Chapter 8: The Challenge Ahead and Regulatory concern

8.1 Introduction

Despite having in place the necessary elements for trading in financial futures, and positive indications for growth, the immediate challenge for the regulators and market participants at the moment is to realise that potential. **A key step involves improving the level of liquidity on both KLOFFE and MME. Without liquidity, investors, particularly institutional investors, are reluctant to use the exchange.** Without the participation of large investors, the exchange will not grow. It is imperative that both MME and KLOFFE overcome this vicious circle, and move on to greater volumes of trading and higher levels of open interest.

It was recognised that the communication between the industry and regulators is vital. Since the SC annual dialogue with the industry in the early 1996, steps were taken together with the Ministry of Finance to address many of the bottlenecks. There were five areas of policy changes relate to :-

- liberalising the licensing scheme;
- reducing supervisory overlap in emergencies
- consolidating the regulatory framework through the merger of the SC and the Commodities Trading Commission (CTC)

- introducing market making
- stepping up education for investors and intermediaries

Now the challenge is to encourage institutional investors. The success of exchange traded derivatives in Malaysia is critically dependent on the participation of domestic institutions. The are the natural hedgers in any market. Despite the sizeable presence of large institutional investors in the cash market, their participation in derivatives has been disappointing. For example, foreign institutions account for about 50% of the trades done on KLOFFE, Local institutions account for a mere 1%. Admittedly, the presence of the local banking community is higher on the MME, but the extent to which it has developed OTC products on the back of exchange traded derivatives has been slow.

Presence of the institutional investors in the exchanges is needed. Unless they are actively participating, foreign institutions would not feel comfortable to be involved, not with the present levels of volume and open interest. While every contribution to the level of trading activity would help, be it from retail investors or market makers, the key has to be to make the exchanges attractive to pension funds, mutual funds and insurance funds, both local and foreign. This remains the supreme challenge in the year ahead.

The treasury function in Asia is changing. The growth of the region's economies has brought growing demand for sophisticated treasury services. As local corporations regionalise their trading activities and the multinationals capitalise on growing demand in new Asian markets. But with growth in cross-border activities come increased risks, and demand from corporate for their banks to provide more services to enable them to manage these risks.

The growing complexity has brought pressure for the centralisation of treasury operations, both in corporate treasuries and in the banking treasuries that service them. The push for centralisation in both sectors is to enable organisations to concentrate the risks to which their regional activities are exposed into a dedicated highly skilled operation that can then analyse, manage and minimise those risks when economies of scale is attain. With risk management, the higher the concentration, the easier it is to see the risks, record them, book them and manage them, and the more transparency they have.

8.2 Customer Support

Malaysian companies are playing a growing part; their increasing business activity beyond the national borders has put pressure on the local banks to extend their services and support them overseas. **Companies must be educated to realise that the traditional method of hedging is now insufficient to manage the uncertainties in business environment brought about by the globalisation of the business environment.**

Assuming Asian growth continues, then Malaysian looks set to attract much of the bank and corporate treasury business of the region. Deciding on where to locate the treasury centre depends on a number of complex factors; such as:-

i) Political stability

ii) World class infrastructure

iii) Tax rate.

iv) Availability of market and product and that

v) The markets are liquid; the more liquidity, the more attractive the market: when a critical mass of liquidity is achieved, the market starts to feed off itself.

It is important that Malaysia remains competitive in this respect to attract the Multi-national Companies to set-up their Regional office in Malaysia. As financial management is normally centralised in the Regional office, with the existence of these regional office will increase liquidity of the financial futures and that will be a major contributing factor to the success of the Financial Futures in Malaysia.

8.3 Growing Sophistication

The markets are growing in sophistication, not just volume. Malaysia needs products and innovative to create a market in the financial futures in Malaysia. There is a developed currency swap market in Thailand and a developed currency option market in Indonesia, there are OTC derivatives that can be structured for most of the main economies in the region. However, Malaysia has yet to obtain the capability and expertise to compete with Singapore for this arena of business. However, the increase in regional head office setting up in Kuala Lumpur allows Malaysia to take a more active role in managing risks using these markets.

The rapid growth in the financial sector has brought with it problems that the industry needs to address. The demand for qualified staff far outweighs supply, and recruiting from the local labour pool is not possible. Consequently, regional treasury centres have to be able to attract expatriate skilled labour, and personal tax regimes, housing costs and quality of life become significant issues. Labour costs accounts for approximately 40% of direct costs of treasury operations, according to Foreign Exchange Market Committee figures. Quality of life is a very important factor, particularly for expatriates with families.

8.4 The Regulatory Concerns

The results of the Bank of England's investigation into the Barings collapse has been published and as expected, the report highlights the serious lack of internal controls and bad management practices that allowed such substantial losses to occur. That Leeson may have acted fraudulently is in part immaterial. Any such fraud should have long been detected by the basic controls a prudent operation should have in place. Allowing Leeson to remain in charge of both front and back office was a serious failing. So was the lack of supervision among the senior management who should have ensured recommendations to segregate these duties were acted upon.

Proper risk management is vital in modern companies. This view has also been reiterated in the annual report of the bank of International Settlements. This argues that recent derivatives losses are generally attributable to inadequate internal controls, inappropriate or misguided usage, or excessive risk taking. To this end, it is a positive step that the International Swaps and Derivatives Association has set up a representative presence in

Hong Kong and Singapore. Derivatives usage in Asia can greatly benefit form the value a professional association like ISDA can bring in pushing for development of consistent documentation and a better understanding of the prudent use and monitoring of derivatives.

What has caused more volubility in the bank of England report, however, has been the lack of censure for the bank of England in its role of supervisor to identify the dangerous position that Barings was taking. It made "an informal concession" - as the British Chancellor of the Exchequer has called it -of excusing Barings from having to notify the Bank of England of exposures beyond the normal limit. The implications for Asia are important. If British financial institutions are not effectively regulated in London, how can Asian investors or businesses feel confidence in their subsidiary operations in Asia ? The question has been rightly raised as to whether a central bank can adequately be both responsible for monetary policy and act as a regulator of the financial markets. Investors must feel confident that regulation is effective no matter in which jurisdiction responsibility may lie.

The results of the reports and their own internal investigations have led both Singapore and Hong Kong regulators to introduce measures that put pressure on companies and banks to maintain adequate risk management controls. The banking community is now also under scrutiny from the Securities and Futures Commission in Hong Kong as to whether its exemption from securities regulation is really appropriate, given the involvement that some may have in equity-based products.

These steps all reflect a growing maturity and willingness in Asian financial markets to adapt quickly to eradicate weaknesses and to promote expertise, what the reports and the authorities have not done is to attempt to lay blame on the products themselves. This is commendable and to do so would have not only been unjust but short-sighted.

For many institutions, the Barings debacle has rammed home the necessity of ensuring both that there are adequate internal control policies and that they are implemented. Malaysian institutions need to have access to derivatives markets that provide them with products structured to their proper business requirements. They also need to control such usage properly, and they need to invest time and money to ensure this happens. To avoid their use would be short-sighted. In world markets, companies that do not know how to use these tools effectively will eventually lose out to those that do.