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Factors Affecting Foreign Investors' Bondholding in Malaysia

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Highlights

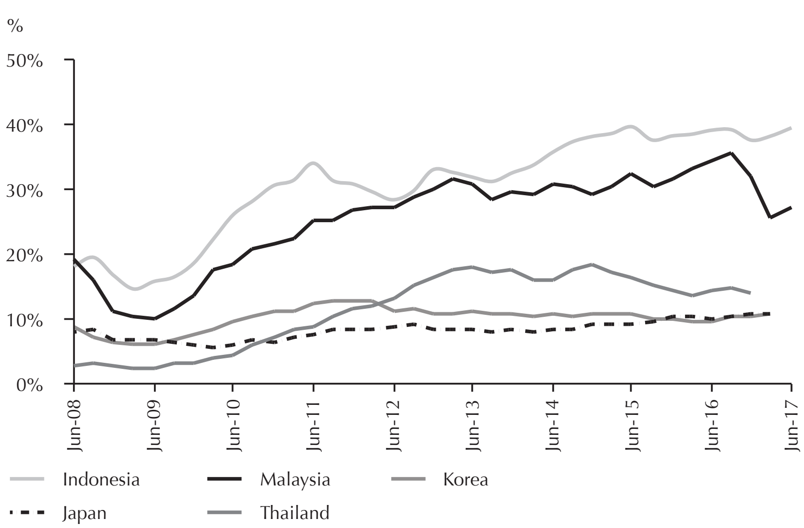
- Malaysia has significant presence of foreign investors' participation in the market that arises from the deep, liquid and investors-friendly bond market.
- Long term investors hold 55% of bond holdings.
- Despite large and sudden portfolio outflows, Malaysia bond market has remained stable and liquid due to the continuous and diverse participation from the long-term foreign investors and the domestic investors.

Introduction: Foreign holdings of Malaysian government bonds

Foreign investors comprise a significant composition of Malaysian bond market, contributing to its position as one of the largest and liquid markets in the region and recognition as part of the major global and regional indices. As at end-June 2017, foreign holdings of Malaysian government bonds stood at RM169.9 billion or equivalent to 26.0% of total outstanding. The numbers have fluctuated over the years, reaching as high as 34.7% in November 2016.

Chart 1

Foreign Holdings of Regional Countries Goverment Bonds



Source: Asian Bonds Online

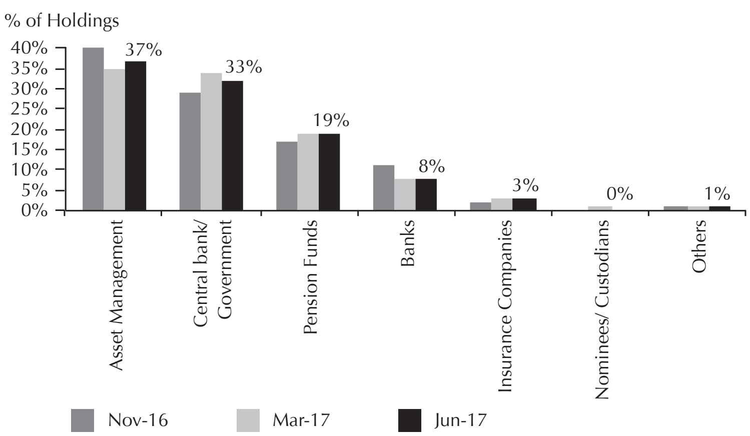
- Malaysia has among the highest foreign participation in the region, second behind Indonesia;
- Malaysia's foreign holding fell towards end 2016 following US presidential election result; and
- Despite reduction in November 2016, foreign holdings in Malaysia are still higher than Thailand, Japan and Korea.

BNM classifies the major investor groups as asset managers, central banks and governments, pension funds, banks, insurance companies, nominees and custodians, and others. As at end-June 2017, long-term investors, such as central banks and governments, pension funds and insurance companies, held 55% of the holdings, while medium to longer term investor, i.e. asset managers, held 37% of the holdings.

Holding by foreign investors are well spread across different bond maturities. As at end of June 2017, more than 65% are in medium and longer dated bonds of more than 3 years maturity. Short dated bonds are mainly held by banks and asset managers. In addition, the foreign bond holdings are also widely distributed with the top 50 investors making up slightly more than 70% of the total foreign holdings. These top 50 also only comprise 10.9% of the total bonds outstanding. Holding by any single investor is also manageable as none of the investors hold more than 1% of the total bonds outstanding.

Chart 2

Distribution of Foreign Holdings of Government Bonds (%)

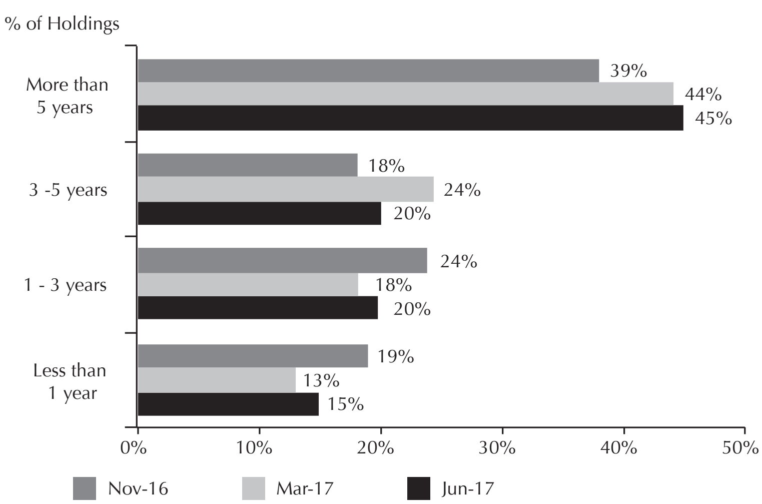


Source: Bank Negara Malaysia, Bond Info Hub

- Malaysian bond market has a diverse profile of foreign investors;
- Biggest foreign investors group in Malaysian bond market is asset managers at 37% of total foreign holdings; and
- Except asset managers and banks, foreign investors have raised their holding from November 2016 level.

Chart 3

Breakdown of Foreign Bondholding by Maturity Profile (%)



Source: Bank Negara Malaysia

- Holdings by foreign investors are well spread across different maturities;
- Foreign investors have raised their holding in medium to long term bond compared to November 2016; and
- Short dated bonds are mostly held by banks and asset managers.

Malaysian bond market is attractive to foreign investors due to its deep, liquid and investors-friendly market

Foreign investors' participation in the Malaysian bond market has been driven by spectrum of factors:

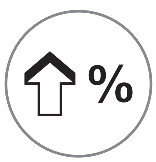
Strong economic fundamental

5.2%
average GDP

Among the high economic growth countries in the region

- Strong economic fundamentals of Malaysia. The country, with a stable A- rating, has consistently been among high economic growth countries within the region, where the Gross Domestic Product (GDP) has recorded an average growth rate of 5.2% between 2011 and Q1 2017. Stable policies; monetary and fiscal, as well economic policy in general, contributes to the sound fundamentals.

Attractive investment return

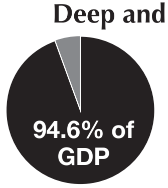


A- Investment grade rating

Positive yield differential against major economies

- Attractive investment return for an investment grade country, Malaysia bond market offers positive yield differential in an environment of sustained global monetary policy accommodation and prolonged period of low interest rates.

Deep and liquid bond market



Largest in ASEAN

Third largest in Asia after Japan and Korea

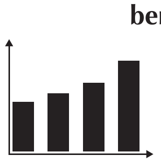
- Depth and liquidity of the Malaysian bond. The market, at 94.6% of GDP, is the largest in ASEAN and the third largest in Asia, after Japan and Korea. A well-developed market infrastructure including the existence of primary dealers obligated to provide two-way prices provide further liquidity and price transparency in the secondary market.

No restriction in foreign investment

No imposition of minimum holding period nor taxes on income and capital gain

- Liberalised investing environment that does not impose any minimum holding period or taxes on interest income and capital gain which are major hindrances on other developing markets for foreign investors.

Inclusion into various global benchmark indices



Inclusion of Malaysia in World Government Bond Index and JP Morgan Government Bond Index

- Inclusion into various major global benchmark indices such as World Government Bond Index and JP Morgan Government Bond Index.

There are also challenges brought by foreign investors

Foreign investors' participation has brought significant benefits[1] in the form of greater investors' diversity and broader investors' base, and with it, greater depth and liquidity to the market. The enhanced liquidity and additional demand also have helped to reduce borrowing cost for both corporate and government when raising funds from the bond market.

However, the increased participation has brought some challenges.

i. The high headline composition of foreign holdings has generated concerns in the past among analysts and international credit rating agencies that it could become a source of vulnerability. Its reversal could have adverse impacts on bond yields and the resulting outflows may cause undue pressure on ringgit. Nevertheless, we should note that the aggregate numbers mask the underlying diversity of the holders.

ii. Foreign investors' holding of local currency bonds contributes to higher external debt. This often has been cited by international credit rating agencies as a source of vulnerability, notwithstanding Malaysia's external assets are more than its external debt.

iii. Foreign investors' flows can be fickle and highly reactive to global market sentiments. It may result in sudden and significant portfolio outflows, creating volatility to the onshore financial markets. This was evident following bonds' holding adjustment of RM26.6 billion in 2013 during the Taper Tantrums[2] and RM60.6 billion in November 2016 to March 2017 after the surprised result of US presidential election and expectation of US interest rate hike.

iv. The sharp reversal of foreign investment had led to rising market volatility and impacted financial markets stability. During these episodes, the government bond yields increased by up to 93 basis points across the yield curve, a slight increase compared to regional countries that have lower foreign participation. Volatility was more pronounced in the foreign exchange (FX) market. From the ensuing capital outflows, ringgit weakened by 4.47% to close at 4.4230 as at end of March 2017, and ranked among the worst performing currencies in the region. Liquidity in the FX market also suffered, compounded by the lack of USD supply from export proceed conversion, with bid-ask spread widened by as much as 110 pips.

The risks of foreign investors' participation were articulated by Jaime Caruana of Bank for International Settlements in his closing panel remark in 2011 at Bank of Japan-BIS high level seminar:
"We must admit that the elimination of barriers to cross-border investment – even it may be beneficial to local bond market development – can at times run counter to policymakers' mandate of stabilising the financial system and macroeconomy when capital inflows are large and volatile. These trade-offs are very real."

[1] The benefits of foreign participation were reflected in IMF's Working Paper 10/88 in 2010 that "Foreign investors could act as catalysts for the development of local bond markets, particularly by diversifying the institutional investor base and creating greater demand for local EM debt securities." The benefits were also echoed by a study by World Bank and IMF (2001) that stated "Foreign investors are an important source of demand for fixed-income securities. Through the positive pressure they place on the quality and services of intermediaries and their emphasis on sound, safe, and robust market infrastructure, they have contributed to the development of national capital markets in many countries."
[2] May to September 2013.

While long-term investors' holdings remains steady, factors affecting short-term investors impact stability of foreign holdings

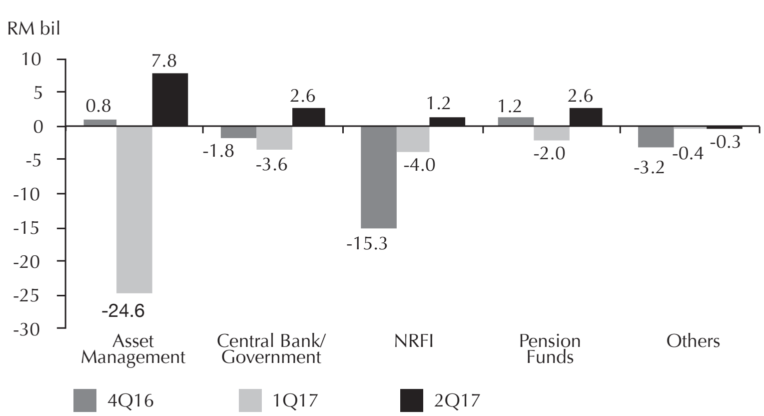
Detailed analysis showed that the recent portfolio adjustment was driven primarily by foreign banks and some asset managers. These investors sold a total of RM49.5 billion of Malaysian government bonds during November 2016 to March 2017, compared to RM10.0 billion that were sold by other investors. Furthermore, the adjustment was from short dated bonds, where RM38.4 billion was sold compared to RM21.1 billion of other bonds.

Foreign investors investing in short dated bonds faced minimal price risk arising from interest rate movement. Hence, in a "risk-on" and "risk-off" environment, portfolio adjustment is swift, resulting in higher volatility in capital flows. This behaviour was apparent after BNM strengthened enforcement actions to reduce the influence and delink the offshore non-deliverable forward (NDF) market from the onshore FX market. It can be argued that these investors took advantage of the liquid and risk-free government bonds to support their exchange rates views.

In contrast, long-term foreign investors are less affected by swing in market sentiments. Their investment remains stable and at times contrarian to the short-term foreign investors' activities, providing stability to the overall foreign bond holdings. However, some of these long-term foreign investors are index-trackers, and any changes to the benchmark index will lead to rebalancing of their investment portfolio. If this were to happen, their actions can also be destabilising to the market as it creates volatility and outflows. This has been observed to some degree with the recent inclusion of additional countries that causes reduction in Malaysia's weight in the global benchmark index. Some of the RM21.5 billion of Malaysian bonds sold in March 2017 by foreign asset managers was triggered by the need to rebalance their portfolio according to the index's weight for Malaysia.

Chart 4

Change in Non-resident Holdings by Types of Investor



Source: Bank Negara Malaysia, internal computation

Malaysian bond market remains robust, despite volatility caused by high foreign holdings

In summary, there is a trade-off between the liquidity and benefits brought by foreign investors and the impact of their participation to the stability of the financial market. Foreign participations expose the market to abrupt reversals, and this may impact orderly functioning of the financial markets. Furthermore, foreign investors' participation open up demand for offshore hedging and the presence of offshore trading creates a new avenue for speculative and heightened volatility. There is a need to relook at the role of foreign investors in domestic bond markets.

Foreign holdings of Malaysian bonds have reduced significantly from its peak, and are now hovering at a more manageable level. The Malaysian bond market now has higher participation of medium to long-term investors, contributing to better stability to the market. Consequently, efforts to safeguard market stability will gear towards supporting this environment and have a truly diverse composition of investors. The reduction in the foreign participation, to a certain extent, contributes towards a more stable bond market.

Bank Negara Malaysia, together with the Financial Market Committee, has introduced several measures to enhance the development of the bond market. Investors now have additional flexibility to actively hedge their exposure while residents have more interest rate hedging avenues through greater liberalisation of regulated short-selling. Adherence to best standard and market practices to promote a fair and effective financial market, while ensuring market order and stability, are strengthened with the issuances of Principles for a Fair and Effective Financial Market and the Code of Conduct for Malaysian Wholesale Financial Markets. Information reporting and settlement infrastructure are being enhanced to provide greater information transparency and surveillance of the financial markets. All these initiatives and measures will contribute towards developing financial markets that are deep and liquid, which will safeguards the interest of not only foreign investors, but also the Malaysian economy and the rest of other market participants.

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