CHAPTER 2 : THE CAPITAL MARKET

2.1 The Role Of The Malaysian Capital Market

The capital market in Malaysia refers to the market in linger-term financial assets, comprising all public and private debt instruments with maturities exceeding one year, corporate stocks and shares for which there are no fixed maturity period, and commodity futures. The main purposes of a capital market in the country are to assist the process of economic development by mobilizing medium-term and long-term funds from a wide cross-section of the population to finance public development programmes and to fund private investment, as well as the banking system in securitising their assets. At the same time, the market promotes private enterprise by providing intermediary services to raise funds for corporate investment and expansion, and in changing the ownership structure of companies. An effective capital market is essential for the financial development of any developing country. In the primary market, new issues of Government and corporate securities are offered directly to investors. On the other hand, secondary market transactions in Government securities and unlisted private debt securities are conducted mainly through the money market, while secondary market trading of stocks and shares and listed private debt securities are carried out almost entirely in the Kuala Lumpur Stock Exchange (KLSE), and to a lesser extent in the Bumiputra Stock Exchange. The private debt securities (PDS) market in Malaysia is a relatively young financial market, when compared with the more established equity market and the market for Government securities.

The Malaysian capital market represented a relatively small sub-sector of the Malaysian financial sector during the early stages of economic development in the early 1960s and 1970s. The banking system then provided the bulk of the financing of economic activities. The capital market has since witnessed significant developments, both in quantitative and qualitative terms in the 1980s and early 1990s. In the 1980s, the capital market expanded mainly to service the needs of the public sector, where the bulk (about 75%) of the new funds raised during this period was in the form of issuance of Malaysian Government securities. Over the years, the markets for equities and Government securities have evolved with a reasonable level of sophistication and maturity. To a large extent, this development reflected recent and on-going measures undertaken by the Government, either directly or in a catalytic role. These measures were mainly to liberalize the capital market and put in place the necessary institutions and instruments, legal and administrative framework, and fiscal incentives to develop an efficient and modern market. the results of these measures are now evident, as the capital market has expanded significantly to effectively complement the banking system in financing economic expansion.

The equity market, the Malaysian Government securities (MGS) market and the corporate bond market have been undergoing dynamic changes in recent years. The Malaysian stock market is now on of the largest in the developing world. It is also one of the more advanced and modern stock market, with fully automated trading system known as SCORE, and a scripless securities clearing and settlement system known as the Central Depository System (CDS). The domestic stock market is also gaining wider international attention, with 79 major foreign funds investing in the companies listed on the KLSE. The MGS market is also much deeper and wider. The secondary market is also quite active with a reasonable level of liquidity. The private debt securities market witnessed an impressive and rapid growth as new innovative instruments were introduced. A milestone in its development was the incorporation of Rating Agency Malaysia Berhad (RAM) in November 1990, the first rating agency in Malaysia and indeed, in East Asia outside Japan. Other notable developments in the capital market were the liberalization of interest rates in 1991, introduction of the Malaysian Savings Bond in 1993, and the setting up of the Securities Commission as the market "watch-dog" in 1993. There is now a host of financial instruments in the financial landscape. These include instruments such as mortgage bonds, transferable subscription rights or warrants, loan stocks, redeemable preference shares, shares option, commercial papers issued under the Note Issuance Facilities (NIF) and Revolving Underwriting Facilities (RUF), and Islamic papers. The latest addition is the trading in the financial futures and options, with the establishment of the Kuala Lumpur Options and Financial Futures Exchange and the Kuala Lumpur Futures Market in November 1995.

Today, Malaysia and other Southeast Asian countries rank high among the list of emerging equities market (Kalotay and Alvarez 1994) in terms of economic growth and expansion. For Malaysia, the capital market is becoming more important in raising new capital needs for the private sector-led economic growth. Already huge infrastructure projects are being implemented, such as the Sepang airport, the privatization of the new township and Government office complex at Perang Besar, the national sewerage system, and the planned construction of the second Causeway to Singapore. The role of the capital market will become even more important in years ahead as the pace of industrialization accelerates. There will be continuous shift of funds requirements away from the government sector to the private sector (Yakcop 1994). Within the private sector, there is an increasing move towards disintermediation, where conventional bank financing is being replaced by capital market borrowing via debt instruments. Despite the skepticism echoed in Singh (1992) as to the superiority of capital market financing over bank financing, it is felt that both financing modes will coexist and continue to play important roles in our economic development (similar points are also discussed by Feldman and Kumar 1994).

The Prime Minister's "Vision 2020" which states among other things that Malaysia would attain the status of an industrialized nation by the year 2020 has now been adopted as the nation's social and economic long term objective. Under the 7th Malaysia Plan covering the period 1996-2000, it is estimated that a total of RM450 billion of new investments will be required up to the year 2000, so as to sustain economic growth at an average rate of 7.5% per annum, the rate which will lead to the realization of the Vision 2020. The amount translates into a yearly average of funds requirement of RM75 billion, of which the infrastructure investment alone is estimated at about RM15 million.

2.2 Funds Raised In The Capital Market

Funds raised in the capital market have increased steadily, over the past three decades (1962-92). This reflected, on the one hand, rising income levels and savings, and on the other hand, the growing demand for medium and long-term funds by both the Government and the private sector to finance their economic activities. Total net new funds mobilised rose from less than RM140 million in 1961 to RM405 million in 1970, RM2.5 billion in 1980 and further to RM17 billion in 1995. During the period 1989-95, net new funds raised in the capital market amounted to about RM68 billion, compared with RM53.2 billion during the period 1980-88. A notable development was the changing structure of capital funds mobilised. Since 1985, the underlying structure of funds raised in the capital market has changed significantly, as shown in Table 2.1. The following key developments are worth noting :

- The increasingly prominent role played by the capital market in financing the economy, especially in the early 1990s. In 1992, net funds raised in the capital market (including short term papers) issued by the corporate sector amounted to RM15.1 billion, as against RM13.7 billion of credit extended by the banking system. In comparison, the capital market played a less important role before 1990. For example, during the period 1981-90, the capital market mobilised an average of RM7.2 billion per year, much lower than the average of RM8.8 billion per year of new credit extended by the banking system
- The significant shift in mobilisation of new funds away from the Government sector to private sector. Traditionally, the Government securities market accounted for the bulk of the new funds raised each year. This position reversed in the 1990s as the Government reduced its borrowings substantially. This was in line with the policy adopted since the mid-1980s to downsize Government operations and to accelerate the privatisation to enhance the private sector's role as the main engine of growth in the economy. Implementation of this policy was made easier by the significant improvement in the Government's overall financial position in tandem with the buoyant economic performance during the last five years.

- The emerging importance of new capital raised in the form of private debt securities, especially in the 1990s. By 1994, almost half of the RM15.3 billion of the new funds raised by the private sector was in the form of PDS.

However, a point of concern is in the absolute amount of RM17 billion raised by the capital market in the year 1994, which is far too little compared to capital requirement. It was earlier mentioned that, under the 7th Malaysian Plan, the capital requirement to support the country's industrial needs was estimated at around RM75 billion a year, until year 2000. Even if we include the RM25.2 billion total bank loans, the amount is still short of the requirement. It is therefore very clear that some strategies are urgently needed to encourage savings and investment in order to increase local capital contribution. But in the short to medium term it is quite inevitable that some of the capital requirement has to be raised in the international market.

TABLE 2.1

FUNDS RAISED IN THE MALAYSIAN CAPITAL MARKET, 1985-94

(in RM million)

	TOTAL FUNDS	PUBLIC SECTOR	PRIVATE SECTOR	SHARES[1]	DEBT SECURITIES[2]
1985	4,236	3,591	645	645	NA
1987	9,473	7,693	1,780	1,385	395
1988	10,260	7,534	2,726	931	1,795
1989	6,870	2,459	4,411	2,508	1,903
1990	14,743	3,816	10,927	8,649	2,278
1991	9,390	3,157	6,233	4,392	1,841
1992	13,793	1,480	12,313	9,181	3,132
1993	6,450	1,230	5,220	3,245	1,975
1994[P]	17,000	1,681	15,319	8,159	7,160

[1] Shares issued by KLSE listed companies.

[2] Securities with maturities more than 1 year

[P] Preliminary figures

Source : 1. Economic Report, Ministry of Finance, Malaysia, various issues.

2. Annual Report, Bank Negara Malaysia, various issues.

2.3 Development Of The Malaysian Equity Market

Over the years, the stock market has undergone rapid development and transformation from simple structure to reach a reasonable level of maturity and sophistication. The stock market developed in tandem with the economy and was reflective of the authorities' commitment to promote the capital market to play a pivotal role as a reliable source of finance for the private sector. Rapid economic development in the country and buoyant external demand presented enterprises with vast opportunities for corporate and business expansion. Coupled with a concern to keep their gearing ratios at prudent levels, companies found it expedient to resort increasingly to financing from the equity market, although bank borrowing remained a major source of financing. At the same time, the need for companies to comply with the requirements of the New Economic Policy also produced a shift of preference towards equity capital. In addition, the well-established banking system, with a satisfactory payment mechanism, aided the growth of the equity market. In the 1980s, the rising costs of bank borrowings associated with rising interest tares during a period of relatively tight credit situation induced a growing tendency among companies to turn to equity financing which was less costly. In the 1990s, the privatisation policy of the Government contributed significantly to the phenomenal expansion of the stock market. Moreover, the high liquidity situation in the economy during this period caused public limited companies to not only raise funds for their operations but also to improve their debt-equity ratios by substituting capital for bank borrowing.

Over the past 35 years, the authorities undertook various measures to review and put in place the necessary physical facilities, as well as the legal and institutional framework for the issuance and trading of securities. At the same time, these measures were needed to instill public confidence and to promote an orderly market. Amongst the major measures implemented by the Government were : the progmulation of a new Companies Act, 1965 to provide for a more comprehensive legal framework in supervising the operations of companies in the country; the establishment of the Capital Issues Committee (CIC) in 1968 to supervise the issue of securities by public companies and in April 1986, the CIC published for the first time, a set of guidelines aimed at providing the public with a transparent set of criteria and standards for the new issues of securities and the valuation of public limited companies; the enactment of the Securities Industry Act, 1973 to provide for an orderly conduct of the securities business, the enforcement of a new Securities Act, 1983 to replace the 1973 legislation to provide for more effective supervision and control of the securities industry and the activities of the stock exchange; and the corporatisation of the stockbroking industry in 1987 to improve the financial strength of the broking firms, inject greater expertise and professionalism into the industry, and to generate greater international interest in the KLSE.

To complement these measures by the Government, the KLSE itself initiated several major reforms to develop and strengthen the Exchange. Among the major developments were : implementation of the first phase of a computerized share scrips clearing system in November 1983; establishment of the Research Institute of Investment Analysts Malaysia (RIIAM) in May 1985 to help the industry raise its level of security analysis and research; installation of a real-time share price reporting system (MASA) for brokers in 1987; the adoption of the KLSE Composite Index in 1986 to replace KLSE Industrial Index to better reflect movement in share prices; the establishment of an Advanced Warning and Surveillance Unit (AWAS) in 1987 to alert KLSE of stockbroking companies and public listed companies facing problems; and the introduction of a new Listing Manual in July 1987, with an entirely new section on corporate disclosure policies and penalties. The KLSE also launched its Second Board on November 11, 1988 to enable viable smaller companies, with a minimum paid-up capital of RM5-20 million and strong growth potential, to raise funds from the stock market.

In the recent years, 1989-93, the stock market witnessed significant growth and development in terms of fund mobilisation, market capitalization, price indices and turnover. This reflected, essentially, the deliberate and concerted efforts on the part of the Government (mainly in a catalytic role) and the KLSE to develop the Exchange into a better organised, modern, more efficient and stronger institution.

One of the most significant development was the announcement by the Minister of Finance in his Budget Speech on October 27, 1989 that Malaysian-incorporated companies should delist from the Stock Exchange of Singapore (SES) by December 31, 1989. This move represented the Government's efforts to develop the capital market by establishing KLSE as an independent exchange.With this split, effective January 1, 1990, the KLSE became the sole official market for Malaysian stocks. The immediate impact of the split was a RM46.1 billion reduction in the market capitalization of the KLSE to RM110 billion on January 2, 1990, as the number of counters fell by 53 to 254 companies.

The rapid expansion of the market was also reflective of the host of measures undertaken by the KLSE to facilitate a larger trading volume, which had surged ahead since 1989, as well as to modernise and enhance the efficiency and transparency of its operations. A new era of modern technology in the stock market was introduced when the KLSE implemented semi-automated trading system known as SCORE (System on Computerised Order Routing and Execution) in 1989. SCORE was designed to do away with the inefficiencies of an open outcry system in matching and executing orders, and to provide market visibility on prices and transactions as well as to improve liquidity in the market. By November 1992, the trading system on the KLSE was fully automated, allowing for speedier matching of orders and more up-to-date information on the real-time information system or MASA. The KLSE also introduced measures to reduce the physical delivery of shares between broking firms and clearing houses, the Securities Clearing Automated Network Services Sdn Bhd (SCANS) to ensure a more efficient settlement system. In January 1990, a new "daily netting" system was introduced, effectively netting the date of contract of all outstanding sales and purchases of the stock transacted on the same day. In addition, the KLSE implemented the Fixed Delivery and Settlement System (FDSS) in February 1990, which was aimed at developing a more organised system of scrip movements and enhance management of cash flow among stockbroking firms.

To support its aim of transforming the Exchange into a world class stock exchange and to forge ahead of its rival bourses, especially within the region, the KLSE undertook the development of a Central Depository System (CDS). The CDS is a scripless trading system that would improve the efficiency of the trading and settlement system and enable the KLSE to handle a much larger volume of trading.

The KLSE introduced additional measures to further improve the accessibility of investors to the equity market. On July 22, 1992, the KLSE extended its trading hours to another 90 minutes to enhance international interest in stocks traded on the KLSE and hence, facilitate investment by investors from different time zones. New financial instruments were also promoted to provide investors with wider choice of investment opportunities and to contribute to more liquidity to the local bourse. The KLSE amended its listing requirements in April 1989 to pave the way for the listing of property trusts. For the listing of a property trust, at least RM75 million units must be subscribed, with a minimum of 10% or RM10 million of these units (whichever is larger) being in the hands of not less than 500 holders, each owning not more than 50,000 units. The first listing appeared in September 1989 and as at the end of 1993, three property trusts were listed on the KLSE. The Exchange also approved the listings of warrants of transferable subscription rights (TSRs), the equity-linked derivatives, from December 29, 1989.

As part of its effort to strengthen investors' confidence in the market, the KLSE embarked on a two-pronged plan to prevent trading disruptions. The plan to establish a 100% disaster recovery environment through the setting up of a disaster site for itself and member companies would be operational in early 1994. An on-site are or trading floor within the Exchange for stockbroking representatives to operate in the event of any technical breakdown is currently in the pipeline. In addition, the KLSE plans to establish a compensation fund to provide recourse to investors and stockbrokers in the event of insolvency of a member company. This Fund is necessary to overcome the inadequacies of the current Fidelity Fund. The KLSE will also introduced a computerized surveillance system in 1994 to enhance its market surveillance system which is currently done manually through AWAS.

2.4 Size Of Market

As a result of a host of measures undertaken by the authorities, the KLSE has transformed itself into one of the largest and most modern bourse in the developing world, from its modest beginnings as a group comprising only four stockbrokers in 1960. Today, the KLSE is the largest in the ASEAN region and the fifth largest in Asia in terms of market capitalization. Market capitalization, which amounted to only RM8 billion or 35% of GNP at the end of 1974, expanded steadily to RM99 billion at the end of 1988 and further to RM566 billion in 1995. Similarly, the number of companies listed on the KLSE has grown rapidly. There were 526 companies with a total value of RM92.4 billion at the end of 1995, compared with 138 companies with a nominal paid-up capital of RM708 million listed at the end of 1961.

2.5 Development Of The Second Board

The Second Board of the KLSE was launched on 11 November 1988. Its primary purpose was to enable small and medium firms which have good performance record and strong growth potential to raise funds from the equity market for expansion purposes.

In 1989 there were only 2 stocks listed on the Second Board. Since then, the number of stocks increased steadily. By 1992, there were 52 stocks listed. The period 1993-1995 saw a rapid rise in the number of listing. Hence by end 1995, the total number of listed stocks had increased to more than three fold to 160.

At the same time, market capitalization increased from RM100 million in 1989 to a staggering RM22.7 billion by end 1995. Given such rapid development, it is not surprising that the daily average volume rose from only 100,000 units in 1989 to 12.7 million units in 1995.

Table 2.2 : Statistics Of The Second Board Of The KLSE (1989 to 1995)

Year	No. of Stocks	Nominal Value (RM billion)	Market Value (RM billion)	Volume (billion units)	Volume (billion units)	Daily Avg. Volume (million units)	Daily Avg. Volume (RM million)
1989	2	0.03	0.1	0.02	0.06	0.1	0.3
1990	14	0.2	0.6	0.08	0.22	0.3	0.9
1991	32	0.5	1.5	0.28	0.85	1.1	3.4
1992	52	0.9	2.9	0.71	2.28	2.9	9.2
1993	84	1.6	13.5	2.74	14.6	11.0	58.8
1994	131	2.9	15.9	1.40	9.81	5.6	39.5
1995	160	3.9	22.7	3.08	20.88	12.7	85.9

2.6 Listing Requirement for KLSE

Main Board

Companies that wish to be listed on the Main Board have to meet the following requirements :

A. Pre-requisites for Admission

- Minimum paid-up capital of RM20 million (after 1 January 1996, the minimum is RM40 million)
- Shareholding spread of at least 25% but less than 50% in the hands of the public and a minimum percentage is in the hands of 500 shareholders holding 500-10,000 shares as follows:

Issued and Paid-up	**Minimum %**
Not exceeding RM50 million	15%
Not exceeding RM100 million	12.5% or RM8 million whichever is the greater
RM100 million and above	10% or RM15 million whichever is the greater

- Issue of a prospectus regardless of the method of floatation and the advertisement of the full prospectus in full.
- Track record of 3-5 years (from 1.1.96, a minimum after-tax profit of RM5 million for 5 consecutive years);

B. Corporate Disclosure Policy

- policy on immediate public disclosure of material information;
- policy on thorough public dissemination;

- policy on clarification or confirmation of rumors and reports;
- policy on response to unusual market action;
- policy on unwarranted promotional disclosure;
- policy on insider trading.

Second Board

The government recognised the importance of private sector participation in the economy and therefore the need to promote the growth of small and medium size companies. The KLSE Second Board was therefore launched with the aim to provide an avenue for the viable small and medium size companies to seek alternative source of funding to implement growth and expansion plans. In order to be considered for listing on the Second Board, companies must meet the following requirements :

- must be a Malaysian incorporated company; paid-up capital of minimum RM5 million and a maximum of RM20 million (1st January 1996 the minimum paid-up capital will be raised to RM10 million);
- track record of 2-3 years (from 1996, listing requirement based on after-tax position-after-tax profit of RM2.5 million for 3 consecutive years)
- shareholding spread of at least 25% but less than 50% in the hands of the public with at least 15% of the issued and paid-up capital in the hands of 500 shareholders holding 500-10,000 shares each;
- continuity of management (from 1.1.96, the minimum period is 3 years);
- the major contributor or core company must be in business for at least 5 years before initial public offering (from 1.1.96);