, excluding Cagamas	*8,402*	*22,224*
Net Issues Short Term Securities, Commercial Papers[1]	-3,208	1,579
Total	**32,990**	**36,982**

[1] Refers to Cagamas Notes and Commercial Papers.
p Preliminary

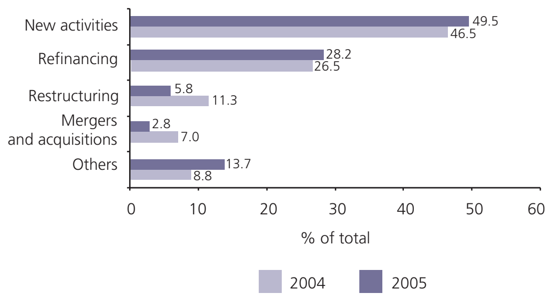
Fund raising activity by the private sector in the bond market increased, encouraged by prevailing low yields.

In the private sector, corporations stepped up issuances of PDS to capitalise on the flattening and declining yield curves at the longer-end in an environment of ample

Graph 9.14
Total Bonds Outstanding



Graph 9.15
Utilisation of Bond Proceeds[1]



[1] Excluding Cagamas

liquidity and strong demand for long-term securities by investors. The strengthening of the private sector-led economic growth contributed to the expansion of the PDS market. As at end-2005, the PDS market accounted for 24% of total debt financing to the private sector, complementing the banking system in providing corporations with opportunity to structure their balance sheet in line with their business requirements.

Issuances of PDS were made by 95 corporations. In total, these companies raised gross funds of RM35.7 billion (2004: RM28 billion), while Cagamas Berhad raised the balance of RM2.5 billion (2004: RM8.3 billion). Consistent with the trend in 2004, the issuances of PDS were mainly to finance new business activity, which accounted for 49.5% of total issuances, followed by refinancing of existing debt. Meanwhile, bonds issued by Cagamas Berhad were reduced significantly due to the ample liquidity in the banking system. After netting out redemptions during the year, net funds raised by the private sector amounted to RM19.6 billion, the highest amount recorded since 2000. Excluding Cagamas bonds, net PDS issuance totalled RM22.2 billion, the highest amount ever recorded by the PDS market.

Corporations in the finance, real estate and business services sector were the main issuers, followed by companies in the utilities and construction sectors, accounting for 36.8%, 19.6% and 17.8% of the total PDS issued respectively. The higher issuance in the finance and business services sector partly reflected the new issuance of asset-backed (ABS) securities originated by financial institutions and residential mortgage-backed securities issued by Cagamas MBS Berhad. In the utility and construction sectors, major issuers were the companies involved in the water projects and independent power producers, which continued to tap the capital market to finance their long-term financing needs.

During the year, the maturity profile of the PDS market lengthened further with the issuance of bonds with a 33-year tenure, by a company involved in infrastructure projects. The tenure of the PDS issuances in 2005 also shifted above 10 years, reflecting the issuers' decision to lock-in the prevailing low yields and hedge possible future interest rates rise. The issuers were mainly companies involved in power production and infrastructure projects, which have long gestation periods and would therefore benefit from long-term financing that matches their projected cashflow. The percentage of short to medium-term securities with tenure between one to five years declined to 34.5%, compared to 45.6% in 2004. Meanwhile, Cagamas MBS extended its Islamic Residential Mortgage Backed Securities (RMBS) to 20 years, thereby lengthening the benchmark curve for the ABS asset class and allowing market participants to price bonds with equivalent tenures.

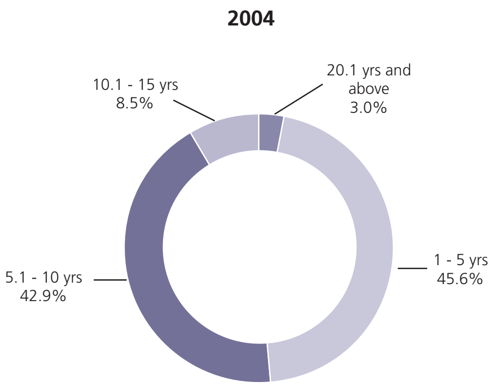
In terms of the types of instruments, Islamic securities (including Islamic Medium Term Notes) remained the most

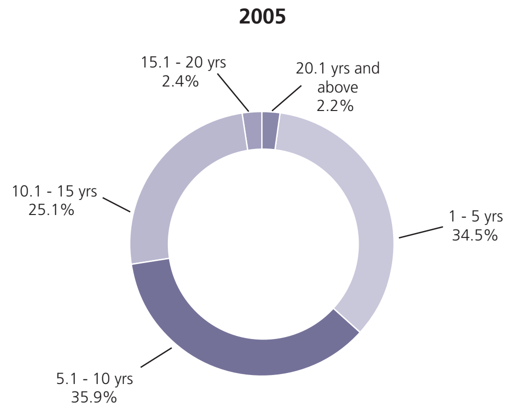
Table 9.6
New Issues of Private Debt Securities by Sector[1]

Sector	2004		2005p	
	RM million	% share	RM million	% share
Agriculture, forestry and fishing	0.0	0.0	892.8	2.5
Mining and quarrying	0.0	0.0	630.0	1.8
Manufacturing	3,264.5	11.6	2,796.3	7.8
Construction	8,844.9	31.5	6,356.1	17.8
Electricity, gas and water supply	7,840.2	28.0	6,976.2	19.6
Transport, storage and communication	796.0	2.8	2,623.3	7.4
Financing, insurance, real estate and business services	4,767.8	17.0	13,122.7	36.8
Government and others	1,315.4	4.7	1,126.7	3.2
Wholesale and retail trade, restaurants and hotels	1,221.1	4.4	1,132.0	3.2
Total	**28,049.9**	**100.0**	**35,656.1**	**100.0**

[1] Excluding Cagamas.
p Preliminary

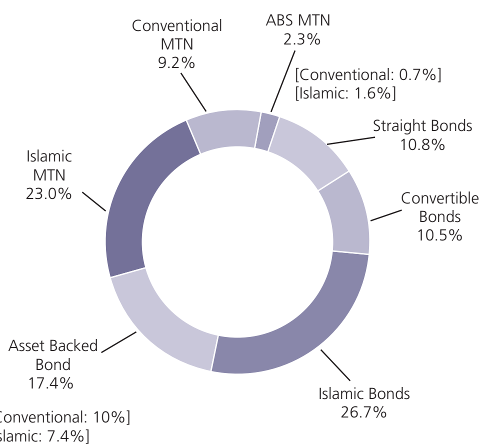
Graph 9.16
PDS Issues by Tenure (excluding Cagamas)





favoured form of debt securities financing, and accounted for slightly more than half of total PDS issued. The implementation of tax incentives for Islamic products as well as measures taken since 2004 to develop a more innovative and sophisticated Islamic capital market resulted in higher issuance of Islamic products during the year. An encouraging development was the issuance of Islamic debt securities backed by future property tax assessment collections by a local authority. The bond was issued based on the *mudharabah* (profit-sharing) concept, which was not widely used previously. The issuance promoted the scope and depth of the Islamic bond market. Meanwhile, Cagamas MBS Berhad issued the inaugural issuance of Islamic RMBS during the year.

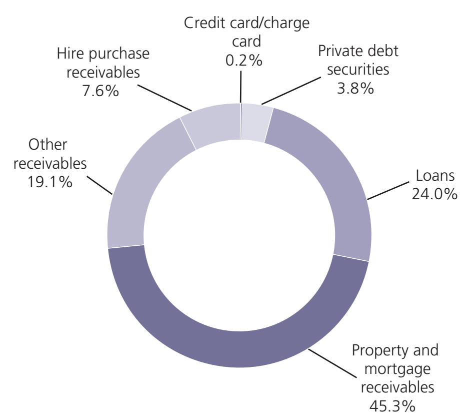
Graph 9.17
PDS Issues by Type of Instrument (excluding Cagamas)



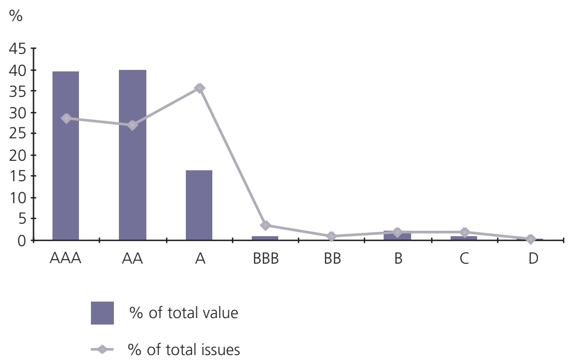
In an environment of continued excess liquidity in the financial system, bonds issued by Cagamas Berhad declined, with 12 issuances of debt securities (including two re-opening exercise) amounting to RM2.5 billion (2004: 18 issues totaling to RM9.3 billion). Out of these 12 issues, seven were issued in the form of fixed rate bonds while the remaining as Islamic securities. The Cagamas Islamic securities, which were previously known as Sanadat Cagamas, are now renamed as Cagamas BAIS (*bai' bithaman ajil* Islamic Securities).

In the securitisation market, Cagamas MBS Berhad issued two issues of RMBS backed by the Government's staff housing loans in August and December. The first issue involved RM2.05 billion of Islamic RMBS based on *musyarakah* principle while the second issue involved

Graph 9.18
ABS Outstanding: Types of Underlying Assets (As at end-December 2005)



Graph 9.19
Rating Distributions of Outstanding PDS
(As at end-December 2005)



Source: RAM and MARC

RM2.06 billion of conventional RMBS. The Islamic *musyarakah* principle bond was the world's first rated Islamic RMBS. In addition, six new ABS (including ABS MTN) were issued during the year backed by underlying assets such as hire-purchase receivables, land and other receivables. In total, the new issues of ABS securities amounted to RM7 billion and accounted for 19.6% of total gross PDS issued in 2005.

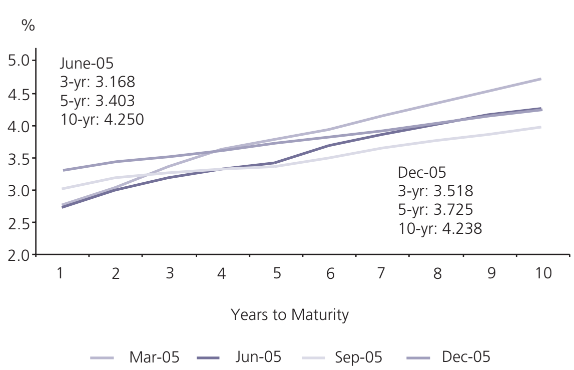
Rating activity during the year remained robust with 156 new long-term PDS issues valued at RM42.3 billion being rated by both the Rating Agency Malaysia (RAM) and Malaysian Rating Corporation Berhad (MARC). The long-term issues accounted for 79% of the total gross value rated. In terms of rating classes, most of the PDS were classified in the AAA, AA and A categories. Throughout the year, 330 rating reviews on existing long-term debt securities were conducted by both agencies, where 276 issues were reaffirmed, 31 upgraded and 23 downgraded. In comparison with the previous year, the proportion of upgrades increased from 7.2% to 9.5% of total reviews, while the percentage of downgrades was also higher at 7% of total reviews, against 3% in the previous year.

The ringgit bond yield curves flattened significantly during the first three quarters of the year, reflecting a similar phenomenon of flattening yield curves experienced globally. During this period, while the short-end of the MGS yield curve held relatively firm, the 10-year MGS yield declined by 78 basis points, driven by the ample liquidity situation coupled with a high demand for bonds amidst lower MGS issuances. The declining yields were also a result of the increasing amount of foreign capital flows into ringgit assets as investors sought higher returns. Conditions in the secondary market were also influenced by concerns over the impact of rising oil prices on the inflation and economic outlook. The yield curves remained stable after the removal of the ringgit peg in July, as demand for long-term bond continued to be high and the market proved resilient to capital outflows.

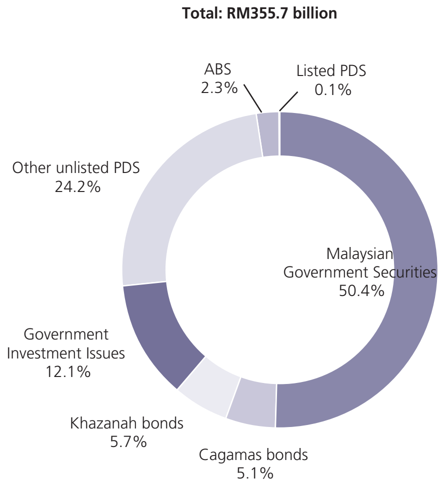
By early September, the short-end of the yield curve rose, indicating that the market had begun to price-in the prospects of possible higher interest rates, following signs of improved economic activity and higher inflation rate. Nevertheless, investors took a cautious stance in trading, after taking into account the possible changes in domestic interest rates, as well as the magnitude of the MGS issuances for the quarter. The MGS yields firmed up across the different tenures by the end of the year, following the 30 basis points rise in the overnight policy rate on 30 November. For the year as a whole, the short-end 1-year MGS yields rose by 106 basis points, while the 10-year MGS yields declined by 50 basis points. These developments resulted in the flattening of the yield curve during the year. Meanwhile, spreads on corporate bonds remained stable, which suggested that there was little change in market participants' perception of corporate credit risks.

Trading in the ringgit bond market averaged RM1.4 billion daily, and amounted to RM355.7 billion for the year (2004: RM355.9 billion), with trading of MGS accounting for 50.4% of total trade. Trading activity in corporate bonds increased to 26.6% of total (2004:18.1%) as investors searched for higher yields from the PDS market. Trading activity in Cagamas papers fell significantly following the lower issuance of Cagamas papers during the year. Liquidity, as measured by the ratio of trading volume to total outstanding bonds, was

Graph 9.20
MGS Benchmark Yields



Graph 9.21
Turnover of Selected Debt Securities (Jan-Dec 2005)



highest for GII and Khazanah bonds, at 4.28 times and 1.84 times, respectively. Liquidity for corporate bonds, however, was the lowest at 0.5 times the outstanding amount.

The introduction of ISCAP (Institutional Securities Custodian Programme), which involved the active use of repo in monetary operations, combined with the MGS lending facility provided by the Bank to the principal dealers since the beginning of the year, helped improved the performance of the repo market significantly. Repo transactions increased by 88.2% to RM347.8 billion (2004: RM184.8 billion), with 76% of the total focused in the MGS market.

On the international front, credit spreads on Malaysia's sovereign bonds narrowed in the first three quarters, following higher demand for Asian dollar credits as economic fundamentals improved and investors seeking better returns. The credit spreads widened in the fourth quarter partly due to the increase in interest rates in major markets, as well as concerns over higher inflationary pressure following the high oil prices.

As part of the initiatives to broaden and deepen the domestic and regional bond markets in East Asia Pacific region, the EMEAP group launched the first regional bond fund or Asian Bond Fund 1 (ABF1) in June 2003. Following from the success of the US dollar ABF1, the EMEAP Central Banks launched the Asian Bond Fund 2 (ABF2) in December 2005, which is mandated to invest in bonds denominated in local currencies of selected member countries namely PR China, Hong Kong China, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand. The ABF2 was launched with the objective of promoting the domestic currency bond market and introducing bonds of multi currencies in a basket as a new asset class for investors. The launching of the ABF2 also led to the inaugural listing of the ABF Malaysian country sub-fund or ABF Malaysian Bond Index Fund on Bursa Malaysia, which comprised investments in ringgit denominated Government and quasi Government securities. The listing of the ABF Malaysian Bond Index Fund (the first Exchange Traded Fund in Malaysia) would add more diversity to the listings on Bursa Malaysia and eventually greater liquidity in the domestic bond market.

Several measures were introduced in 2005 to further strengthen the bond market. The detailed bond market measures are explained in the box **"Key Capital Market Measures in 2005"**.

Exchange-traded Derivatives Market

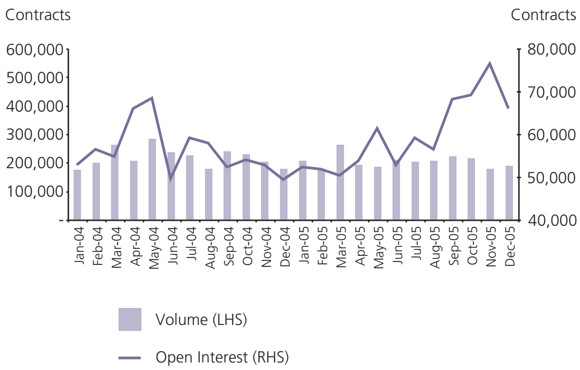
The exchange-traded derivatives market in Malaysia remained active during the year although trading volume declined. Turnover on Bursa Malaysia Derivatives dropped by 6.6% (2004: +32%). While the annual trading volume decreased slightly to 2.5 million

Table 9.7
Sovereign Over US Treasury Benchmark

	Benchmark	Dec-04	Mar-05	Jun-05	Sep-05	Dec-05
MALAYSIA 09	5-yr UST	47	65	58	45	55
MALAYSIA 11	5-yr UST	92	88	68	54	60
CHINA 11	5-yr UST	85	66	75	52	61
INDONESIA 06	2-yr UST	65	108	49	75	52
KOREA 08	2-yr UST	56	68	44	10	3
PHILIPPINES 10	5-yr UST	377	253	236	119	97
THAILAND 07	2-yr UST	54	64	64	40	65
PETRONAS 06	2-yr UST	49	45	44	37	39

Source: Bloomberg.

Graph 9.22
Bursa Malaysia Derivatives : Total Monthly Volume And Month-end Open Interest



Source: Bursa Malaysia Derivatives

contracts (2004: 2.6 million), trading performance remained high for the third consecutive year since 2003. In terms of average daily volume, the financial futures contracts, especially the KLCI Futures and the 3-month KLIBOR Futures, continued to improve compared to the year before. Though relatively small, the modest growth recorded during the year in the financial futures market was largely due to increased interests by financial institutions in taking hedging positions against anticipated interest rate hikes.

The Crude Palm Oil (CPO) Futures market continued to be the most active on the Bursa Malaysia Derivatives market in 2005, accounting for 47% of the total volume transacted during the year. However, the total contracts cleared during the year declined by 15.9% to 1.16 million contracts (2004: 1.38 million contracts), representing a notional value of 28.96 million tonnes of crude palm oil. The decline was attributed to a significantly reduced price range of RM252 (2004: RM621) for the benchmark 3-month CPO contract, implying a reduction in volatility in the market. Meanwhile, no contracts were traded at the Crude Palm Kernel Oil (CPKO) Futures market during the year.

The 3-month CPO Futures commenced the year trading at RM1,378 per tonne, and initially declined to the lowest daily traded price of RM1,252 per tonne on 2 February. The decline in prices was caused by the bumper CPO output recorded in January. However, prices soon recovered to register the highest daily traded price of RM1,504 per tonne on 16 March. Thereafter, prices consolidated to a tight range of between RM1,380 and RM1,430 per tonne for the rest of the year. The upward momentum in prices was

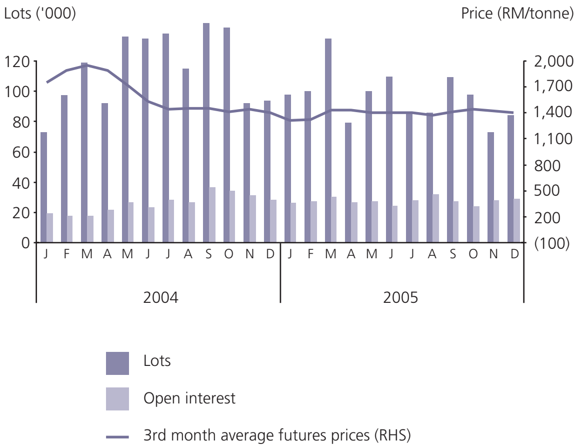
Table 9.8
Performance of Bursa Malaysia Derivatives Products

Products	Turnover						Share of total volume in Bursa Malaysia Derivatives (%)	
	2004			2005				
	Number of lots	Annual change (%)	Average daily volume	Number of lots	Annual change (%)	Average daily volume	2004	2005
CPO Futures	1,378,334	-3.6	5,603	1,158,510	-15.9	4,709	52.3	47.1
Open interest position (as at end-year)	28,314			28,918				
Palm Kernel Oil Futures	449	n.a.	2	-	-100	-	0.02	-
KLCI Futures	1,088,419	228.6	4,424	1,111,575	2.1	4,519	41.3	45.2
Open interest position (as at end-year)	*10,092*			*17,814*				
KLCI Options	-	-	-	-	-	-	-	-
3-month KLIBOR Futures	141,969	18.6	577	162,592	14.5	661	5.4	6.6
Open interest position (as at end-year)	27,418			37,966				
3-year MGS Futures	4,327	454	18	9,753	125.4	40	0.2	0.4
5-year MGS Futures	19,494	-83.6	79	17,215	-11.7	70	0.7	0.7
Open interest position (as at end-year)	-			150				
10-year MGS Futures	-	-100	-	100	100	0.4	-	-

n.a. Not available

Source: Bursa Malaysia Derivatives Berhad

Graph 9.23
Crude Palm Oil Futures



Source: Bursa Malaysia Derivatives

limited by the overall strong increase in CPO production, and rising stocks in Malaysia, coupled with higher harvests of palm oil's closest competitor, soybean, in the US, Brazil and Argentina. On the other hand, robust export volume, as well as market participants' favourable expectations on future demand for palm oil-based bio-diesel, established a floor on CPO prices that contributed to the reduced volatility in the prices of the CPO futures market during the year. The 3-month CPO futures ended the year at RM1,397 per tonne, which was 1.4% higher than the price at the start of the year.

The KLCI Futures market in 2005 recorded a small increase of 2.1% (2004: 229%) in trading activity, with average daily volume still higher than in the previous year. The derivatives liquidity ratio, which represents the ratio between the turnover value of futures against the turnover value of underlying KLCI component stocks, increased to 48.9% in 2005 (2004: 46.9%). In tandem with the lacklustre performance of the KLCI, the growth of KLCI Futures' volume was impinged by poorer than expected market sentiments, following concerns regarding the implications of high oil prices.

Activity in the financial futures market continued to show overwhelming interest. The improvement in market sentiments was mainly influenced by changing expectations on economic growth and expectations about domestic interest rates. Participants of the financial futures market were predominantly domestic institutions, which accounted for more than 95% of total trading activity. The 3-month KLIBOR Futures continued to record a positive growth of 14.5% (2004: 18.6%). Total turnover of MGS futures increased by 13.6% (2004: -80.1%). The 3-year MGS futures contributed significantly to the higher performance and registered an impressive growth of 125.4%, due primarily to the concentration of the underlying market activity in the shorter tenures.