The Capital Market in Malaysia

Yutaka Shimomoto

Yutaka Shimomoto is Economist, Asian Development Bank and Chief Economist, Nikko Securities Co., Ltd. (1997–1999)

Introduction

The capital market in Malaysia has undergone a robust development since the late 1980s. The delisting of Malaysian and Singaporean companies from their respective stock exchanges at the end of 1989 was a milestone in the development of Malaysia's equity market. With the proliferation of privatization projects and the equity boom in 1993, market capitalization exceeded that of Singapore by the mid-1990s, making the Malaysian market one of the fastest growing in the region.

The equity market has contributed to the development of the private sector, with initial public offerings (IPOs) and issuances of new shares enabling many companies to obtain cheap financing. Equity investments by individual, institutional, and foreign investors increased substantially, and market infrastructure was developed accordingly. Computerized trading, electronic clearing and settlement, and central depository systems were in place by the end of 1997. The regulators, the Kuala Lumpur Stock Exchange (KLSE) and Securities Commission (SC), have been improving standards on transparency, disclosure, accounting, and corporate governance. But these standards still fall short of international standards, as was revealed, for instance, by the Renong-United Engineers (Malaysia) (UEM) case in November 1997, resulting in a loss of market confidence.

Meanwhile, various steps were taken in the late 1980s to develop the bond market. Initially, efforts were focused on Government and Cagamas bonds. The central bank, Bank Negara Malaysia (BNM), played an important role in introducing the principal dealer and auction systems to develop the secondary market for these bonds. However, BNM's attempts were only partially successful. The statutory requirements for holding Government and Cagamas bonds have impeded market development. Moreover, the lack of benchmark yield curve and the issue of *riba* (interest) had serious implications for bond market development. The latter was addressed in the mid-1990s when new debt instruments based on Islamic principles were issued.

Since 1995, the Government has encouraged private and public entities to issue bonds to raise funds, while BNM has tried to develop market infrastructure to support bond issues. During the financial crisis, some bonds issued by the private sector defaulted, hurting confidence in the market. As the financial crisis deepened, many listed companies and stockbrokers became distressed and some private debt securities defaulted. Thus the capital market in Malaysia is facing serious challenges. The Government introduced measures to curb speculation on foreign currency and to restrict the trading of Malaysian equities within KLSE on 1 September 1998, causing temporary adverse effects on the capital market. In order to restore foreign investors' market confidence, these measures need to be lifted.

Overview

Capital Market Development

As Singapore was once part of Malaysia, companies in these two countries listed on both KLSE and the Stock Exchange of Singapore (SES) until the end of 1989. Since then, KLSE has taken various measures, including the introduction of computerized trading, a central depository, and efficient clearing and settlement systems, to develop market infrastructure. In addition, the regulatory framework has been reviewed to promote IPOs and equity investments by domestic and foreign investors. As a result, some big privatized companies (e.g., Telekom Malaysia Berhad and Tenaga Nasioni Berhad [TNB]) were listed on KLSE, making it one of the fastest-growing markets in the region in the mid-1990s.

By the end of the 1980s, the primary market for Government bonds was relatively developed. The Government introduced the principal dealer system to develop the secondary market as well, and at the same time, an auction system for Government securities to promote fair pricing. Although the private debt securities (PDS) market had deepened when the first Cagamas bonds were issued in October 1987, it did not develop until the mid-1990s. The Government has introduced various measures to enhance market infrastructure and put in place an appropriate regulatory framework. These included the establishment of a credit rating agency (1990), guidelines on PDS issues (1992), tax exemption on interest income from PDS (1993), scripless trading for unlisted PDS (1996), an auction system for the PDS primary market (1996), and a bond information and dissemination system (1997). Despite Government efforts, a lack of benchmark yield curve hinders the development of the bond market.

Financial Crisis and the Capital Market

The financial crisis in Malaysia has predominantly affected the banking sector. At the end of 1997, banking sector assets accounted for RM480 billion or 1.8 times the gross national product (GNP). These figures indicate that a substantial amount of funds had been mobilized and provided to the private sector as loans. However, given the implicit control of BNM, external debts in the private sector are relatively small. The banking crisis was more a result of overlending, coupled with the lack of prudential regulation and supervision.

The capital market, in particular the equity market, played an indirect role in increasing the number of bank loans. Banks actively raised funds in the equity market, which expanded their capital base. With the development of the capital market and capital account liberalization, disintermediation emerged to some extent. However, the role of bond and offshore markets was not so significant except for bonds with warrants issued during the equity boom in the mid-1990s.

Corporate entities, at the same time, actively tapped funds in the equity market, resorting to IPOs and new issues of shares for easy financing during the equity boom that began in 1992. Some corporate players, in particular, obtained funds from the capital market and banks to optimize their financial assets. They were successful in building up corporate empires while the boom lasted. However, when it was over, they had to settle large debts from the banking sector and bond market. With the bankruptcy of these corporate players, nonperforming loans (NPLs) of certain banks mounted.

Loans for share purchase contributed to an increase in banks' NPLs. In addition, stockbrokers had been providing their customers with credit facilities for share trading. However, when share prices collapsed in the wake of the financial crisis starting in July 1997, banking institutions and stockbrokers incurred losses resulting from loan defaults of customers, in particular. The capital base of stockbrokers was not sufficient to cope with the big losses. As a result, some stockbrokers became distressed and were suspended by KLSE.

Capital Market Prospects

The market infrastructure for the equity market might be developed, but transparency, disclosure, and corporate governance need to be improved. In particular, speedy and frequent disclosure of appropriate information is essential. In addition, the details of asset value and off-balance-sheet items should also be disclosed. BNM has introduced a quarterly disclosure standard for banks, for example, on profit and loss accounts, and NPLs. Disclosure of the balance sheet is also necessary.

Since disclosure practices and corporate governance do not conform to international standards, legal enforcement needs improvement. Most investors are focused on short-term placements, making it difficult to enhance corporate governance. The public has to be encouraged to make long-term investments. An increase in dividend payments could be considered. Dividends are subject to withholding tax while interest income from long-term deposits, bonds, and capital gains from sale of shares are tax-exempt. Due to the withholding tax, companies, particularly major shareholders, are reluctant to pay high dividends. They prefer to use the profit for further expansion, which leads to an increase in asset values (capital gains). In addition, they tend to maximize their returns by injecting their family assets into the listed company. If they were exempted from the tax on dividends, companies would increase their payout ratios and investors would be encouraged to hold shares for longer periods. In this case, shareholders must pay more attention to the management of companies in order to receive better dividends. This could, in turn, improve corporate governance.

Before the crisis, funds required by the private sector were readily available from commercial banks, the equity market, and offshore markets as a result of the deregulation and liberalization of financial markets during the decade. However, the financial environment changed after the crisis began. The private sector experienced difficulties securing funds because (i) commercial banks faced liquidity problems, (ii) bearish equity market made it difficult for companies to float new shares, and (iii) offshore loans became costly due to currency depreciations. As the Government has also suffered tight budgetary constraints, partly because of a decline in revenues from traditional sources, it is seriously considering the bond market as an alternative source of funds for the private and public sectors.

Equity Market

Revival of Foreign Exchange Control

A shock wave hit the equity market when BNM and KLSE announced curbs on foreign exchange and trading of shares respectively on 1 September 1998 (the US dollar was fixed at RM3.80 the next day) with immediate effect. The measures included:

- restricting the trading of Malaysian shares within KLSE, and
- allowing foreigners to sell shares any time but proceeds could not be converted into foreign currency unless the shares had been held for at least one year.

BNM's exchange control measures were introduced primarily to regain monetary independence and insulate the Malaysian economy from possible further deterioration in the world economic and financial environment. Meanwhile, KLSE's measures were aimed at restoring confidence by ensuring an orderly and fair market, and improving overall transparency in the stock market. These promote greater accountability and disclosure without compromising investor confidentiality. The critical issue is how to exit from these control measures with minimum disruption.

With KLSE recognizing the trading of Malaysian shares in KLSE only, the Central Limit Order Book (CLOB), the over-the-counter market in Singapore where many Malaysian shares have been traded, was badly hit. CLOB ceased the trading of Malaysian shares on 4 September 1998.

As Malaysia needs foreign capital, foreign investors have an important role to play. Without a robust equity market, corporate entities have to rely on the banking sector for financing, putting an additional burden on a liquidity-tight sector. For this reason, the authorities should review the measures and put in place an environment that will attract local and foreign investors to the equity market.

STOCKBROKERS

During the market downturn in 1997-1998, it was generally found that stockbroking firms with insufficient capitalization, poor risk-management capabilities, and substantial counterparty exposures experienced more severe difficulties in managing the fallout from the crisis.

Stockbrokers' faulty internal management and risk control was a leading factor in these incidents. The lack of supervision by KLSE may have also contributed to the problems. KLSE subsequently introduced a new single client and single security limit for margin financing on 19 January 1998. The single client limit was set at 30 percent of the adjusted capital while the single security limit was pegged at 20 percent of the adjusted capital or 10 percent of the paid-up capital of the listed company, whichever is lower. In addition, KLSE introduced a gearing ratio of two times against adjusted capital (1.5 times for utilized borrowings). Stockbrokers were required to fully comply with the ratios by the end of 1999. With the new requirements, stockbrokers will be eventually forced to increase their capital bases, which are now under review by KLSE and SC.

KLSE sets the capital requirements and restrictions for stockbrokers. They must have:

- paid-up capital of more than RM20 million;
- minimum liquid assets of RM500,000 or 5 percent of aggregate debt, whichever is larger; and
- restrictions on single customer or single securities.

Despite these requirements and restrictions, stockbrokers still became distressed. Stockbrokers' capital should be increased to accommodate any future losses.

In addition, share-purchase financing became another source of problems. Stockbrokers had arranged for their customers to obtain credit facilities from commercial banks and finance companies. Share-purchase financing had been profitable for these financial institutions as well as stockbrokers. Hence, these financial institutions provided investors with credit through stockbrokers, resulting in an increase in share-purchase financing. Although BNM announced a ceiling on share-purchase financing on 28 March 1997, it was too late to minimize the losses of banks and finance companies.

BNM monitors share-purchase financing but KLSE should also review the margin trading ratio depending on market conditions in order to better regulate the market.

DISCLOSURE

Frequency and timing of disclosure are urgent issues to be addressed. The regulators, KLSE, SC, and the Registrar of Companies (ROC), supervise and enforce disclosure standards based on the Securities Industry Act, Companies Act, and rules and regulations set by KLSE and SC. There are three types of disclosure: initial, periodic, and continuous. KLSE is responsible for day-to-day supervision and enforcement. An initial disclosure is required in the case of IPOs, and the information that has to be disclosed in a prospectus is stipulated in the Companies Act. While initial disclosure is deemed to conform to international standards, there are problems with periodic and continuous disclosures.

For periodic disclosure, listed companies are required to disclose their profit and loss accounts twice a year and their balance sheets at the end of the financial year. Moreover, financial statements must be disclosed within 90 days of the account book closing.

However, investors may not be able to get timely details of the financial condition of these companies. The urgency of providing timely information to investors is illustrated by the case of Time Engineering Bhd (TEB), which was among the listed companies announcing financial results within the required period, only to be suspended by KLSE for insolvency.

The present disclosure standards were decided in the days before the widespread use of computers. Current technology allows companies to discern their financial positions more promptly. Regulators should require listed companies to report their unaudited financial records (profit and loss account and balance sheet) quarterly and within a month of the account being closed, rather than within 90 days.

The TEB case also indicates that there are some problems on continuous disclosure. When the unaudited financial statement of TEB was disclosed in mid-March 1998, the company did not reveal any specific problems. However, by July, TEB was insolvent, indicating a drastic deterioration of financial position in the interim. In Chapter 6 of the SC Guidelines, the requirement for timely disclosure of information is clearly stipulated. Under this rule, TEB should have disclosed negative information within the required period.

KLSE, ROC, and SC have been improving accounting, auditing, financial reporting, and disclosure standards. For instance, KLSE has introduced a watch list of companies.[1] These measures will help investors obtain better information for their investment decisions compared with a few years ago.

Meanwhile, BNM requires banks to disclose their profit and loss accounts and NPL ratio on a quarterly basis. This will also help improve disclosure standards. However, banks are not required to publish their balance sheets quarterly. Off-balance-sheet items are increasing, as the banking business becomes more sophisticated. Similarly, asset value of securities, asset-liability mismatches, credit risk, and liquidity risk are not adequately disclosed. Investors need such critical information. Otherwise, they get a clear picture of a bank's financial condition only at the end of the financial year.

Corporate Governance

With disclosure practices not conforming to international standards, legal enforcement not adequately in place, and most investors focused on short-term placements, it is difficult to improve standards of corporate governance. A regulatory framework has to be promptly put in place, while the public should be encouraged to make long-term investments to enhance corporate governance.

INSTITUTIONAL INVESTORS

Institutional investors (e.g., Permodaran Nasional Bhd. [PNB] and Employees' Provident Fund [EPF]) can play vital roles in enhancing corporate governance, which has become an increasingly important issue in Malaysia. PNB was established to increase Bumiputras' (indigenous people) shareholdings (up to 30 percent by 1990). It owns sizable stakes in listed companies in various sectors: banking, manufacturing, services, transport, construction, trading, mining, plantation, and conglomerates. EPF and other Government-related investment institutions have also mobilized their funds to attain national goals, i.e., they are expected to increase Bumiputras' shareholding up to 30 percent. For this reason, these institutional investors are basically long-term investors.

Dividends are small and capital gains through the disposal of shares are not expected, given the passive investment policy. Nonetheless, PNB and other public investment entities such as EPF have been aggressively investing in equities. Despite a relatively low return on investment (ROI) (EPF's dividends fell to 6.7 percent in 1997 from 7.7 percent in 1996), these institutional investors have not come under fire from the public. Part of the reason is the book value/cost accounting system. However, the goal to increase Bumiputras' shareholding up to 30 percent discourages them from selling shares in the market. As such, these institutional investors can exercise their rights to increase either or both dividends and the asset values of the invested companies by improving corporate governance. Nevertheless, if the accounting method were switched to the marked-to-market system, the investment behavior of PNB or EPF would have to change.

INDIVIDUAL INVESTORS

Many listed companies are owned by one shareholder or a family group (referred to here as "owner group"). In contrast to the spirit of corporate governance, these owner groups insist on exercising their rights of share ownership, believing that they are legally entitled to control the company. This is a concept generally accepted by even small shareholders. Corporate governance poses a challenge to this concept. For instance, sales of overvalued properties and companies to the listed companies controlled by the owner groups take place occasionally. This is partly due to the passiveness of individual investors who hold shares for a short period (they seldom attend general meetings), and expectations that the deals will contribute to increases in share prices.

Many individual investors in Malaysia regard the equity market as a kind of casino, in which the public acts as speculative and short-term investors. Since the onset of the equity boom in late 1992, many investors have expressed their investment performance in terms of "win" or "lose." This suggests that the public is concerned only with capital gains. It also indicates that many investors do not consider whether a company is financially sound or not. As long as share prices are increasing, they do not care about transparency or corporate governance, even welcoming "rumor-driven" speculative price movements.

The public generally stays clear of foreign-owned companies, which tend to have conservative management styles, and pay relatively high dividends. Individual investors are attracted by shares that carry the expectation of sharp price hikes.

Given the public's reluctance to demand or exercise their rights over their shares, an effective way of improving corporate governance should be identified. The distressed market sent a serious message to the securities industries, bankers, regulators, and Government officials, who are considering how to regain market confidence. They are particularly concerned with foreign investors as their investments attract local investors to the market. For this reason, regulators are ready to take serious measures to enhance corporate governance.

MAJORITY SHAREHOLDERS

A listed company is a precious asset for an owner group, which will try to maximize profits from the firm through every possible means, causing conflict of interest between majority and minority shareholders.

Compensation for directors and executives in Malaysia is relatively low. Since dividends are subject to tax, the owner group will want to maximize benefits in other ways. Therefore, the provision of tax deductible nonpecuniary benefits (e.g., car, house, or travel) is not unusual in Malaysia and they are considered as equitable returns from investment in a listed company.

Owner groups also turn to other means to maximize their profits, tending to sell products or services of the listed company to a connected company at below market price, or the listed company buys products, services, or assets of a connected company at above market price. During the equity boom of the mid-1990s, there were many cases in which an owner group bought a listed company and sold connected companies to the listed company in the form of share swap. This practice provides the owner group with various profits, as follows:

- in addition to the sale of their assets at above market price, the owner group is able to convert illiquid assets to liquid assets;
- it can use the shares of the listed company as collateral and invest the borrowed money in other businesses; and
- it can obtain more business opportunities from the listed company.

Such related party transactions are restricted by law; however, it is difficult to curb these practices within the present legal framework. If new incentives for the owner group were devised, such as tax exemption on dividends and a reduction in income tax on directors' fees, these issues would be addressed to some extent.

Legal Framework

RENONG-UEM DEAL AND THE WEAKNESSES OF THE LEGAL FRAMEWORK

Corporate governance, transparency, and disclosure standards will improve if an adequate regulatory framework (legislation, supervision, market surveillance, law enforcement, and penalties) is put in place. Regulators must have a legal base on which to put in place a robust market framework. The need for a better regulatory environment is illustrated by the Renong-UEM deal.

UEM bought a 32.6 percent stake in cash-strapped Renong Bhd. for RM3.24 billion in November 1997. Some of the issues that emerged from the deal included the following:

- UEM was given a waiver from making a general offer and purchased Renong's stakes from related parties; and
- UEM's financial soundness will deteriorate as the acquisition of Renong stakes was made at above market price using borrowed money.

Fund managers and analysts were unhappy with the deal, while investors expressed their disillusion and lack of confidence in the market.

Several issues concerning legal framework and corporate governance arose from the Renong-UEM case. According to the Companies Act, shareholder approval is not required for cash transactions. Official approval for mergers and acquisitions and takeovers basically comes from SC. But in the case of an acquisition paid for in cash, SC approval is not required, unless enforced by other regulatory authorities such as the Foreign Investment Committee (FIC) (SC guideline 17.05; Acquisitions by Cash). FIC has the power to waive a general offer in the national interest. It used this power to approve the Renong-UEM deal, although it is questionable whether it was all in the national interest.

Despite serious losses to the investors, the Renong-UEM deal was deemed legal by regulators. No directors or executives were charged by the authorities. UEM was fined only RM100,000 by KLSE for a breach of disclosure requirements. If directors and executives responsible for negligence or criminal acts faced stiffer penalties, they might try harder to comply with the rules and regulations.

INSTITUTIONAL INVESTORS AND UNLISTED BANKS

As EPF, PNB, and other Government-controlled institutional investors are allowed to adopt the book value/cost accounting system, their asset portfolios do not reflect market value. Thus, it is important to use instead the marked-to-market accounting system, and present a real picture of their performance to the public. Institutional investors should review their investment policies to improve return on investment (ROI) by taking a more active governance role.

The Ministry of Finance, Inc. (MOFI) and Khazanah Holdings Bhd. (Khazanah) were established by the Government as private entities to invest in strategic projects such as infrastructure, public utilities, and industrial projects (Telekom, Tenaga, Proton, etc.). Their investment policy of passive portfolio management is similar to those of EPF and PNB. Detailed information on MOFI and Khazanah are not disclosed to the public. Since these entities' major shareholder is the public, and their sources of funds belong to the taxpayers, full disclosure of their financial statements would improve transparency and disclosure standards.

As the financial crisis deepened, large NPLs of unlisted commercial banks (e.g., Bank Bumiputra and Sime Bank) have emerged. Although BNM sets various requirements to ensure the soundness of banks, unlisted commercial banks are not subject to requirements set by SC and KLSE, resulting in their low degree of transparency, disclosure, and corporate governance standards. Such standards need to be improved because these banks retain sizable financial assets and provide listed companies with a substantial amount of loans and guarantees. Any difficulties will have adverse impact on listed companies.

Recommended Measures

FOREIGN EXCHANGE CONTROL AND RESTRICTIONS ON FOREIGN INVESTORS

Although capital control measures implemented by BNM were aimed to restore order in the economy and stockmarket, investors' disappointment, in particular that of foreign investors, resulted in panic selling. The measures taken by KLSE to disallow trading of Malaysian shares on CLOB in Singapore proved a big blow to foreign investors. Although the Malaysian authorities had never officially sanctioned the trading of Malaysian shares on CLOB, it had helped attract foreign investors to Malaysian shares. If the Malaysian authorities were unhappy with

CLOB, they could have taken the same restrictive measures long ago.

The Government and KLSE must urgently take necessary measures to attract foreign investors to the market. First, restrictions on foreign exchange for portfolio investments should be lifted as soon as possible. Foreign investors had believed that the Malaysian market was undervalued. In fact, they had been carefully planning to invest in the market once macroeconomic and political situations improved. Second, the CLOB issue should be solved urgently and amicably. Third, the Malaysian authorities should encourage Malaysian companies to be listed in overseas markets as many Asian corporate companies had been promoting the idea of listing their shares on foreign markets before the onset of the financial crisis.

STOCKBROKERS

Share-purchase financing and margin trading financing contributed to the banking crisis to some extent. The former is subject to the supervision of BNM and the latter is under SC regulation. Although both regulators have tried to restore order, they have not been successful. KLSE has introduced measures to enhance prudential standards of stockbrokers. In turn, stockbrokers should improve their internal control measures to avoid huge losses, particularly on margin trading.

SC and KLSE should review the margin trading ratio depending on market conditions. As the Stock Exchange of Thailand had changed the margin ratio frequently depending on market sentiment, KLSE should follow suit.

LEGAL FRAMEWORK

Priority has been given to sustaining share prices to stabilize the equity market. However, the authorities should take long-term measures to promote a more robust development of the market. As the Renong-UEM deal indicated, the lack of legal framework to enforce transparency, disclosure, and corporate governance has been challenged. It is important for regulators to have a legal base from which to promote a robust market framework.

Investors want restoration of discipline in the market and the regulators should respond to this demand swiftly. In connection with this, FIC's power should be reviewed. FIC was established originally to assess the foreign investment from the viewpoint of national interest. But its power should be confined to matters relating to foreign investments.

Moreover, an additional regulatory framework will be required to enhance the transparency of Government-related institutional investors.

CORPORATE GOVERNANCE

Given that the disclosure practices and accounting systems do not satisfy investors' expectations, the legal enforcement is not adequately in place, and most investors are focused on short-term investments, it is difficult to improve the standard of corporate governance. A regulatory framework must be promptly put in place. In addition, the general public should be encouraged to make long- term investments to enhance corporate governance. Increasing the dividend payments might be one answer.

As investors in many listed companies in such sectors as banking, manufacturing, services, transport, construction, trading, mining, plantation, and conglomerates, public investment entities such as PNB, EPF and other government-related investment institutions are basically long-term investors. With dividends payments small and capital gains not expected, their role is to increase Bumiputra's shareholdings. This was made possible partly due to the book value/cost accounting system. If the accounting method were changed to the market value (marked-to-market) system, the investment behavior of PNB or EPF would change. These institutional investors could then exercise their rights to increase either or both dividends and the asset values of the companies. This would enable them to optimize the benefits to the public, while enhancing standards of transparency, disclosure, and corporate governance.

Bond Market

Government Bond Market

ISSUES RELATED TO MONETARY POLICY

Monetary Policy

Of the 10 monetary policy instruments,[2] the most common in Malaysia are reserve requirement, liquidity requirement, credit control and guidelines on lending, and direct lendings/borrowings. Although the liquidity requirement was set by BNM to maintain prudential standards in banking institutions, it functions as a monetary instrument.

Reserve and liquidity requirements for commercial banks were set at 4 and 15 percent of eligible liabilities, respectively.[3] However, the liquidity requirement was replaced with a new framework in January 1999. The new liquidity framework requires commercial banks to maintain certain liquid assets based on the maturity profile of their assets, liabilities, and off-balance sheet commitments, and to make a projection of their liquidity surplus and shortfall. The assessment will be based upon the ability of a commercial bank to match its short-term liquidity requirement, which will be determined by reckoning the maturing obligations and assets. It is envisaged that the new framework will lead to commercial banks optimizing their asset management in the secondary market.

When a certain sector of the economy overheats, credit to that sector is controlled. BNM has used short-term direct borrowings, generally with maturities of between one and three months, to sterilize large capital inflows since late 1991. In some cases, however, the maturity has been lengthened to six months. Since February 1993, BNM has also issued Bank Negara bills (BNBs) to mop up excess liquidity.

BNM's use of direct instruments as primary instruments for monetary regulation and indirect instruments as supplementary instruments suggests that there are some impediments to the use of open market operations in Malaysia as a tool of monetary policy. In fact, direct lending/borrowing has been a more effective monetary tool than open market operations. High reserve and liquidity requirement ratios and inefficient open market operations have hindered the development of the bond market.

In March 1998, BNM announced a new monetary policy with changes from direct instruments to indirect instruments (employing open market operations and repurchase operations). With the policy changes, coupled with the deepening financial crisis, BNM reduced the reserve requirement from 13.5 to 4 percent (four times since February 1998) to supply liquidity to the banking system. The liquidity requirement ratio for commercial banks was also decreased from 17 to 15 percent on 16 September. The reduction in statutory requirements will help increase liquidity in the banking system. Meanwhile, the benchmark interest rate (three-month interbank rate) was cut to 8 percent to reduce the cost of funds. This was made possible by fixing the foreign exchange rate at RM3.80 against $1 on 2 September.

Open Market Operations

Open market operations are not often used as a monetary tool in Malaysia due to underdeveloped secondary market in Government bonds. The instruments used for open market operations are Treasury bills (T-bills), Malaysian Government securities (MGS), Government investment issues (GIIs), Malaysia Savings Bonds, BNBs, Cagamas papers, banker's acceptance (BAs), negotiable certificates of deposit, and Floating Rate Negotiable Certificates of Deposit (FRNCDs). However, trading of Government bonds has been limited, attributable to the issuance of bonds with low market yields.[4]

To address this issue, a new issuing practice and other measures were introduced between 1986 and 1989. With the introduction of the principal dealer on 1 January 1989 involving selected commercial banks, merchant banks, and discount houses, open market operations began to take place between BNM and principal dealers (PDs).[5] PDs were given access to BNM's rediscount window. In turn, PDs were required to underwrite and make markets for Government bonds by providing two-way quotations in the secondary market within a 15-sen spread. Since 1 January 1996, the PDs have been appointed annually.

Market yields of Government bonds are determined through auction by PDs. However, the compulsory subscription by PDs and the limited supply of Government bonds have left the yields low. Supply is limited by compulsory holdings of Government bonds arising from the high liquidity requirement. This means that BNM cannot effectively use Government bonds for open market operations. As a result, BNM has encouraged the development of a secondary market under which Government bonds are traded among financial institutions.

In some countries where Government bonds are not issued due to fiscal surpluses, central banks often issue short-term papers to mop up excess liquidity. BNM since 1993 has issued BNBs to mop up excess liquidity. However, it does not issue BNBs often because they are costly. Hence, it relies more on instruments such as the reserve and liquidity requirements as well as direct lendings/borrowings to control liquidity.

Liquidity Requirement

Malaysia's liquidity requirement, which was not adjusted between 15 October 1986 and 15 September 1998, is an effective instrument of monetary policy. Of the eligible securities, Government bonds make up the biggest share. As commercial banks' deposits rise, they are required to increase their holding of eligible assets to meet the liquidity requirement. The rapid growth in deposits held by commercial banks since the late 1980s has resulted in an accumulation of Government bonds. However, the issuance of Government bonds has declined due to the budget surpluses since 1993. Hence, commercial banks have been forced to invest in other eligible securities to meet the liquidity requirement. The Government, BNM, and Cagamas Bhd. issue other securities such as T-bills, BNBs, Malaysia Savings Bonds, Cagamas bonds, and other papers to meet this demand.

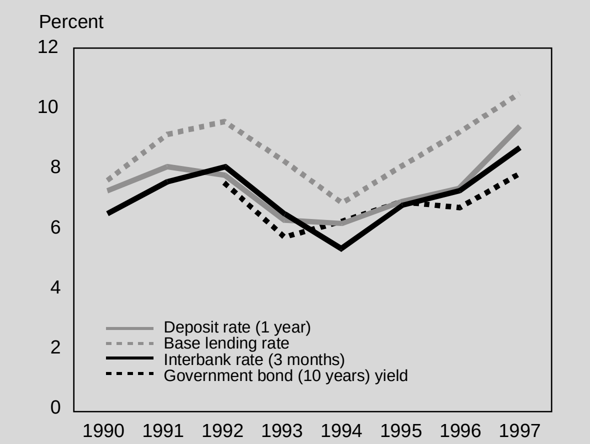
While the liquidity requirement helps maintain prudence among banking institutions, it also increases the costs of funds to them. They receive deposits from customers and are required to invest a certain portion of money in the eligible securities to comply with the liquidity requirement. Due to the illiquid secondary market, banking institutions usually hold the securities until maturity. Thus they are exposed to maturity mismatch and interest risks, resulting in high-cost investments.

LACK OF BENCHMARK YIELD CURVE

Interest Rate Structure

A three-month interbank rate, determined through direct lendings/borrowings by BNM, is a major determinant of other interest rates in Malaysia. There is a strong correlation between the three-month interbank rate, base lending rate, and deposit rate (see Figure). Even the market yields of medium- and long-term Government bonds have shown a strong correlation with the three-month interbank rate since 1992. This sets Malaysia's interest rate structure apart from that of developed countries.

Interest Rate Structure



Source: Bank Negara Malaysia.

But the interest rate structure poses a problem to the Government bond market. Despite the Government's insistence that its bonds be issued at market rates, the market yields clearly indicate the presence of distortions in the interest rate structure. As commercial banks are required by BNM to hold a certain amount of Government bonds that carry low yields, they are paying the cost of the distortion. This is eventually passed on to their depositors and borrowers. If the Government takes appropriate measures to correct the distortions, institutional investors, who hold a large amount of the low-yield bonds, may also be forced to accept substantial losses. A rise in interest rates in 1989 left banking institutions with large capital losses because of the low yield bond requirement. To cope with the difficulties, BNM introduced in April 1989 a new accounting system for the valuation of bonds. Commercial banks are allowed to book the value of Government bonds at cost, adjusted for amortization of premiums or accretion of discount. They are permitted to amortize the gains or losses over the maturity period. Although the fundamental issue of the low yield Government bonds remained unresolved, this new accounting system gave an incentive for commercial banks to invest in the bonds.

Auction System for Government Bonds

Along with the PD system, the Government introduced an auction system in January 1989 to put a pricing structure in place. Government bonds, with maturity period of up to 10 years, are issued by auction through PDs. In turn, financial institutions have to purchase the securities through PDs. Government bonds with a maturity period exceeding 10 years are subject to advance subscription by EPF and the National Savings Bank (NSB). The auction system and the principal dealer system have, to a certain extent, contributed to the development of the Government bond market.

These systems worked well during the period of stable interest rates, and trading of Government bonds has gradually increased. But when interest rates rose between 1990 and 1992, the PD system did not serve its purpose. The auction system operated as if there was fair pricing of Government bonds. In an auction of Government bonds, PDs have the obligation to underwrite the entire amount of primary issue. As there are 14 PDs, appointed in 1998, each PD is required to subscribe to a minimum of 10 percent of the entire issue (this means that the total bidding amount will be at least 140 percent of the amount issued). Therefore, undersubscription has not become an issue. PDs submit the notation at the market in terms of yields. The market yield is determined by the weighted average yield of successful bids. Meanwhile, the issuer reserves the right to accept or reject any or all the bids submitted by PDs. Thus, it is difficult to obtain a fair market yield.

In addition, an underlying factor has distorted market yield. Liquidity requirements for banking institutions and statutory requirements for EPF and NSB have created high demand for Government bonds. However, there have been fewer issuances of bonds by the Government due to the fiscal surpluses since 1993. The high demand and short supply have made the issuance of Government bonds with low market yields possible and prevented the creation of a benchmark yield curve, which is important for the development of the overall bond market. This has been identified as an important issue and as such, the liquidity requirement is being reviewed.

INACTIVE BOND TRADING

Narrow Investor Base

Commercial banks, finance companies, and merchant banks have to comply with statutory requirements and invest in eligible securities (mostly Government and Cagamas bonds). The Government also requires EPF and NSB to hold a certain percentage of their funds in Government bonds. EPF has been the biggest subscriber to Government bonds, although its holdings have declined due to limited supply. Government bonds' share of the total funds managed had fallen to 29.4 percent (RM38.1 billion) at the end of 1997.

In fact, when a new EPF Act was introduced in June 1991, holdings of "eligible securities" were reduced from 70 to 50 percent, "provided that the total amount of funds invested in such securities at any one time shall not be less than 70 percent of the Fund's total investments" (Section 26, EPF Act, 1991). This clause gave EPF a broader flexibility in portfolio management. Eligible securities include loans that are fully guaranteed by the federal Government, BNM papers with a maturity of at least three years from the date of issue, and any instrument issued by a state government or local authorities with a maturity of at least three years from the date of issue. Since then, EPF has diversified its portfolio and invested in other instruments, a policy change made due to its increasing funds. As the issuance of Government bonds declined due to fiscal surpluses, these institutions are confronted with a shortage of eligible securities and as a result, have maintained a captive investment policy on Government bonds and seldom traded in the markets.

Ineffective Principal Dealer System

A new principal dealer system, with an annual review of the dealership, was introduced in January 1996 to promote trading in the secondary market. However, the trading volume declined to RM12.4 billion in 1997 from RM25.4 billion in 1996 while the amount outstanding fell to RM69.9 billion in 1997 from RM72.2 billion in 1996. This was attributed to fewer Government bonds outstanding, and commercial banks' tendency to hold Government bonds until maturity. Inactive bond trading has made it difficult for the PD system to develop a robust secondary market.

Through repurchase agreements with BNM, PDs are allowed to secure funds from BNM for a period of less than one month. This is an attractive incentive. However, PDs cannot hedge the interest risks through a bond futures market, because it does not exist in Malaysia. Similarly, PDs' main sources of funds are short-term deposits, and the lack of a futures market has contributed to increased interest risks. As a result, PDs have been incorporating the cost of risks in their price quotations.

PDs are composed of commercial banks, merchant banks, and discount houses. Commercial and merchant banks are subject to reserve and liquidity requirements. These requirements push up the costs of funds, which result in higher price quotations. As PDs are required to play the role of market makers, they are expected to accommodate any amount of sale or purchase orders placed by customers. However, since the prices offered by PDs are not attractive to investors, bonds are seldom traded. High costs and risks associated with bond holdings are the major reasons for the ineffectiveness of the PD system.

Lack of Borrowing, Short Selling, and Futures Market

The lack of borrowing and short selling as well as the absence of a futures market have hindered the development of the secondary market in Malaysia. If the framework of borrowing bonds is improved, investors can borrow bonds against the collateral of cash for short selling.

Malaysia Monetary Exchange (MME) is planning to introduce bond futures to make the borrowing of bonds an attractive investment option in Malaysia. If bond borrowing is institutionalized and short selling is encouraged, demand for bonds will increase. A well-developed futures market plays an important role for the development of a secondary market.

Private Debt Securities Market

UNDERDEVELOPED PRIVATE DEBT SECURITIES MARKET

The types of private debt securities (PDS) issued in Malaysia are straight bonds, bonds with warrants (BWs), convertible bonds, Islamic bonds, and Cagamas bonds. Cagamas bonds, BWs, and straight bonds were the most common PDS issued until 1993, up to which time the PDS market was relatively inactive. The outstanding amount of PDS increased sharply from RM15.1 billion in 1993 to RM63.3 billion in 1997 (see Table) and since 1994, Islamic bonds have comprised the biggest share of PDS issues. A substantial amount of BWs was also issued when the equity market was bullish before the onset of the financial crisis. Despite a relatively large issue of Islamic bonds, they are predominantly issued as private placements.

Cagamas bonds are issued regularly by Cagamas Bhd., a secondary mortgage market institution. Demand for Cagamas bonds is high because of their AAA rating and those of the shareholders (BNM, commercial banks, and finance companies) of the issuing company. However, the main reason for their attractiveness is that BNM recognizes Cagamas bonds as eligible assets for meeting liquidity requirements. As such, they are treated virtually like Government bonds. If they were not recognized as eligible assets, Cagamas bonds would be issued with much higher market yields.

LACK OF CONFIDENCE OVER PDS

Investors never had full confidence in the Malaysian PDS market due to various risks, including price, default, and liquidity. This is despite the efforts of regulators to establish confidence. The Rating Agency Malaysia Bhd. (RAM) was established in November 1990 to assess credit risks of PDS issuers. As ratings became compulsory for issuing PDS, RAM boosted confidence in the PDS market. A second rating agency, Malaysia Rating Corporation Bhd. (MARC), was established in 1995 to cope with an increasing demand for PDS.

Despite the efforts of RAM and MARC to build confidence in the PDS market, they face certain constraints. While they have tried to obtain as much information as possible to improve the accuracy of ratings, insufficient disclosure standards hinder their efforts. Nevertheless, due to BNM's efforts since the onset of the financial crisis, the banking sector's disclosure standards have improved.

But investors remain skeptical about PDS. About 50 percent of PDS are issued with a bank guarantee. It is a common practice that bank guarantees are used to lower the cost of funds further and to meet the trust deed requirements of certain institutional investors. However, this practice may hinder the development of the bond market. If an issuer improves its rating, it is not required to obtain a bank guarantee, resulting in a cost reduction. In turn, investors should review their portfolio policy by enhancing fund management skills. Nevertheless, this would not be sufficient to quell investors' fears about the various risks in the PDS market. In particular, with the rising number of corporate defaults due to the financial crisis, investors are particularly concerned about default risks.

FRAGMENTATION OF THE REGULATORY FRAMEWORK

Regulation of the PDS market in Malaysia is split between BNM and SC. BNM's concern is credit allocation to the private sector while that of SC is capital market development. One of the major concerns of BNM and SC is the utilization of funds raised in the PDS market. BNM requires all PDS issuers to seek its approval for issues as well as ratings. If the issuers are public companies, they are also sub-

Private Debt Securities: Amount Outstanding (RM million)

Item	1993	1994	1995	1996	1997
Cagamas Bonds	5,015	8,925	9,312	13,227	16,756
Other Private Debt Securities	10,081	15,131	22,701	33,517	46,543
Total	**15,096**	**24,056**	**32,013**	**46,744**	**63,299**

Source: Bank Negara Malaysia.

ject to the approval of SC. As most of issuers are listed (public) companies, they have to obtain approvals from the two regulators.

A third force in the regulation of PDS issues is ROC. Although BNM and SC have set guidelines for the PDS market, the details of PDS issues are stipulated in the Companies Act of 1965. In particular, ROC requires issuers to register prospectuses unless PDS are either guaranteed by the federal Government or issued in private placement. It also requires an issuer to provide certain information in the prospectus that complies with the requirements set by BNM and SC.

BNM set guidelines on the issuance of PDS in December 1988. The main requirements are:

- minimum shareholders' funds for issuers set at RM25 million;
- disclosure of proceeds' utilization and sources of repayment;
- minimum size of an issue set at RM25 million;
- debt-equity ratio of issuers kept within prudential limits;
- underwriting requirements; and
- minimum rating of BBB for long-term papers and P3 for short-term papers.

In addition, approval should be obtained from the Controller of Foreign Exchange if PDS are issued on a bearer basis and by a nonresident (foreign) controlled company. Although the Banking Department of BNM acts as one-stop coordinating department and a separate application for approval from the Controller of Foreign Exchange is not required, this requirement has become a stumbling block in getting swift approval.

Even if issuers comply with the requirements set by BNM and SC, they (except Cagamas Bhd.) are required to obtain approvals from the two bodies. The approval process usually takes a few months (sometimes up to six). This delay is an important impediment to issuers who may miss an opportunity to issue PDS at low cost and may have to seek fresh ratings if there is a change in the financial environment in the meantime.

BNM, SC, and the departments concerned have recognized some of these problems and organized interdepartmental meetings twice a year on the development of the bond market.

NARROW INVESTOR BASE

Some investors were restricted from investing in PDS until June 1997, when the Minister of Domestic Trade and Consumer Affairs made an order to lift the restrictions stipulated in section 47B of the Companies Act of 1965. These restricted investors included fund managers, individuals, and corporate entities within certain criteria, offshore banks, and offshore insurance companies. Nevertheless, some institutional investors are still reluctant to invest in PDS. For instance, Pilgrims Fund was established to invest in equities because its unit holders are unwilling to receive interest income. PNB invests in Islamic bonds but will not diversify its portfolio.

The Government has reviewed its policy of requiring EPF to hold Government bonds. EPF is now allowed to invest more funds in other securities such as equities and PDS. In fact, EPF has been providing private entities engaged in infrastructure projects with a large amount of funds in the form of loans and PDS. However, EPF's portfolio management has come under fire over its low dividend rate of 6.7 percent in 1997 (one-year fixed deposit rate was 9.3 percent at the end of 1997). Consequently, EPF has reviewed its fund management policy.

Both EPF and PNB have adopted an accounting system based on cost/book value. They have divided their portfolio investments into two categories: short-term and long-term. Securities in the long-term category are recorded in book or cost value. However, the differences between the book/cost value and market value are adjusted (but not fully) in the investment revaluation reserve item. This accounting method does not reflect the clear financial positions of these institutions. Subsequently, the institutions manage their funds without paying much attention to performance. As these are public funds, they may have to reconsider their investment policies when the accounting system is reviewed. Despite being exempted from paying stamp duty and income tax on interest earnings, individuals are not investing much in the PDS market. Investment in PDS by unit trusts has not been actively promoted and this is also contributing to the low level of individual investments in the PDS market.

MARKET INFRASTRUCTURE

BNM has been trying to develop a market infrastructure for PDS, improving the trading, clearing, settlement, and depository systems. To this end, BNM introduced SPEEDS (Sistem Pemindahan Elektronik untuk Dana dan Sekuriti: the electronic funds and securities transfer settlement system) in the PDS market (unlisted bonds only) in January 1996. SPEEDS comprises two components: Interbank Fund Transfer System (IFTS) and Scripless Securities Trading System (SSTS). All new issues of unlisted long-term bonds are required to be made in scripless form and traded under SPEEDS to facilitate the transfer of securities, payment of interest, and redemptions. In the near future, it is planned that all unlisted PDS will be issued in scripless form.

With the introduction of the Fully Automated System for Tendering (FAST) of PDS in 1997, all commercial papers (CPs), medium-term notes (MTNs) and Islamic CPs (including private placements), except long-term bonds, are issued through FAST. The system was introduced to provide a uniform set of procedures to govern the issuance and tendering of PDS.

The Bond Information and Dissemination System (BIDS) was launched in October 1997. BIDS has been providing information on primary and secondary markets including information on all outstanding PDS, Government bonds, T-bills, and Cagamas papers. It helps to improve the liquidity and efficiency of the markets.

While most of PDS trading takes place in over-the-counter markets, Cagamas bonds, like all Government bonds, are traded in SPEEDS. As the Malaysian Institute of Bond Dealers was incorporated in 1996, a trading facility similar to the Thai Bond Dealing Center could be introduced when BIDS is fully installed. BNM should speed up the remaining work of market infrastructure development to facilitate PDS trading.

UNDERWRITERS

Merchant banks generally carry out underwriting of PDS, although some discount houses are also allowed to underwrite. They were required to earn at least 30 percent of their income from fee-based business activities until the end of 1996. In the mid-1990s, they preferred to underwrite equities rather than PDS due to the equity boom and the limited demand for PDS by institutional investors.

With the increasing variety of PDS, merchant banks now have more business opportunities to underwrite them, especially as Islamic bonds are acceptable to a wide variety of institutional investors. However, merchant banks have relatively small capital bases, such that an unsuccessful underwriting could endanger their position. This is a disincentive for them and other underwriters to actively participate in underwriting and market making.

Reserve and liquidity requirements are also an impediment to underwriting in the PDS market. An underwriter subscribes to PDS, then allots them to various investors. If the underwriter failed to allot the PDS immediately, it would have to secure the necessary funds to pay the issuer. It usually obtains the funds in interbank markets. Although the money is borrowed for underwriting, it is considered as an eligible liability and is subject to reserve and liquidity requirements. This increases the cost to issuers; thus underwriters request BNM to waive the statutory requirements.

SINGLE CUSTOMER LIMIT

Banking institutions such as commercial banks, merchant banks, and finance companies are subject to the single customer limit under which they cannot provide a single customer with loans exceeding 25 percent of shareholders' funds. Since PDS are considered as loans to BNM, banking institutions are subject to this limit but discount houses are not. Hence, discount houses usually take positions on PDS, thereby limiting the market players.

If a banking institution would like to take a position on a specific PDS that exceeds the single customer limit, it has to request BNM to waive the limit. This issue has not arisen much since most banking institutions do not invest in PDS. However, as BNM is planning to abolish discount houses, it will have to review the regulation.

Overall Bond Market

INTEREST

As the majority of Malaysians (mostly Malays) are Moslems, whose teachings prohibit payment of interest, many are reluctant to invest in interest-bearing instruments. Motivated primarily by the *riba* issue, the Government established PNB, the biggest unit trust company, to encourage the *bumiputras* (mostly Moslems) to mobilize their savings through unit trusts that invest mostly in equities.

The Government started issuing Government Investment Notes in 1983 and BNM has also implemented a similar scheme. These instruments are similar to Government bonds and BNBs. However, they do not carry coupons but instead, pay dividends, which are roughly equivalent. In March 1993, commercial banks introduced noninterest bearing accounts. A similar innovation has emerged in the PDS market and the first Islamic bond was issued in 1990. Since then, the volume of Islamic bond issues has increased steadily, and in 1997, RM5.2 billion was raised by Islamic bond issues, representing the biggest share (26.9 percent) in the PDS market.

ISLAMIC BONDS

The increasing volume of Islamic bonds has contributed to the development of the PDS market over the last few years. However, PDS trading remains relatively inactive. Islamic bonds are issued through private placement, allotting the bonds to Government institutions. For instance, Kuala Lumpur International Airport Bhd. (KLIA) issued a RM2.2 billion Islamic bond in 1996. KLIA, a company developing the new Kuala Lumpur International Airport, can obtain financial support from the Government since it is a national project. As a result, a large portion of the KLIA Islamic bond was allotted to EPF. Similarly, many Islamic bonds (especially if the amount involved is large) have been issued with Government support. This implies that the market yield of most Islamic bonds is below that of the market, which creates adverse effects on the secondary market.

KHAZANAH BONDS

Given the lack of a benchmark yield curve and shortage of Government bonds, the Government decided to issue *khazanah* bonds to help foster a robust bond market. The first *khazanah* bonds were issued in September 1997, based on the Islamic *mudharabah* concept (no coupon or interest payment), with a face value of RM1 billion and maturity of three years. *Khazanah* bonds were expected to be issued every quarter and the maturity to extend from three to 10 years within five years. Due to the financial crisis, however, the issuance of *khazanah* bonds was temporarily stopped in December 1997, but resumed in March 1998 (RM1 billion, with a three-year zero coupon).

DISTORTION OF YIELD

Despite BNM's persistence in deregulating interest rates, long-term rates (yields) are not yet fully liberalized in Malaysia. Yields are determined through the auction of Government bonds but the auction is conducted through compulsory subscription by PDs. In addition, the auction reflects a high demand for

Government bonds by banking institutions and the short supply of Government bonds, resulting in low yields.

The distortion can also be observed in the PDS market. For instance, Cagamas papers are also issued by auctions, producing yields similar to those of Government bonds. Most Islamic bonds are issued by private placement, and issuers and investors—basically Govemment-related companies or institutions—are influenced by the Government. As a result, investors are expected to accept the offered price of bonds. Hence, bond yields in Malaysia, regardless of whether they are Government bonds or PDS, have been systematically distorted by the Government.

The secondary market is adversely affected by the distorted yields. Despite the Government's introduction of a new accounting system for valuation of Government bonds held by banking institutions, many banks have not actively traded in the secondary market partly to avoid losses. As PDS are issued in a manner similar to Government bonds, trading remains inactive.

Recommended Measures

MONETARY POLICY

BNM has been employing direct lendings/borrowings as a major instrument for monetary regulation. In March 1998, it announced, in a policy change, that open market operations would be used as a major instrument for monetary management. However, to achieve this, there has to be a sufficient supply of financial instruments in the market. The large outstanding Government bonds (RM69.9 billion at the end of 1997), Cagamas papers, and *khazanah* bonds cannot be used for open market operations now since they have been issued at lower yields than prevailing market rates. Thus, BNM has to depend on short-term papers, such as T-bills, BNBs, BAs, and NCDS. BNM should issue more BNBs for open market operations.

In line with the policy change, reserve and liquidity requirements were reviewed in July 1998. To adjust the liquidity requirement, a marking system should be introduced to spare existing Government bondholders from incurring big losses. For instance, a certain percentage of Government bonds held by commercial banks, finance companies, merchant banks, EPF, and NSB should be defined as permanent holdings and these institutions should be required to hold the bonds until maturity. This measure should remain in force until the yields of financial institutions' holdings of Government bonds become market-based or interest rates decline to levels below the market yields.

PRIMARY MARKET AND BENCHMARK INTEREST RATES

A short-term benchmark interest rate can be obtained through open market operations. However, the creation of a long-term benchmark yield curve should be the target. BNM has studied the possibility of creating a benchmark yield curve through Cagamas papers. But it realized that the demand for Cagamas papers would decline substantially if they were to be excluded from the list of eligible securities. Moreover, Cagamas papers should be issued with high market yields. Since September 1997, the Government has started issuing *khazanah* bonds, which are not recognized as eligible securities, hoping that they will help to create a benchmark yield curve.

The existing auction system by PDs has hindered the creation of a benchmark yield curve. PDs' compulsory subscription should be eliminated, and the statutory requirements for banking institutions, insurance companies, EPF, and NSB should be reduced. With a new auction framework to improve price quotations, Government bonds, Cagamas papers, and *khazanah* bonds would be issued at market rates.

With the July 1998 changes in policy, the capability of *khazanah* bonds to create a benchmark yield curve was enhanced. In addition, if a new auction system without compulsory subscription to Government bonds, Cagamas papers, and other papers were introduced, it would help successfully launch the issuance of debt securities at market rate.

With the introduction of Islamic bonds, the primary market for PDS has developed rapidly. However, the demand for Islamic bonds has been artificially created through either or both statutory requirements and Government guidelines in the case of big issues. This has resulted in large issues of these bonds at distorted rates. The Government should thoroughly review the issuance of Islamic bonds. A fair yield curve would be reinstated if Government bonds, Cagamas papers, and *Khazanah* bonds would be issued at fair market rates.

Cagamas bonds are issued to finance the purchase of mortgage loans from commercial banks and finance companies. Their role is important in addressing certain issues in the banking sector, such as maturity mismatch and liquidity enhancement. Nevertheless, the sale of housing loans is undertaken with recourse. This means that the sold loans still remain in the seller's balance sheet. Since Cagamas Bhd. has addressed the recourse issue, BNM should take necessary measures to facilitate the sale of mortgage loans without recourse.

UNDERWRITERS AND MARKET INFRASTRUCTURE

As the Government achieved a fiscal surplus since 1993, the development of the PDS market became a focal issue. Nevertheless, the market framework was designed to ease the issuance of Government bonds; for example, EPF and NSB are subject to the statutory requirements. A new intermediary, without the statutory requirements, should be introduced to prompt the development of the PDS market.

With the existing PDS auction system, the approved FAST members, commercial banks, merchant banks, discount houses, insurance companies, development banks/finance institutions, EPF, Cagamas Bhd., and Khazanah Nasional Bhd., can bid at auctions for short- and mid-term PDS (it is expected that long-term PDS would be included in the near future). This auction system has helped improve the primary market. Here the role of underwriters is important. However, the regulatory framework for underwriters has remained unchanged.

Commercial banks, merchant banks, and discount houses can underwrite PDS, but merchant banks dominate the market. They are subject to statutory requirements and their capital bases are generally small relative to commercial banks, leaving them reluctant to expand their underwriting business in PDS. Merchant banks should increase their capital bases to cope with their roles as underwriters and market makers. BNM should waive its statutory requirements when it underwrites PDS. To improve their regulation, stockbrokers should be encouraged to underwrite PDS.

With the improvement in the market infrastructure, particularly the auction, settlement, and clearing systems for PDS, the demand for Islamic PDS has increased. In addition, the introduction of a new trading system, similar to the Thai Bond Dealers Center, may help develop the secondary market. BNM should speed up its remaining work on market infrastructure development.

REGULATORY FRAMEWORK

BNM, SC, and ROC are the joint regulators of PDS. In addition to complying with their requirements, issuers must obtain approvals from these authorities. This approval process is time-consuming and has become a constraint on the timely issue of PDS. Issuers who comply with the requirements should be allowed to issue PDS without approval.

It is recommended that:

- BNM and SC should consolidate the two sets of requirements into a single set;
- approval from the Controller of Foreign Exchange should be eliminated;
- all the sections related to securities businesses in the Companies Act of 1965 should be incorporated into a new law, and the power of the Registrar of Companies should be transferred to SC; and
- SC solely should be given the responsibility to regulate the PDS market.

Furthermore, BNM should relinquish all of its operational tasks to a private sector entity to develop a self-regulatory organization and the amount of funds raised should be determined by the market. In the case of an issuer violating any requirement, including the utilization of funds, SC should prosecute.

BORROWING OF BONDS AND THE FUTURES MARKET

The borrowing of bonds against cash collateral is seldom used in Malaysia. If this practice is encouraged and institutionalized, a more active and liquid cash market in Government bonds and PDS can be created. It will help investors to take a long or short bond position with or without having the required bonds in their physical possession. It is difficult to develop a futures market without a well-developed cash market. MME is planning to introduce a suitable bond futures market.

The borrowing of bonds will create a new dimension in the securities industry. Long-term bondholders, such as EPF, NSB, and commercial banks, can generate extra income from lending bonds. While they are required to hold Government and Cagamas bonds to meet statutory requirements, the lending of bonds does not breach the requirements since borrowers sell the bonds in the repurchase market. If the Government will make the income from bond lending tax-exempt, this will serve as an incentive for investors to use the new scheme.

CONFIDENCE ON PDS

Despite the introduction of a rating system, confidence about PDS has not been fully established and about 50 percent of PDS have been issued with bank guarantees. BNM is trying to disseminate information on PDS to investors on a real-time basis through BIDS. A new auction system for PDS has been introduced, and clearing, settlement, and depository systems are being improved to enhance the efficiency of trading. Nevertheless, it is important to enhance the disclosure and corporate governance standards to restore confidence on PDS.

INVESTORS

The roles of market players such as banking institutions, discount houses, insurance companies, EPF, and NSB should be reviewed. Commercial banks, for instance, are expected to mobilize depositors' funds on a short-term basis. However, because of statutory requirements, BNM forces them to allocate a certain portion of funds for long-term investment, resulting in maturity mismatches. In addition, as their funds are subject to the reserve requirement, the costs of funds become higher compared with those of nonbanking institutions.

BNM should waive the single customer limit for merchant and commercial banks when they underwrite or invest in PDS. It should also review the role of banking institutions and encourage nonbanking institutions to invest in bonds.

EPF, Pilgrims Fund, Armed Forces Fund, and PNB are expected to play active roles in the bond market. However, these institutions, with the exception of EPF, place their funds in the equity market or short-term instruments. Moreover, their accounting system is based upon book value/cost and losses from investments in the equity market are not clearly reflected in their balance sheets. Their accounting system should be reviewed and they should be encouraged to invest in Government bonds and high-quality PDS to sustain stable portfolio management.

SECONDARY MARKET

The development of the secondary market hinges on policy changes in monetary instruments (for example, open market operations, liquidity and reserve requirements), the creation of a benchmark yield curve, and the restoration of confidence in the PDS market. With limited Government bonds available in the market, BNM should rely on short-term papers, Cagamas papers, and *khazanah* bonds for open market operations, provided that Cagamas papers and *khazanah* bonds are issued at market rates. Meanwhile, with an increase in PDS, BNM and the Government should take the necessary steps to encourage PDS institutional investors. In particular, EPF, PNB, insurance companies, and various pension funds should review their portfolio investment policies, and increase their investments in high rated PDS.

Unit trusts investing in bonds should also be created to encourage individual investors. In addition, there is a need to educate the staff of other institutions, such as pension funds, mutual funds, insurance companies, cash-rich corporations, and high net worth individuals, on the advantages of investing and trading in bonds, rather than having them simply leave their surplus funds in fixed deposits or shares.

Appendix

Supplementary Report

INTRODUCTION

The Malaysian authorities took two significant measures on 1 September 1998: the introduction of capital controls and the restriction of trading of Malaysian shares to the Kuala Lumpur Stock Exchange (KLSE). Bank Negara Malaysia's (BNM's) capital controls helped to insulate the Malaysian economy from the Asian crisis while lowering market interest rates and expanding liquidity in the banking sector.

Nonperforming loans (NPLs) in the banking sector have increased since the onset of the financial crisis, fueled partly by loans related to share trading. This implies that the banking system had been vulnerable to depreciation of asset values. Individuals, corporate entities, and Government-related portfolio management institutions invested heavily in equities, thus the collapse in share prices had a significant impact.

The 1 September measures also had an adverse effect on the equity market. The capital controls restricted foreign investors from selling their Malaysian shares, as those traded in the Central Limit Order Book (CLOB) were frozen. As a result, foreign investors since then have been reluctant to invest in Malaysian shares. However, given the limited shares available in the market due to the restrictions, share prices have recovered.

Meanwhile, the authorities have been addressing issues connected with the capital market. The Government formulated the National Economic Recovery Plan (NERP) on 21 July 1998. NERP spells out overall policy directions, and those pertaining to the capital market aim to (i) improve transparency and the regulatory environment, (ii) improve the capital market, and (iii) develop the private debt securities (PDS) market. Implementation of NERP started in the fourth quarter of 1998, resulting in a restoration of market confidence and financial market stability.

The Securities Commission (SC) and KLSE have emphasized the improvement of transparency and the regulatory environment, and are focusing on corporate disclosure, corporate governance, and prudence of stockbroking companies (SBCs). With a large amount of NPLs in the banking sector, the authorities have taken various steps to strengthen this sector. Bond market development, in particular, the development of the PDS market, has become an urgent agenda.

This supplement outlines the various measures taken by the authorities in line with the policy directions of NERP. In addition, issues not specifically dealt with in NERP are described.

NATIONAL ECONOMIC RECOVERY PLAN AND THE CAPITAL MARKET

Equity Market

Stockbroking Companies

Capital Adequacy. The distress of SBCs was the most urgent issue facing authorities in restoring market confidence. On 7 January 1999, SC approved the new capital adequacy requirements (CAR) subject to the condition that the basis of computation (adjusted capital) be harmonized with that of the new CAR. The new CAR, which is determined in relation to levels of daily risk exposure of SBCs, was introduced by KLSE.

The new CAR was implemented in two stages:

(i) Stage One: The issuance and dissemination of Rule 17G on Capital Adequacy Requirements of KLSE Rules Relating to Member Companies (KLSE Business Rules) took effect on 28 May 1999; and

(ii) Stage Two: Complete shift to the new CAR rules and the full enforcement of Rule 17G, which replaced Rule 17A of the KLSE Business Rules on Minimum Liquid Funds Requirements, on 1December 1999.

With the introduction of the new CAR, it is expected that the monitoring of SBCs will be improved and enhanced by the following:

(i) incorporating internationally recognized approaches and measures, thus setting the standards for an overall risk control framework for SBCs;
(ii) promoting an environment of enhanced risk management by enabling SBCs to identify the capital available to cover the risks of their business; and
(iii) providing a proactive alert mechanism for SBCs to quantify, manage, and address the risks of their business.

Nonperforming Account, Bad Debt, and Doubtful Debt. With the collapse of share prices, coupled with the lack of risk management, many SBCs experienced financial distress. However, the authorities could not ascertain the financial position of SBCs quickly as there were no standards for the treatment of interest on nonperforming accounts, or provisions for bad and doubtful debts in financial statements. Thus, KLSE announced the introduction of a new Rule 16A of Rules Relating to Member Companies on 29 June 1999. In order to achieve smooth implementation of the new rule, KLSE, in consultation with SC, agreed to allow SBCs a transition period of one year, starting 1 July 1999.

KLSE consulted industry participants such as the Malaysian Institute of Accountants, Malaysian Association of Certified Public Accountants, and Malaysia Accounting Standards Board on the formulation of the rule concerning the Suspension of Interest and Provision for Bad and Doubtful Debts. It also sought and obtained Ministry of Finance approval for 50 percent tax relief on interest suspended by SBCs for a two-year period.

With the implementation of the rule on 1 July 2000, SBCs will be required to comply with Rule 16A in respect of disclosures in their monthly accounts and in their audited accounts for the financial year. The new rule will provide the authorities with the basis for the assessment of SCBs' financial positions. It covers the following areas:

(i) classification as a nonperforming account,
(ii) suspension of interest on nonperforming accounts,
(iii) specific provision for bad and doubtful debts,
(iv) reclassification of nonperforming accounts to performing accounts, and
(v) general provision for bad and doubtful debts.

Gearing Ratio. Excessive borrowing by SBCs resulted in distress and an increase in NPLs in the banking sector. The authorities set up a new rule to cap the ceiling on the borrowing by SBCs. Under the previous rule, SBCs were required to comply with a gearing ratio on utilized level of 2.5 times by end-1998, 2.0 times by 30 June 1999, and 1.5 times by the end of 1999.

However, with the introduction of the new CAR and considering the rule's negative impact on the equity market, the rule was revised as follows:

(i) SC has approved the abolishment of the gearing ratio on approved limit for SBCs and has also made the gearing ratio on utilized level less stringent to no more than 2.5 times. The revised gearing ratio is in line with the National Economic Action Committee's recommendations; and
(ii) a comprehensive review on the need for gearing ratios will take place after the full implementation of CAR.

Merger of Stockbroking Companies. There are 62 SBCs and most of them are undercapitalized. With the introduction of the new CAR, the undercapitalized SBCs cannot cope with large amounts of transactions. Moreover, the financial services market will be liberalized within three years under the World Trade Organization (WTO) agreement. As such, increasing the capital base has become an urgent issue facing SBCs. In fact, BNM announced a merger plan for the banking sector on 29 July 1999.

On 8 August 1999, the Malaysian authorities encouraged SBCs to merge into stronger and larger entities to enhance their capability in handling larger volumes of transactions. To protect the business interests of small SBCs, the opening of branch offices by SBCs is not allowed, resulting in limited access to retail investors. It is envisaged that small SBCs may resist the mergers. However, it is an inevitable process for the survival of the stockbroking industry.

Broker's Commission and Remisiers. Remisiers are recognized commission agents belonging to SBCs. They submit security deposits (usually bank guarantees) to SBCs and execute orders from their customers. Although remisiers are capped on their trading limits by SBCs subject to the amount of their security deposits, the lack of legal certainty has allowed them to exceed the limits. To address this issue, KLSE has amended its rules to bring into force a new standard remisiers agreement that aims to enhance the legal certainty in relationships between SBCs and remisiers. The main features of the new agreement include:

(i) the rate of commission for remisiers will be fixed and standardized;
(ii) remisiers' security deposits are segregated from clients' assets;
(iii) remisiers are responsible for any losses incurred by SBCs arising from any transaction in securities dealt by, or through, the remisiers; and
(iv) remisiers are exonerated from liability in respect of losses through the willful default, negligence, instruction, or incorrect administrative procedures and accounting statements issued by the directors, officers, and employees of SBCs.

To protect the commission and rebate, only SBCs, remisiers, financial institutions, and their wholly owned subsidiaries were allowed to enjoy commissions and rebates on brokerage. The authorities took steps to broaden the institutional base in equity investments by allowing the institutions to be entitled to brokerage commission. This measure is expected to supplement the new guideline on remisiers. KLSE extended the categories of institutions eligible for rebates on brokerage commission effective 16 November 1998.

Under the previous rule, the rebates for institutions were set in the range of 0.25 to 0.5 percent of the brokerage commission, depending on the deal between the financial institutions concerned and SBCs. The new rule was expanded to include life insurance companies, general insurance companies, superannuation of employees provident funds, finance companies, asset management companies and unit trust management companies, and trust companies or institutions in the categories of institutions eligible for rebate.

Quarterly Reporting of Financial Position. KLSE announced on 28 November 1998 that it would undertake quarterly reporting of the financial position of SBCs to promote investor protection through greater transparency in the stockbroking industry, with effect from 4 January 1999. This measure will help enhance the disclosure standard and supplement the monitoring of SBCs.

Strengthening the Stockbroking Industry. KLSE announced its new Memorandum & Articles (M & A) and Rules on 14 June 1999, which came into effect on 1 July 1999. The new rules had incorporated new and enhanced measures adopted in 1998 to strengthen the stockbroking industry. They consisted of new regulatory requirements and resulted in a consolidated and comprehensive set of rules. Among the key areas covered in the new rules for SBCs include:

(i) best business practice,
(ii) dealing in securities,
(iii) rules on trading,
(iv) delivery and settlement,
(v) financial resources and accounting requirements,
(vi) audit regulations, and
(vii) disciplinary action.

Corporate Governance

Controlling shareholders in Malaysia have occasionally engaged in abuses of the system, reflecting the weak regulatory environment and weaknesses in corporate governance. Investors, local as well as foreign, are understandably upset whenever such abuses and exploitations emerge. The authorities have recognized the weaknesses of the existing legal framework and regulatory environment. As such, they have taken decisive and comprehensive measures to protect investors in line with the formation of NERP.

Minority Shareholders. The President of KLSE announced on 4 October 1999 the complete revamp of KLSE's listing rules regarding related party and interested party transactions to better protect minority shareholders. His decision was made given that the existing rules could not prevent abuses by controlling shareholders. The new rules require:

(i) the appointment of an independent corporate adviser to advise minority shareholders of the company as to whether transactions are fair and reasonable or are to the detriment of minority shareholders;

(ii) the board of directors to be mindful of a collective responsibility to ensure that such transactions are in the best interests of the company; and

(iii) interested directors, substantial shareholders, or connected persons with any interest, direct or indirect, in such transactions not to vote on the resolution of the transactions.

SC introduced a new takeover code on 1 January 1999 that should improve regulation on takeovers and mergers. The code provides minority shareholders with a fair opportunity to consider an offer. It also includes provisions imposing certain criminal liabilities and discourages "creeping" control of a company.

Controlling Shareholders. Amended procedures and regulations for direct business transactions in relation to the restriction of directorship came into force on 22 March 1999. Directors of public listed companies (PLCs) shall hold no more than 25 directorships in companies of which:

(i) the number of directorships held in PLCs shall not be more than 10, and

(ii) the number in other companies (i.e., other than PLCs) shall not be more than 15.

A high-level Finance Committee on Corporate Governance released a "Report on Corporate Governance" on 25 March 1999 that provides 70 explicit recommendations on three areas, in particular:

(i) strengthening of the statutory and regulatory framework for corporate governance;

(ii) enhancement of the self-regulatory mechanisms that promote good governance; and

(iii) establishment of training and education programs to develop the corporate culture in relation to corporate governance, as well as to ensure that there is the necessary human and institutional capital available.

Work is currently underway on implementing the committee's recommendations as follows:

(i) the primary duty of a nominee director is to act in the best interests of the company, not the party that made the nomination. However, a nominee director has often faced difficulties due to status. On 20 August 1999, the Chairman of SC issued a stern warning to nominee directors to report all wrongdoings in their companies to the authorities or face the consequences of inaction;

(ii) all directors have to attend approved courses as a condition for mandatory accreditation; and

(iii) the proposed Institutional Shareholder Watchdog Committee will monitor and combat abuses by company insiders against minority shareholders. The Employees Provident Fund (EPF) has been asked by the Ministry of Finance to initiate the setting up of the watchdog group.

There are recommendations in the report with regard to the level and composition of directors' remuneration, procedures, and disclosure for remuneration. Among other things, the report suggests that the level of remuneration should be sufficient to attract and retain directors needed to run the company successfully. It also recommends that remuneration be linked to corporate and individual performances for executive directors, and the level of experience and responsibilities for nonexecutive directors.

Central Limit Order Book

With the measure taken on 1 September 1998 to concentrate share trading in KLSE, Malaysian shares traded in CLOB have been frozen. The authorities in Malaysia and Singapore have been negotiating to reach an amicable agreement to solve the issue. The measure was effective in stabilizing share prices in KLSE as the supply of shares was limited. But foreign investors were disillusioned by this drastic measure taken by the Malaysian authorities, resulting in a lack of confidence in the market.

With an announcement on 12 August 1999 that the Malaysian shares would be included in Morgan Stanley Capital International (MSCI), resolution of the CLOB issue became an urgent one for the authorities. This was because the announcement contained a condition that the CLOB issue should be solved before the shares' inclusion in MSCI. SC approved a proposal concerning the purchase of the frozen CLOB shares by Telekom Malaysia Bhd. (Telekom) and United Engineers (Malaysia) Bhd. (UEM) on 21 September 1999. However, Telekom pulled out from the proposal on 19 October 1999 while UEM proceeded with the negotiations. It is anticipated that an agreement will be reached soon given that the share prices have recovered tremendously compared to September 1998 and that investors can compromise with the offered prices.

New Accounting Standards

The development of sound accounting standards through the Malaysian Accounting Standards Board (MASB) is essential. All PLCs have to comply with new accounting standards regulations, the Securities Industry (Compliance with Approved Accounting Standards) Regulations of 1999, which came into force on 18 June 1999. SC established the Financial Reporting Surveillance and Compliance Department in April 1999 to ensure PLCs' compliance. It is expected that corporate disclosure and transparency will be enhanced as a result.

On 22 June 1999, MASB issued a notice on the application of the approved accounting standards in the preparation of financial statements. The following standards, which came into force on 1 July 1999, are required to be prepared or lodged under any law administered by SC, BNM, or the Registrar of Companies (ROC) pursuant to subsection 7(1) of the Financial Reporting Act of 1997 and regulation 3 of the Financial Reporting (Publication of Approved Accounting Standards) Regulations of 1999:

(i) MASB Standard 1: Presentation of Financial Statements;
(ii) MASS Standard 2: Inventories;
(iii) MASB Standard 3: Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies;
(iv) MASB Standard 4: Research and Development Costs;
(v) MASB Standard 5: Cash Flow Statements;
(vi) MASB Standard 6: The Effect of Changes in Foreign Exchange Rules; and
(vii) MASB Standard 7: Construction Contracts.

Disclosure

KLSE announced new disclosure rules on 12 March 1999 to facilitate the move towards disclosure-based regulation. Quarterly reporting of financial statements will be mandatory for all PLCs. The reports include balance sheets, income statements and explanatory notes on purchase or disposal of shares, corporate proposal status and group borrowings, debt securities, and off-balance-sheet items.

The reports must be filed with KLSE for public release within two months from the end of every financial quarter. These quarterly reports are aimed at providing timely information to assist investors in their decisions and to enhance the accountability and corporate governance of PLCs. PLCs will also be required to issue their audited annual accounts, and auditors' and directors' reports within four months from the end of a financial year, with effect from the financial year ending on or after 31 July 1999.

Clearing and Settlement

A swift and accurate clearing and settlement system is one of the most important aspects in securities trading. The current clearing and settlement system of KLSE enables a delivery versus payment (DVP) environment or a same day securities and cash settlement for direct members of the system through its clearing house, Securities Clearing Automated Network Services (SCANS). However, membership to the clearing and settlement system of KLSE has been restricted to SBCs. In order to extend the benefits of DVP to other investors, KLSE has held discussions with selected custodian banks and representatives of the Association of Stockbroking Companies of Malaysia to obtain feedback before finalizing the Institutional Settlement Service (ISS) Business Requirements Definition document. A discussion on the ISS mock run strategy was also held on 14 May 1999 with selected custodian banks.

The new SCANS Rules to revamp SCANS were approved by SC on 5 July 1999. The new rules include the enhancement of DVP with ISS as follows:

(i) to facilitate the settlement of trades of institutional investors directly with the clearing house, KLSE launched ISS on 15 July 1999. ISS, which will be offered by KLSE through SCANS, will enhance the current DVP environment by extending the clearing membership to include resident custodian banks and institutional investors. The new category of membership will be known as Nontrading Clearing Members; and

(ii) on 28 July 1999, KLSE formally approved eight banks and a custodian services company to settle their trades directly with its clearing house via ISS. Nontrading Clearing Members have direct access to the clearing and settlement facilities of KLSE via the ISS and will be able to achieve same day settlement for cash and securities.

Amendments to the Malaysian Central Depository (MCD) Rules took effect on 3 May 1999 to allow local custodian banks to hold underlying securities for American depository receipts (ADRs) and global depository receipts (GDRs) programs with certain conditions attached, including the following:

(i) the underlying securities must be a sponsored depository receipt program;

(ii) the approval of MCDs must be obtained for holding underlying shares in a GDR;

(iii) the underlying securities for each depository receipt program are held by not more than five custodians;

(iv) the total number of underlying securities for all depository receipts entered into by an issuer on the stock exchange is not more than 5 percent of the total issued and paid-up capital of the issuer as defined in the rules of KLSE; and

(v) each custodian shall hold the underlying securities for a depository receipt program in a securities account opened solely for that purpose and is clearly designated in the manner prescribed by MCD.

Suspension

The suspension of trading is important to restrain volatility and to maintain a fair and orderly market. However, the suspension period should be minimized to ensure a fair and orderly market. For this purpose, KLSE issued a Practice Note No 1/1999—Request for Suspension, which took effect from 14 June 1999. This practice note clearly addresses the following:

(i) strengthened policy of KLSE on suspension,
(ii) reasons for suspension,
(iii) period of suspension,
(iv) procedures for making a request for suspension, and
(v) obligations of PLCs with respect to announcements.

The strengthened policy was developed in consultation with SC and with feedback and cooperation from relevant industry participants. This will benefit shareholders and investors by enabling greater control in the conduct of their investments through the continued trading of securities, unless suspension is necessary to maintain a fair and orderly market.

The policy will also enhance the responsibility and accountability of PLCs in making company announcements to ensure that investors are better informed, resulting in the sustained growth and the promotion of long-term investment interest in the stock market.

Share Buy-back Scheme

In conjunction with the enforcement of the amendments of the Companies Act of 1965, KLSE issued guidelines on 1 November 1998 governing purchase of own shares by listed companies. The new guidelines provide for the utilization of share premium account for share buy-back and the option to treat repurchased shares as Treasury shares. Treasury shares can be retained, distributed as dividends, or resold.

The new guidelines also contain antimanipulation rules as follows:

(i) the purchase price must not be more than 15 percent above the weighted average market price of the shares for the five market days immediately prior to the purchase;
(ii) the resale price of Treasury shares must not be less than the weighted average price of the shares for the five market days immediately prior to the resale; and
(iii) the provision of financial assistance by PLCs to buy back their own shares is now prohibited.

Front-line Regulation Task Force

Capacity building and strengthening of KLSE as a frontline regulatory organization have been an urgent agenda. To achieve this objective, a study was undertaken to review the functions of divisions/departments within the KLSE Group. An Organization and Methods (O & M) Department has been set up to review systems and methodology to streamline functions.

On 2 October 1998, a KLSE Frontline Regulation (FLR) Task Force presented to SC a draft report on the overall direction and the measures/strategies that the KLSE Group has undertaken and intends to undertake in order to become a frontline regulatory organization. The areas covered included self-regulation, enforcement of rules and regulations, regulation of behavior of issuers, regulation of behavior of market intermediaries, and regulatory management of the secondary market.

Monitoring and Enforcement

Before the formulation of NERP, the regulators had been monitoring activities in the equity market and there was law enforcement against breaches of regulations. However, the NERP recommendations have intensified these further and strict law enforcement is now taking place.

Pending Actions

The regulators have achieved great progress in implementing various recommendations of NERP. Their efforts should be adequately appraised. However, there are some pending actions to be undertaken. These pending actions include the following:

(i) *Fund management capability.* Greater efforts, including a relaxation of bureaucratic and procedural controls, should be undertaken to realize the creation of a vigorous fund management capability in Kuala Lumpur.
(ii) *Problems with warrants and transferable subscription rights (TSRs).* Currently enforced restrictions on capital raising by issuing warrants and TSRs should be lifted.

(iii) *Circuit breakers*. A broader based circuit breaker mechanism should be considered to address the problem of excessive volatility in the market (work in progress).

(iv) *Corporate exercises*. In a dynamic market, corporate exercises and restructuring should be allowed to continue, especially in the productive and strategic sectors of the economy. Restrictions on initial public offerings (IPOs), rights issues, and corporate restructuring exercises should be lifted to allow PLCs to restructure and raise funds in the market.

(v) *Review of the Second Board*. There is a case to be made for tightening qualitative criteria for admission to the Second Board in order to restore order, discipline, and credibility as well as to refocus on original intentions. Only companies with the best attributes and growth potential ought to be given an opportunity to take the short cut route of raising public capital through the Second Board. The authorities should consider reducing the number of companies on the Board by weeding out those that failed to perform up to the profit forecasts, etc. A consolidation and merger exercise could also be encouraged (work in progress).

Bond Market

Measures by BNM, CDRC, and National Bond Market Committee

Compared with the emphasis given to the equity market by the authorities to regain market confidence, the measures taken to develop the bond market have been limited. Although the authorities have recognized the importance of the development of the bond market, the Government and BNM have been more concerned about economic recovery and soundness of the banking system.

BNM has been increasing the foreign reserves to cope with any "ringgit attack" once foreign exchange controls are lifted. In turn, it is taking the funds out of the banking system as deposits for sterilization. The sterilization has two aspects: (i) it confines the increase in loans to the private sector, and (ii) it allows commercial banks to improve profits by enjoying interest margins without risks.

Meanwhile, the Government needs funds to finance the budget deficit. It tends to raise funds at low cost by taking the traditional steps of issuing Government bonds. However, the review of interest rate structures has not been initiated. The Corporate Debt Restructuring Committee (CDRC) has been undertaking debt restructuring, and its efforts will contribute greatly to the soundness of the banking system. One of the measures taken by CDRC is to have distressed companies issue bonds with the proceeds to be used for the settlement of debts. BNM allows banking institutions to invest in bonds issued by companies with a BB rating as part of their debt restructuring process.

BNM has set various targets on credit extension to banking institutions. Investment in bonds is deemed to be credit extension and it is an easy process for banking institutions given that the investment does not require any time-consuming processes and costs are minimized as the size of bonds is relatively big. The CDRC's measure will help develop the primary market for PDS. However, the secondary market for PDS may remain underdeveloped.

After taking measures to enhance market confidence in the equity market, the authorities have shifted their attention to the bond market. It is envisaged that effective and comprehensive policy measures for the robust development of the bond market will be undertaken in the near future.

An initiative by the authorities to develop the bond market emerged in August 1999. The 1999 Malaysian Capital Market Summit was held from 10 to 11 August 1999 in which various papers about addressing the bottleneck and pending issues for the development of the bond market were presented. Given the need for innovation in the bond market, an announcement was made on 7 September 1999 that the National Bond Market Committee (NBMC) had commenced work. The Committee is now working on an overall policy direction and rationalization of the regulatory framework for the development of the PDS market. It is expected that issues connected with interest rate structure, monetary tools, auction system of Government bonds, regulatory framework, and market infrastructure, etc., will be included on the agenda.

In addition, a seven-member committee on the formulation of the Capital Market Masterplan was formed by the First Finance Minister on 23 September 1999. The masterplan will tackle various weaknesses of the capital market as a whole but it will focus on the bond market.

Shelf Registration Scheme

As one of the efforts to develop the bond market, a "shelf registration" scheme will be introduced to give greater flexibility to companies qualified to issue serial bonds on their own within a certain time frame. This step is also aimed to deepen the repo market and increase choices for investors. BNM has also issued guidelines on asset securities. Companies are allowed to issue bonds with the rating BB in order to ease debt restructuring.

Regulatory Framework

A centralized approval system for PDS issues is under consideration and necessary law amendments are being proposed. Under the existing system, an issuer has to obtain approvals from BNM, SC, and ROC. This system is time consuming and may result in missed opportunities to issue PDS at low cost. The new system and the shelf registration scheme will help considerably to develop the PDS market.

Investor Base

Following the move by BNM to allow companies to issue bonds with a BB rating for their debt restructuring process, commercial banks, merchant banks, and discount companies are permitted to invest in BB rated bonds and retain bonds where the rating has been reduced to BB. However, finance companies are allowed to do so only if the bonds are fully secured and backed by commercial banks or licensed merchant banks.

Pending Actions

Regulators have been making progress in implementing various recommendations of NERP. However, there are some actions still to be taken. These include the following:

(i) *Reducing the inventory cost for market makers.* The PDS market will get a big boost if the holdings of Government bonds and PDS by the commercial and merchant banks could be exempted from the requirement of statutory reserves and liquidity ratio.

(ii) *More active role for commercial and merchant banks in the PDS market.* As a quid pro quo for the exemption, commercial and merchant banks should play a more active role in trading of PDS. At present, when a commercial bank arranges for a PDS issue, PDS are traded for a while among the discount houses but they inevitably end up quickly in the vaults of EPF and the insurance companies.

(iii) *Promotion of PDS among foreign fund managers.* PDS should continue to be promoted among foreign fund managers, who should be allowed to purchase PDS irrespective of their sources of ringgit. Foreigners have been active participants in the development of the PDS market. Even PDS issued on an Islamic basis, for instance, the Petronas Islamic bonds, used to be taken up by them.

(iv) *Institutional participation in the PDS market.* Increasing institutional participation, such as by EPF, *Khazanah*, *Tabung Haji*, and Police Cooperative.

(v) *Repo market.* Increasing liquidity in the secondary market by facilitating a more active repurchase agreement (repo) market.

(vi) *Benchmark yield curve.* Reviving the benchmark program through Khazanah Nasional.

Derivatives Market

Early Warning System

An early warning system for "Adjusted Net Capital" of futures brokers has been devised by SC, Kuala Lumpur Options and Financial Futures Exchange (KLOFFE), Malaysian Derivatives Clearing House (MDCH), Kuala Lumpur Commodity Exchange (KLCE), and Malaysia Monetary Exchange (MME). It allows bourses and the derivatives clearing house to monitor capital and liquidity situations of futures brokers, and enable early precautionary steps to be taken.

The early warning system came into effect on 4 January 1999 and is monitored by KLOFFE, Commodity and Monetary Exchange (COMMEX), MDCH, and SC.

Circuit Breakers

KLSE has studied the issues relating to circuit breakers. The study has been conducted with KLOFFE, KLCE, MME, and MDCH to come up with a working paper for further discussion with SC.

Pending Actions

Other pending actions to be taken in the implementation of NERP include the following:

(i) *Securities borrowing and lending, and regulated short-selling.* While the suspension of these activities is necessary under the present market environment, they should be reintroduced when stability and confidence are restored because they promote the long-term development of the capital market.

(ii) *Put and call transactions.* Relevant authorities, particularly SC and ROC, should vigorously pursue and punish all parties involved in the abuse of "put and call" transactions to restore public confidence.

ISSUES AND POLICY RECOMMENDATIONS

Equity Market

The authorities have made various efforts to restore confidence in the equity market. However, two issues still need to be addressed: portfolio management policies of Government-related institutions (GRIs) and low dividend payment.

Portfolio Management Policies of Government-Related Institutions

GRIs, such as EPF, PNB, Tabung Haji, and the Ministry of Finance Inc. (MOFI), have invested a great deal of funds in equities, sometimes to comply with their statutory requirements. As GRIs are managing funds from the general public, their portfolio management policies should be conservative. Equity investment is risky and share prices are always volatile. As such, GRIs stand to make big losses or gains depending upon market conditions.

The institutions' portfolio consists of long-term investments. GRIs do not trade shares often. This means that they do not contribute to any increase in trading volumes. Dividend payments by PLCs are relatively low. As a result, income generation of GRIs in terms of dividends and capital gains is limited.

With an increase in bond issues, along with improvements in the standards of disclosure and corporate governance and efficiency of the equity market, GRIs should review their portfolio management policies to (i) increase investments in bonds as recommended in NERP, (ii) trade shares actively, and (iii) demand that PLCs increase their dividend payments. GRIs' policy changes will, in particular, help enhance the standards of corporate disclosure and governance as well as increase trading volume.

Low Dividend Payment. Individual investors invest in shares on a short-term basis with the expectation of capital gains. Their primary concern is an increase in share prices. On the other hand, many GRIs are long-term investors as some of them are required to comply with statutory requirements. The low dividend payment is attributable to the lack of incentives for controlling shareholders of PLCs as dividend income is subject to tax. If tax cuts or exemptions were offered for dividend income, dividend payments would increase. This would give investors more options in determining their investments, moderate price fluctuations, and enhance corporate governance as investors would hold shares for longer periods.

Bond Market

Despite the measures taken by the authorities so far, the most important issue—interest rate structure—has remained unchanged. The authorities have recognized the importance of the benchmark yield curve, and efforts have been made to establish this by issuing *khazanah* bonds. Government bonds are a natural strategy for reestablishing a benchmark yield curve. However, the Government has been raising urgently needed funds by placing the bonds with traditional subscribers. Thus, a review of the interest rate structure is necessary for the development of the bond market.

The mortgage-backed securities (MBS) market is relatively well developed in Malaysia. However, the authorities should take into account the following considerations for the deepening of the PDS market:

(i) mortgage loans should be sold to the National Mortgage Corporation (Cagamas Bhd.) without recourse, and

(ii) Cagamas bonds should be excluded from the eligible securities that can comply with the liquidity requirements imposed by BNM.

The authorities should also take measures to develop an asset-backed securities market to improve balance sheets of banking institutions as well as corporate entities that will contribute to further development of the PDS market.

Distorted Interest Rate Structure. It is important to have an appropriate interest rate structure if a robust bond market is to be developed. Despite various measures taken by BNM, the establishment of a benchmark yield curve has not yet materialized. Market forces can bring about an interest rate structure. However, distortions will emerge as the authorities tackle the financial crisis.

With the introduction of capital controls on 1 September 1998, BNM is at liberty to determine interest rates. In fact, it reduced the interest rates substantially to stimulate the economy. However, the monetary tools used to reduce interest rates were inappropriate. BNM tapped funds from banking institutions by accepting a large amount of deposits at the "intervention rate" (a three-month rate). It also intervened by imposing a margin limit on the base lending rate. As the banking sector has been suffering from mounting NPLs, BNM has moved to tighten liquidity to curb loans and to restore a prudential banking system.

BNM has set loan targets to the banking institutions to stimulate the economy. Since a bond is deemed as a form of loan and banking institutions are cautious in extending new credits to corporate entities, a new directive set by BNM has become an attractive option. BNM has allowed commercial banks, merchant banks, and discount companies to invest in bonds issued by companies with a BB rating for their debt restructuring process, and retain bonds where the rating has been reduced to BB.

The low interest rate policy is beneficial to the public and private sectors as it reduces the cost of funds. The Government as well as Government entities have issued bonds to finance the State coffers and various development projects. Various financial institutions and provident funds have subscribed to these bonds. In turn, the financial institutions are allowed to invest in bonds that carry a BB rating or above. In the process, BNM's new directive may contribute to a distortion in interest rates. Measures should be taken to establish a benchmark yield curve and bonds should be issued in line with this.

Open Market Operations and Auction System for Government Bonds. With the new rules on liquidity requirement effective 1 January 1999, banking institutions can now adopt a flexible approach to Treasury management. However, BNM's direct borrowing and lending is the main tool to regulate money, and open market operations are limited. BNM should change the system of direct intervention to the indirect tool of open market operations.

BNM should also eliminate the existing auction system, which results in oversubscription in each auction. The principal dealers should bid in the auction at their determined prices, which would be a first step towards establishing a benchmark yield curve.

As for BNM's new rule pertaining to investment in PDS issued by companies with a BB rating or above as part of their debt restructuring, this will help develop the bond market. However, it is not clear how prices of these bonds should be determined, in particular, in the secondary market.

Mortgage-backed Securities/Asset-backed Securities

The MBS market has been developing since the first issue of Cagamas bonds in October 1987. Cagamas bonds are issued to finance the purchase of mortgage loans from commercial banks and finance companies. MBS help reduce maturity mismatches and enhance liquidity in the banking sector. However, the sale of housing loans to Cagamas Bhd. from banking institutions is undertaken with recourse. This means that the sold loans still remain in the seller's balance sheet. BNM should move towards the sale of mortgage loans without recourse.

Cagamas bonds are recognized as eligible securities by BNM. Thus the demand for Cagamas bonds by banking institutions is significant as the holdings of these bonds comply with liquidity requirements. As such, the yield curve of Cagamas bonds is similar to that of Government bonds. The authorities should review the status of Cagamas bonds in the context of eligible securities and have Cagamas Bhd. issue bonds at market rates.

The authorities should also seriously study the development of the asset-backed securities (ABS) market. With the onset of the financial crisis, improving balance sheets has become an important agenda. ABS will help convert loans and receivables into cash assets through the securitization process, and thus contribute to the diversification and deepening of the PDS market. The authorities should therefore put in place a regulatory environment for the development of MBS/ABS markets.

Notes

[1]Watch list triggers are based on financial data disclosed in periodic financial statements and include shareholder funds under 50 percent of paid-up capital, gearing ratio of four or greater, significant losses over two years, and significant amounts of bonds or loans due for repayment in the following year.

[2]The monetary instruments used by BNM are as follows: (i) reserve requirement, (ii) liquidity requirement, (iii) credit control and guidelines on lending, (iv) open market operations, (v) direct lendings/borrowings, (vi) centralization of Government and EPF deposits with BNM, (vii) discount operations, (viii) limits on swap transactions with foreign customers, (ix) interest rate regulations, and (x) moral suasion.

[3]Commercial banks, finance companies, and merchant banks are required to maintain a certain percentage of (i) eligible assets in the form of cash deposits without interest in the Central Bank and (ii) eligible liquidities in the form of eligible liquid assets. Eligible assets comprise deposits (including negotiable certificates of deposit and repurchase agreements) and net interbank borrowings. Eligible liquid assets include cash, clearing balances with the Central Bank, money at call, Treasury bills, Government securities, Government investment certificates, Cagamas bonds, bills discounted or purchased, Bank Negara bills, Bank Negara Malaysia certificates, and State Government securities.

[4]Malaysian Government securities, Malaysia investment issues, and Malaysia savings bonds are referred to here as Government bonds, unless otherwise specified.

[5]A market yield is determined through auction. Principal dealers are invited to bid in the auction of Government bonds by submitting the prices on yield basis. The weighted average of the successful yields will become the market yield of the Government bonds. The principal dealer system was also introduced to facilitate the development of a secondary market in Government bonds.