Meeting Challenges of the Decade

CHAPTER 2

MEETING CHALLENGES OF THE DECADE

The challenges of this decade are different from those that Malaysia faced over the previous ten years. The level of uncertainty in the operating environment is far greater, with the global economy and markets still adjusting to the long-term consequences of the global financial crisis in 2007–2008.

Malaysia is already undergoing structural changes as a key feature of the nation's transformation into a high-income and high-growth economy. Malaysia ranks among the leading trading nations and is a successful middle-income economy. The process of transforming Malaysia's economic structure and performance has begun with the implementation of recommendations under the New Economic Model (NEM) and National Key Economic Areas (NKEA).

The formulation of CMP2, therefore, occurs at a critical juncture. There is a need to strengthen the positioning of the capital market to meet challenges from the changing global landscape and to support the national economic transformation process.

In this context, deep and broad markets are a necessary prerequisite to enable the private sector to expand its role in intermediating savings to meet the investment needs of the population and to provide competitive funding sources to meet the financing needs of private sector businesses. In doing so, capital markets play an important role in financing business ventures, creating jobs, widening ownership of assets, and generating returns on long-term savings.

Towards this end, CMP2 outlines the strategies to transform the competitive dynamics of the capital market over the next 10 years. It outlines growth strategies to address key structural challenges and critical linkages to foster a more diverse and innovative intermediation environment and to nurture new growth opportunities.

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In tandem with the changing intermediation landscape, CMP2 outlines governance strategies to ensure robust regulatory oversight and active stakeholder participation to enhance confidence in the integrity and soundness of Malaysia's capital market.

2.1 Transforming the competitive dynamics of the Malaysian capital market

Well-regulated markets strengthen the efficiency of capital allocation and engender the trust that is effectively required for the private sector to function as a source of dynamic growth. Over the years, capital markets have broadened access to financing, covering a full spectrum of economic activities and entities ranging from start-ups to large-sized privatisations.

Capital markets have also widened their reach to millions of investors and have become essential channels of organised investment schemes including managing retirement savings. These savings are matched with financing needs through a wide array of products to increase a nation's capacity to grow.

The growing role of markets thus reflects the vital contribution of capital markets in financing the development of a diverse and vibrant global economy. (See Box 1)

By global benchmarks, Malaysia is generally regarded as having well-developed equity and debt markets as its markets are relatively large compared to the size of the economy. As at the end of 2010, Malaysia's equity market capitalisation and outstanding debt securities were at 165% and 97% respectively as a proportion of nominal GDP.

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While the core building blocks for market intermediation were built in CMP1, there are still gaps and inefficiencies that inhibit the level of financing activities, either directly or indirectly, for primary and secondary investments. Several of the weaknesses relate to the broader eco-system and these are being addressed by initiatives in the NEM and Economic Transformation Programme (ETP).

Box 1

Expanding role of markets in the global economy

The past two decades marked the remarkable ascendency of markets in the global economy. As a reflection of this trend, global equity market capitalisation amounted to US$10.4 trillion - less than half nominal GDP in 1990. As markets expanded rapidly, their influence on economic activities increased. By 2010, equity market capitalisation had risen more than six-fold to US$67.3 trillion or 108.9% of global GDP.

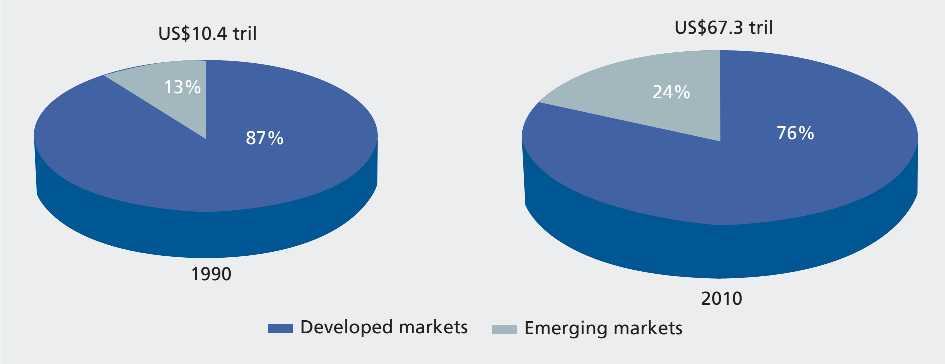
In 1999, powered by internet stocks and in 2007, powered by emerging markets, global equity market capitalisation rose to 120% of GDP, only to retreat after a market downturn. Market volatility through its impact on valuations, returns and long-term expectations, is exerting greater influence on long-term economic growth prospects.

Global equity market capitalisation to nominal GDP ratio 1990–2010

Source: World Federation of Exchanges, World Bank and Securities Commission Malaysia estimates

The gap between developed and emerging markets has narrowed, reflecting the spread of financial activities and innovation worldwide. The emerging markets' share of global equity market capitalisation rose from 13% in 1990 to 24% in 2010.

Distribution of global equity market capitalisation



Source: World Federation of Exchanges, World Bank and Securities Commission Malaysia estimates

CMP2 focuses on addressing the structural weaknesses, and enhancing efficiencies in critical linkages in the capital market, to foster a more diverse and innovative intermediation environment and to nurture new growth opportunities. In relation to this, several key challenges were identified as follows:

- **Increase capacity and efficiency of the capital market in financing investment requirements for economic growth.** The ETP estimates that RM1.4 trillion in investments are needed to achieve economic growth targets over this decade. One of the priorities is therefore to strengthen the role of the capital market in promoting capital formation from start-up stage to the financing of large-scale projects and innovation;

- **Address structural imbalances between private sector savings and investments.** Malaysia has large domestic savings which are currently not efficiently intermediated to finance investments in the economy. Over the past decade, the success in establishing prudent institutional management of savings has led to savings being increasingly concentrated in a narrow range of highly liquid and low-risk investments. This in turn has limited the diversity of intermediation products and services and reduced the supply of risk capital that is needed to drive vigorous economic expansion;

- **Deepen secondary market liquidity.** The savings concentration that occurred during the past decade resulted in institutional demand for high-quality assets far exceeding supply. This subsequently reduced the free float and liquidity for these capital market assets. The low liquidity is also caused by the low tolerance for risks, the insufficient diversity in investment strategies, the low levels of risk intermediation (hedging and arbitrage), relatively high friction costs and the limited electronic channels for trading;

- **Build scale and identify new growth opportunities.** The size of Malaysia's capital market relative to the economy suggests that the capital market is approaching the limits of growth based on the domestic economy. The reliance on domestic growth has also tended to limit revenue growth, operational scale and, to an extent, the ability to compete for talent. There are several inter-related approaches to expanding growth boundaries. They include pursuing opportunities through greater internationalisation, identifying untapped growth opportunities outside core intermediation areas, and facilitating business models oriented towards capturing scale-driven efficiencies or high value-add in niche areas; and

- **Build capacity and strengthen the information infrastructure.** Apart from strengthening the ability to attract and retain talent, there will be a greater need to adapt to a changing workforce, a diffused working environment and the pervasive use of technology in many aspects of capital market activities in the future landscape. The infrastructure for the development of human capital, and for capital market information, will increasingly define the potential for future growth.

2.2 Managing risks from a changing landscape

The growth of capital markets around the world has been driven by financial innovation that provided new tools to organise tangible and intangible capital into productive ventures. Advances in financial theory and technology facilitated the conversion of properties, commodities, businesses, and ideas into readily tradeable assets. This underpinned an expansion in the financing of new ventures and the emergence of new industries.

While financial innovation has channelled greater flows of capital into financing innovation and enterprise, it has also increased the financialisation of economic activities relative to the generation of productive wealth. The rising proportion of financial assets relative to physical assets is a phenomenon arising from the globalisation of financial markets as well as the expanding role of intangible assets in creating wealth.

The financialisation of economies is also perceived to be a major source of instability. In this context, there has been an increase in the occurrences of financial crises around the world over the past two decades. The impact of these financial crises has been substantial. Societies have been affected by market failures which caused severe losses in the value of retirement savings as well as the closure of businesses and loss of jobs.

Although not perfect, markets are still by far the most effective tool to allocate resources and manage risks. In allocating resources and risks, market imperfections reflect the tensions in maintaining a delicate balance between the interests of different stakeholders and the need to manage the risks inherent in transactions.

The lessons are that increasing financialisation needs to be accompanied by strong regulatory oversight and governance arrangements to manage the risks from profit-seeking tendencies that result in excesses, abuses, and the preoccupation with short-term outcomes.

Historically, incremental layers of regulation were added to restore public confidence in capital markets after each episode of market failure. Regulation plays a crucial role in correcting market excesses by reassuring investors that investment and market activities will be conducted in a fair manner and in their best interests.

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The challenges to the Malaysian capital market stem not only from the intrinsic instability of increased financial activities but also from the increased complexity of financial intermediation in a multi-venue, multi-product and multi-asset environment. (See Box 2)

Box 2

Changing patterns of global market development

Financial and technological innovation has changed the pattern of global capital market development through stimulating variety and diversity. Rising sophistication, flexibility, and mobility of capital market activities pose greater challenges for regulators to manage the risks to investors and stability.

- **Greater choice, diversity and complexity.** Markets today offer considerably more choice with an expanded range of products that facilitates more precise combinations of risks, returns, and liquidity to accommodate a variety of issuers and investors.

- **Fragmentation of activities and assets.** Capital market activities are increasingly being transacted electronically with multiple parties handling specialised parts of a transaction. Securitisation and derivatives are also being used to alter the economic rights, risk characteristics and transparency of products. This presents difficulties in understanding and valuing products, affects monitoring of market transactions and presents challenges in risk assessment.

- **Increasing shift from relationships to transactions.** With electronic channels, investors are simultaneously using a number of service providers to obtain more advantageous terms and prices. Contact between clients and intermediaries are increasingly based on transactions and this is creating greater transience in intermediation relationships.

- **Increasing international mobility.** The creation of common rules, standards, and infrastructure links across markets has improved the mobility of economic activities, assets and transactions across borders.

It is important to learn from the lessons of past financial crises that innovation and complexity will create risks that will continuously test the resilience of the Malaysian capital market. Managing these risks will be the key challenge in deepening and broadening the Malaysian capital market.

In this regard, Malaysia has maintained strong regulatory oversight over the past decade and it is the Malaysian experience that sound regulation grows resilient markets and healthy industries. It is the SC's view that regulation plays a crucial role in defining the governance arrangements to reinforce investor trust and confidence in the integrity of markets and in ensuring widespread social acceptance of growth-enhancing financial innovation.

However, it is not intended for regulation to be a substitute for capital market stakeholders being vigilant and actively shaping governance practices that ultimately result in responsible and conscientious financial and corporate behaviour which generates sustainable long-term wealth.

CMP2 will therefore focus on ensuring robust governance arrangements to manage the risks to investor protection and stability. In this context, managing the risks from a changing intermediation landscape will require the following:

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- **Clear points of accountability with effective regulatory oversight and reach.** In the changing landscape, intermediation will be more diverse and fragmented with potential vulnerabilities across the entire transaction chain. This requires an extension of oversight to ensure there is no regulatory vacuum. Regulation must be strengthened to address information asymmetries, ensure fair conduct as well as provide sufficient avenues for recourse to aggrieved customers;

- **Higher standards and capabilities in the operation of intermediaries.** The pursuit of high growth inevitably encompasses higher levels of risk. These risks must be managed through ensuring higher standards of ethical conduct as well as placing priority on clients' interests and internal controls;

- **Extension of regulatory focus to stability risks.** It is necessary to ensure markets have the resilience to withstand shocks to mitigate disruptions to the intermediation process that may be severe enough to impair the efficient allocation of savings. Sufficient regulatory oversight and reach will be required to detect risks hidden in complex products and opaque venues and to facilitate timely action to mitigate or resolve emergent risks;

- **Higher corporate governance standards.** Investors need to be assured of their rights as shareholders to encourage greater supply of capital. Greater stewardship by Boards, more extensive shareholder participation, and increased accountability for the reliability of disclosures, will reinforce good governance practices; and

- **Broadening participation in governance.** Market and self-disciplinary mechanisms can only function effectively through the active participation of all stakeholders in shaping the norms and beliefs to reinforce ethical conduct in the capital market and to broaden the scope of business to encompass socially responsible objectives.

2.3 Growth prospects to 2020

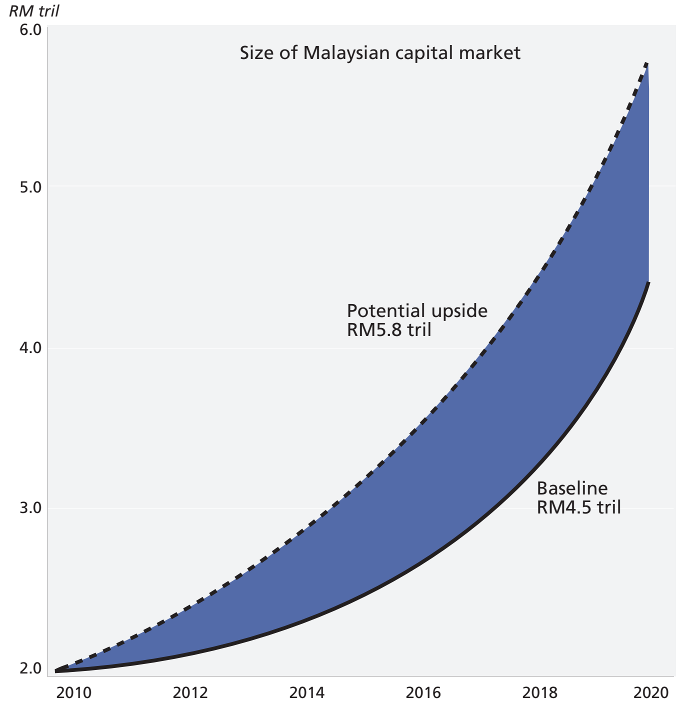
The Malaysian capital market has significant growth prospects. The SC estimates the size of Malaysia's capital market (comprising stockmarket capitalisation and debt securities) to more than double from RM2.0 trillion in 2010 to RM4.5 trillion by 2020.

The baseline forecast is predicated on annual real GDP growth of 6.5% and historical market benchmarks, and is subject to prevailing economic and market conditions. Overall, the long-range forecasts provide a reasonable reflection of baseline growth prospects based on extrapolation of historical trends.

Further analysis indicates there are strong upside prospects for the Malaysian capital market. The structural reforms and high impact investment projects under the NEM and ETP can accelerate economic growth momentum with a significant impact on the upside for the long-term growth of the capital market.

Chart 5

Projections for Malaysia's capital market to 2020



Source: Securities Commission Malaysia estimates

Based on benchmarks for regional financial centres, it is estimated that internationalisation of the stockmarket could increase the potential size of the Malaysian capital market by another 30% to RM5.8 trillion in 2020. Higher levels of internationalisation would also have positive growth effects on the bond market and ICM.

In addition, several segments are expected to achieve critical mass such as ICM which is projected to increase from RM1.1 trillion in 2010 to RM2.9 trillion in 2020 and the investment management industry where AUM is projected to rise from RM377.4 billion in 2010 to RM1.6 trillion in 2020. The most important effect from achieving critical mass is the facilitation of volume strategies and higher efficiency from increased economies of scale.

Based on historical trends, the growth of the investment management industry is likely to outpace the growth of equity assets over this decade. This is a feature typical of an economy in transition from middle income to developed status. Projections indicate that the penetration rate for unit trusts is likely to almost double from 18% in 2010 to 34% in 2020, which is closer to levels usually seen in developed markets.

The annual notional value of derivatives trading of RM512.1 billion in 2010 is currently largely based on CPO futures contracts. There is substantial upside from further expansion of derivative products and this will deepen liquidity across market segments through positive spill-over effects from higher levels of inter-market trading, hedging and arbitrage.

With the core intermediation industries reasonably developed, the developmental focus will shift towards nurturing future growth segments particularly in ancillary layers supporting intermediation activities. The development of more competitive niches will foster higher productivity and value-add activities with the supporting clusters providing positive growth feedback effects.

Overall, CMP2 offers a broad set of strategies that are aimed at addressing key structural challenges and critical linkages to create a conducive environment for private sector intermediation and expanding the growth boundaries of the capital market.

These will be complemented with strategies to ensure effective governance arrangements to sustain confidence in the integrity of Malaysia's capital market and to maintain strong regulatory oversight to safeguard the interests of investors.

OVERVIEW OF CMP2 STRATEGIES

GROWTH

- Promote capital formation
- Expand intermediation efficiency and scope
- Deepen liquidity and risk intermediation
- Facilitate internationalisation
- Build capacity and strengthen information infrastructure

GOVERNANCE

- Enhance product regulation to manage risks
- Expand accountabilities as intermediation scope widens
- Robust regulatory framework for a changing market landscape
- Effective oversight of risks
- Strengthen corporate governance
- Broaden participation in governance