The Malaysian Capital Market - A Review of Recent Developments

The 1990s is set to be another exciting decade for the capital market. The responsibility for developing a more diversified and healthy capital market should be shared equally between the government and other market players.

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The capital market in Malaysia is referred to in the publication, Money and Banking in Malaysia, as "the market in longer term financial assets, comprising all public and private debt instruments with maturities exceeding one year, corporate stocks and shares for which there is no fixed maturity period, and more recently, commodity futures".

Essentially, the Malaysian capital market covers securities under the stock market, Malaysian government securities (MGS), Cagamas bonds and negotiable certificates of deposits (NCD). However, it excludes dealing in trade bills, treasury bills and bankers acceptance.

In the primary market, government securities and corporate stocks are offered directly to investors, while in the secondary market, government securities are traded in the money market with corporate stocks traded in the two local stock markets: the Kuala Lumpur Stock Exchange (KLSE) and the Bumiputra Stock Exchange.

In creating liquidity, the capital market has two main purposes. Firstly, to assist in the mobilisation of funds available in the economic system for investment and development activities, and secondly, to enhance the development of the corporate sector.

The capital market (as illustrated in Table 1) can be classified under :

a) The non-securities market which includes government securities and other unquoted debt instruments issued by banks and corporations

b) The securities market which deals with quoted stocks and debentures.

CAPITAL FUNDS MOVEMENT

Over the last three decades funds raised in the capital market have increased steadily. As shown in Table 2, net new issues of bonds, stocks and shares in the private sector - including those of other corporate sectors - rose from $2.8 billion in 1988 to a new high of $10.9 billion in 1990. Government securities dominated total new shares during the 1988 - 1989 period, while ordinary share issues represented the largest proportion of total net funds raised in 1990. Rising income levels, savings and also the demand for long-term funds by the government and corporate sector raised the total funds available by 199.2 per cent from $4.909 billion in 1986 to $14.688 billion in 1990. With the listing of the Malaysia Fund Inc. in New York in May 1987, a

Table 1

Simplified Comparison Between Securities and Non-Securities Markets

Market	Securities	Players
Stockmarket (Equity Capital)	Ordinary shares Preference shares	Individuals Corporations (listed, unlisted)
	Commodity futures Financial futures	Local institutions Foreign institutions
	CULS (Convertible unsecured loan stock) Unconvertible loan stock	
	Property trusts Rights TSR Foreign securities	
Debt Securities Market (Loan Capital)	MGS GIC	Commercial banks Merchant banks Finance companies Discount houses Corporations Insurance companies Other institutions (eg. EPF, BNM)
	Cagamas bonds NCDs Debentures	

Source: Bank Negara Malaysia

total of US$87 million was available for foreign funds.

The domestic market meanwhile provided the single most important source of capital funds with various forms of deposits accounting for 40.2 per cent ($67 billion) of the total funds of $166.7 billion raised during the 1980 - 1988 period. The incremental capital output ratio (ICOR) in 1990 was about 60 per cent higher than in 1980. Net funds raised by the corporate sector increased from 15 per cent in 1986 to 74.1 per cent in 1990. The World Bank and the Asian Development Bank supplemented domestic sources for the financing of development projects, by providing 77 per cent of loans worth $8.1 billion from multilateral and bilateral sources.

RECENT CHANGES AND DEVELOPMENTS

From 1970 to 1980, the capital market experienced significant development, both in quantitative and qualitative terms but it was the 80s - in particular the late 80s - that saw the development of several new instruments including corporate and mortgage bonds, with equity-linked derivatives such as warrants or transferable subscription rights (TSR) introduced in 1990.

The Government Securities Market

Until the mid 80s the market for these securities was a captive one. It was also illiquid due to high transaction costs. The Central Bank was the only market maker and a futures or options market was non - existent.

However, from the late 80s, the market has been made less captive, with the implementation of several financial reforms. There is now no binding constraint for licenced financial institutions to hold longer-dated MGS. The transaction cost has been reduced to a more competitive level and many market makers have been appointed to underwrite the primary issues and provide two-way quotations in the secondary market.

Following the freeing of the coupon rates in 1987, the trading of MGS in the secondary market has improved significantly. With the flotation of three issues of Investment Certificates, the net funds raised totalled $7.53 billion, a reduction of two per cent from the record amount raised in 1987. To reduce foreign borrowings, several steps were taken. For example, since 1987, the maturity structure of new issues has been shifted. Shorter-term maturities (two, five, six, eight and nine years) were introduced to account for $4.7 billion (55 per cent of the new issues) in 1987 - 1988, while longer-term maturities (16 - 21 years) were reduced to form 7.6 per cent from 85 per cent of new issues in 1981 - 1986. This has shifted the yield curve considerably. The classification of the MGS by original maturity is shown in Table 3.

To futher develop a viable secondary market for the MGS and Cagamas bonds, the Scripless Securities Trading System (SSTS) was introduced on January 2, 1990. There was a marked improvement in the trading of securities. The secondary trading of the MGS and Cagamas bonds increased from a monthly average of $667 million to $820 million and from $923 million to $1.638 billion respectively, from 1989 to 1990.

The freeing of the bank lending rate from the control of the Central Bank with effect from February 1, 1991 was implemented as a step to

Table 2

Funds Raised in the Capital Market

	1985	1986	1987	1988	1989	1990[4]	1986	1987	1988	1989	1990[4]
	$ million						% change[5]				
By Public Sector											
Government securities, gross[1]	4700	4900	8550	7450	4985	5141	4.3	74.5	-12.9	-33.1	3.1
Less : Redemptions	1189	703	879	1345	1345	1243	-40.9	25.0	53.0	0.0	-7.6
Equals : Net issue	3511	4197	7671	6105	3640	3898	19.5	82.8	-20.4	-40.4	7.1
Plus : Advance subscriptions	80	422	-178	932	-1272	-	427.5	-142.2	-623.6	-236.5	-100.0
Less : Government holdings	-	-1	-	3	-91	-					
Equals : Net Federal receipts	3591	4620	7493	7034	2459	3898	28.7	62.2	-6.1	-65.0	58.5
Investment Certificates (net)	-	100	200	500	-	-100	-	100.0	150.0	-100.0	-
Net Funds Raised	3591	4720	7693	7534	2459	3798	31.4	63.0	-2.1	-67.4	54.5
By Private Sector											
Ordinary Shares[2], net	632	189	1385	931	2508	8422	-70.1	632.8	-32.8	169.4	235.8
Public issue	237	26	311	169	1316	3757	-89.0	1096.2	-45.7	678.7	185.5
Private placement	-	-	77	-	-	-	-	100.0	-100.0	-	-
Rights issue	358	70	868	668	1145	4419	-80.4	1140.0	-23.0	71.4	285.9
Special issue[3]	37	93	129	94	47	246	151.4	38.7	-27.1	-50.0	423.4
Loan Stock	-	-	70	36	366	697	-	-	-48.6	916.7	90.4
Debt Securities											
Bond issue	-	-	100	1250	1250	400	-	-	1150.0	0.0	-68.0
Promissory Note	-	-	225	609	577	1696	-	-	170.7	-5.3	193.9
Less : Redemptions	-	-	-	-	50	325	-	-	-	-	550.0
Equals : Net issue	-	-	325	1859	1777	1771	-	-	472.0	-4.4	-0.3
Net Funds Raised	632	189	1780	2826	4561	10890	-70.1	841.8	58.8	61.4	138.8
TOTAL	4223	4909	9473	10360	7110	14688	16.2	93.0	9.4	-31.4	106.6

Source: Bank Negara Malaysia Annual Report 1985; 1988; 1990

1 Refer to Federal Government securities, excluding treasury bills.

2 Refer to corporate securities issued by Malaysian incorporated companies listed on the stock exchange.

3 Special issues to Bumiputra investors nominated or approved by the Ministry of Trade and Industry.

4 Preliminary

5 Formula to compute % change is as shown below:

$$\% \text{ Change} = \frac{\text{Current year} - \text{Previous year}}{\text{Previous year}}$$

Table 3				
Malaysian Government Securities : Classification of Original Maturity				
Maturity (years)	**Nominal Value in $ million**			**Percentage of Total**
	1987	**1988**	**1989**	
2 - 3	949.9	649.9	599.9	1.1
4 - 5	150.0	850.0	850.0	1.5
6 - 9	630.0	4,480.0	5,480.0	10.0
10 - 11	584.7	2,511.5	5,064.1	9.3
12 - 15	5,731.1	7,171.1	6,927.1	12.7
> 15	28,538.8	32,790.8	33,633.3	61.7
National defence bonds	-	-	-	-
Advance subscriptions	96.6	340.7	2,000.0	3.7
Total	36,681.1	48,794.0	54,554.4	100.0

Source : Bank Negara Malaysia

promote further, the creation of a viable secondary market as well as to develop a competitive market in financial futures.

The Corporate Securities Market

a) *The Stock Market*

While the securities market witnessed some major developments in the 1960s and 1970s, it was certain changes in the 1980s that brought the Kuala Lumpur Stock Exchange (KLSE) to its present level of sophistication. The KLSE together with other regulatory bodies have effected various changes and improvements in line with the greater demand for a more technologically-oriented trading activity.

Such changes included the establishment of a computerised clearing system known as SCANS (Securities Clearing Automated Network Services Sdn Bhd) in 1984. Meanwhile, to provide for more effective supervision and control of the industry, the Securities Industry Act 1973 which gave the government powers to curb excessive speculation, insider trading and provisions for the licencing of dealers, was modified in 1983. In addition, in 1986, the Companies Act 1965 was further amended to tighten shareholders' interests and strengthen disclosure requirements. In the same year the Panel on Takeover and Mergers (TOP) was introduced and subsequently enforced on April 1, 1987.

Since then, the KLSE has introduced more measures to improve its operational efficiency such as :

i) The corporatisation of stockbroking firms in 1986 by allowing corporations to own a stake in the broking firms. The stockbroking industry was further strenghtened with the requirement for the merging of small-capital securities firms to meet the KLSE's growing trading activities

ii) The installation of a real-time share price dissemination system (MASA 1) in 1987 providing real-time prices quoted at any given moment on the trading at the KLSE to brokers and subscribers

iii) The adoption of a new and up-to-date KLSE composite index to replace the KLSE industrial index

iv) The establishment of an Advance Warning and Surveillance Unit (AWAS) to alert the KLSE of stockbroking houses and public listed companies facing problems

v) The introduction of a Research Analysis Early Warning System to study and investigate listed companies' performance, and prospects in detecting early signs of trouble

vi) The introduction of a new listing manual in July 1987 covering corporate disclosure policies and penalties

vii) The launching of the KLSE second board on November 11, 1988 for the listing of smaller, viable companies with strong growth potentials.

Steps were also taken in 1990 to improve the clearing settlement procedure to a more systematic and efficient one. They included:

i) The implementation of a new "daily-netting" system on January 2 which effectively nets on the date of contract all outstanding sales and purchases of stocks transacted on the same day

ii) The implementation of the Fixed Delivery and Settlement System on February 12 to control script movement and provide stockbroking firms with a better management of their cash flows. This system enables the KLSE to handle a much greater volume than presently possible

iii) The setting up of a Broker Depository System which was followed by a Central Depository System in 1991

iv) The establishment of MASA II to give additional information to the users

v) The launching of the second board index in January 1991 to

Table 4

Summary of the Kuala Lumpur Stock Exchange in Terms of Size, Capitalisation, Trading Activity and Composite Index

Year End	No. of Companies	Nominal Value ($ billion)	Market Capitalisation ($ billion)	Turnover ($ billion)	Turnover (billion units)	Composite Index (points)
1973	262	3.8	13.3	2.0	0.5	N.A
1986	288	23.5	64.5	3.4	2.3	252
1987	291	26.6	73.9	10.1	5.3	261
1988	295	29.4	96.7	6.8	4.0	357
1989*	307	34.3	156.1	18.5	10.2	562
1990**	285	29.7 (as of 20 Sept)	131.7	29.5	13.2	584.65 (as of 29 June)
1991***	299 (as of 2 Aug)	38.8 (as of 31 July)	167.5 (as of 31 July)	18.4 (as of June)	7.5 (as of June)	553.46 (as of 30 Aug)

* including 2 second board companies ** including 14 second board companies *** including 17 second board companies

Source: *Kuala Lumpur Stock Exchange and The New Straits Times*

provide investors with a performance indicator of the smaller companies.

An eventful development took place in January 1990 with the splitting of the KLSE and the Singapore Stock Exchange (SES). This separation was inevitable due to growing differences in the growth of securities in Malaysia and Singapore. The listing of Malaysian incorporated companies was withdrawn from the SES and vice versa. A new OTC market, ie. the Central Limit Order Bank (CLOB) International, was subsequently formed in January 1990 in Singapore with 133 Malaysian counters and six foreign counters. Since the OTC market is not bound by any corporate disclosure rules, it has been declared unofficial by the KLSE.

To attract more foreign investors to invest in the companies listed on the KLSE by providing some risk protection, the Finance Minister and the Capital Issues Committee (CIC) have agreed in principle to establish the much needed Kuala Lumpur Options and Financial Futures Exchange (KLOFFE).

Along with its rapid growth in sophistication, the KLSE has also experienced spectacular growth in terms of size, capitalisation, trading activity and composite index. Table 4 compares the relevant figures for the last few years to those for 1973, the year KLSE began its operations as an exchange independent of the SES.

b) <u>*Private Debt Securities (PDS) Market*</u>

Since its inception in the second half of the 1980s, the PDS has shown considerable growth even though it is still in its initial stages of development. New market and innovative instruments are continuously being introduced. Table 5 shows the composition of PDS.

Financial institutions were the largest holders of PDS during 1987 - 1989, absorbing about 96 per cent of the total issue. They were replaced however by the Employees' Provident Fund which provided $823 million or 49 per cent of the total issued in 1990. Financial institutions' holding was reduced to $435 milion (26 per cent of total issued).

Several measures taken to ensure the attractiveness of investing in the PDS included:

i) The exemption of corporate bonds from stamp duties to make the market for PDS as viable as that for government securities

ii) The provision of tax incentives for unit trusts, property trusts and the establishment of venture capital companies

iii) The review of the Stamp Duty Legislation to promote effective dealings and trading in the secondary market

iv) The plans to draw guidelines for the listing of property trusts.

Several guidelines were also implemented from January 1989 to facilitate the development of primary and secondary markets for the PDS such as:

Table 5

Total Amount of PDS Issued During 1987 - 1990

Type	Total Amount ($ million)
Conventional medium and long term bonds	$2024
Promissory notes	530
Convertible bonds	175
Al-Bai-Bithaman Ajil principle (deferred payment sale)	138
Al-Musharakah principle (joint participation)	240

Source : Bank Negara Annual Reports

i) Minimum shareholders' funds, of issuers of $25 million

ii) Disclosure of proceeds utilisation and sources of repayment

iii) Minimum size of an issue at $50 million (reduced to $25 million with effect from January 1, 1990)

iv) Underwriting requirements

v) Debt-equity ratio of not more than 2:1.

c) <u>The Bond Market</u>

Corporate bonds have great potential as alternative financing instruments to fill the vacuum created by government securities. However, with the exception of the bonds issued by Cagamas Berhad and Malaysian Industrial Development Finance - both government-owned corporations - the bond market in Malaysia is non-existent. Ample liquidity in the economy and the overwhelming response from the public at large for new share issues are obstacles to the development of other alternative instruments. Of the total of $4.561 billion of the new funds issued by the private sector in 1989, 57 per cent or $2.826 billion was tapped from the stock market through public issue, rights issue, special issue and loan stock. This situation was more prevalent in 1990. Of the total of $10.890 billion raised by the private sector, 83 per cent or $8.422 billion was tapped from the stock market.

One significant change in the capital market was the setting up of Cagamas Berhad - the national mortgage corporation owned by the Central Bank - in December 1986. Established to develop a secondary mortgage market, the company provides high quality liquid investment in the form of Cagamas bonds with a status comparable to that of the Malaysian government securities. These bonds provide a facility for primary lenders (namely the government and other major financial institutions) to obtain liquidity for their previously illiquid portfolios of housing loans.

Cagamas bonds are 'straight' bearer bonds with a fixed coupon rate and semi annual interest payments. They have been approved by the Central Bank as financial instruments. They qualify as liquid assets for corporations to meet the prescribed statutory liquidity requirement. They also qualify as "Prescribed Investments" under the Second Schedule of the Insurance Act 1963. Although the bonds are unsecured obligations legally, they are fully backed by housing loans and other assets of the Cagamas Berhad.

In contrast to the non-existence of bonds issued by the private corporations, 1989 was a successful year for Cagamas Berhad. It floated three series of unsecured bearer bonds — $500 million (maturity of five years), $400 million (maturity of three years) and $350 million (maturity of two years). However in 1990 the corporation made only one bond issue amounting to $400 million, due to uncertainty of the direction of interest rates. Total bonds issued by Cagamas Berhad since its inception amounts to $2.950 billion.

Since their first introduction to the market in October 1987, Cagamas bonds have managed to establish themselves as an attractive form of investment. The three 1989 issues were oversubscribed by 273 per cent, 219 per cent and 607 per cent respectively.

The 1990 issue was oversubscribed by 517 per cent. The bonds were also actively traded on the secondary market and the volume of such trading increased progressively from $63 million per month in 1988 to $92 million per month in 1989. The monthly turnover reached its highest point of $2.1 billion during the first half of 1990, but because of high interest rates, it fell to an average of $1[illegible] million in the second half of 1990. Table 6 shows the movements of trading volume in the Cagamas bonds from 1987 - the year of inception - to 1990.

In order to ensure investors of the financial soundness of corporations which issue bonds, a credit rating firm, the Rating Agency Malaysia Berhad (RAM) was incorporated in November 1990 to begin operation in mid 1991. Several large corporations with good credit standing have raised more funds by issuing term notes (yielding up to 6.9 per cent per annum) due to favourable monetary conditions in recent years.

d) <u>Commodity Futures Market</u>

The development of a commodity market in Malaysia was necessitated

Table 6

Trading Volume in Cagamas Bonds (1987 - 1990)

		Issues 1/89	Issues 2/89	Issues 3/89	Issues 1/90	Other Issues	Total	Average Daily Volume
		M$ million						
1987	4Q	-	-	-	-	114	114	2.9
1988	1Q	-	-	-	-	1,145	1,145	27.0
	2Q	-	-	-	-	1,207	1,207	35.4
	3Q	-	-	-	-	3,665	3,665	59.3
	4Q	-	-	-	-	1,639	1,639	22.8
1989	1Q	794	-	-	-	2,357	3,151	44.1
	2Q	247	259	-	-	592	1,098	16.5
	3Q	1,354	946	-	-	722	3,022	60.3
	4Q	N.A.	N.A.	N.A.	-	N.A.	3,225	51.2
1990	1Q	3,247	701	1,314	-	1,785	7,047	113.7
	2Q	1,717	1,314	880	1,868	180	5,959	99.3
	3Q	45	30	-	-	3	78	1.3
	Oct	-	3	-	-	-	3	0.1
	Nov	-	-	-	-	-	-	-

Source : Khong Kim Nyoon, "Operations of Cagamas Berhad in the Secondary Mortgage Market", Banker's Journal Malaysia, February 1991; 63, p.1.

by the country's pre-eminent position in the production of primary commodities which include rubber, palm oil, tin, tropical timber and cocoa. Marketing and hedging facilities for these commodities had to be developed to promote the service sector in commodity trading.

The first step towards this direction was the establishment of the Kuala Lumpur Commodity Exchange (KLCE) - which was earlier incorporated with the Kuala Lumpur Clearing House - on October 23, 1980. The Commodities Trading Act 1980 was introduced to protect the industry from serious abuse in commodity trading practices.

With the introduction of rubber futures contracts in September 1983, other futures soon followed. The palm kernel futures contract was introduced in 1986, tin futures contract in 1986, and US$ cocoa futures contract in August 1988. Except for tin futures, the other futures contracts generally have not shown active trading activity due to poor performance of the market conditions for the commodities.

CHALLENGES AND OPPORTUNITIES

The Malaysian capital market is rapidly expanding at an unprecedented pace, especially in the 1990s. Malaysia, with all the makings of a fifth Asian "dragon" is poised to become a strong player in the global economy. This will be the result of the country's economic growth, the shift of the centre of the global economy from the Atlantic to the Pacific region and its membership of the economically vibrant Asian regional group.

Prospects for and growth in the government securities market depend largely on the existence of an active secondary market. Several problems would have to be resolved first before such a market can be created. The more important issues include:

a) the lower coupon rates of the MGS compared to the perceived market rates of return which imply that there will be losses in the sales of the MGS. In 1987 alone, the government brought down the yield curve three times with the collapse of interest rates

b) the limitation placed on the trading of MGS because of holding statutory requirements on the provident funds and financial institutions

c) the perception by both individuals and corporations that the MGS is not an attractive investment because of its relatively lower yields and general lack of liquidity.

In the securities industry, the KLSE is ready for rapid change not only in size, but in structure and sophistication. There have been tremendous transformations in various aspects including the automation of the trading system, the strengthening of broking houses, increased participation of foreign brokers, better delivery and facilities, and the creation of a stronger identity. Market capitalisation of the KLSE will increase significantly if the 7 - 8 per cent economic growth experienced since 1988, can be sustained.

The planned privatisation of $16.3 billion worth of government-owned companies will expand the market capitalisation further. A wider range of financial instruments including their derivatives will have to be offered in view of the private sectors' increasing participation in the strong economy. The manufacturing sector will benefit directly from the economic growth. If the pace of current growth can be sustained, manufacturing can account for more than one-third of the GDP by the end of 1990s. More companies from this sector will raise funds via the KLSE. However, the resulting liquidity from national income and savings due to larger exports could also suppress the growth of the KLSE.

With the increasing influence of overseas markets, particularly the Tokyo and New York markets, there is a growing influx of foreign investors to Malaysia. There will therefore be more foreign-owned corporations listed on the KLSE. Of late, the Japanese firms have shown such increasing participation. However, the split of the KLSE from the SES will continue to pose stiff competition in share trading. Local brokers will have to further improve the quality of their research, apart from offering more services. Foreign institutional investors who will no doubt raise the KLSE market capitalisation tremendously, could also liquidate their assets if adverse events occur elsewhere. There should therefore be a proper balancing in the internalisation of the KLSE to avoid such possibilities.

Much effort has been directed at promoting the bond market, starting with the setting up of the Cagamas Berhad to allow corporations to raise funds at a low cost. Oversubscription and active trading in the secondary market are evidence that the Cagamas bonds have marked a new era of securitisation in Malaysia. However, the level of such activity still fluctuates quite sharply, since the bonds are much influenced by factors such as interest rates and market sentiments. Apart from the present ample liquidity in the economy and the public preference for new share issues, the lack of a free market in bonds is the major obstacle for bonds to be considered as attractive investments. The non-existence of other private bonds is seen as proof that Cagamas bonds have not been able to successfully pave the way for other private corporations to tap the capital funds outside the equity and bank loans markets.

Being the first private institution to issue fixed rate securities at market determined prices, Cagamas bonds have however served as a trail-blazer and benchmark market in Malaysia. The establishment of RAM will help protect investors' interests by efficiently pricing private bond issues according to the issuers' true credit standing. This measure will encourage companies to raise more fixed rate funds directly from the market and promote at the same time, investors' demand for their papers with greater confidence.

The Malaysian bond market will have difficulty in attaining full potential as a vibrant market with active secondary trading without the presence of a viable financial futures and options market. It is timely for such a market to be established in Malaysia to enable investors to hedge their positions in the cash market and to provide the much needed liquidity. Given this prospect, the players in the market - especially the financial institutions - should double their efforts in developing an active and sound bond market in Malaysia.

CONCLUSION

The 1990s is another exciting decade with various possibilities for the capital market. An important trend in the coming years is the declining growth of government expenditure. The large economic downsizing of public sector expenditure will continue according to plan and will involve further the privatisation of public enterprises and the promotion of private initiatives as the main engine of growth. The government will no longer absorb large quantities of funds and this action will create a vacuum in the supply of adequate government securities to the present capital market. Another important trend is the growing flow of foreign investments into the country which suggests an increasing demand for Malaysian stocks in the near future. There is therefore an urgent need to develop a wide range of alternative financial instruments which are acceptable to the local and foreign investors in terms of liquidity, marketability, adequate returns and acceptable risk. The responsibility for developing these instruments and a more diversified and healthy capital market should be shared equally between the government and other market players. ❑

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