Malaysia—Update

Yield Movements

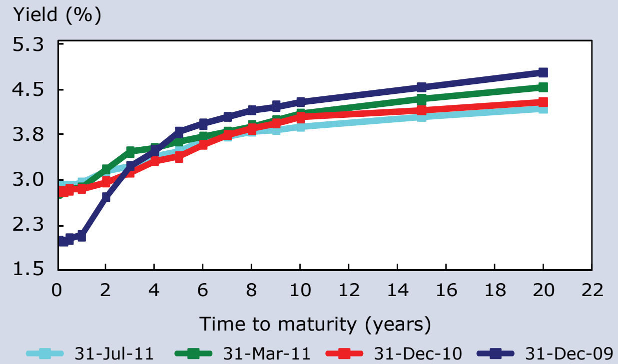
The yield curve for Malaysian government bonds flattened between end-March and end-July, with rates rising on the very short-end of the curve and falling from the belly to the long-end **(Figure 1)**. Movement at the very short-end of the yield curve, which rose between 7 basis points (bps) and 14 bps, reflected rising inflation. Yields at the belly to the long-end of the curve fell between 2 bps and 36 bps. As a result, the yield spread between 2- and 10-year maturities narrowed to 72 bps at end-July from 92 bps at end-March and 106 bps at end-December 2010.

Bank Negara Malaysia (BNM) decided to keep its key policy rate steady at 3.0%, but increased the statutory reserve requirement ratio 100 bps during its last Monetary Policy Committee meeting on 7 July. BNM has increased the statutory reserve requirement ratio a total of 300 bps to 4.0% since the start of the year.

In June, consumer price inflation in Malaysia rose to 3.5% year-on-year (y-o-y) from 3.3% in May and 3.2% in April. During the first 6 months of 2011, the consumer price index increased 3.0%, driven mainly by the rise in the cost of food and transportation.

Malaysia's economic growth eased slightly to 4.6% y-o-y during 1Q11 from 4.8% in the previous quarter. Robust growth in domestic demand cushioned a decline in net export growth. Domestic demand increased 6.6% y-o-y in 1Q11, driven by strong private sector consumer spending and public consumption, which rose 6.7% and 6.1% y-o-y, respectively. Meanwhile, gross fixed capital formation expanded 6.5% y-o-y in 1Q11. Exports posted 3.7% growth in 1Q11, up from 1.7% in the previous quarter but significantly lower than the 9.9% growth for full-year 2010. Imports increased 8.4% y-o-y, driven by stronger demand for intermediate, capital, and consumer goods. Amid lingering uncertainty over the condition of the global economy, the Malaysian government

Figure 1: Malaysia's Benchmark Yield Curve—LCY Government Bonds



LCY = local currency.
Source: Bloomberg LP.

expects the domestic economy to grow 5.0%–6.0% in 2011 on the back of a sustained increase in domestic consumption.

Size and Composition

As of end-June, the total amount of outstanding local currency (LCY) bonds had increased 16.7% y-o-y to MYR812.2 billion (US$269 billion), driven by double-digit growth in both LCY government and corporate bonds **(Table 1)**. Outstanding LCY government bonds expanded 20.9% y-o-y to MYR484.9 billion, with outstanding central bank bills surging 57.0%. Excluding central bank bills, outstanding LCY government bonds rose a more modest 13.4% y-o-y. Meanwhile, outstanding LCY corporate bonds increased 11.1% y-o-y.

On a quarter-on-quarter (q-o-q) basis, total LCY bonds outstanding increased 3.7% in 1Q11, as LCY government and corporate bonds grew 2.9% and 4.9% q-o-q, respectively.

During the first half of 2011, issuance of government bonds—Malaysian Government Securities (MGS) and Government Investment Issues (GII)—surged 60.6% to MYR53.0 billion from MYR33.0 billion in the same period last year. The increase in issuance

Table 1: Size and Composition of the LCY Bond Market in Malaysia

	Amount (billion)								Growth Rate (%)						
	Mar-11		Apr-11		May-11		Jun-11		Mar-11		Apr-11	May-11	Jun-11		
	MYR	US$	MYR	US$	MYR	US$	MYR	US$	y-o-y	q-o-q	m-o-m	m-o-m	y-o-y	q-o-q	m-o-m
Total	783	259	794	268	797	265	812	269	20.9	3.7	1.4	0.3	16.7	3.7	1.9
Government	471	156	481	162	481	160	485	161	30.1	5.8	2.0	0.0	20.9	2.9	0.9
Central Government Bonds	371	123	365	123	372	124	376	125	13.2	7.0	(1.8)	2.1	13.5	1.3	1.1
Central Bank Bills	100	33	116	39	108	36	108	36	206.9	2.0	16.1	(6.4)	57.0	8.8	0.1
Others	0	0	0	0	0	0	0	0	(73.0)	(52.1)	0.0	0.0	(52.1)	0.0	0.0
Corporate	312	103	314	106	316	105	327	108	9.2	0.7	0.6	0.7	11.1	4.9	3.5

LCY = local currency, m-o-m = month-on-month, q-o-q = quarter-on-quarter, y-o-y = year-on-year.

Notes:
1. Calculated using data from national sources.
2. Bloomberg LP end-of-period LCY—US$ rate is used.
3. Growth rates are calculated from LCY base and do not include currency effects.
4. "Others" refers to Khazanah Bonds issued by Khazanah Nasional Berhad and Cagamas, Bonds and Notes, Bithaman Ajil Islamic Securities, Sanadat ABBA Cagamas, and Sanadat Mudharabah Cagamas issued by Cagamas Berhad.

Source: Bank Negara Malaysia, Fully Automated System for Issuing/Tendering (FAST), and Bloomberg LP.

was due to maturing government bonds, estimated at MYR45.0 billion, as well as the need to fund a budget deficit that is targeted to reach 5.4% of gross domestic product (GDP) in 2011.

Issuance of LCY corporate bonds amounted to MYR27.0 billion in 2Q11, up 55.7% q-o-q and 17.7% y-o-y. In January–June, LCY corporate bond issuance rose 26.7% y-o-y. Among the largest corporate issues during the first half of 2011 were *sukuk* (Islamic bond) issuances from Pengurusan Air (MYR9.5 billion), GovCo Holdings (MYR3.0 billion), Sarawak Energy (MYR3.0 billion), Pembinaan BLT (MYR1.1 billion), and Rantau Abang (MYR1.0 billion). Tanjong Capital also issued MYR1.4 billion worth of 10-year hybrid notes through private placement. Hong Leong Bank sold MYR1.0 billion worth of Lower Tier 2 notes and raised another MYR1.4 billion from the sale of Tier 1 securities issued through Prominic Berhad. Finally, Maybank Islamic issued a MYR1.0 billion Tier 2 subordinated *sukuk.*

As of end-June, the top 20 corporate issuers in Malaysia accounted for 45.0% of total LCY corporate bonds outstanding **(Table 2)**. Cagamas Bhd, Khazanah Nasional, and Binariang GSM remained the biggest issuers of corporate LCY bonds at the end of 2Q11, with MYR19.1 billion, MYR13.2 billion, and MYR11.3 billion outstanding, respectively.

Investor Profile

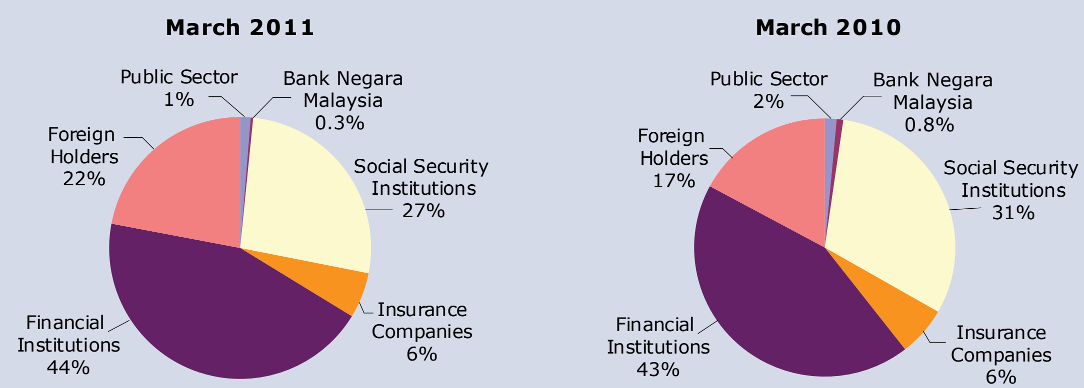
As of end-March, financial institutions were still the largest holders of MGS and GII, with 44.2% of total outstanding government bonds, followed by social security institutions, which held 26.5%. Insurance companies comprised 5.6% of the total **(Figure 2)**. Meanwhile, foreign investors held 22.0%, up slightly from a 21.5% share at the end of 2010, partly due to expectations of further appreciation of the Malaysian ringgit. Partly as a result of the appreciation of the ringgit since mid-2009, foreign holdings of Malaysian government bonds have risen from a low of 10.0% at end-June 2009 to 22.0% at end-March 2011 **(Figure 3)**.

Table 2: Top 20 Corporate Issuers in Malaysia (as of June 2011)

Issuers	Outstanding Amount (MYR billion)					State-Owned	Privately-Owned	Listed Company	Type of Industry
	BONDS	IBONDS	MTN	IMTN	TOTAL				
1. Cagamas			9.42	9.70	19.12	Yes	No	No	Finance
2. Khazanah		13.20			13.20	Yes	No	No	Quasi-Govt. and Other
3. Binariang GSM		3.02		8.28	11.30	No	Yes	No	Transport, Storage, and Comm.
4. Pengurusan Air SPV				10.65	10.65	Yes	No	No	Utilities
5. Project Lebuhraya		5.82		3.68	9.50	No	Yes	Yes	Transport, Storage, and Comm.
6. Prasarana	5.10	2.00		2.00	9.10	Yes	No	No	Finance
7. Maybank	6.10	1.50			7.60	No	Yes	Yes	Finance
8. Malakoff Corp		1.70		5.60	7.30	No	Yes	No	Finance
9. KL International Airport	1.60	4.26			5.86	Yes	No	No	Transport, Storage, and Comm.
10. Rantau Abang Capital Bhd				5.80	5.80	No	Yes	No	Quasi-Govt. and Other
11. Senai Desaru Expressway Bhd				5.58	5.58	No	Yes	No	Construction
12. CIMB Bank	5.50				5.50	No	Yes	No	Finance
13. Valuecap	5.10				5.10	Yes	No	No	Finance
14. 1Malaysia Development				5.00	5.00	Yes	No	No	Finance
15. AMBank	0.49		4.48		4.96	No	Yes	Yes	Finance
16. Jimah Energy Ventures				4.54	4.54	No	Yes	No	Utilities
17. Putrajaya Holdings		0.67		3.78	4.45	Yes	No	No	Finance
18. Bank Pembangunan Malaysia	1.00		2.40	0.90	4.30	Yes	No	No	Finance
19. Celcom Transmission				4.20	4.20	No	Yes	No	Transport, Storage, and Comm.
20. Tanjung Bin Power				4.07	4.07	No	Yes	No	Utilities
Total Top 20 LCY Corporate Issuers					**147.12**				
Total LCY Corporate Bonds					**327.30**				
Top 20 as % of Total LCY Corporate Bond Outstanding					**45.0%**				

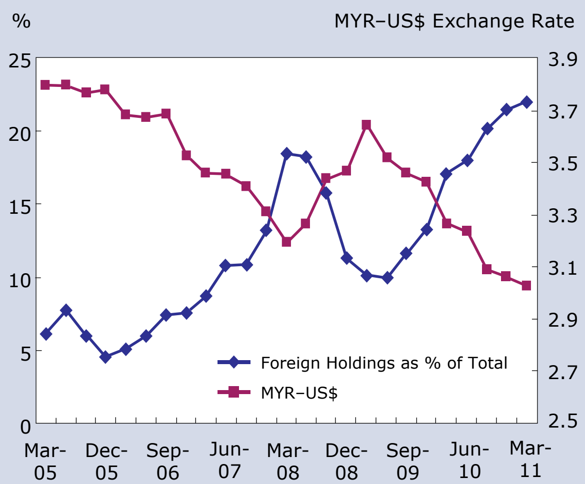
IBONDS = Islamic bonds, IMTN = Islamic medium-term notes, LCY = local currency, MTN = medium-term notes.
Source: Bank Negara Malaysia, Fully Automated System for Issuing/Tendering (FAST).

Figure 2: LCY Government Bond Market Investor Profile



LCY = local currency.
Source: Bank Negara Malaysia.

Figure 3: Foreign Holdings of LCY Government Bonds vs. the MYR–US$ Exchange Rate, 2005–2011



LCY = local currency.
Source: Bank Negara Malaysia and Bloomberg LP.

Rating Changes

In July, Standard & Poor's (S&P) lowered Malaysia's LCY long-term sovereign credit rating from A+ to A with a stable outlook following the implementation of a revised methodology and assumptions for sovereign ratings. According to S&P, the gap between LCY and foreign currency (FCY) ratings narrowed on most sovereigns under the revised methodology. Meanwhile, S&P affirmed Malaysia's LCY short-term rating at A-1 as well as the FCY short- and long-term ratings at A-2 and A-, respectively. S&P also noted that despite the forecast of 5.2% economic growth in 2011, the country is experiencing slow fiscal consolidation as a result of rising government subsidies **(Table 3)**.

Table 3: Selected Sovereign Ratings and Outlook for Malaysia

	Moody's	S&P	Fitch
Sovereign LCY LT Rating	A3	A	A
Outlook	stable	stable	stable
Sovereign FCY LT Rating	A3	A-	A-
Outlook	stable	stable	stable

FCY = foreign currency, LCY = local currency, LT = long-term.
Source: Rating agencies.

Policy, Institutional, and Regulatory Developments

SC Issues Guidelines on the Registration of Credit Rating Agencies

In March, the Securities Commission (SC) in Malaysia issued guidelines on the registration of credit rating agencies. The guidelines are meant to enhance the agencies' standards in key areas such as the transparency of rating criteria, objectivity of the rating process, and management of conflicts of interest. The new guidelines set out the regulatory and supervisory requirements for rating agencies and supersede the Practice Note on Recognition of Credit Rating Agencies for the Purpose of Rating Bond Issue that was issued by the SC in January 2006.

Among the provisions in the new guidelines is the requirement that the rating agencies maintain a minimum of MYR1 million of shareholders' funds unimpaired by losses. The agencies are required to develop rating criteria and methodologies appropriate for each type of bond and industry, and to publish these before any rating is assigned to a bond issue. The credit rating agencies are also required to conduct timely and regular rating reviews of outstanding bonds, and regularly publish these rating reviews and reports.

SC Launches New Capital Market Masterplan

In April, the SC launched the Capital Market Masterplan 2 (CMP2), a continuation of the previous Capital Market Masterplan, in an effort to expand the role of domestic capital markets in financing economic growth. The CMP2 aims to provide market participants a clear understanding of the government's long-term strategies for the development of Malaysia's capital markets, including

(i) promoting capital formation,
(ii) expanding intermediation efficiency and scope,
(iii) deepening liquidity and risk intermediation,

(iv) facilitating internationalization, and
(v) building capacity and strengthening information infrastructure.

The CMP2 cites the need to increase the capacity of the bond market to finance a wider base of industries and projects, as well as more sophisticated ventures. To this end, the CMP2 has articulated strategies that include

(i) strengthening disclosure and documentation standards and practices,
(ii) enhancing the credit rating agency regulatory framework,
(iii) reviewing the bond default process and promoting an active market for pricing distressed issues,
(iv) expanding participation of the investment management industry in the bond market,
(v) strengthening bond trading and post-trade infrastructure,
(vi) facilitating greater retail participation in the bond market, and
(vii) expanding the range of fixed-income products.

The CMP2 also outlines governance strategies to ensure investor protection and stability.

BNM Liberalizes Rules on Direct Investment Abroad

BNM announced new measures in May to liberalize regulations on residents directly investing abroad and on inter-company loans and trade financing. Effective 1 June, the measures allow resident companies that meet prudential requirements to undertake any amount of direct investments abroad, effectively exempting them from the prevailing MYR50 million limit on investment in FCY assets. Resident companies will also be allowed to borrow any amount, in either ringgit or FCY, from non-bank related companies.

BNM also lifted the MYR5 million limit on offshore FCY trade financing. Residents may now borrow offshore, including for FCY trade financing, up to an existing aggregate limit of MYR10 million for individuals and MYR100 million for companies.

BNM Issues New Islamic Monetary Instrument

BNM began issuing a new Islamic monetary instrument in June called BNM Monetary Notes–*Istithmar*. The notes are based on the *istithmar* (investment) concept, which refers to a portfolio structure combining the principles of *ijarah* (sale and lease-back of assets) and *murabahah* (commodity mark-up sale transaction).

SC Issues Revised Guidelines for Corporate Bonds and *Sukuk*

In July, the SC issued revised guidelines for private debt securities and *sukuk* in line with the broader objectives of the CMP2. The revised guidelines will replace the earlier Guidelines on Offering Private Debt Securities and Guidelines on the Offering of Islamic Securities, both of which were issued in July 2004. The revised guidelines streamline the approval process and time-to-market for the issuance of corporate bonds and *sukuk.* The revised guidelines also remove the mandatory rating requirement for selected issues or offers, and provide greater disclosure of relevant information for debenture holders. The revised Islamic Security Guidelines provide greater clarity to ensure compliance with *sharia'h* (Islamic law) rulings and principles endorsed by the *Sharia'h* Advisory Council of the SC.