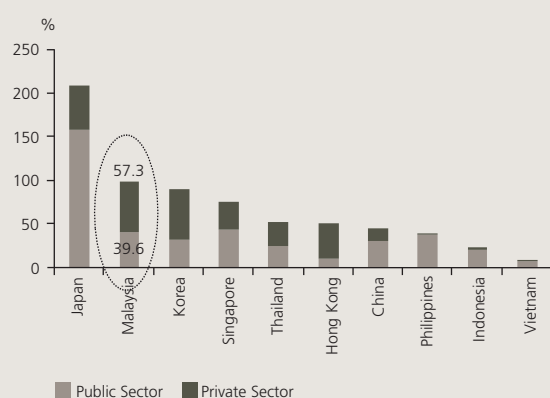


Malaysian Bond Market

The Asian Development Bank¹ (as at 30 June 2006) ranked the Malaysian debt securities market as the second largest in Asia after Japan at 96.9% of GDP. The Malaysian private debt securities (PDS) market (as a percentage of GDP) is also the largest relative to other regional economies.

Chart 1
Size of Asian Debt Securities' Market Relative to GDP



¹ Includes short-term and long-term debt securities
Source: Asian Bonds Online (as at June 2006)

Table 1
Size of Asian Debt Securities' Market

	Size relative to GDP (%)	Public sector	Private sector	Total
		USD billion		
Japan	206.7	6,968.9	2,185.3	9,154.2
Malaysia	96.9	55.5	80.3	135.8
Korea	88.2	260.6	470.5	731.1
Singapore	73.9	52.6	38.0	90.7
Thailand	50.8	44.1	51.5	95.6
Hong Kong	49.3	16.6	73.8	90.4
China	43.5	716.4	332.5	1,048.9
Philippines	37.7	39.9	0.3	40.2
Indonesia	22.0	61.7	7.4	69.1
Vietnam	7.4	3.7	0.2	3.9

¹ Includes short-term and long-term debt securities
Note: Numbers may not necessarily add up due to rounding
Source: Asian Bonds Online (as at June 2006)

The current state of the Malaysian bond market is the culmination of concerted efforts undertaken by the Government, Bank Negara Malaysia and the Securities Commission. It has long been recognised that the existence of an efficient financial market, including a strong and vibrant domestic bond market, is important to support sustainable economic growth and financial stability. The presence of a deep and liquid bond market provides an alternative channel to raise financing to support economic activities, thus dispersing the concentration of credit risk and reducing excessive reliance on the banking sector. Financing through the bond market also reduces the risk of funding mismatch, particularly for projects with longer gestation periods. Moreover, with direct access to potential investors, bond issuers also enjoy lower funding cost and have the ability to custom-design a financing workout that best suits individual projects and cashflow needs. A deep and liquid bond market also provides investors such as insurance companies, pension funds, asset management companies and other institutional investors with an avenue for investment portfolio diversification that corresponds with their liability and risk-return profile.

Given these beneficial outcomes, considerable efforts have been undertaken to develop the Malaysian bond market as far back as the early 1980s. Historically, the Malaysian bond market has been dominated by Government bonds, mainly issued to finance the developmental needs of the

¹ Statistics collected by the Asian Development Bank encompass short-term and long-term debt securities

country. With the privatisation programme in the mid-1980s, and sustained economic growth, private sector demand for longer-term financing has risen sharply, providing further impetus to domestic bond market development. The Asian financial crisis further underscored the risk of over reliance on the banking system and the need for a diversified financial system.

The formation of the National Bond Market Committee in 1999 and formulation of strategic roadmaps as envisioned in the Capital Market Masterplan and Financial Sector Masterplan served as a catalyst for the development of the Malaysian bond market. Through structured and progressive initiatives, as well as coordinated efforts between Bank Negara Malaysia and the Securities Commission, the Malaysian bond market is now deeper, broader and more efficient, providing greater diversity of products across a wider range of tenures to meet the needs of investors and issuers alike.

Robust Development in the Bond² Market

The Malaysian bond market has developed into one of the most sophisticated bond markets in the region. Total bonds outstanding increased at a rapid pace from RM157.3 billion at end-1998 to RM415.9 billion at end-2006 (outstanding debt securities, including short-term securities, grew from RM166.2 billion in 1998 to RM453.9 billion in 2006). This growth was driven by both the public and private sectors, underpinned by a steady increase in volume of bond issuance, which more than doubled since 1998 from RM31.8 billion to RM77.2 billion in 2006.

Of significance is the robust growth in the issuance of sukuk, which had increased during the same period from RM3.1 billion (9.7% of total bond issuance) in 1998 to RM31 billion (40.1% of total bond issuance) in 2006, reflecting the growing demand for sukuks in Malaysia and around the globe. Supported by a comprehensive Islamic financial system (fully functional Islamic banking, money market, capital market, Shariah compliant equity counters and takaful business), Malaysia's sukuks represented 67% of the total global sukuks outstanding valued at USD46.8 billion³ as at 23 January 2007. Malaysia was the first country to issue sovereign global sukuk with a nominal amount of USD600 million in 2002, of which 15% of the total issue amount was subscribed by investors from European countries and the United States of America. The supportive operating landscape also attracted several well-regarded multilateral organisations (such as the International Finance Corporation and International Bank for Reconstruction and Development) to issue sukuks in ringgit.

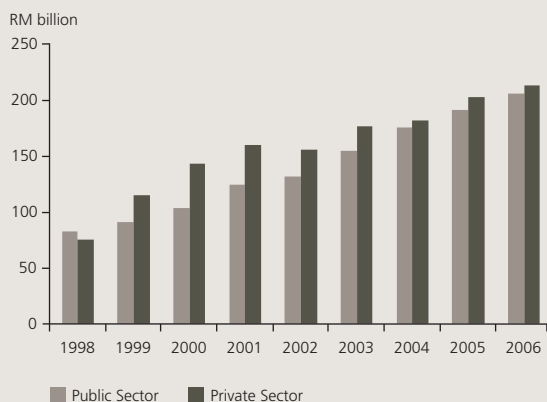
The private sector accounted for most of the increase in sukuk issuance, which saw private sukuks outstanding more than doubled as a percentage of total private bonds outstanding from 22.5% at end-2001 to 47.1% at end-2006. Meanwhile, public sukuks outstanding as a percentage of total public bonds outstanding increased at a slower pace from 11.4% to 15.1% during the same period. As at end-2006, RM30.9 billion and RM99.2 billion of outstanding sukuks were issued by the public and private sectors respectively.

In addition to the growing size, the volume of secondary trading in the Malaysian bond market has also increased with sale and purchase transactions amounting to RM366.9 billion

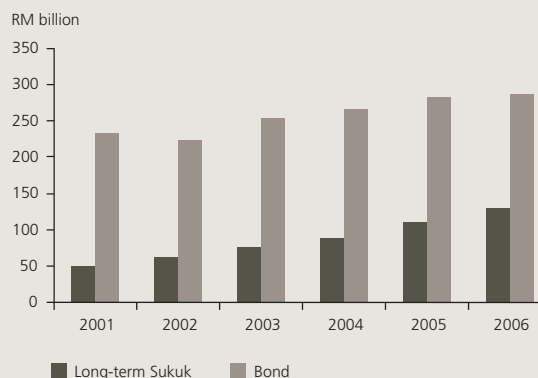
² Refers to debt securities with an original maturity period of more than one year

³ Source: Bloomberg

**Chart 2
Malaysia: Total Bonds Outstanding**

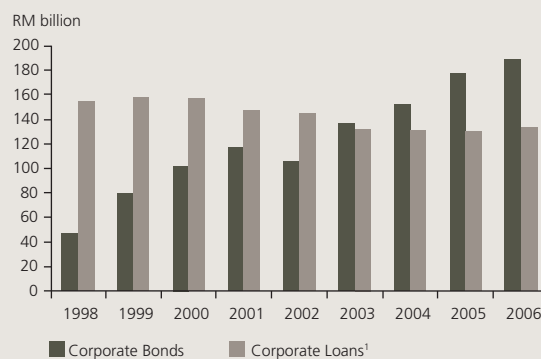


**Chart 3
Outstanding Long-term Sukuk vs. Bond**



for the year 2006 (1998: RM62.2 billion). The most actively traded papers were the Malaysian Government Securities (MGS), accounting for 52.3% of total trading activities and with a turnover ratio of 1.08 times in 2006 (1998: 0.28 times). In addition, repurchase agreement (repo) transactions involving bonds recorded significant increase from RM85.3 billion in 2002 to RM586.1 billion in 2006. This increase was most prevalent in MGS repos as a result of the introduction of the Institutional Securities Custodian Programme (ISCAP) and securities lending facility for the principal dealers in 2005.

**Chart 4
Size of Corporate Bonds Market against Corporate Loans¹**



¹ Excludes loans to small and medium enterprises

Following the efforts undertaken to promote the private sector bond market, the composition of the Malaysian bond market had also changed. As at end-2006, private sector bonds accounted for 50.7% of the total bonds outstanding as compared with 48% as at end-1998, placing Malaysia as one of the few markets in the region where private sector bonds exceed that of the public sector. A positive trend was also observed in terms of diversifying the sources of financing for the

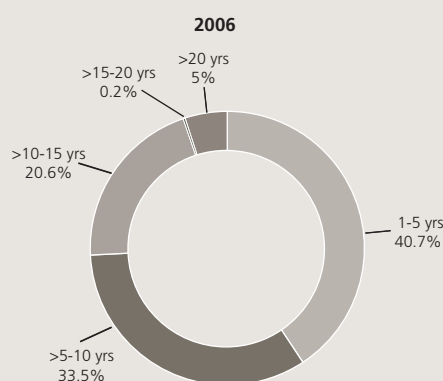
economy and reducing the reliance on the banking sector, whereby corporate bonds outstanding as a percentage of total corporate financing⁴ has increased from 21.2% in 1998 to 57.8% in 2006.

Since 1998, it was observed that PDS issuers represented a wide scope of economic sectors indicating that corporations now have better access to the capital market as a source of financing. Although the finance, insurance, real estate and business services sectors remain as the major issuers of PDS, accounting for 41.5% of total PDS issued in 2006 (1998: 71.1%), there has been increasing participation from the transport, storage and communications; electronic, gas and water; and construction sectors. In recent years, the agriculture, forestry and fishing; and mining and quarrying sectors also raised financing through the bond market with total issuance volume of RM1.5 billion and RM1.6 billion in 2005 and 2006 respectively. Notably, 81% of the outstanding private sector bonds issued (in terms of total value) as at end-2006 were high-end investment grade issues of AA and above.

Reflecting the greater dynamism and innovation taking place in the Malaysian PDS market, there has been a proliferation of new types of instruments. In 1998, 72.3% of the bonds issued were straight bonds with a further 23.5% being issued by Cagamas Berhad (the national mortgage corporation). Since then, bonds with warrants, asset-backed bonds and bonds with additional features such as stepped-coupon and “floaters” have been issued in the Malaysian market. As a comparison, straight bonds and Cagamas bonds now only account for 22.3% and 18.4% of total PDS issued in 2006 respectively.

The extended maturity profile of the Malaysian PDS market provides investors with wider range of choices for their investment needs. In 2006, more than 50% of total PDS issuances had maturities of more than five years. More corporate issuers are tapping into the bond market to raise long-term funds as reflected by the increase in issuance of PDS with more than 20-year tenure (including a PDS with the tenure of 33 years).

Chart 5
PDS Issues by Tenure (excluding Cagamas)



⁴ Total corporate financing = Total corporate loans (excluding loans to small and medium enterprises) + corporate bonds

Bond Market Development Supported by Comprehensive Measures

Strong infrastructure and a comprehensive legal, regulatory and administrative framework put in place by the regulatory authorities have had a very significant impact on the development of the bond market. As summarised in Table 2, several initiatives were undertaken with focus on key strategic areas aimed at promoting further growth in the bond market and enabling it to play a more significant role in financing the needs of the economy.

**Table 2
Initiatives Undertaken to Support the Development of the Bond Market in Malaysia**

Strategy	Initiatives
Introducing an efficient and facilitative issuance process	<ul style="list-style-type: none"> • Release of Guidelines on the Offering of PDS – 2000 • Introduction of a shelf-registration scheme – 2000 • Release of Guidelines on the Offering of Asset-Backed Securities (ABS) – 2001 • Release of Asset Securitisation Report to provide detailed information on ABS issuance including surveys and structures – 2002 • Introduction of Guidelines on the Offering of Islamic Securities to set common standards between conventional and Islamic PDS – 2004 • Introduction of a web-based Fully Automated System for Issuing/Tendering (FAST) – 2005
Broadening the issuer and investor base	<ul style="list-style-type: none"> • Universal brokers allowed to trade in the over-the-counter (OTC) bond market – 2002 • Introduction of a tax-neutral framework and tax deduction on issuance expenses for ABS – 2003 • Islamic PDS are accorded various tax incentives (e.g. stamp duty waiver, tax deductions on issuance expenses) and a tax-neutral framework – 2003, 2005 • Multilateral development banks, multilateral financial institutions and multinational corporations are allowed to raise ringgit-denominated bonds – 2004 • Removal of withholding tax on interest income derived from investments by non-residents in all ringgit-denominated bonds – 2004 • Allowing a wider group of investors to have access to the information memoranda and trust deeds of ringgit-denominated bond issues database to facilitate decision making – 2005
Improving liquidity in the secondary market	<ul style="list-style-type: none"> • Non-financial institutions are allowed to enter into repurchase transactions with financial institutions – 2000 • The Securities Borrowing and Lending Programme is introduced via the Real Time Electronic Transfer of Funds and Securities (RENTAS) system – 2001 • ISCAP is introduced to facilitate securities lending by major institutional investors to Bank Negara Malaysia for use in market operations – 2005 • Introduction of callable MGS and MGS switch auction to increase the amount of benchmark securities and further enhance trading in the secondary market – 2006, 2007
Improving price discovery process	<ul style="list-style-type: none"> • Establishment of Bond Information and Dissemination System (BIDS) as a central information platform to enable reporting of all bond market transactions and wide dissemination of information – 1997 (further information on the Malaysian bond market can be obtained from the following websites: https://fast.bnm.gov.my; http://rmbond.bnm.gov.my; http://iimm.bnm.gov.my) • Release of Guidelines on the Registration of Bond Pricing Agencies to provide independent and objective fair value prices, on a daily basis, for all ringgit-denominated bonds traded in the OTC bond market – 2006 • Daily publication of indicative yield-to-maturity of Government securities (conventional and Islamic) – 2005

Strategy	Initiatives
Establishing a reliable and efficient benchmark yield	<ul style="list-style-type: none"> • Introduction of an annual auction calendar for MGS to enhance transparency and facilitate longer-term planning by issuers and market participants – 2000 • Revision of the principal dealers system every two years – to enhance principal dealers' function as market makers for benchmark papers – 2006 • Introduction of profit-based Government Investment Issues – 2005
Facilitating the introduction of risk management instruments	<ul style="list-style-type: none"> • Introduction of 3, 5 and 10-year MGS futures – 2002, 2003 • Introduction of Guidelines on Regulated Short-selling of Securities – 2005
Source: The Securities Commission and Bank Negara Malaysia	

Supplementing the bond market is a comprehensive and modern depository, delivery and settlement system. Malaysia adopts a scripless system for all bonds issued in the country. The trading of bonds is settled via the RENTAS system on a delivery versus payment basis. In addition, trading of MGS can be cleared with major global custodian banks and through the International Central Securities Depositories (ICSD) such as Euroclear and Clearstream. Selected authorised depository institutions (ADIs) that are clearing members in RENTAS, are appointed by the ICSDs as clearing agents in Malaysia. Non-residents and offshore investors may also individually appoint ADIs that are RENTAS members as custodians. Most of the financial institutions in Malaysia are also members of Society for Worldwide Interbank Financial Telecommunication (SWIFT), which facilitates the efficient transmission and confirmation of cross-border payment and settlement instructions in foreign currencies.

The significant growth in the bond market is also supported by the liberal foreign administration policies that allow free entry and exit of investors in the Malaysian financial market. In addition, the increasingly liquid market had improved the ability of investors to invest in or divest from the market. This was supported by the abolition of the 15% withholding tax on bonds or sukuk issued in Malaysia making such instruments more attractive and competitive in terms of yield. Moreover, hedging is freely allowed, providing investors with more risk management options. Further relaxation in the foreign exchange administration policies allows issuers to issue foreign currency-denominated conventional bonds or sukuk in Malaysia. This new policy is expected to further expand and diversify the available asset classes in the Malaysian financial market.

Foreign investors are also free to establish and maintain banking relationships with any licensed banking institutions (including locally-incorporated foreign banks) to facilitate investment activities in Malaysia. Similarly, non-residents can also obtain credit facility in ringgit, in aggregate amount of up to RM10 million, from any licensed banking institutions in Malaysia. In addition, non-resident stockbroking companies and custodian banks can now obtain any amount of ringgit overdraft facilities from any licensed banking institutions to finance funding gaps relating to settlement of ringgit instruments settled through the RENTAS and Bursa Malaysia. Supported by the increasing size of the Malaysian bond market coupled with the conducive operating and legal environment, and measures taken to broaden the investor base, the liquidity of the bond market is approaching that of the developed markets. These attributes have collectively increased the attractiveness of

the Malaysian market to foreign institutional investors. As at end-2006, foreign investors' holdings in the debt securities market amounted to RM35.5 billion or 8.5% of the total outstanding debt securities as compared with only RM0.8 billion or 0.3% in 2001.

Malaysia is fully supportive of stronger regional economic and financial co-operation initiatives that are aimed at broadening and deepening the domestic and regional bond markets in the East Asia Pacific region. In this regard, Malaysia has participated in both Asian Bond Funds (ABF) launched under the auspices of the EMEAP group ("Executives' Meeting of East Asia and Pacific Central Banks", comprising 11 central banks and monetary authorities in the East Asia and Pacific region).

Launched in June 2003, the ABF1 was aimed at channeling a small portion of the very sizeable official reserves held by Asian economies back into the region as well as providing useful means for Asian central banks and monetary authorities to diversify their investments beyond the traditional reserve assets and to enhance returns. Following the success of ABF1, ABF2 was launched in December 2005 with the objective of promoting domestic currency bond markets by introducing bonds of multi-currencies in a basket as a new asset class for investors. The launching of 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 Malaysian bond market is already well received by foreign investors and is included in major bond indices such as that of Lehman Brothers and JP Morgan. In July 2007, Malaysia is expected to enter the World Government Bond Index (WGBI) subject to meeting certain WGBI eligibility criteria. Upon inclusion, Malaysia will become the 23rd Government bond market to enter the WGBI. This is expected to bring more global long-term institutional investors to Malaysia, who seek to participate in markets and economies with sound fundamentals and best in class infrastructure. The strategic initiative of the Malaysia International Islamic Financial Centre that aims to develop Malaysia into a centre for the origination, distribution and trading of sukuk is expected to provide further impetus to the development of an increasingly vibrant and progressive bond market. Despite the success that has been recorded thus far, further efforts will continue to be undertaken to create a conducive environment to develop a bond market that is deep, liquid, efficient, transparent and effective to support the needs of the nation and to meet investors' expectations.