Speech for Annual Dinner of Financial Market Association of Malaysia

By Dato' Lee K. Kwan

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Dato' Muhammad Ibrahim, Deputy Governor, Bank Negara Malaysia,

Distinguished guests from Bank Negara Malaysia, Bursa Malaysia Derivatives, Association of Banks in Malaysia, Association of Money Brokers, Malaysian Association of Corporate Treasurers and Asian Institute of Chartered Bankers,

Members of the Financial Markets Association of Malaysia or PPKM,

Good evening and welcome to the 2015 Annual Dinner.

First, let me thank and congratulate the Social Committee led jointly by Jamzidi Khalid and Jamil Baharuddin from AmBank, Calbert Loh from Bangkok Bank, Ms. Sylvia Wong from Standard Chartered, Ms. Karen Sta Maria from First Taz and our Carole for achieving yet another outstanding turnout for this year's Annual Dinner. We have taken up the maximum number of tables the Majestic Hotel can offer plus taking the unprecedented step of squeezing 11 to a table and even then we have to turn members away as we can only seat 1,180. On behalf of the FMA, we would like to apologize to our members who were unable to purchase tickets for this event. On a brighter note, we would like to inform all of you that the probability of winning prizes including lucky draws remain as high as ever thanks to the very generous sponsors vividly displayed in the backdrop. For everyone's information, the value of the prizes to be given away tonight is worth more than RM150,000 in value.

Financial market performance (annualised YTD Sep 2015 vs 2014)

In terms of the performance of the Malaysian financial markets, 2015 has been a volatile year which saw a slowdown in the GDP growth of the country to about 5%, a weakening of the Ringgit which declined by 25% during the year emanating from the slowdown in China, Malaysia's largest trading partner, likely and some would argue imminent increases in USD interest rates as their non-farm payroll numbers have been strong over the last few years where unemployment is now back down to levels prior to the 2008 GFC of about 5%, our own domestic issues in Malaysia and the collapse in commodity prices.

Despite these challenges, I am pleased to see that the Malaysian financial markets have remained resilient and trading volume has increased marginally by RM0.6 trillion or 2% to an annualized trading volume of MYR29.5 trillion as of September 2015 YTD. The Foreign Exchange market managed to grow by 10% in Ringgit terms to RM10.4 trillion in 2015 from RM9.5 trillion in 2014 while transaction volume in money markets dropped marginally to RM16.3 trillion compared to RM16.4 trillion in 2014 which is not unexpected with the implementation of Basel 3 as money markets are unsecured interbank lending and borrowing instruments. Repo / Reverse Repo on the other hand, which are secured credit and funding facilities have finally started to grow strongly this year with market volume MYR 430 billion, 219% higher than the MYR196 billion of market volume recorded in 2014. In the secondary Sukuk and bond markets, trading volume declined to RM2.1 trillion from RM2.4 trillion in 2014.

One of the bright spots in our financial markets this year is that the trading volume of OTC derivatives increased 146% to MYR625 billion notional traded compared to RM254 billion in 2014. In particular, the transaction volume for Klibor interest rate swaps and Islamic profit-rate swap increased by 151% from 2014. The growth in the interest rate and profit rate term structure hedging markets and healthy future prospects going forward owes in no part to Bank Negara Malaysia's efforts to make Malaysia a netting-friendly jurisdiction, leveling the playing field in terms of capital charge between Malaysian banks and banks elsewhere in dealing with customers and foreign counterparties, and especially for ringgit-based derivative products.

For the Ringgit bond origination primary issuance markets, 2015 has been a slower year with new issuances up to September YTD decreasing by 11% to RM118.3 billion compared to RM133.4 billion in the same period in 2014. Sukuk continue to be the most preferred instrument by both the Government and corporates, with total issuances of RM38 billion and RM30 billion respectively.

All in all, not too bad considering the year Malaysia is going through.

Market development

On market development, this area remains the primary focus of PPKM as the well-being, healthy and efficient functioning and development of the financial markets is a heavy responsibility with annual trading volumes approaching RM30 trillion across a multitude of asset classes from FX to bonds to money to equity, commodity and hedging instruments which have a significant impact on the economy, businesses, investors and individuals. It has as usual been a very busy year on this front and while there are many ongoing projects, I will, in the interest of time, just highlight 3 focus areas as this is an annual dinner party and not a Market Technical Development Committee meeting.

First is, we are in the midst of rolling out **credit spread pricing** for Ringgit corporate bonds. This is in addition to the quotation of absolute yields which will certainly continue unchanged. As most of you are aware, a full scale presentation and discussion was conducted in BNM last Thursday in which the presentation slides have since been circulated out. In brief, FMA PPKM banks will be quoting credit spreads for Ringgit corporate bonds referencing off the Klibor IRS curve, where the credit spread quote is to be dollar duration matching based off the Z spread methodology. The objectives are to ensure that the methodology adopted is an accurate representation of the credit spread, is not misleading to investors and issuers, where the quoting convention is to be standardized across banks where the same credit spread quote means the same from one bank to another down to the mathematical translation into actual prices so that there is no ambiguity – standardized and mathematically defined - and most importantly, we are trying to ensure that the credit spread price quote has the same deal-able trading execution quality as the absolute yield price quote and is not just a number. In the presentation slides, I also gave a few examples of the deceptive nuances of the US Treasury + credit spread quotes to watch out for.

In the adoption of this methodology, we factored in evolution and growing pains of the USD markets and went straight to best practices and technology unsaddled by history and historical market conventions. In addition, the analytics to compute z spread off Klibor IRS is readily available in Bloomberg where you can toggle corporate bond prices and the IRS curve to your heart's content. Don't get me wrong as Bloomberg is not paying me to say this nor do I own any shares in Bloomberg.

In addition, we will also be publishing credit spreads off MGS'es and GII's and the market convention we will be adopting is the following: for corporate bonds with maturity less than 1.5 year, the credit spread will be computed referencing BNM's 1 year MGS rate, for corporate bonds with maturity between 1.5 year to less than 2.5 year, the credit spread will be computed referencing BNM's 2 year MGS rate all the way to 9 years where corporate bonds with 8.5 yr to less than 9.5 residual maturity will reference the 9 year MGS. For corporate bonds with 9.5 year to maturity to less than 12.5 years, they will reference the 10 year MGS, for corporate bonds with 12.5 years to less than 17.5 year residual maturity, the corporate bond will reference the MGS 15 years. The MGS and GII levels utilized to derive the credit spreads are from the daily BNM FAST Consolidated YTM page. But do please note that the credit spread quoted off MGS/GII is not dollar duration matching, is for reference purposes and not dealable as the Malaysian markets today are not sufficiently developed to generate the negative dollar duration necessary to trade out the credit spread of Ringgit corporate bonds into a real price which require a well-functioning reverse repo / repo market and MGS bond futures market.

The development of the RM credit spread market is important as the world has been on a one very long bull run of mostly declining interest rates since the 1997/98 Asian financial crisis and especially since the 2008 global financial crisis. Today, whilst the Malaysian government & corporate bond markets have developed strongly and is now the largest in ASEAN with outstanding issuances of RM1.1 trillion or 97% of GDP, it however remains a mostly absolute yield market which restricts our ability to price, trade out or hedge the interest rate term structure risk component separately from the credit spread risk return component. In essence, the state of development is such that markets today buy the interest rate and credit risk return components TOGETHER and sell both the interest rate and credit risk return components TOGETHER. In a rising interest rate scenario say rates going up by 2 to 3% (almost unimaginable after such a long period of low interest rates), this will result in either massive liquidation or alternatively suffer large mark-to-mark losses fuelling fund redemption and/or cut loss limits, forcing liquidation in a difficult selling environment creating a negative spiral. This is evidenced that whenever RM rates go up or there is fear of rates rising, liquidity in the Ringgit corporate bond markets collapse by 50% or more as the interest rate risk return component is not dynamically managed separately from the credit spread risk return component.

Hence, the next major step in the development is to develop the technology where one can still earn 5 year credit spreads without having to necessarily take on 5 year interest rate risks where the earnings profile can instead be a 5 year credit spread plus a 5 year floating interest rate risk return profile which will significantly reduce the losses in a rising interest rate environment short of selling down the book and shutting off the corporate bond market. This is exactly what a developed credit spread and interest rate hedging markets such as the USD and CAD fixed income markets are able to achieve where as long as it is not a credit crisis but an interest rate cycle of rising or declining rates, the credit markets continue to function efficiently for both issuers and investors.

As such, PPKM member banks will commence publishing credit spreads in addition to absolute yields starting 1st December 2015 in their daily Ringgit corporate sukuk and bond axis.

(b) The second high priority area of market development is the **Ringgit repo / reverse repo market**. Standing here before you about the same time last year, we listed down the benefits of a developed Ringgit Repo market as it will significantly improve the liquidity of the ringgit bond market to mitigate the effects of a high savings rate nation of mostly long only buy and hold investors, adds to price transparency and quality of prices good for larger amounts for both issuers and investors alike, and significantly enhances interest rate hedging and facilitation of the credit spread markets referencing MGS'es. It will also improve the resilience of the Malaysian financial system during times of stress as we have all witnessed in the 2008 global crisis and the 2012 European sovereign and banking crises how reliance on unsecured lending and borrowing can seize up the entire financial system in both the USA and Europe. For Malaysia, as our Ringgit bond markets are already well developed and populated with high credit quality issuers of government and mostly AAA and AA rated issuers, the benefits of a well-developed collateralized repo funding markets are very clear.

To realise this objective, PPKM has completed the drafting of the Malaysian Country Annex of the 2011 Global Master Repurchase Agreement or GMRA and submitted the document to Bank Negara Malaysia for consideration. We hope this set of documentation will be used as a standard template for dealings in Repo between Malaysian banks and shall minimize the need for banks to bilaterally negotiate with each other. This standard could also be subsequently rolled out later to institutional investors and asset managers where they can secure funding realiably and cheaply by repoing out their bonds and thereby reducing their need to carry large cash holdings incurring negative carry to cater for their cash requirements such as redemptions.

PPKM will also be publishing a repo hair-cut framework which is based on the future volatility in the yield of the bonds over the repo tenor and the potential decline in the collateral bond price putting very little emphasis on the creditworthiness of the borrower to repay and instead rely on the value of the security / collateral value to make good. The recommended repo hair cut will be a function of (i) Tenor of the repo, (ii) Tenor of the underlying security where longer duration bond has more price sensitivity, and (iii) Rating of the corporate bond which may have different yield volatilities. This is however just a recommended framework and FMA PPKM will leave counterparties to bilaterally negotiate the specifics with each other.

We expect these proposals to complement the market quotation methodology already announced by PPKM on 30 March 2015 where bid-offer of Ringgit Repo transactions shall be quoted on yield basis just like for bonds. In addition, we conducted the second Repo & Global Master Repurchase Agreement ("GMRA") in collaboration with the International Capital Market Association (ICMA) in October this year and it was a huge success with traders, lawyers, accountants, regulators etc attending and familiarizing themselves on the intricacies of Repos and Reverse Repos.

And, as mentioned earlier, the Ringgit Repo market has finally started to grow with market volumes up 219% this year to MYR 430 billion compared to MYR196 billion of market volume recorded in 2014. But this is still a drop in the ocean and much more work needs to be done.

The third major initiative is the collaboration with the **Asian Institute of Chartered Bankers** (previously IBBM) focusing on 3 main areas. First is the PKMC Curriculum, Lecture and Examination which sets the minimum standards and entry point of new entrants to the Malaysian financial markets. We are collaborating with AICB, to update the PKMC Curriculum to better reflect the requirements of the Malaysian financial markets today. This will include expanding the fixed income curriculum and not just to be glossed over under money markets which is a 1 year and under market while fixed income is the longer tenor market averaging 5 and 7 years with risk and return that are much greater (b) bank balance sheet management and in particular the credit for funds pricing for deposits that is consistent with the cost of funds pricing for loans, behavioral vs contractual deposit roll over profile, Basel 3 in addition to BNM statutory reserve requirements (c) bootstrapping and building of zero coupon curves, awareness of the implied 3 month Klibor forward rates, how it reconciles to 5 year klibor interest rate swaps to 3month klibor futures and a basic understanding on options, of volatility risks and return around the implied forwards etc

Working with AICB, we will be elevating the status of PKMC holders who have passed all the modules and brand the certification accordingly. Dato' MI and Mr. Donald Joshua Jaganathan of BNM suggested something like Certified Treasury Practitioners or Angus' suggestion of Certified Financial Markets Practitioners to tie in with the FMA under the AICB umbrella. In addition, we will endeavor to make the study and lecture materials a lot more professional that FMA PPKM students preparing for the PKMC exams have a proper book that they can study with instead of loose sheets of paper today and where some of the lecture materials are copyrighted by the lecturers.

We will also be focusing on developing the Financial Markets Infrastructure as well as Member Professionalism and Conduct with AICB.

Continuing education

On the continuing education front for our existing members, the Seminar Committee chaired by KT Tan did a wonderful job organizing the following key events during the year which were very successful such as

(a) Global drivers in capital markets;

(b) the GMRA Workshop in collaboration with ICMA to develop the repo market;

(c) Financial market simulation module;

(d) Industry briefing on the Tri-Reduce Multi-lateral Risk Compression System to optimize returns; and

(e) FX Summit 2015 with Bloomberg.

For 2016, we have even more ambitious plans to widen the continuous learning and exposure for our members.

But it was a very lonely experience in the Bloomberg FX conference held on 22nd Sept 2015 arguing why the Ringgit has overshot and just as well a week after, the Ringgit rallied from almost 4.50 to 4.10. The arguments given then are still as valid as they are today where (a) the current account, trade and balance of payments will show improvements going forward month after month as the sheer affordability of both imports and investments abroad with US Dollar now at 4.30 vs 3.30 or GBP at 6.60 vs 5.00 will decline substantially and this was consistent with what we saw in after the 97/98 Asian financial crisis (b) the FCA / foreign currency account bank deposit balances onshore of about USD30 billion are balances held by exporters from their foreign currency proceeds plus foreign currencies purchased by Malaysian individuals with and without credit facilities. They are NOT monies held by foreigners that can be withdrawn but are captive monies onshore owned by Malaysian businesses and individuals sitting on significant mark-to-market gains. This is also why there is an abundance of USD onshore despite the turbulence that the nation is going through in 2015 (c) investments abroad totaled RM522 billion as of June 2015 and similarly, these Malaysian investors are sitting on significant windfall FX gains. Any hedging or locking in of these gains whether spot, forward or options is a purchase of RM spot from delta hedging and we have seen how quick the RM can rally in today's thin markets in early October from 4.50 to 4.10 evaporating the unrealized windfall gains that businesses and fund managers are sitting on. But on the other hand, the fair value of the Ringgit is also no longer the good old days of 3.30 to the USD or 5.00 to the GBP as the US Dollar is very strong. Perhaps if fair valuation is to reference other commodity nations such as Canada and Australia, the MYR would have been 3.80 to 3.90 in Sep and about 4.0 today after the US nonfarm payroll number last friday.

In closing, this has been a busy year for FMA PPKM where developing the Malaysian financial markets prudently will continue to be our key objective. The focus remains on value creation as opposed to providing greater avenues for punting and speculation. This includes more efficient financing in both amount and price to customers, greater availability to longer tenor fixed rate financing to better match their risk return requirements, better hedging markets to allow the productive sectors of the economy to better manage their interest rate, currency, equity and commodity input price risks as well as developing a greater range of investment products for institutional investors and individual savers as we are a high savings rate nation. We must continue to safeguard, develop and build the Malaysian financial markets prudently which is now approaching RM30 trillion in annual trading volume. And, please bear in mind that PPKM remains a voluntary organization and we certainly welcome folks who are willing to contribute as opposed to just complain.

Thank you everyone for your continued support and I wish you all greater success going into the new year. Thank you.